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July 11, 1995

To: Members of the Executive Board

From: The Secretary

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

The attached paper provides supplementary 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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# Capital Account Convertibility: Review of Experience and Implications for Fund Policies--Annex

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

(In consultation with other Departments)

Approved by Manuel Guitián and Jack Boorman

July 7, 1995

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## I. Multilateral and Regional Frameworks for Liberalization of Capital Movements

Multilateral and regional frameworks have been a significant contributing factor toward progress in the liberalization of capital movements. In particular, the Organization for Economic Cooperation and Development (OECD) Code of Liberalization of Capital Movements (the Code) and the Directives of the European Community (EC) have been important because their objectives have been fully attained, and their rules apply to the industrial countries, among which the bulk of capital flows take place today. In the group of developing countries, a limited degree of international capital mobility has been in the context of the regional monetary arrangement of the CFA franc zone. A new impetus for the liberalization of certain capital movements is likely to come from the newly created World Trade Organization (WTO), through agreements on the liberalization of international trade in financial services and the associated capital movements.

The goals defined within these alternative frameworks for the liberalization of capital movements have broadened considerably over time, but important differences remain between them. Initially, the liberalization effort centered on the removal of restrictions on direct investment and capital flows linked to trade in goods and services, largely in the form of exchange controls. With time, more attention was given to other factors hampering free capital movements, and the scope of liberalization efforts was expanded to include all capital transactions, both short- and long-term. A principal remaining difference concerns interpretation of the liberalization objective. The OECD embraces an approach based on the "uniformity of treatment" under different national rules, while the EC has for some time devoted effort to harmonizing and standardizing national rules and regulations for various transactions. A further significant difference is that the directives of the European Union (EU) embody forms of compulsion and compliance dates, while the OECD Code does not. In addition to these approaches adopted by the OECD and the EU, which included the liberalization of financial services as a way to enhance the freedom of capital movements, efforts in the context of the WTO are aimed at liberalizing trade in services, including financial services and the associated capital flows.

### 1. The OECD Codes

The OECD Code stemmed from a primary objective of the Organization. The Convention establishing the Organization in 1961 states that, in order to pursue the aims of the OECD, member countries agree "to pursue their efforts to reduce or abolish obstacles to the exchange of goods and services and current payments and maintain and extend the liberalization of capital movements". Detailed undertakings in this regard were set out in the "Codes of Liberalization of Capital Movements", first adopted in December 1961. 1/ Article 1(a) of the Code states the general aim that: "Members shall progressively abolish between one another, in accordance with Article 2, restrictions on movements of capital to the extent necessary for effective economic co-operation." The Committee on Capital Movements and Invisible Transactions (CMIT) is mandated under Articles 18 and 19 to consider all questions concerning the interpretation and implementation of the provisions of the Code.

Article 2(b) mentions the transactions to be liberalized. 2/ These are contained in Annex A to the Code, consisting of two lists. List A contains priority operations that, once liberalized, cannot be restricted without reference to the Organization. List B has items subject to more flexible treatment, since under Article 2(b)(iv) members have the option of lodging a reservation on a List B item even after the item has been liberalized. The operations on List B are those for which it was thought that there might be a more frequent need for restrictions, such as the access of foreign bond issues and inward and outward credit operations of domestic financial institutions.

Under Article 2(a), each member "shall grant any authorization required for the conclusion or execution of transactions and for transfers on Lists A and B", unless the member maintains a reservation on an item in Annex B to the Code (as under the Fund's Article XIV), or has invoked an Article 7 derogation clause that provides temporary dispensation (as under the Fund's Article VIII) from its obligation to preserve the freedom of operations not covered by reservations. 3/

The OECD codes have a legal status equal to OECD Decisions and are binding on all members. Under the Code of capital movements and invisible transactions, members agree to adopt and apply laws, regulations, and policies that treat all residents of the OECD area on an equal footing. However, the obligation to liberalize does not imply the need to harmonize national laws, or to deregulate according to some international standards.

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1/ A companion Code of Liberalization of Current Invisible Operations was adopted at the same time. In addition to covering a wide range of current payments relating to foreign trade, production and business, and income from labor and capital, the code for invisibles also covers a broad range of service operations, including detailed treatment of the sectors of insurance, transport, tourism, audiovisual works, and now banking and financial services.

2/ This is further enforced by Article 16 that allows a member to refer to the OECD if it considers that another member has taken discriminatory measures.

3/ Because the goal of full liberalization is to be achieved progressively over time, members not in a position to comply immediately can lodge a reservation on the items. This can be done when a member joins the organization or when new obligations are added to the Code.

The practice has been for other countries seeking to join the OECD to be required to comply with the obligations of the codes prior to formal membership.

a. Forms of controls covered

List A includes direct investments, most portfolio operations in quoted securities, commercial credits and personal capital movements, the issue of securities, operations in quoted securities, real estate operations and financial credits, and loans. List B, a subset of List A, covers operations on money markets, real estate operations, financial credits and loans, other operations in negotiated instruments, operation of deposit accounts, operations in foreign exchange, and personal capital movements.

