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To: Members of the Executive Board

From: The Secretary

Subject: Capital Account Convertibility - Review of Experience and Implications for Fund Policies - Background Paper

The attached paper provides background material to the paper on capital account convertibility - review of experience and implications for Fund policies, which was circulated as SM/95/164 on July 10, 1995, and is tentatively scheduled for discussion on Friday, July 28, 1995.

Mr. Quirk (ext. 38520) or Mr. O. Evans (ext. 37183) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Capital Account Convertibility: Review of Experience and Implications for Fund Policies--Background Paper

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

(In consultation with other Departments)

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July 7, 1995

Contents

I. Introduction

This paper reviews the experience with capital account liberalization in industrial and developing countries and the evolution of the Fund's views on this issue. The paper is organized as follows. Section II addresses the experience of industrial countries in capital account liberalization, including the nature of the underlying flows, the effectiveness of systems of controls, instances of reimposition of capital controls, and the Fund's position on members' efforts to liberalize the capital account. Section III discusses the experiences of a range of developing countries that have already adopted capital account convertibility. It deals with issues of sequencing leading up to convertibility, the roles of monetary and exchange regimes, implications of the development of financial markets, and the internal phasing of decontrol within the capital account. The Section also discusses the Fund's advice on capital account liberalization in the context of Article IV consultations and technical assistance activities. A separate paper presents Annex material. 1/

II. Experience with Capital Account Liberalization in the Industrial Countries 2/

All industrial countries have as of June 1995 eliminated exchange controls on both capital inflows and outflows. This has ended a unique period in the history of international financial relations following the Second World War in which most countries maintained substantial restrictions on capital movements in attempts to fend off destabilizing external financial influences and to retain national savings for use in domestic reconstruction and development. Canada, Switzerland, and the United States maintained a liberal environment for most types of capital movements throughout the period, although there were temporary exceptions. The evolution of capital account liberalization in other industrial countries was relatively slow in the early stages and did not gain momentum until the late 1980s. An early start was made by Germany in 1958 when it removed all controls on capital outflows. Tight controls on capital inflows were maintained, since balance of payments surpluses engendered pressures toward an appreciation of the deutsche mark and threatened its exchange rate parity under the Bretton Woods system. Controls on inflows were removed in 1969, but were subsequently reintroduced on two occasions before being removed again in 1981.

1/ "Capital Account Convertibility: Review of Experience and Implications for Fund Policies--Annex" (SM/95/164, 7/7/95, Sup. 3).

2/ This section deals with the experience in the 23 countries defined by the Fund as industrial countries: Australia, Austria, Belgium, Canada, Denmark, France, Finland, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Although the floating of exchange rates following the breakdown of the Bretton Woods system in the early 1970s provided a degree of freedom to national monetary policies, this did not by itself cause an immediate shift in industrial countries toward the liberalization of capital controls. The shift was instead largely influenced by the increasingly global nature of financial markets and the changing political attitudes toward controls on financial and capital markets. The controls were also removed in part as a response to the pressure from corporations in the home countries to permit financing of expansion of their production facilities abroad, and from domestic banks facing competition from international financial markets. Multinational corporations and international banks, in particular, posed the problem of evasion of restrictions imposed by their home governments as well as the possibility of exit from the home market. As the globalization proceeded and the sophistication of market techniques that sidestepped controls (e.g., swaps) progressed, governments increasingly recognized the ineffectiveness of remaining controls and their costs in terms of preventing full participation by domestic agents in international activities. The process of liberalization throughout the group of industrial countries accelerated in the 1980s and early 1990s. A significant shift toward complete liberalization was initiated with the rapid removal of capital controls by the United Kingdom (1979) and the completion of the liberalization process by Japan (1980). Next came the quick removal of all capital controls by Australia (1983) and New Zealand (1984), and extensive liberalizations by European countries.

In the context of the European Union (EU), where capital account liberalization was viewed as another step in the eventual monetary integration of the area, 1/ a first episode of complete decontrols occurred in the Netherlands (1986), Denmark (1988), France (1989), Belgium, Ireland, Italy, and Luxembourg (1990). This was closely replicated by several members of the EFTA--Sweden (1989), Austria, Finland, and Norway (1990). The final set of liberalizations took place in those EU members for whom more distant deadlines had been set; thus, Portugal and Spain on January 1, 1993, and Greece on July 1, 1994. On January 1, 1995, Iceland became the last industrial country to adopt full capital convertibility.

1. Characteristics of capital flows and related controls

One notable feature of capital account liberalization in industrial countries has been the close relationship between the removal of capital *controls on inflows and outflows* and the strength of the balance of payments position. Countries which had a strong balance of payments position (e.g., Germany and Japan) tended to rely on controls on inflows, whereas those which had a generally weaker position (e.g., France and Italy) maintained controls on capital outflows. Germany and Japan began the process of

1/ The EU directives not only required members to remove controls within the area, but also encouraged their removal with respect to the rest of the world.

dismantling the systems of heavy controls on capital flows as they moved from a position of weak balance of payments and low international reserves, to one of balance of payments surpluses and abundant reserves. Controls on capital outflows were removed first, while those on capital inflows were retained. The latter were eventually removed in the late 1970s following their periodic removal and reimposition. By contrast, France and Italy had experienced capital outflows in the 1970s and early 1980s and did not eliminate controls on such flows until the late 1980s.

Another notable feature of the process of capital account liberalization has been the differentiation that countries usually made between *short-term and other flows*. Inward or outward short-term flows were viewed as potentially destabilizing and, therefore, were usually subject to more stringent controls than long-term flows, such as foreign direct and portfolio investment. The removal of controls on short-term capital movements therefore took longer than that on long-term capital. Similarly, when reimposing capital controls, countries normally focused on short-term capital movements. In recent years, however, with the exception of direct investment, the relevance of the differentiation between long- and short-term capital movements has tended to diminish because of the spread of secondary markets and derivative instruments.

A distinction has often been made between the financial transactions affecting *capital movements and the underlying real transactions*. This primarily applies to foreign direct investment but is often also relevant for other closely related transactions, such as ownership of real estate by nonresidents. While the removal of controls on capital-related financial transactions was completed by most countries long ago, the deregulation of the underlying transactions has been a relatively drawn-out process, frequently involving difficult multilateral or regional negotiations. Experience with deregulation of cross-border controls on underlying transactions has been similar to that with deregulation of trade in services, including, for instance, the right of establishment of branches of banks and other financial institutions in host countries.

2. Reimposition of capital controls

In the postwar years, there have been periods when controls have been reimposed by countries faced with difficulties in achieving domestic and external balance. Among the countries liberalizing at an early date, Germany, Switzerland, and the United States introduced selective capital controls at various times until the end of the 1970s. Some industrial countries also invoked national derogations to the OECD Code of

Liberalization of Capital Movements in the 1980s. 1/ More recently, a temporary tightening of controls on outward short-term capital movements was effected by Ireland, Portugal, and Spain in 1992 in the aftermath of market disturbances within the ERM of the EU.

In the face of sustained current account deficits and capital outflows, the United States (1964-73) imposed a "voluntary restraint" on direct investment abroad and an interest rate equalization tax, the latter with a view to maintaining domestic interest rates below foreign rates on comparable financial instruments. 2/ These measures were lifted in the aftermath of the general float of currencies in 1973, which provided an extra degree of freedom for national monetary policies and thus reduced the need to maintain measures to restrict capital outflows.

Both Germany and Switzerland reintroduced controls on short-term capital inflows in the 1970s to ward off excessive appreciation of the domestic currency and an expansion of monetary aggregates. Germany twice imposed reserve requirements on external liabilities of banks and nonbank financial intermediaries (1971-75 and 1977-81). 3/ Switzerland (1972-80) maintained a ban on interest payments on nonresident deposits in the country and a penalty rate on any increase in nonresident deposits.

A number of industrial countries also retained derogations to the OECD Code of Liberalization of Capital Movements after 1980; this was in addition to existing reservations. Such derogations were applied by Denmark (1979-83), Finland (1985-91), Iceland (1961-90), Norway (1984-89), Spain (1982-85), and Sweden (1969-86). 4/

1/ As noted in Annex I, "derogations" to the OECD Code refer to the introduction of new restrictions on transactions under List A that did not exist before or to the reintroduction of formerly abandoned restrictions, whereas "reservations" refer to the continued maintenance of restrictions existing as of the entry into force of the Code and which were not removed at any time later.

2/ For a period (1968-70) the United States also maintained a reserve requirement on Eurodollar borrowing.