Liberalization refers in the Code to the abolition of official restrictions on the conclusion or execution of both transactions and transfers. The obligation to liberalize goes beyond restrictions imposed directly on foreign exchange transactions, in the sense that the underlying transactions themselves should not be frustrated by legal or administrative regulations. It applies to cross-border operations between residents of OECD countries, and is not applicable to residents of non-OECD countries, or to operations between residents of the same country. For instance, in the area of direct investment, members are not permitted to keep or introduce regulations or practices that raise special barriers or limitations with respect to nonresident investors from OECD countries, and that have the intent or the effect of preventing or significantly impeding direct investments by such nonresidents. Restrictions in the form of reservations by member countries are common in this area, particularly with regard to direct investments in the area of broadcasting, and air and sea transport. Real estate is one area often considered of second-order importance in the process of liberalization. However, the Code covers purchases of buildings and land, and construction of buildings for gain or personal use, and includes rights that would be accorded to residents, such as transfer of ownership.

The Code has been amended to widen its coverage several times (1964, 1973, 1984, and 1989). It was first amended to include measures that could indirectly restrain capital movements and were not originally considered as violating the obligations under the Code. The revisions in the 1980s reflected both the broad liberalization of capital movements that had already taken place in the OECD area, and a growing awareness that the progressive integration and sophistication of financial markets rendered limits on various capital flows increasingly unenforceable. The amendments in 1989 were to include provisions for operations in money markets, including operations in securities and in interbank markets; short-term financial credits and loans to both private individual and financial institutions; foreign exchange operations, including spot and forward transactions; long-term commercial credits; swaps, options, futures, and other innovative instruments; and securities issued simultaneously in more than one market. As a result of the last revision, the liberalization recommendations adopted by the OECD Council now cover all capital movements and the right of establishment under the Code of Liberalization of Capital Movements, and the freedom to provide banking and financial services under the Code of Liberalization of Current Invisible Transactions.

Some aspects of the Code are similar in transactions coverage and treatment to Article VIII of the IMF Articles of Agreement. For example, where transfers are made at rates of exchange other than those prevailing in the official market, it is considered restrictive if exchange rate differentials exceed 2 percent for several months. Administrative procedures such as compulsory deposit requirements, tax or interest rate penalties, and queuing arrangements that impede transactions covered by the Code are treated as restrictions. Repatriation and surrender requirements for foreign exchange receipts, restrictions on the terms of trade financing contracted by private parties (maturity, interest rate, etc.), and limits on the periods for acquiring foreign exchange for imports, can be regarded as restrictions under both the Fund's Article VIII and the OECD Code. On the other hand, certain measures that raise the cost of international transactions such as taxes, levies, and deposit requirements are not within the purview of the Code. This is because they are viewed as not necessarily preventing the transactions, and are therefore considered to be less harmful than discretionary authorizations.

b. Transitional arrangements for retaining controls

The OECD approach emphasizes the continuity of progress in liberalizing capital transactions, rather than the achievement of change that could be subsequently reversed. Consistently with this approach, Article 7 provides the following reasons for which a member may elect to defer, or not to take, the measures under Article 2(a) as follows:

(i) If a member's economic and financial situation does not justify complete liberalization;

(ii) If previous liberalization measures result in economic and financial disturbance, the member can withdraw those measures; and

(iii) If a member's overall balance of payments develops adversely at a rate and in circumstances that the member considers serious, the member may temporarily suspend the measures of liberalization taken or maintained.

A reservation on List A items may be lodged only at the time a member adheres to the Code, whenever specific obligations begin to apply or obligations relating to an item are extended, or when new obligations are added to the Code. Once withdrawn, a reservation cannot be relodged and, unlike derogations, there is no time limit for their removal although the member must submit to a periodic examination. Derogations may be invoked at any time, but only if the member can demonstrate that it needs to reintroduce restrictions because of the problems listed in (i) to (iii) above. Derogations can be maintained for a limited time only. For instance, under item (iii) above, the member would be obligated to ensure that 12 months after the reintroduction of restrictions, it liberalizes (to a reasonable extent) transactions and transfers subject to Article 2(a) and those that were suspended. Moreover, within 18 months the member should revert to compliance with the obligations under Article 2(a). In this respect, the member is required to report to the OECD within 10 months after suspending liberalization (under derogations), actions taken or proposed to comply with obligations under Article 7(d)(i) (within 16 months in case of compliance with Article 7(d)(ii)). On the other hand, if the member finds that it is unable to meet the objectives, it must indicate the reasons in a report that also states steps it has taken, and proposes to take, to restore economic equilibrium. The report would also include the results of actions taken and specifies any further time that the member considers that it will need to attain the objectives.

In addition to these arrangements, Article 2(b)(iv) of the OECD Code states that, without unnecessary damage to the financial or economic interest of another member and with the avoidance of discrimination between other members, "a member may lodge reservations relating to the obligations...at any time, in respect of an item in List B".

The value of these "safety valve" provisions lies in enabling member countries in difficulty to remain party to the Code and not lose sight of the ultimate goal of liberalization. It encourages members to withdraw precautionary reservations by enabling them to restore their reservations later in the form of derogation, if need be. It also enables OECD member countries to benefit from liberalization measures taken by other member countries.