3/ Other measures included restrictions on the sale of money market instruments to nonresidents and authorization requirements for the acquisition of domestic bonds, and subsequently equities, by nonresidents. These measures were circumvented, as direct borrowing offshore was replaced by sales of corporate bonds to nonresidents, and promoted disintermediation. The Bundesbank was therefore faced with having to introduce an ever-widening range of indirect and quantitative controls aimed at closing loopholes in the regulations. Nevertheless, the Bank was unable to prevent short-term capital inflows as expectations of exchange rate appreciation grew.

4/ In addition, Turkey, an OECD member not counted by the Fund among the industrial countries, applied derogations (1962-85).

Three EU countries (Ireland, Portugal, and Spain) reintroduced or reinforced capital outflow controls, albeit for a very short period, in the face of disruptions in the ERM in the second half of 1992. 1/ Spain had already given up all controls by mid-1992. Faced with a severe currency crisis in September 1992 and with a sharp tendency for the peseta to depreciate out of the band, the authorities reintroduced some measures to stem capital outflows in September-November 1992 in the form of taxes on certain short-term transactions. 2/ Ireland and Portugal also intensified the controls on capital outflows (September-December 1992) that they were allowed to retain until January 1, 1993. 3/ Any effectiveness of these actions in stemming capital outflows was likely to have been very short-lived. All three countries not only lifted all the remaining controls by the agreed EU deadline, but also did not reintroduce them during the subsequent episodes of exchange rate tension within the EU.

3. Relationship to domestic financial sector liberalization

In some industrial countries--for instance, Japan, the United Kingdom, and the United states--the liberalization of capital controls preceded the deregulation of domestic financial markets, in the context of generally comprehensive systems of prudential supervision. The disparity of regulatory treatment between domestic and external activities tended to induce cross-border activity. For instance, the strict regulatory environment on domestic banking operations maintained by the United States after the Second World War in contrast to the liberal environment for external operations, was a significant factor in the initial development of the Eurodollar market--a form of activity conceived by domestic banks to circumvent local restrictions. Similarly, the development of specialized offshore banking centers owed much to the arbitrage opportunities offered by the restrictive nature of the domestic regulatory environments in most countries, in comparison with those prevailing in the offshore centers. In such cases, somewhat paradoxically, the national authorities either permitted access by domestic banks to the offshore centers or otherwise were unable or unwilling to enforce the existing external controls. The reason for this, as noted by many observers, was that countries that did not allow access by their financial institutions and multinational companies to offshore markets and

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1/ Controls were also considered, but not implemented, in Sweden and Finland in the late 1980s when capital inflows surged as the authorities attempted to tighten their respective monetary policies to slow overheating economies, while at the same time maintaining stable exchange rates. The inflows abated within a few years, however, as economic growth slowed down (a sharp contraction in the case of Finland) and the outlook for the two countries' currencies deteriorated.

2/ The intent of the Spanish measures was to raise the cost and lower the attractiveness of engaging in particular transactions.

3/ Unlike Spain, these countries relied on enforcing existing controls consisting of quantitative restrictions on some forms of short-term capital transactions.

that were more restrictive in the application of controls, were losing ground in the emerging worldwide competition for funds, relative to the countries that had lesser controls or that applied them in a more liberal fashion.

Deregulation of domestic financial operations was phased in Japan over a long period from the late 1970s onward, displaying a significant lag in relation to the liberalization of external financial transactions, which was completed in 1980. This led to some arbitrage opportunities arising from domestic regulation and, in particular, to the strong growth of both short-term capital inflows and outflows. In the United Kingdom, capital controls were abolished rapidly at the outset of a significant wave of reforms initiated in 1979, whereas quantitative controls on the banking system, already circumvented through the offshore market, were not lifted until 1980.

More recent financial liberalizations in industrial countries have tended to avoid issues of sequencing external decontrol measures before the reform of the domestic financial markets. For instance, in France the dismantling of capital controls took place with domestic deregulation between 1985 and 1990, thus avoiding the circumvention of domestic restrictions by arbitrage flows through foreign markets. In Spain, a major phase of trade and financial market liberalization began in the context of its accession to the European Community in 1986. The elimination of remaining controls on interest rates and the development of open-market operations were effected in the reform process, whereas key capital controls were retained until later.

4. Fund policy treatment

In recent years, because the process of capital account liberalization in most industrial countries has been largely completed, Article IV consultations have tended to give prominence selectively to this issue. Attention has been given in consultations with countries where such liberalization has had an important bearing on the Fund's exercise of surveillance over exchange rate policies. Among recent consultations with industrial countries, the issue of capital controls received prominence in the case of Greece and Iceland, two countries that only recently fully liberalized capital flows. The Executive Board welcomed the move in these cases, echoing the consensus expressed earlier when other industrial countries liberalized their systems. In the case of the United Kingdom in 1977, which along with Italy was one of the last two cases of industrial countries implementing Fund-supported stabilization programs (through stand-by arrangements), the staff urged a relaxation of controls over capital outflows. 1/ In the event, there was a modest relaxation of certain

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1/ See "United Kingdom--Review and Consultation Under Stand-By Arrangement" (EBS/77/469, 12/21/77), p. 10.

exchange controls on capital. 1/ The authorities subsequently decided to progressively remove all capital controls. 2/ These steps were welcomed by Executive Directors, who at the time noted the beneficial effects that this would have on reducing upward pressures on the exchange rate. 3/ This general sentiment has also been evident in the Fund's support of the multilateral initiatives under the OECD Code and the EU directives.

III. Experiences with Capital Account Liberalization by Developing Countries 4/

The evolution of capital account liberalization has varied across developing countries, reflecting, inter alia, their differing degrees of macroeconomic imbalance and balance of payments strength, and the extent of general economic liberalization. Prior to the mid-1980s, liberalization of capital account transactions was almost always undertaken from a relatively strong balance of payments position (Indonesia, 5/ Malaysia, and Singapore) but more recently a number of developing countries have adopted full convertibility following balance of payments deficits (Mauritius and Trinidad and Tobago), including in some cases large external payments arrears (in a number of Latin American and Caribbean countries). In the Baltic republics, where the elimination of capital controls followed the breakup of the former U.S.S.R., the balance of payments was in surplus owing in part to large reserve-related transfers. Current account positions tended to be less problematic; where countries experienced current account deficits in the period leading up to liberalization, with a few exceptions (Costa Rica, The Gambia, and Jamaica) the deficits were relatively small, usually well below 5 percent of GDP.

1/ See "United Kingdom--Review and Consultation Under Stand-By Arrangement" (EBS/77/469, Sup. 1, 1/10/78), p. 2.

2/ See "United Kingdom--Recent Economic Developments" (SM/81/30, 2/5/81), pp. 86-87.

3/ See "United Kingdom--1979 Article IV Consultation" (EBM/79/149, 8/29/79), p. 18; and "United Kingdom--1980 Article IV Consultation" (EBM/81/25, 2/20/81), p. 13.

4/ The discussion in this section is based on case studies of developments in the selected countries adopting full convertibility, with the year of adoption in brackets: Argentina (1991); Costa Rica (1992); El Salvador (1992); Estonia (1993-94); The Gambia (1992); Guyana (1991); Indonesia (1970); Jamaica (1991); Latvia (1992); Lithuania (1992); Malaysia (1973); Mauritius (1994); Peru (1991); Singapore (1978); Trinidad and Tobago (1993); and Venezuela (1989). The countries were chosen to provide a representative sample across the various regions.

5/ Indonesia's current account was in deficit when it liberalized in 1971, but the deficit was small and the overall balance of payments was in surplus.

Outstanding external debt was substantial in many cases, particularly among Latin American and Caribbean countries, where it typically exceeded 500 percent of export earnings, and in Indonesia (250 percent). Exceptions were Singapore, where the external debt burden was almost nonexistent, and the Baltic republics and Malaysia, where it was moderate. Gross reserves holdings varied considerably across the liberalizing countries, from a low of less than one month of import cover in Jamaica to a high of over one year of cover in Malaysia. 1/ Reserves holdings averaged about 4-5 months of import cover when full convertibility was adopted, although holdings that were freely usable for purposes other than debt servicing were often lower than this. Domestic macroeconomic imbalances at the inception of the capital account reforms were large in a number of countries, with inflation rates varying considerably during the period preceding liberalization, ranging from 5 percent in Indonesia and Singapore to over 1,000 percent in the Baltic republics.

1. The process of capital account reform

The experience of a growing number of countries in adopting capital account convertibility offers an opportunity to examine the sequencing and speed with which reforms have been undertaken, with a view to determining if particular approaches have been associated with successful liberalization. In particular, lessons could be drawn on whether the chances of success are enhanced by other reforms introduced before the opening of the capital account. There is also the issue of measures that need to be adopted concurrently with the elimination of capital controls, so-called necessary conditions.

a. General issues of sequencing

Historically, capital account convertibility tended to be part of a gradual phased approach to economic reform, occurring after current account convertibility in some countries, usually in the context of financial sector reforms. Malaysia provides an example of such an approach. In Malaysia's case, a system of administered interest rates was in effect when liberalization of capital commenced. Malaysian financial institutions were therefore reformed simultaneously, in order to provide scope for market-based interest rates and to encourage the development of a stock market. Mexico serves as another example. Although it did not achieve full convertibility, it had a tradition of a relatively open capital account. The debt crisis in the early 1980s led to the reimposition of exchange controls that were soon lifted in the context of a newly introduced free foreign exchange market. Significant trade and fiscal reforms were instituted over a five-year period starting in 1982. Financial reforms, however, were instituted relatively late in the process, when it became apparent that to enhance the efficiency of the financial system and to improve the effectiveness of monetary policy,

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1/ Almost all liberalizing countries had floating exchange rate regimes (see Section III.1.b).

greater reliance on market forces was needed. Indonesia, on the other hand, is a longstanding example of a successful and sustained opening of the capital account in which capital liberalization took place, in 1971, before the financial sector was reformed. Trade was not substantially liberalized until 1980, while interest rates became market-determined only in 1983. Certain constraints on the financial system were maintained until 1988 but, although administered, real interest rates were positive from the outset of capital convertibility.

More recently, the process of liberalizing various categories of capital has tended to be less gradual, while the sequencing has continued to vary. A number of countries have moved to capital convertibility in a one-step process (Costa Rica, Hong Kong, Jamaica, Kyrgyz Republic, Mauritius, 1/ Singapore, Trinidad and Tobago, and Venezuela 2/). In the Baltic republics, exchange controls were liberalized over a very short period of time, with both Latvia and Lithuania achieving convertibility at around the time of the introduction of their national currencies. Similarly, Estonia eliminated all remaining controls on capital account transactions in the year following the establishment of a currency board in 1992. In Latin America, Argentina began to liberalize current account transactions in 1989 and completed the transition to full convertibility in 1991 in conjunction with the introduction of a currency board arrangement. El Salvador started its move to capital convertibility in 1991 and implemented most of the measures within the following year. Similarly, convertibility of the Paraguayan guaraní was also established over a two-year period (1991-92).

b. Roles of monetary and exchange regimes

Freedom from controls on capital movements heightens the role of domestic interest rates in avoiding destabilizing capital flows. It is reasonable to expect that successful opening of the capital account would require that domestic financial markets be competitive either prior to or concurrently with the adoption of full convertibility in order to achieve market-related interest rates. Real interest rates were positive in most, but not all, cases at the time that full convertibility was adopted. Negative real rates in Costa Rica, Estonia, Guyana, Latvia, Lithuania, and Peru were soon raised to internationally competitive levels. Not surprisingly, most developing countries that abolished controls on capital transactions freed their domestic financial markets either prior to, in conjunction with, or soon after the capital account reform. For example, in the case of most countries in Latin America that have recently liberalized and where financial markets have been already fairly well-developed, interest rates on loans and deposits were freed and indirect monetary

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1/ In Mauritius convertibility was preceded by freeing up export surrender requirements.

2/ Venezuela subsequently (five years after liberalizing) reimposed exchange controls (see Annex III).

instruments such as treasury bills were introduced well before the establishment of full convertibility. In some cases, credit ceilings were eliminated as a first step in the reform program, before the establishment of capital convertibility (Costa Rica, Jamaica, and Trinidad and Tobago).

Rapid credit expansion by the central bank had also been a major problem in many countries prior to liberalization. Measures to reduce the extension of central bank credit, including credit to government through tighter fiscal policies, were taken at the time of reform in almost all countries (e.g., El Salvador, Estonia, Jamaica, Lithuania, Mauritius, Peru, Trinidad and Tobago, and Venezuela). Reserve requirements received increased emphasis as a tool to manage liquidity after the elimination of the credit ceilings in a number of countries (Argentina, El Salvador, Jamaica, Peru, Trinidad and Tobago, and Venezuela). At first, there was a tendency to raise reserve requirements, but with subsequent interest rate deregulation such requirements were often lowered.

In other countries, reform of the financial sector took place together with broader-based reforms that included capital account liberalization. For example, in the case of the Baltic republics, a financial infrastructure did not exist, and there was little choice but to undertake reforms on all fronts simultaneously. Virtually all countries emphasized use of open-market operations, 1/ in order to be able to sterilize bank liquidity. Such operations were introduced following, or simultaneously with, the elimination of credit ceilings and reduction in reserve requirements. Instruments used were central bank securities or government bonds, or both. 2/ Given that secondary markets were not developed in most countries, primary issuance was often used as the initial form of operations.

In countries with limited foreign exchange markets, approaches to the choice of exchange rate regime were mixed, although most had floating regimes. A fixed rate regime backed by a currency board was adopted in Argentina, Estonia, and Lithuania, providing a strong institutional commitment to exchange rate stability and low inflation. In contrast, floating exchange regimes were adopted along with full convertibility in El Salvador, The Gambia, Guyana, Jamaica, Latvia, Peru, and in Venezuela where dual official and free foreign exchange markets were unified on the basis of the arrangements in the free market. Mauritius and Trinidad and

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1/ In countries with currency board-like arrangements less priority was accorded to open-market operations. For instance, in Argentina the purpose of open-market operations (reversed transactions through interest rate tender using government foreign currency-denominated bonds) was mainly to smooth out sharp fluctuations in short-term interest rates and international reserves.

2/ Central banks in Venezuela and Lithuania offered deposit facilities to market participants. However, the facilities were discontinued in Lithuania with the introduction of the currency board and were replaced by sales of central bank certifications in Venezuela.

Tobago also adopted full convertibility in the context of freely floating exchange rate regimes, replacing their earlier exchange rate pegs (to a currency basket in Mauritius and to the U.S. dollar in Trinidad and Tobago). Exchange rate flexibility in Costa Rica was gradually increased in 1990 with the widening of the spread between official buying and selling rates, while a freely floating exchange rate regime was adopted in 1992 at the time that controls on capital transactions were eliminated. Other countries (Indonesia, Malaysia, and Singapore) adopted managed floating regimes, with an eye to ensuring the competitiveness of export industries.

c. Prudential supervision and market information

The liberalization of capital movements has in most cases been accompanied or followed by strengthened prudential supervision and regulation, especially in the area of foreign exchange risk assumption by financial institutions. Opening of the capital account could increase the risks for banks, through the impact of increased volumes of capital flows on the deposit base, and a possible increase in exchange rate volatility on banks' open foreign currency positions. Capital account liberalization therefore required strengthened supervision related to foreign exchange risks, generally undertaken as part of a broad process of ongoing financial sector reforms. In most of the countries surveyed, the bulk of the reforms to improve prudential standards was underway prior to and during liberalization, while in some others (Costa Rica, Guyana, Indonesia, Jamaica, and Peru) the reforms took place mainly during and after adoption of capital convertibility. Prudential reforms have focused on improvements in the supervisory framework, particularly the adoption of new regulations, reporting, and increasing the ability of the supervisory authority to enforce the regulations. Most of the reforms have been directed toward achieving international coordination and harmonization of supervisory practices, and have used the Basle Accord on capital standards as well as other standards in the major industrial countries as yardsticks.

Internationally accepted accounting principles and disclosure norms become highly important when capital movements are free. 1/ This has been recognized in a number of countries. For instance, a new accounting system for banks in China became effective in July 1993, and in the Baltic states accounting standards that meet EU requirements are soon to be implemented. In addition, as a member of the International Accounting Standards Committee (IASC), Hong Kong issues statements of standard accounting practice that in all respects comply with IASC requirements. However, significant improvements in accounting and disclosure practices remain necessary in a number of

1/ For example, the 1994 banking crisis in Venezuela revealed inadequacies in the accounting rules covering such areas as capital adequacy, loan classification, provisioning, and lending to related parties. For further discussion, see "Venezuela--The Banking Crisis" (SM/95/39, 2/17/95).

the liberalizing countries. In some countries, in the context of inadequate accounting and information systems, sudden information disclosures may have contributed to instability of capital flows.