Annex E of the Code deals with the decision of the Council in 1960 on measures and practices of reciprocity and discrimination. The Decision recognizes that in a number of respects reciprocity has operated to broaden the effective sphere of liberalization, although a more extensive use of reciprocity and discriminatory practices in the area of inward direct investment and the right of establishment could reduce the effective sphere of liberalization among member countries. The Decision made a record of all measures and practices concerning reciprocity and discrimination by member countries as of the date of the Decision and states that: 1/ "Measures and practices...shall be progressively abolished without, in so doing, extending the scope of restrictions to inward direct investment or establishment."

A periodic examination is required of the measures and practices of each member along with the reservations maintained, if any. Periodic reviews and consultations with members are key instruments for implementing the Code, while the Code itself constitutes a yardstick against which progress can be judged. In the course of consultations with individual

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1/ The reservations here are mainly related to the establishment of subsidiaries or branches of foreign banks.

members, the nature and purpose of remaining restrictions are examined by the CMIT and discussed. This process also provides a forum in which peer pressure for further progress is applied. Reports from such consultations are confidential and are submitted to the OECD Council, which either takes a decision recognizing the modification of restrictions applied by a member under the Code or makes an appropriate recommendation. 1/ However, unlike the EU provisions discussed below, there is no time frame set within which the original reservations must be removed.

The reservations lodged by member countries are contained in Annex B of the Code. As of June 30, 1993, Luxembourg had no controls, while the Netherlands and the United Kingdom maintained certain limited controls on direct investment. The controls in the two countries related to ownership of airlines and vessels (the United Kingdom has also reservations on investment in certain broadcasting licenses). In addition to partial reservations on direct investment, Austria and Denmark maintained partial reservations on operations in real estate. In the case of Denmark, the reservations on direct investment related to ownership of Danish flag vessels, while in addition to a similar reservation, Austria also maintained restrictions on direct investment in banking (conformity to local needs or national economic interest), auditing, legal services, energy, and transport. Countries with the most reservations were, in ascending order, Iceland, Greece, Ireland, and Portugal. 2/

A comparison of the various reservations shows that most countries have progressively removed restrictions, particularly since the early 1980s. Denmark's three reservations at the end of June 1981 on List A and four on List B, were reduced to one on List A and three on List B by end-December 1989 and to one each on Lists A and B by end-June 1993. At the same time, the Netherlands had two and four reservations, respectively, on Lists A and B and was reduced to only one reservation by December 1, 1989. The maintenance or removal of controls can be put in two groups--non-EU and EU members. Australia and New Zealand removed most controls in 1983 and 1984, respectively, although they still maintain partial reservations on a number

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1/ The OECD Council decisions have a legal effect, while recommendations do not formally oblige a member to act in a prescribed manner.

2/ The reservations by Mexico are not contained in the 1993 OECD list because the country joined the OECD in 1994. Mexico's reservations include inward direct investment, acquisition of real estate for residential purposes, purchases by nonresidents of domestic shares and other securities of a participating nature, operations in domestic currency, financial operations in foreign currency abroad by resident banks, and purchases of foreign instruments abroad by resident securities firms for their own account.

of items. 1/ Turkey began dismantling its controls late in 1989-90, while the Nordic countries and Iceland have done so in the context of EFTA. Denmark and France had, by 1988 and 1989, respectively, removed almost all restrictions, while Austria, Italy, and Ireland took measures in 1988-90 in compliance with EU Directives.

Almost all members have at one time or another taken advantage of Article 7 of the Code to introduce restrictions temporarily in response to balance of payments difficulties, exchange rate crises, or undesired monetary developments. A number of countries invoked these derogation clauses to support measures to stem capital outflows (the United Kingdom, the United States, Denmark, France, Italy, and Sweden) while others did so to limit undesired inflows of capital (Austria, Australia, Finland, Germany, Japan, and Switzerland). The United Kingdom, which had no reservations as of end-June 1981, had by December 1, 1989 made a partial reservation on direct investment regarding investment in air transport, broadcasting, and acquisition of United Kingdom flag vessels. The United States, which as of December 1, 1989 had only one reservation on List A, (involving direct investment in atomic energy, broadcasting, air transport, domestic and coastal shipping, and thermal and hydroelectric power and geothermal steam) had by June 30, 1993 introduced two more reservations on List A (operations in securities markets and operations in collective investment securities) and one on List B involving operations on money markets. Finland, France, Norway, and Spain have also within the last 15 years temporarily put restrictions on operations not covered by reservations. 2/

The areas in which there are the most reservations are the issuance of foreign securities on domestic markets, and credits and loans unrelated to the international trade of the member country. In contrast, commercial credits and loans, personal capital movements, life assurance, and the physical movement of capital assets are almost unrestricted.

## 2. The European Union Directives

The Treaty establishing the EC assigned lower priority to the liberalization of capital movements than to the elimination of restrictions on trade and the creation of a customs union. Impediments to capital movements were to be eliminated progressively and "only to the extent necessary to ensure the proper functioning of the common market". 3/ In contrast to

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1/ Australia: Direct Investment (including banking, real estate, and mass circulation), operations in real estate, operations in securities, and Operations on money markets, other operations in negotiable securities and nonsecuritized claims, and financial credit and loans. New Zealand: Direct Investment (including acquisition of 25 percent or more of any class of shares in a New Zealand company), Operations in real estate, and Operations in securities on capital markets.

2/ Some of these reservations were made at the time of the 1989 amendment to the Code.

3/ See *European Economy*, No. 36, May 1988, p. 7.

the specific timetable laid down for the liberalization of trade, the Treaty left it to the Council to decide the pace of progress in the liberalization of capital movements.

Until the adoption of the Single European Act in 1987, progress in liberalizing intra-Community capital movements was based largely on two directives (issued in 1960 and in 1962) on capital transactions. These related directly to the exercise of the other basic freedoms, which called for a complete liberalization of foreign direct investment, commercial credits and guarantees, personal capital movements, as well as the acquisition of foreign securities quoted on a stock exchange. Countries which had already liberalized broader categories of financial transactions agreed to maintain such liberalization. Under these directives, there was no commitment to liberalize short-term capital movements unrelated to trade. Overall, relatively little progress was achieved, and toward the end of that period several countries introduced exceptional measures affecting previously liberalized transactions. By the early 1980s, only five of the ten member countries (Belgium, Germany, Luxembourg, the Netherlands, and the United Kingdom) had abolished all exchange controls on capital movements. 1/

Progress in liberalizing capital movements resumed in 1983 in the context of discussions of financial integration within the EC area. In the following year, the authorization process for exceptional arrangements applied to capital movements was tightened. These efforts culminated in the ratification of the Single European Act in 1987, and a target date of December 31, 1992 was established for creating a common area free from any restrictions on the movement of goods, persons, services, and capital. The Act specifically required that all restrictions on capital movements still in force must be removed, and that all forms of discrimination affecting the provision of financial services across all member states must be eliminated. The Act explicitly recognized that full liberalization of capital movements is a necessary condition for the creation and the proper functioning of the common market. 2/

The adoption of the Single European Act reflected broad agreement that full liberalization of capital movements, integration of financial services, and reinforcement of the EMS were preconditions for completing the single market. To achieve that goal, the EC strengthened monetary cooperation and convergence efforts, and adopted measures to harmonize national rules and regulations with regard to the provision of banking and financial services and certain aspects of taxation (minimum VAT and certain excises). In parallel, policy coordination and the implementation of safeguard

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1/ However, Belgium and Luxembourg continued to operate a two-tier foreign exchange market.

2/ Various aspects of the creation of a single European financial market are discussed in "International Capital Markets, Part II. Systemic Issues in International Finance", *World Economic and Financial Surveys* (Washington: International Monetary Fund, August 1993).

arrangements were viewed as preferable to relaxing exchange rate discipline. Nonetheless, progress in this area was not considered a precondition for further liberalization of capital movements.

a. Forms of controls covered

When preparing the final directives for liberalizing intra-EC capital movements, the Commission identified three broad categories of capital movements: (i) capital operations including commercial credits, direct investment, and various capital movements, all considered directly linked to fundamental freedoms of the common market; (ii) operations in financial market securities, essential for the creation of a single European financial market; and (iii) financial credits and operations in money market instruments, necessary for the establishment of a unified financial system of the European Community.

Unlike the OECD Code, the Treaty did not define what was meant by "movements of capital". The practical application of the obligation to liberalize, and the safeguard clauses that allowed exceptions, were drawn up as Directives by the Commission. The nomenclature of movements of capital was first annexed to the 1960 directive and was based on earlier work by the Organization for European Economic Corporation. The directive ranked all movements of capital in four lists, each of which was subject to a different degree of liberalization: List A contained operations to be unconditionally liberalized at exchange rates as close as possible to the official rate; List B operations were also to be unconditionally liberalized but not necessarily at the official exchange rate; List C contained operations to be liberalized conditionally, in that restrictions could be reintroduced if such capital movements could disrupt the economic policy objectives of the member state; and List D contained operations in which member states made no undertaking regarding their liberalization except that they were obliged to notify the Commission of the rules governing them.

Lists A and B covered direct investments, investments in real estate, commercial credits and guarantees, personal capital movements, acquisition of foreign securities quoted on stock exchanges, transfers in performance of insurance contracts, authors' royalties, etc., which were all unconditionally liberalized.

Further liberalization of capital movements proceeded in two stages. The first stage was to complete the liberalization under the EU Law of the *Capital Operations most directly necessary for the proper functioning of the* common market, and for the linkage of financial markets within the common market. This was enforced under the Council Directive of November 17, 1986, which set February 28, 1987 as the latest date for compliance. The key element of the second directive, adopted in June 1988, was the goal of full liberalization of short-term capital movements, regardless of whether they were linked to current account transactions, including monetary movements, shifts in leads and lags, and speculative positions. 1/ All the remaining restrictions were to be eliminated by end-1992. The EU Directives on capital account liberalization therefore differ in an important respect from that of the OECD, because they embody forms of compulsion and compliance dates.