Credit rating institutions promote market scrutiny of the prudential position of financial institutions and also enhance the ability of investors to protect their interests. For example, in order to better assess banks, Bank Indonesia has introduced in recent years a sophisticated rating system that gives weights to capital, asset quality, management, earnings, and liquidity in line with international practice. Malaysia set up a credit rating agency in 1990 to rate all issued private debt securities and to disseminate widely and on a timely basis information for the rated companies to potential investors. Since 1992, Argentina has required that all publicly offered securities be rated by at least two authorized private agencies.

It is common practice for financial institutions and other enterprises to make disclosure to the public of information on their financial health on a regular basis, usually quarterly. Malaysia introduced in 1993 new guidelines and minimum standards governing the disclosure of information by stockbrokerage and securities firms. The Hong Kong Securities and Futures Commission oversees information disclosure guidelines that were revised in 1993, setting out in detail standards and procedures expected of institutions in their record keeping and procedures for customer identification and reporting. Since 1992, the Government of Argentina has also begun implementing stronger reporting, disclosure, and auditing requirements.

d. Internal phasing of capital account decontrol

The sequencing of capital account liberalization would appear to have received less attention in developing countries, partly because it has become increasingly difficult to institute a phased approach to decontrol of specific categories of the capital account, except perhaps for those controls which can be enforced outside the exchange system. 1/ Financial

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1/ For those industrial countries which liberalized controls over extended periods (e.g., Denmark, Japan, and the Netherlands), liberalization generally began with less volatile transactions and with those more directly necessary to normal business activities, so as to soften the short-term impact of liberalization of capital transactions on the balance of payments and the economy. Thus, outward direct investments were usually authorized sooner than portfolio investments abroad, and trade credits were liberalized before financial loans; transactions in shares were liberalized before those in interest-bearing securities and, when these were liberalized, transactions in long-term bonds were permitted first, while controls on transactions in money market instruments were maintained as long as possible.

asset flows have become increasingly fungible. 1/ Rapid financial innovations and increasingly attractive investment opportunities abroad appear to have made it more difficult for those countries that had not liberalized earlier to maintain the effectiveness of their controls. It has also proven difficult to resist acceleration of liberalization measures once a certain critical mass has been achieved and close substitutes for controlled capital operations have become available. 2/

It may be possible to maintain controls on those foreign capital transactions that relate to underlying transactions (e.g., inward direct investment flows and nonresidents' real estate transactions) even while other controls are removed, because they can be monitored and enforced outside the exchange system. Indeed, many countries do maintain such controls. The structure of controls presently maintained by developing countries (which can be seen in Table 1 in Annex II) 3/ may also shed some light on this issue. As with industrial countries, controls on direct investment are far more common than other controls in developing countries, with controls on inward investment being more common than those on outward investment. This suggests that the main purpose of these controls is not generally to support the balance of payments. Other categories of control are also often maintained, with a slight majority of controls on outflows, possibly indicating that countries consider a mutually supportive set of controls important.

2. Developments following liberalization of capital accounts

Initial responses of the balance of payments to liberalization of capital accounts have been strong in most of the developing countries reviewed. Rather than resulting in capital flight, the elimination of capital controls on both outflows and inflows, accompanied in most instances by a tightening of financial policies, would appear to have generated confidence and resulted in new inflows. For example, Argentina's overall balance of payments position moved from a deficit equivalent to 7 percent of GDP in 1989 to a surplus of over 2 percent of GDP by 1993, while Venezuela's balance of payments recovered from an overall deficit of 8 percent of GDP in 1988 to a surplus of 3 percent of GDP in 1991. In the other Latin American countries, overall balance of payments positions also improved sharply, although in some cases they deteriorated in later years (Costa Rica,

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1/ See C. Claessens, M.P. Dooley, and A. Warner, "Portfolio Capital Flows: Hot or Cold" in *The World Bank Economic Review*, Vol. 9, No. 1, 1995, pp. 153-74

2/ These problems are not new: as noted above, Germany attempted to impose partial controls in the 1970s but had increasingly to widen the coverage of the controls as loopholes developed, until they were ultimately removed.

3/ The categories of capital transactions in the survey reported in the table are broadly those employed by both the OECD and the EU in their codes for capital transactions.

El Salvador, Guyana, and Mexico). Because the inflows have reflected the confidence of the markets in the liberalized systems, as well as the general course of stabilization and restructuring, they have of course remained sensitive to macroeconomic policy reversals or failures.

Current account performance following liberalization was uneven, with deficits decreasing in some countries (El Salvador, Jamaica, and Malaysia), and increasing in others (Argentina, Estonia, The Gambia, Lithuania, Peru, and Singapore). To a certain extent, a larger current account deficit in the balance of payments would be expected, as credible reforms lead to larger capital inflows. International reserves tended to increase, and official reserves holdings grew in all countries except Costa Rica (for example, Argentina, the Baltic republics, Indonesia, and Venezuela). Moreover, many countries that had accumulated substantial external payments arrears were now able to reduce or eliminate them altogether through cash payments or rescheduling and, importantly, to avoid accumulating new arrears (except Costa Rica). 1/

Domestic policies were usually tightened together with the elimination of the capital controls, as part of a broad stabilization effort in the context of Fund-supported economic programs. Credit expansion was curbed in most countries (Argentina, Costa Rica, Estonia (initially), Guyana, Indonesia, Latvia, and Venezuela), although in some credit growth remained relatively high following the liberalization (Jamaica, Peru, and Singapore), and there was rapid depreciation of the exchange rate (Jamaica and Peru). 2/ Only in El Salvador and Latvia did the nominal exchange rate appreciate. Moreover, fiscal policies were significantly tightened in most countries (Argentina, El Salvador, Estonia, The Gambia, Indonesia, Latvia, Lithuania, and Venezuela). 3/ Inflation generally declined immediately following convertibility (exceptions were Jamaica and Singapore), partly owing to the freeing up of import constraints associated with capital inflows and, in certain cases, due to the effects of exchange rate appreciation or a slower rate of depreciation.

As noted in Section III.1.c, the environment for prudential supervision and regulation changes with the liberalization of the capital account. Reforms of market standards have therefore been undertaken to enhance the ability of the financial system to handle risk in an international setting, while strengthening domestic banks to compete with foreign banks and reducing the overall need for government intervention. This has involved

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1/ Costa Rica's gross foreign reserves fell slightly in 1993 following the liberalization package introduced in 1992, and then deteriorated further in 1994 as the fiscal and current account imbalances widened, which contributed to a drop-off in private capital inflows.
2/ Fiscal policy was already tight in Estonia and Latvia.
3/ Argentina's public sector balance switched to a surplus, while the fiscal improvement in Venezuela was only temporary as a significant turnaround took place in 1991.

the privatization of banks and licensing of new ones in El Salvador, Estonia, and Peru; and recapitalization, mergers, and closures in Costa Rica, El Salvador, and Peru. For this purpose, the responsibility for bank supervision and regulation has been clarified in a number of countries, including in Costa Rica, El Salvador, Jamaica, and Venezuela. New bodies have also been established to regulate capital markets, particularly with regard to reporting, disclosure, and insider trading, and to streamline supervision.

In some cases, deficiencies in financial sector reforms (particularly in the areas of supervision and intervention) have created problems. In those cases in which banking sector problems intensified after rapid liberalization of the capital account (Argentina, Costa Rica, Latvia, and Venezuela), they appear to have reflected mainly magnified effects of pre-existing weaknesses in the structure of banks' balance sheets, including large volumes of nonperforming loans and insufficient capital, and institutional weaknesses. Inadequate or delayed implementation of prudential reforms has spilled over into exchange markets in some instances (Indonesia and Venezuela). Bad banking practices and asset stripping were largely responsible for the recent problems in Latvia. In Venezuela, resort to exchange controls in the 1970s and 1980s contributed to extensive disintermediation and the consequent weakness in the banking system, eventually culminating in the banking crises in early 1994. The resulting crisis of confidence and pressures on the exchange rate of the bolivar led to the reimposition of exchange controls. (For further discussion, see Annex III.)