The second Directive also sought to end the possibility of dual foreign exchange markets as well as the maintenance in the domestic regulations of member states of discriminatory forms of treatment relating to capital operations based on nationality, place of residence of the parties, or on the location of the capital invested. Moreover, EC residents were to be treated equally. Nonetheless, restrictions could still be imposed on non-EC residents. The second Directive reclassified the obligations within the rules of unconditional liberalization by merging Lists A and B, repealed the First Directive of May 11, 1960 and set July 1, 1990 as the latest date for compliance.

b. Transitional arrangements

In order to make it less difficult to bring all the authorized restrictions to an end at once, the Directive ensured that there was partial liberalization for countries with exceptional circumstances, such as time of accession to the EU, balance of payments difficulties, high external debt, or an underdeveloped national financial system. In this regard, under Article 5 of the June 1988 Directive, transitional periods for compliance were given to Greece (1992), 2/ Ireland (1990), Portugal (1992), and Spain (1990), for a variety of reasons such as precarious balance of payments positions, high external indebtedness, and less-developed financial systems. Article 3 provides a safeguard clause which permits the reintroduction of controls on short-term capital movements if they seriously endanger a member state's monetary or exchange rate policy as follows: "where short-term capital movements of exceptional magnitude impose severe strains on foreign-exchange markets and lead to serious disturbances in the conduct of a Member State's monetary and exchange rate policies, being reflected in particular in substantial variations in domestic liquidity..." The introduction of such measures does not require advance approval by the Commission and other countries. However, mutual consultations are required about adequate measures when dealing with disruptive capital movements to or from third countries. The member state may take protective measures as a matter of urgency or consult with the Commission to authorize these measures. In the former case, the Commission, after consulting with the

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1/ For more discussion of the related issues and the text of the Directive see "European Communities (EC) - New Directive on the Liberalization of Capital Movements", SM/88/158, 7/26/88. At that time, the staff expressed the view (footnote 1, p. 3), that "the directive is consistent with the Fund's functions and its member obligations under Articles IV, VI, and VIII of the Articles of Agreement."

2/ The transitional period for Greece was subsequently extended to June 1994, and Greece liberalized short-term capital in May 1994.

member state, decides whether the measures should be continued, amended, or abolished. The protective measures can be applied for a maximum period of six months.

The operations on which protective measures can be taken include: operations in securities and other instruments normally dealt in the money market; operations in current and deposit accounts with financial institutions; operations in units of collective investment undertakings; short-term financial loans and credits, personal capital movements (loans); and physical import and export of financial assets.

The provisions of capital liberalization directives were incorporated in the Maastricht Treaty. 1/ Under the Treaty, all restrictions on capital movements and payments within the EU and between the EU and third countries are prohibited, except for restrictions that were in place as of end-1993, which could be maintained until end-1995. 2/ In exceptional circum-stances, when movements of capital to and from third countries can disrupt or threaten to disrupt the operation of the economic and monetary union, the Council may adopt measures restricting the movement of capital to and from third countries, involving direct investments (including in real estate), establishment, the provision of financial services, or the admission of securities to capital markets.

A progressive phasing of capital liberalization measures is envisaged for countries seeking EU membership. The association agreements signed between the EU and six eastern European countries provide a framework for ongoing economic integration with the EU, including in the areas of trade in goods and services, and the movement of capital and labor. 3/ During the transition period, the contracting parties agree to remove all restrictions on foreign direct investment, including on profit remittances, and on the

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1/ See "Treaty on European Union", Council of the European Communities, Commission of the European Communities, Brussels, 1992, especially Article 73a-h, and Article 109h-i under Title II, including provisions amending the Treaty establishing the EEC, with a view to establishing the EU.

2/ Article 73b (op. cit., p. 18) explicitly states that all restrictions on payments and on capital movements between member states and between member states and third countries shall be prohibited.

3/ In December 1991, the EU signed association agreements with the governments of Czechoslovakia, Hungary, and Poland. The agreement with Czechoslovakia was replaced by separate agreements with the Czech Republic and Slovakia in October 1993, and similar agreements were concluded with Romania and Bulgaria in February and March 1993. For further discussion of the trade liberalizing aspects of the agreements, see Annex IV to "Economic Union - Common Policies and Recent Institutional Developments - Supplementary Materials - Annexes", (SM/94/120, Sup. 1, 5/18/94). Association agreements with Baltic countries were signed recently, but have not yet been ratified, while negotiations are underway on an agreement with Slovenia.

repatriation and liquidation of these investments. In addition, in the first stage of that period, measures should be taken to create the necessary conditions for the increased application of EU rules on the free movement of capital, and no new restrictions could be introduced. During the second stage, the efforts will be intensified to enable full application of the EU rules on capital movements.

The association agreements include safeguard provisions that could be applied in case of serious balance of payments difficulties. Under such circumstances, countries can adopt restrictive measures on imports or capital movements for a minimum period absolutely necessary to remedy the balance of payments situation. However, no restrictive measures can be applied to foreign investment, and in particular to the repatriation of invested amounts or associated revenues. Furthermore, the agreements allow for the introduction of restrictions on granting or contracting of short- and medium-term credits by the associated countries as long as their currencies have not full convertibility in the meaning of Article VIII of the Fund, and to the extent that the restrictions are permitted according to their status in the Fund.

The full benefits of the liberalization of capital movements cannot be realized if investment decisions, regarding both direct and portfolio investment, are distorted by significant differences between member states in corporate and personal taxation of capital or taxation of income from capital. The positions of governments on the harmonization of taxation of income from capital differ widely. There is no agreement on how disparities in tax treatment will distort capital flows, while other countries are concerned about the loss of revenue that they would incur if their tax rates were aligned with those of the low-taxation countries.