3. Effectiveness of maintaining and reintroducing control mechanisms

Studies of the effectiveness of capital control mechanisms have suffered to some extent from a lack of agreement on what constitutes effectiveness. 1/ Controls have often had some impact in the sense that they have created differentials between domestic and international interest rates. The evidence accumulated, nevertheless, points to the general inefficacy of such controls, particularly on outflows, in maintaining an unsustainable exchange rate beyond a brief period. While controls may contribute to some differential between domestic and foreign yields, the differentials tend to be small and relatively unimportant compared to the gains from successful speculative attacks on an exchange rate under pressure.

a. Continued maintenance of controls

While the available estimates of capital flight show substantial variation--underlining the difficulty with inherently disguised flows--they suggest that capital controls have generally not been all that effective in curbing capital flight, inter alia because significant linkages have

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1/ See "A Survey of Academic Literature on Controls Over International Capital Transactions" (SM/95/164, 7/7/95, Sup. 3).

continued to exist between domestic and foreign markets. Different methods to define flight capital have been put forward in the literature. Some studies have defined capital flight as large domestic capital outflows, while others have argued that foreign capital precipitously pulled out of a country should also be included. The channels through which capital flight takes place are numerous and may also include legal channels that are used to make international payments and transfers (for instance, transfers through the banking system). Further, misinvoicing of trade transactions, and changes in the terms and conditions under which trade financing is extended to importers and exporters, are the main forms of large-scale capital flight in developing countries with extensive capital controls.

For a group of developing countries, mostly in Latin America, a variety of studies by Fund staff and others provide estimates of capital flight when these countries maintained capital controls in the early 1980s (Argentina, Chile, Mexico, the Philippines, and Venezuela), supporting the view that the controls were not very effective. For instance, during 1982 in Argentina capital flight was estimated to have continued at a brisk rate, despite the reintroduction of exchange controls on capital transfers. Capital flight in Chile is estimated to have ranged from US$800 million to US$900 million during 1982 despite capital controls. In Mexico, several estimates show capital flight throughout the period 1976-84, although the estimated peak year varies. Similarly, capital flight from the Philippines is estimated to have been sizable in the period following substantial tightening of capital controls in 1993. In Venezuela, capital controls were reintroduced in 1983, but capital flight continued with estimates ranging from US$1 billion to as high as US$5 billion. Most available estimates suggest that the capital flight occurred despite the maintenance of controls on capital flows.

In the context of technical assistance missions that have focused on the elimination of capital controls, the Fund staff has often provided estimates of the magnitude of capital flight, emphasizing that controls on capital outflows have been largely ineffective and that their elimination would recognize the de facto situation. In most of these cases, estimates of capital flight ranged between 20-30 percent of export receipts (Nigeria, 1981-84; Guatemala, 1982-88; Honduras, 1982-80; Jamaica, 1983-89; and Venezuela, 1984-86). In a few cases the magnitudes were even larger, as for example in Egypt, where the estimate was close to two thirds of export receipts; in Trinidad and Tobago where it amounted to more than one half of export receipts; and in Somalia where such estimates equalled annual export receipts. *It also appears that the scale of capital flight often intensi-*fied prior to liberalization (for instance, in Nigeria and Venezuela). In many countries the main channel for capital flight was identified as trade misinvoicing (Egypt, Guatemala, Honduras, Jamaica, Nigeria, Somalia, and Trinidad and Tobago), although in some cases capital flight took the form of short-term outflows (El Salvador, Nigeria, and Venezuela) or private transfers (Fiji).

b. Reimposition of controls

Reimposing controls on capital outflows would appear to reintroduce the disadvantages of maintaining controls on outflows discussed earlier. In particular, the recent experience of Venezuela (reviewed in Annex III) has been consistent with the general findings regarding their effectiveness. However, the phenomenon of large capital inflows associated with renewed access to international financial markets in the context of stabilization and liberalization has raised the issue of whether temporary capital controls on inflows might be useful to deal with short-term shocks to the balance of payments or complications to monetary management. The broad conclusion drawn here is that controls on capital inflows cannot substitute for adjustments to fundamental macroeconomic policies, such as fiscal policy and exchange rate policy, and can contribute to distortions and inefficiency. The temporary use of such controls may have provided a brief breathing space to the authorities, allowing them to take necessary macroeconomic policy measures, although the available evidence is not conclusive.

Both developed and developing countries that have adopted full convertibility have occasionally reintroduced controls on capital transactions, sometimes in conjunction with controls affecting current transactions. One rationale put forward for reintroducing the controls has been that they can help to protect the balance of payments position. Alternatively, the controls might serve a longer term and more systemic role of ensuring greater independence of financial policies and exchange rate stability. The success of such policy reversals is examined here for a group of countries that had reintroduced exchange controls on capital transactions after the onset of the debt crises in the early 1980s, and the experiences in the 1990s of Chile, Colombia, Malaysia, and Venezuela that are the subject of case studies in the Annex paper.

(i) Controls on outflows

Argentina, Chile, Mexico, and Venezuela reintroduced controls on capital transactions in the early stages of the 1980s debt crisis, as capital outflows mounted. Despite the introduction of extensive controls on international capital transactions (in isolation or in conjunction with exchange controls on current international transactions), they were generally unable to avert balance of payments crises or to sustain overvalued nominal exchange rates. As noted in Section III.3 above, the large-scale capital flight that continued through this period of capital controls is well-documented.

The common factor behind the problems facing these countries was poor economic policies. Loose financial policies generally led to appreciation of real exchange rates, eroded external competitiveness, and contributed to widening current account deficits. In the early stages, the current account deficit was usually financed by capital inflows, and consequently the overall balance of payments remained in surplus. As it became clear that policies were inconsistent with a sustainable balance of payments position, expectations of devaluation started to mount, contributing to private capital outflows. Capital flight continued despite exchange controls on capital transactions, as evidenced by large negative errors and omissions in the balance of payments and estimates of misinvoicing from partner country trade data. Further, as a result of restrictions on current and capital account transactions, parallel market premia emerged. Therefore, despite the policy autonomy that exchange controls were intended to provide, capital flows remained sensitive to changes in monetary and fiscal policies, and controls were increasingly circumvented through deepening parallel markets. Subsequent tightening of fiscal and monetary policies, together with exchange rate adjustments, generally led to a rapid improvement in the overall balance of payments as the direction of capital flows was reversed. Overall, controls on capital outflows did not succeed in isolating the economy from external developments, nor in protecting the balance of payments position. Further, the controls often gave rise to distortions in financial markets, inhibiting intermediation and development of those markets, as well as promoting tax evasion. The recent experience of Venezuela, which reintroduced exchange controls in 1994, has been along similar lines.

An alternative perspective on the effectiveness of capital controls is provided by the experience of the group of countries that varied the extent of controls on capital account transactions over an extended period (Egypt, Hungary, India, Korea, Nigeria, Turkey, and Zaïre). Despite their structural differences, these countries show some similarity in the composition of capital account transactions, as capital flows appeared to be dominated by official transactions. Recorded private sector capital flows, including portfolio flows and direct foreign investments, appeared rather modest. However, other private flows that may be similar to capital flows were generally significant (e.g., trade-servicing transactions or workers' remittances). Moreover, it would seem that these flows were in fact relatively sensitive to changes in the authorities' policies, both fiscal and monetary. In several instances, as confidence in the authorities' policies weakened, outflows associated with workers' remittances intensified, while balances held in domestic foreign currency accounts were quickly remitted offshore. Capital flight, usually in the form of over- and underinvoicing of imports and exports, accelerated in response to inconsistent policies. Official reserve positions deteriorated as the authorities attempted to defend overvalued nominal exchange rates, and external payments difficulties emerged, leading to the accumulation of external payments arrears (Egypt, Nigeria, Turkey, and Zaïre).

(ii) Controls on inflows

Some countries that have experienced destabilizing surges of capital inflows have resorted to exchange controls or related incentives to help cope with them. 1/ The inflows have generally resulted from a combination of successful economic stabilization, liberalization, improved confidence in economic policies and performance, renewed access to international markets, distortions in domestic financial markets that resulted in high real interest rates, and speculation regarding exchange rate appreciation. In some cases, costless forward cover facilities provided by central banks have also been a factor. 2/

Countries have generally relied on a mix of both quantitative restrictions and indirect measures aimed at influencing effective interest rate differentials or incentives for banks to accept nonresident funds. Indirect measures have included differential reserve requirements on non-resident deposits in domestic banks, unremunerated reserve requirements on foreign borrowing that raised the effective interest rate paid, interest rate caps, and the assessment of taxes on the transfer of marketable instruments.

The evidence on the effectiveness of the relatively few instances of controls targeting surges of capital inflows is not conclusive. Often, countries that have applied controls on capital inflows have taken other policy measures concurrently to counter the inflows, making it difficult to dissociate the impact of the controls. While there is some evidence that short-term inflows may have been reduced by the controls targeted at them, they may often have been replaced by capital flows with nominally longer-term maturities. Thus, the potentially expansionary effects of the inflows on liquidity may not have been effectively curbed. 3/

Malaysia recorded increasing capital inflows in the early 1990s in response to widening interest rate differentials in its favor, heightened foreign interest in Malaysia's stock market, and speculation of a pending appreciation of the ringgit. Tightening monetary policy to limit the

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1/ Most recently Brazil, Chile, Colombia, Korea, Malaysia, Mexico, and Spain.