3. World Trade Organization

The WTO was established in 1995 to provide a common institutional framework for the conduct of trade relations among its members as contained in the associated agreements dealing with trade in goods and services and intellectual property. 1/ Membership in the WTO involves acceptance of several agreements, including the Multilateral Agreements on Trade in Goods (of which the General Agreement on Tariffs and Trade (GATT) 1994 is the best known), the General Agreement on Trade in Services (GATS), and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). 2/ The

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1/ See *Agreement Establishing the World Trade Organization*, Article II, paragraph 1, included as an Appendix to "The World Trade Organization--Institutional Aspects", (SM/94/304, 12/20/94). For a discussion of jurisdictional aspects of the WTO relationship with the Fund, see "The Relationship of the World Trade Organization with the Fund--Legal Aspects", (SM/94/303, 12/30/94).

2/ The Agreement Establishing the WTO, and associated agreements, were adopted as part of the "Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations", April 15, 1994.

GATS includes provisions proscribing members from imposing restrictions on capital transactions related to the provision of services identified in such agreements.

Although the primary objective of these agreements is the freedom to provide services and not the related capital movements, "the GATS is the first agreement of universal (as opposed to regional) application that proscribes certain restrictions on capital transactions". 1/ The GATS obligation on capital movements extends to particular capital transactions that are associated with "specific commitments" intended to liberalize trade in services. 2/

4. CFA franc zone

Countries adhering to the franc zone have maintained limited capital convertibility. The CFA franc zone was established at the end of 1945, although the current monetary arrangements with France date from 1973. 3/ Under these arrangements, the convertibility of the CFA franc is supported by an operations account maintained by each of the zone's two central banks with the French Treasury. Capital transactions between member countries, including France and Monaco, have been free of exchange controls, although capital transfers outside the zone are restricted and require approval. Inward capital transfers are free of restrictions except for foreign direct investment and borrowing transactions, which are subject to registration and authorization. Direct investment abroad and lending require the prior approval of the Ministry of Finance of a member country.

## II. Survey of Capital Controls in Developing Countries 4/

One quarter of the 155 developing country members of the Fund were free of restrictions on capital transactions, either in the form of exchange controls on capital movements or restrictions on underlying capital transactions, at the end of 1993 (Table 1). Controls on capital flows appear to have been in place in the rest of the Fund membership to varying degrees. However, definitive statements in this area are difficult because as, reflecting the jurisdictional mandate of the Fund, the reporting by members of capital controls is less detailed than that of restrictions on current international payments and transfers. A positive list approach is used by

1/ SM/94/303, op. cit., p. 44.

2/ Under the GATS, countries undertake commitments according to a positive list approach whereby they offer market access and treatment only for the service industries listed in their schedules.

3/ For recent reviews of CFA franc zone issues see "Common Policy Issues of the CFA Franc Zone Countries", EBS/94/151, (7/29/94), and "A Review of the CFA Franc Arrangements", SM/90/136, (7/9/90).

4/ The data in this Annex are those reported by country authorities for the *Annual Report on Exchange Arrangements and Exchange Restrictions*, 1994.

Table 1. *Capital Controls in Developing Countries:*
Reporting by Category

| | Number of Countries Maintaining Controls 1/ |
|---|---|
| (i) Any form of capital control | 119 |
| (ii) Comprehensive controls | 67 |
| - on outflows | 67 |
| - on inflows | 17 |
| (iii) Foreign direct investments: | 107 |
| - of nonresidents | 84 |
| - of residents | 35 |
| Profit repatriation and capital liquidation | 34 |
| Taxes on capital transactions | 9 |
| Nonresident-controlled enterprises | 6 |
| (iv) Portfolio investments: | 61 |
| - of nonresidents | 30 |
| - of residents | 33 |
| Security issuance by nonresidents | 15 |
| Security issuance abroad by residents | 6 |
| Debt-to-equity conversion | 2 |
| (v) Financial transactions: | 78 |
| - of nonresidents | 41 |
| - of residents | 66 |
| Trade-related financial transactions | 7 |
| Deposit requirements for borrowing from abroad by residents | 2 |
| (vi) Deposit accounts: | 83 |
| - of nonresidents in foreign exchange | 37 |
| - of nonresidents in local currency | 52 |
| - of residents abroad | 29 |
| - of residents in foreign currency with domestic banks | 23 |
| (vii) Other capital transfers: | 70 |
| - personal capital transfers | 34 |
| - blocked accounts | 24 |
| - real estate transactions: | |
| - of nonresidents | 23 |
| - of residents | 30 |

Source: *Annual Report on Exchange Arrangements and Exchange Restrictions, 1994.*

1/ A total of 155 countries were surveyed.

many developing countries so that regulations covering capital transactions permitted freely or subject to an approval process are reported. However, in other countries, capital controls (either in the form of outright prohibitions or provisions on an ad hoc basis) are not specifically reported, but are included in a general statement that capital transactions are restricted. The restrictiveness of certain categories of developing countries' exchange controls on capital is therefore likely to exceed that specifically reported at present.

Capital control structures and enforcement methods vary considerably from country to country, both concerning the forms of transactions and transactors (juridical persons and individuals) that are influenced by the controls. Methods to enforce the exchange controls may involve registration or licensing of capital transactions. The transactions may be subject to an approval process, quantitative restrictions and limitations imposed on the scope of transactions (e.g., the maturity structure restricted), or outright prohibition. 1/ Given that capital controls most often reflect authorities' concerns about capital flight, capital outflows tend to be more widely and tightly regulated than inflows. The result is that capital account transactions of residents are typically more restricted than those of nonresidents.

For the purpose of structuring this survey, exchange controls affecting capital account transactions of residents and nonresidents are organized into five different categories: (i) foreign direct investments of residents and nonresidents; (ii) portfolio investments; (iii) borrowing and lending by residents and nonresidents involving resident and nonresident institutions; (iv) transactions effected through deposit accounts; and (v) other capital transfers. Finally, a table provides numerical information about the extent of each category of controls reported in the *Annual Report on Exchange Arrangements and Exchange Restrictions*.

## 1. Foreign direct investment 2/

Regulations limiting foreign direct investment by residents and nonresidents are reported by 91 developing countries. Of these countries, investment activities of nonresidents are regulated in 84, and those of residents in 35. Forms of controls include: (i) special procedures for the approval of investment applications; (ii) regulation of repatriation or reinvestment of profits; and (iii) regulated liquidation of the initial

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1/ Some capital transactions may be approved by an authorized bank up to a certain amount, while amounts exceeding this limit must be authorized by the central bank (in some countries the Ministry of Finance). Reporting to the central bank may be required, certain transactions may be subject to notification (ex ante notification), or sometimes notification may be accompanied by inspection.

2/ Regulations on foreign direct investment, where the underlying transaction is restricted but capital remains unrestricted, would not normally constitute capital controls.

investment. While more developing countries control direct foreign investments by nonresidents, these exchange controls appear to be less restrictive and more flexible than controls affecting investment outflows of residents. For example, foreign funds are relatively easily converted into domestic currency for investment purposes, whereas conversions of domestic funds into foreign exchange by the residents for investments abroad are often subject to ceilings or are prohibited.

Controls on inward direct investments are often very selective, being used to limit rather than prohibit investment activities, or to try and direct them to certain specific sectors of the economy (such as export-oriented industries). 1/ Direct investments of nonresidents in specific industries are, however, frequently prohibited. 2/ Limits are also often imposed on the minimum amount of capital that must be invested by the nonresidents, or on the aggregate share of foreign ownership of enterprises. In some cases the share of foreign equity ownership is tied to the percentage of exports in total production. 3/ Foreign investments from certain regions may be treated more liberally than investments originating in other parts of the world. 4/ Activities of majority-owned nonresident enterprises are frequently more restricted than those in which the foreign participation is below 50 percent. Repatriation of profits and initial capital following liquidation is regulated in 34 countries, while in 9 countries taxes are imposed on transfers of capital from direct investment. In one reported instance, the share of foreign ownership arising from direct foreign investment must be lowered one decade after the investment. Different exchange rates are sometimes used in the context of foreign direct investments; for example, two countries apply a more depreciated exchange rate for direct investments.

Specific regulations governing foreign direct investments of residents are reported by 35 developing countries. Prior approval from the Ministry of Finance, central bank, or investment board is often required to effect such transactions, but a requirement to finance outward direct investments by borrowing the required funds abroad may also be imposed on residents.

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1/ This is often the case even when no exchange controls are enforced.

2/ The industries typically include defense, petrochemical sector, utilities, law, education, communication, transport, and handcraft.

3/ For example, full ownership is allowed in Malaysia when exports are 80 percent of output or more, 79 percent ownership is allowed when the export share is from 51-79 percent, 51 percent ownership is allowed when exports represent 20-50 percent of output, and 30 percent ownership is allowed when the exports are less than or equal to 20 percent of output.

4/ Member countries of WAEMU and the Common Monetary Area (CMA) maintain liberal policies with regard to direct investments from member countries, but the direct foreign investments from other countries are regulated more tightly. Another example is Iraq, which treats direct investments from Arab countries more liberally than investments from other countries.

In most cases, the authorities require that residents provide information on income derived from investments abroad, for purposes of taxation or exchange control.

2. Portfolio investment

One fifth of developing countries report exchange controls affecting portfolio investments. In the case of inflows, few restrictions are generally imposed, either because such investments are welcomed or because the domestic financial system is undeveloped and portfolio-type investments are not available. In the case of outflows, investments by residents abroad are often prohibited as part of a comprehensive exchange control system. In this case, the restrictions may not be reported separately.

Issuance of securities by nonresidents in the domestic market are reported to be regulated in 15 countries, while the issuance of securities by residents in foreign markets is regulated in only a few countries. Other forms of controls on portfolio investments include, inter alia, limits on the type of domestic, municipal, or public utilities stocks, and shares of listed private companies. Individual and general limits are imposed on the number of shares that can be acquired by nonresidents, both in absolute terms or as a percent of paid-up capital. Moreover, the restrictions on repatriation of dividends and capital gains are often tied to placing the funds in blocked accounts (indefinitely or for a fixed period of time). Some countries restrict transfers of domestic securities between residents and nonresidents. 1/ A number of developing countries impose a ceiling on the share of foreign securities in the portfolio of pension funds, mutual funds, and investment companies. In a few cases, special rules apply to debt-to-equity conversion, 2/ and limits are imposed on the acquisition of foreign securities by individual residents.