2/ A 1988 Fund study of practices in forward exchange markets concluded that assumption of exchange rate risks by governments had led to large fiscal or quasi-fiscal losses in many cases, in some representing multiples of the monetary base. Peter J. Quirk, et al, "Policies for Developing Forward Foreign Exchange Markets", *IMF Occasional Paper* No. 60, (June 1988), pp. 17 and 21-23. Since the mid-1980s, such practices have been far less prevalent, although losses by the Mexican Government on issuance of dollar-denominated tesobonos in 1994 could be as high as 5 percent of GDP (at the present exchange rate).

3/ Case studies of such controls in Chile, Colombia, and Malaysia are discussed in detail in Annex III.

inflationary consequences of these inflows encouraged further inflows, and in September 1991, statutory reserve and liquidity requirements were imposed on ringgit borrowing in order to equalize the regulatory costs between offshore and domestic sources. Despite these and other measures, as well as depreciation of the ringgit, the inflows persisted, although they slowed as domestic liquidity conditions were eased in 1994 and the currency was allowed to appreciate in nominal terms. Further controls on inflows were introduced between January and August of 1994.

Chile took steps to limit temporary capital inflows while maintaining an attractive environment for longer-term foreign capital. In early 1992, the 20 percent reserve requirement on external loans was extended to foreign exchange deposits, while some controls on outflows were removed. The reserve requirement was designed to discourage temporary inflows, as it applied for a period of one year regardless of the maturity of the borrowing or deposit. Increased commissions were applied to swap operations. At the same time, the central bank conducted open market operations aimed at sterilizing the capital inflows and also gave some greater flexibility to the exchange rate. The reserve requirement on bank borrowing abroad was subsequently increased to 30 percent in May 1992, as was the requirement on foreign borrowings by Chilean companies in August 1992. Despite these measures and relaxation of controls on capital outflows, the capital account surplus continued to increase in 1992 and remained at a high level in 1993. The controls may have led to a change in the composition of inflows in 1993, as short-term inflows slowed while long-term inflows strengthened.

Overall, the effectiveness of capital controls, particularly on outflows is likely to be limited. Similar experiences have been evident in other cases where effective multiple exchange rates have been introduced to deal with the problem of capital inflows. 1/ Nevertheless, there are circumstances in which controls or incentives might provide a breathing space during which an appropriate macroeconomic policy response can be formulated and policy measures can be taken. The OECD Code of Liberalization of Capital Movements provides explicitly for the introduction of such emergency measures, although subject to strict time limitations. 2/ However, even with such time limits, the usefulness of a reprieve from inflows is likely to be limited. The ability to circumvent controls will make any breathing space very short, and the amount of policy adjustment that can be introduced in such a time frame (say, a few months) will be correspondingly lessened. 3/

1/ For discussion of the classical multiple exchange rates for capital, see the 1984-85 review papers (SM/84/64, SM/84/65, SM/85/19, and SM/94/202).

2/ Article 7 allows for the introduction of temporary restrictions in response to balance of payments difficulties. See Annex I for further details.

3/ This view is supported by the recent experiences discussed above of Ireland and Portugal in 1992.

4. Fund policy treatment

As with the industrial countries, the Fund has generally welcomed liberalization of restrictions on capital account transactions in developing countries. The approach, however, has been selective, with particular prominence being given to these issues, for example, where capital movements became a significant factor in macroeconomic developments and exchange rate management. Where policy advice has been given, it has centered on appropriate adjustments in fiscal, monetary, and exchange rate policies in response to large capital inflows, and the tightening of any controls over capital movements was generally discouraged. 1/ An acceleration of the liberalization process was sought when conditions were deemed appropriate. In Korea, for example, the authorities were encouraged to implement the capital account liberalization program already in place, 2/ and the staff took the view that "further liberalization of capital outflows could help mitigate the macroeconomic complications associated with strong inflows." 3/ Staff reports, however, have suggested support for a more measured and gradual approach to liberalization of inflows. In the case of Chile, which was also in the process of a gradual removal of its system of controls on capital transfers, the staff encouraged further liberalization in this area. This position reflected concerns about the need to unify the exchange rate, and the desire to achieve a deepening of capital and exchange markets. 4/

Capital account liberalization was also supported in cases where significant private and public capital inflows were accompanied by very large current account surpluses. In Botswana, the authorities worked very

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1/ The group of countries reviewed includes those in which the issue of capital inflows was explicitly addressed in the Chairman's summing up of the discussions of Article IV consultations during 1993-95. (Argentina, Botswana, Indonesia, Korea, Malaysia, Mexico, Thailand, and Venezuela.)

2/ In June 1993, the authorities presented a five-year plan for financial liberalization and capital account opening. See "Korea--Staff Report for the 1994 Article IV Consultation" (SM/94/220, 8/16/94), pp. 14 and 18.

3/ Executive Directors agreed with the staff's view. See "The Acting Chairman's Summing Up at the Conclusion of the 1994 Article IV Consultation with Korea, Executive Board Meeting 94/83 - September 12, 1994" (SUR/94/109, 9/22/94). The staff also proposed liberalizing capital outflows during Article IV consultation discussions with Thailand. See "Thailand--Staff Report for the 1992 Interim Article IV Consultation" (SM/92/90, 4/29/92), p. 6. Executive Directors noted a positive influence of the liberalization of capital flows in containing inflation and keeping the real exchange rate relatively stable during the 1993 Article IV consultation discussion. See "The Acting Chairman's Summing Up at the Conclusion of the 1994 Article IV Consultation with Thailand, Executive Board Meeting 93/74 - May 21, 1993" (SUR/93/53, 5/26/93).

4/ See "Chile--Staff Report for the 1992 Interim Article IV Consultation" (SM/92/113, 6/4/92), p. 7.

closely with the private sector to abolish eventually the existing capital controls and to unify the financial and commercial exchange rates. During the 1994 Article IV consultation discussions, the mission indicated that it would welcome a timely removal of the remaining capital controls, noting that their abolition might require supporting measures to stimulate the development of a full-fledged capital market in the country. 1/

On several occasions concerns were expressed about the imposition of capital controls. Malaysia introduced controls on short-term capital flows in early 1994 to stabilize market conditions, and the authorities believed that they had succeeded in halting speculative flows. Nonetheless, in the context of Article IV consultation discussions, they agreed with the staff that such measures introduced distortions and were not desirable in the longer term. 2/ During the Board discussion, Directors "supported the authorities' decision to remove the controls in August 1994." 3/ In mid-1994, Venezuela imposed extensive exchange controls in response to the instability created by the banking crisis. This resulted in substantial delays in processing foreign exchange transactions, contributed to the accumulation of large external arrears, and the curtailment of access to private capital markets. In the Article IV consultation discussion, Executive Directors "expressed serious concern about the persistent accumulation of external arrears", and they "regretted the imposition of exchange controls, which...created serious distortions". Moreover, they "urged the elimination of exchange controls, while recognizing that this could be achieved only in the context of strong fiscal and credit policies and may need to be implemented in a phased manner". 4/

Notwithstanding this general approach, however, there has been an acceptance that in individual cases special considerations might justify a more favorable view of measures restraining capital inflows. Such an approach was taken by the staff during discussions with Indonesia, which faced a high external debt burden. In 1991, the authorities introduced controls on public sector borrowing by all public sector entities, including those "with no more than indirect links to the state", although the controls

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1/ See "Botswana--Staff Report for the 1994 Article IV Consultation" (SM/94/266, 11/2/94), p. 9.

2/ See "Malaysia--Staff Report for the 1994 Article IV Consultation" (SM/94/239, 9/1/94), p. 11.

3/ See "The Acting Chairman's Summing Up at the Conclusion of the 1994 Article IV Consultation with Malaysia, Executive Board Meeting 94/90 - September 23, 1994" (SUR/94/117, 9/30/94).

4/ See "The Acting Chairman's Summing Up at the Conclusion of the 1994 Article IV Consultation with Venezuela, Executive Board Meeting 95/20 - March 1, 1995" (SUR/95/25, 3/6/95).

were not imposed on private sector borrowing. In the report for the 1993 Article IV consultation, the staff "endorsed the authorities' determination to maintain control over publicly related borrowing". 1/

On the part of the authorities, a more measured approach to capital account convertibility has reflected their desire to protect independence in conducting monetary policy. In Chile, for instance, additional instruments to create disincentives to short-term capital inflows were used. 2/ In a similar context in Thailand, consideration was given to "requiring appropriate provisioning by commercial banks in respect of guarantees against foreign borrowing." 3/ In 1993, during discussions with Argentina the possibility of imposing a marginal reserve requirement to help slow credit expansion and capital inflows was raised, but the authorities did not consider that measures to curb capital inflows were necessary. 4/

Several Fund-supported programs have played a role in external sector liberalization in the transition economies of eastern and central Europe. 5/ A rapid liberalization of certain capital account transactions has been largely motivated by the expectation of significant private capital inflows and, in particular, of private foreign direct investment and the associated managerial and technological resources that are considered critical for the transformation process.

Virtually all Fund-supported programs in eastern and central Europe included measures to facilitate the inflow of foreign capital, such as the passage of liberal foreign investment codes. 6/ These measures were further strengthened by opening the privatization process to foreign

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1/ See "Indonesia--Staff Report for the 1993 Article IV Consultation" (SM/94/22, 2/22/94), pp. 17 and 22. There is the qualification that controls imposed by government on its own operations do not have the same economic significance as capital controls.

2/ See "Chile--Staff Report for the 1993 Article IV Consultation" (SM/93/124, 6/11/93), pp. 3 and 9.

3/ See "Thailand--Staff Report for the 1992 Interim Article IV Consultation" (SM/92/90, 3/29/92), p. 6.

4/ See "Argentina--Staff Report for the 1993 Article IV Consultation and Review Under the Extended Arrangement" (EBS/93/101, Sup. 1, 7/9/93), p. 7.

5/ This review covers Fund-supported programs in Albania, Bulgaria, the Czech and Slovak Republics, Estonia, Hungary, Latvia, Lithuania, Poland, and Romania.

6/ These typically included the right to unrestricted remittance of profits abroad and provisions for liberal repatriation of capital in the event of liquidation.

investors, and often granting them treatment equal to domestic investors. 1/ When the liberalization of foreign investment regimes was not proceeding as rapidly as originally agreed, the staff and Directors "encouraged the...authorities to take a more positive and consistent view of the role that foreign capital could play in the economy and emphasized the contribution that foreign investment could make to the transformation process." 2/ In the assessment of progress in external liberalization, Directors have generally endorsed up-front measures to liberalize the external trade and payments system. However, it has also been recognized in some instances that restrictions on capital outflows could be maintained until financial imbalances are reduced and the external reserve position improved. 3/

Fund programs have frequently included provisions regarding certain restrictions pertaining to current account transactions, but which also may have significant implications for the capital account. Measures that require foreign exchange repatriation or surrender requirements can often be intended to restrict residents' ability to engage in capital account transactions. Without such requirements, effective restrictions on capital outflows may be difficult to enforce regardless of the intensity of restrictions on current and capital account transactions, where the monitoring and control of capital transactions is relatively weak. However, the same weakness tends also to affect the enforcement of the surrender and repatriation requirements.

The Fund has pursued a case-by-case approach with regard to exchange repatriation and surrender requirements and internal convertibility in programs in eastern and central Europe. In the cases of Estonia and Lithuania, the staff argued against the introduction of surrender requirements. In Estonia, limited capital account convertibility was one of the key elements in the 1992 currency reform package, but full surrender of foreign exchange by exporters was maintained. The 1993 stand-by arrangement welcomed the authorities' commitment to liberalize the remaining restrictions on capital account transactions, including the repatriation and

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1/ In some cases, large investments in strategic sectors and investment in large public sector enterprises required special approval. For example, see Albania. See "Albania - Request for the First Annual Arrangements under the Enhanced Structural Adjustment Facility" (EBS/93/93, 6/16/93). Furthermore, the first annual program under the ESAF arrangement with Albania provided for the elimination of a tax on repatriation of dividends and capital ("Albania - Enhanced Structural Adjustment Facility - Medium-Term Economic and Financial Policy Framework Paper, 1993-96") (EBD/93/103, 6/17/93).

2/ For example, see "The Acting Chairman's Summing Up at the Conclusion of the 1992 Article IV Consultation with the Republic of Poland, Executive Board Meeting 92/99 - July 31, 1992" (SUR/92/61, 8/12/92).

3/ See, for example, "Albania--Stand-By Arrangement" (EBS/92/121, Sup. 2, 9/3/92), p. 8, (EBM/92/106, 8/26/92).

surrender requirements. 1/ After these requirements were abolished by end-1993, Executive Directors praised Estonia for introducing full convertibility of the kroon for current and capital account transactions. 2/ In the 1993 Article IV discussions with Lithuania, which at that time had eliminated all other restrictions on capital transactions, 3/ the staff noted that in the proper policy environment a surrender requirement would not be necessary and, therefore, the staff could not positively recommend it. The surrender requirement was abolished following the introduction of the new currency. In most other cases, Fund programs included commitments to abolish surrender requirements, and several countries also permitted banks to offer foreign exchange accounts. 4/

In programs with Czechoslovakia and its successor states, the Czech Republic and Slovakia, the Fund encouraged the liberalization of transactions on current and capital accounts. In the 1990 stand-by arrangement, Czechoslovakia pledged to introduce a very liberal foreign investment regime under which foreign companies were subject to less restrictive regulations than those applicable to domestic enterprises as regards repatriation of profits, transfers of capital participation, and borrowing from foreign banks; it also permitted the establishment of majority- or wholly

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1/ See "Republic of Estonia--Request for Stand-By Arrangement and Purchase Under the Systemic Transformation Facility" (EBS/93/166, 10/8/93), p. 53.

2/ See "The Acting Chairman's Summing Up at the Conclusion of the 1994 Article IV Consultation with the Republic of Estonia, Executive Board Meeting 94/32 - April 8, 1994" (SUR/94/42, 8/12/92).

3/ The staff stated that it could not endorse the introduction of the surrender requirement planned by the authorities, but that such arrangements could be consistent with the program provided that the foreign exchange so surrendered was sold to the Bank of Lithuania at a unified, market-determined rate, and there was no administrative allocation of foreign exchange. See "Republic of Lithuania - 1993 Article IV Consultation and Review Under the Stand-By Arrangement" (EBS/93/42, 3/17/93, and Cor. 1, 4/8/93), pp. 17-18.

4/ For example, in Albania all surrender requirements have been eliminated but full repatriation of foreign exchange earnings was required until 1994, although not enforced. However, banks can offer foreign currency accounts. In Bulgaria, full repatriation of foreign exchange receipts to the domestic banking system was required within one month, but official surrender requirements were abolished. In the 1991 stand-by arrangement with Czechoslovakia, the authorities stipulated the requirement of full repatriation of export earnings. In Latvia, the surrender requirements were abolished early on, and all residents, including enterprises, have been continuously permitted to hold foreign currencies in cash, in bank accounts, or abroad, and to use them for domestic payments. In Poland, repatriation and surrender requirements have been maintained for enterprises, while other residents can open foreign exchange accounts with domestic banks. In Romania, there is no surrender requirement.

foreign-owned companies. 1/ Following the breakup, the Czech Republic maintained its commitment to further liberalize capital account transactions. 2/ The Slovak Republic, however, introduced some restrictions relating largely to external trade financing, in response to virtual depletion of foreign exchange reserves. In that context, Directors supported the staff's concerns, and in concluding the 1993 Article IV consultation they pointed to high costs of the "strategy which had included reliance on external controls". 3/ The restrictions were removed in December 1993.

On occasion, the staff and the Executive Board have encouraged an accelerated transition to full capital account convertibility. For example, such an objective has been explicitly included as one of the principal elements of the program with Albania. This was motivated by the openness of the economy and Albania's very limited administrative capacity. 4/ A rapid liberalization of capital outflows was considered as one of the possible measures that would help alleviate the impact of continuing, large capital inflows experienced by the Czech Republic since 1993. Pointing to the limitations on the authorities' ability to sterilize such inflows, as well as the likely adverse impact of exchange rate appreciation on competitiveness, the staff welcomed "the planned further relaxation of remaining restrictions on both current transactions,...and capital transactions." 5/ This view was reiterated in the staff report for the 1994 Article IV consultation. 6/

5. Technical assistance

One focus of the Fund's technical assistance in the area of foreign exchange systems has traditionally been on efforts to facilitate current account convertibility in its member countries. However, since the mid-1980s, technical assistance has also involved advice on the adoption

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1/ See "Czech and Slovak Federal Republic - Staff Report for the 1990 Article IV Consultation and Request for Stand-By Arrangement and for Purchases Under the CCFF" (EBS/90/215, 12/20/90), pp. 73-74.

2/ See "Czech Republic--Staff Report for the 1993 Article IV Consultation and Review Under Stand-By Arrangement" (EBS/93/107, 7/6/93 and Cor. 1, 8/5/93), p. 13.

3/ See "The Chairman's Summing Up at the Conclusion of the 1993 Article IV Consultation with the Slovak Republic, Executive Board Meeting 93/104 - July 26, 1993" (SUR/93/79, 7/30/93).

4/ See "Albania--Enhanced Structural Adjustment Facility--Medium-Term Economic and Financial Policy Framework Paper, 1994-97" (EBD/94/145, 8/25/94), p. 8.

5/ See "Czech Republic--Review Under Stand-By Arrangement" (EBS/93/205, 12/20/93), p. 10.

6/ See "Czech Republic--Staff Report for the 1994 Article IV Consultation" (SM/94/180, 7/8/94), p. 6.

of full current and capital account convertibility, and exchange system reforms have been linked frequently to the establishment of full convertibility. 1/

In view of extensive capital flight and disintermediation of foreign exchange identified in the context of technical assistance, the approach adopted to achieving full convertibility included the legalization of a parallel (illegal) market, thereby generalizing a free market for foreign exchange. Nigeria was one of the first cases in which convertibility for both current and capital account transactions was proposed by the Fund staff as part of the reform program, and a transitional two-tier exchange system was introduced with the Fund's technical assistance during 1986. 2/ A move to full convertibility was indicated by the lack of transparency and inefficiencies associated with controls, which had already been undermined by extensive parallel market trading. Formal elimination of the controls was seen as bringing realism to the exchange system and providing proper incentives for the private sector to rationalize the allocation of foreign exchange resources.

Because the free markets were to be built on existing parallel markets, the proposed exchange rate regimes were usually floating ones (Egypt, El Salvador, Guatemala, Honduras, Jamaica, Korea, Nigeria, and Venezuela). However, in each case country-specific circumstances had to be considered. Exchange restrictions did not exist in Venezuela's free market and foreign exchange purchases for both current and capital account transactions could be effected freely in this market. The official exchange rate, however, was significantly overvalued and foreign exchange at the subsidized rate was rationed, subject to extensive leakages and exemptions. The unification of official and parallel market rates played an important role in ending the implicit subsidies, and thus in overall fiscal adjustment supporting convertibility.

In El Salvador, banks were state-owned and collusion in the banking sector was a concern; arrangements in the free market were used as a benchmark to establish the exchange regime for the banks. A unified exchange system had been introduced in Guatemala earlier, and the spread between the official and illegal cambio market rates was negligible. This

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1/ Countries to which the Fund has provided technical assistance in the area of capital convertibility include, with the year of the assistance in parenthesis: Liberia (1985); Nigeria (1986); Somalia (1986) Dominican Republic (1987); Venezuela (1988); El Salvador (1989); Guatemala (1989); Korea (1989, 1992, and 1994); Honduras (1990); Jamaica (1990); Egypt (1990-91); Lithuania (1992); Trinidad and Tobago (1993); Fiji (1993); Cyprus (1994); Malta (1994); Sri Lanka (1994); and Czech Republic (1995).

2/ Regional convertibility had been discussed in 1982 in the context of an intraregional monetary arrangement (ECCA). Technical assistance in the area of capital account convertibility was provided by the ETR Department until 1992, when this function was passed to MAE.

suggested that de facto convertibility was already in effect, and that formal abolition of the controls would make the exchange system more transparent and improve confidence. In Honduras and Jamaica, as well as in Egypt, it was recommended that a free market be established on the basis of the parallel market, since most foreign exchange transactions were already channeled through this market. Full convertibility was recommended by the Fund staff in Somalia as a means to ensure a unified exchange system after the introduction of an auction market for the distribution of foreign aid-related funds in 1986, because there was concern that multiple exchange rates could emerge without the elimination of all exchange controls.

Other technical assistance in the area of capital convertibility has placed less emphasis on the existing role of the informal market (Czech Republic, Cyprus, Fiji, Korea, Lithuania, Malta, Sri Lanka, and Trinidad and Tobago). Lithuania provides an example of a transition economy in which market-based systems did not exist initially and had to be developed. The Fund staff recommended that a fully convertible exchange system be established, since this would facilitate integration into international markets and would result in an efficient allocation of resources. Technical assistance was provided to the authorities in drafting a currency law that included capital convertibility provisions.

In Sri Lanka and Trinidad and Tobago, elimination of remaining controls on capital account transactions was perceived by the Fund staff as a logical extension of earlier reforms involving elimination of controls affecting current account transactions. Technical assistance on the elimination of controls on capital transactions in the cases of the Czech Republic, Korea, and Malta was motivated in part by their desire for membership in another international or regional organization (OECD in the case of the Czech Republic and Korea, and the EU in the case of Malta). The Fund staff's advice in these instances focused on the possible sequencing of reforms leading to full convertibility.

While recommendations for full convertibility in the context of technical assistance reflected the diverse circumstances of countries, some common themes can be found. In virtually all cases surveyed, the ineffectiveness of existing controls was evidenced by estimates of capital flight. Improved transparency associated with a free exchange system, and the recognition of an active informal market were also key considerations in the recommendations. Further, the promotion of a competitive and efficient exchange system was also frequently a factor.

Specific rationales for promoting capital convertibility in individual cases have included: removal of exchange controls to facilitate investment and growth as the mismatch between import and production capacity and the underutilization of installed capital was eliminated (Nigeria); unification and decontrol of interest rates to provide incentives for reflows (Venezuela); elimination of the implicit subsidy resulting from an overvalued exchange that distorts income distribution and creates bias toward imported goods away from the use of domestic labor (Venezuela); decontrol and better monetary and fiscal policies for more efficient allocation of resources and to facilitate import and export substitution (El Salvador); improved transparency as regulations are brought into line with reality (Egypt, Guatemala, Honduras, and Jamaica); capital decontrol to remove incentives for massive capital flight (Guatemala); most transactions are already handled through parallel markets (Egypt, Honduras, and Jamaica); convertibility facilitates integration into the world economy (Lithuania); controls prevent efficient pricing and allocation (Lithuania and Nigeria); capital liberalization would be a natural extension of the reform process (Fiji and Trinidad and Tobago); elimination of capital controls would help to establish the same degree of liberalization as in neighboring countries (Trinidad and Tobago); macroeconomic conditions are conducive for the move to full convertibility (Fiji); liberalization is likely to encourage competition in the financial sector (Fiji); to promote policy discipline (Sri Lanka); and to release pressure on monetary policy (Czech Republic).

The Fund staff has also provided technical assistance in support of convertibility involving related operational aspects, such as linkages with monetary management, development of instruments and markets for securities, reserves management, reporting systems, and the development of interbank market operations in foreign exchange. Technical assistance on exchange systems has also included recommendations regarding mechanisms for managing liquidity in anticipation of capital inflows resulting from the liberalizations, including analysis of money demand and management of sterilization of operations. 1/ Recent technical assistance provided to the Czech Republic, which was already experiencing strong capital inflows, emphasizes the need to continue the liberalization of exchange controls and the domestic financial markets, in order to minimize arbitrage opportunities and ensure optimal portfolio allocation.

In countries with floating exchange rates, crucial to the support of convertibility was the emergence of a forward market for foreign currency. Such markets have proven sensitive to the overall state of openness of financial systems and slow to emerge in developing countries, although the benefits associated with forward cover in offsetting exchange rate risks are widely understood. The Fund staff has generally noted that the development of a forward market arrangement by the private sector is helped by market-based exchange rate regimes and flexible interest rates (Bangladesh, Guatemala, Jamaica, Korea, and Venezuela). At the same time, the staff has cautioned strongly against the provision of forward cover by official entities (such as the central bank), since such guarantees have often resulted in substantial quasi-fiscal losses (Jamaica and Venezuela).

1/ The 1988 Venezuela report contained extensive discussion, and subsequently also the reports for Guatemala, 1989; Honduras, 1990; Jamaica, 1990; and Egypt, 1991.

A special problem has emerged in some developing countries resulting from large backlogs of exchange applications or accumulations of external payments arrears. Technical advice on convertibility in such cases has often involved sequestering the overhang in order to ensure that the freely convertible foreign currency market functions properly (Egypt, El Salvador, Honduras, and Jamaica).