3. Borrowing and lending

One half of developing counties report regulations on borrowing and lending transactions between residents and nonresidents. Most of these countries restrict borrowing from abroad, with the controls varying from registration with the authorities to meeting certain criteria on loans, including volume, interest rate, term, and grace period. 3/ About

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1/ The consent of the authorities may be required for the transfer of domestic shares by residents to nonresidents, or for a stock transfer from a resident to a nonresident, and between nonresidents.

2/ For example, Costa Rica imposed an annual limit of 6.25 percent of the face value of the debt converted on dividend remittances associated with debt-equity conversion. In Venezuela, certain public debt can be converted into equity and investors are required to deposit a guarantee equivalent to 5 percent of the total investment.

3/ Separate regulations normally apply to financial transactions that are associated with imports and exports. However, regulations may be applied to limit the terms of such contracts (e.g., the maturity of letters of credit).

one quarter of developing countries report that nonresidents are not permitted to borrow from residents in either the domestic currency or foreign currencies. Specific regulations for trade-related financial transactions (e.g., involving maturity) are implemented in a few countries. 1/ Some developing countries set deposit requirements for foreign borrowing by residents, and in others the controls on borrowing abroad differentiate between public and private sectors, banks, and nonfinancial enterprises, or individuals and companies. Special provisions may also be in effect for export-oriented industries and enterprises. Approval of applications for foreign loans is assigned to an authorized bank, central bank, or Ministry of Finance, depending on the size and purpose of the loan in question. In a few cases, limits are imposed on total foreign borrowing of private banks.

4. Deposit accounts

Deposit accounts opened by residents and nonresidents in either domestic or foreign currencies are reported to be regulated by 83 countries, albeit to varying degrees. By comparison, nonresidents' accounts denominated in domestic currency are regulated in 52 countries, while nonresidents' accounts denominated in foreign currencies are regulated in 37 developing countries. In order to open accounts, certain requirements may be enforced regarding the domicile of the applicant, origin of the funds, etc. Resident accounts in foreign exchange with domestic banks are controlled in 23 countries, and those with foreign banks in 29 countries. In most cases, the central bank issues positive list regulations permitting certain debit and credit transactions from such accounts, as well as allowing movements of funds between designated accounts.

Restrictions are often imposed on transactions between nonresident and resident accounts, or between local and foreign currency accounts. As a general rule, transfers between similar accounts are not restricted. Administration of all or some transactions that will be effected through these accounts is often delegated to authorized banks. Accounts held by immigrants, emigrants, citizens living permanently abroad, as well as expatriates, are occasionally granted more liberal treatment compared with similar accounts of residents and nonresidents.

5. Other capital controls

Other miscellaneous capital transfers subject to controls include personal transfers of capital, and the purchase and sale of land and residential properties. Authorities of 34 developing countries report that they have imposed controls on personal capital transfers, including gifts, endowments, inheritances, remittances abroad by nonresident employees, emigration, and immigration. 2/ Annual per capita or per family limits on

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1/ Within the meaning of the Fund's Article XXX, such restrictions can apply to current international transactions.
2/ See previous footnote.

such transfers are generally set, while approval of the Ministry of Finance or central bank is required for amounts exceeding these limits. The following forms of exchange controls involving personal transfers are used most frequently: (i) emigration allowance limits; (ii) individual permission and licensing of transfers of personal capital; (iii) restriction of annual allocations of inheritances; (iv) limits on the share of earnings eligible for remittances abroad by foreign workers; and (v) limits on gifts between residents to nonresidents. Blocked accounts are reported by 24 countries.

Transactions involving land and other real estate are restricted in 45 developing countries; the restrictions apply to residents' cross-border transactions in 30 countries. Purchase of real estate and its liquidation by nonresidents are governed by special regulations in 23 countries, based on various laws and government decrees affecting ownership of land and other immovable property. Restrictions on the transactions vary from explicit bans on the acquisition of land and real estate by nonresidents or by citizens living abroad, to limits on the size and location of property. Some countries restrict ownership by nonresidents to long-term (up to 50-year) leases on land.

## III. Recent Experiences with Capital Controls: Chile, Colombia, Malaysia, and Venezuela 1/

### 1. Chile

Chile's economy was seriously affected by the debt crisis of the 1980s. Growth slumped sharply through the mid-1980s, following which effective stabilization polices were introduced. Rapid recovery then ensued, prompting the Central Bank of Chile to attempt to reduce aggregate demand by raising interest rates. The official reference interest rate was increased by about 2 percentage points to 8.7 percent (in real terms) in January 1990, pushing the real bank lending rate to about 16.5 percent. 2/ At that time, the exchange rate was being managed flexibly, being allowed to fluctuate within bands 5 percent either side of a central reference rate. The reference rate was adjusted daily with the goal of offsetting the differential between local and world inflation on an annual basis. Following the tightening in monetary policy, the exchange rate began to appreciate toward the top of the band, and by June 1990 it was about 7 percent more appreciated than it had been in January. Nevertheless, short-term capital inflows began to surge, prompting the introduction of policies from 1991-92

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1/ These issues were also reviewed in the recent international capital markets report (SM/95/101, 5/11/95, Chapter VI).

2/ Most financial instruments in Chile are indexed, and the Central Bank influences the level of domestic real rates mainly by open market operations in its indexed instruments.

(primarily with measures to control and discourage inflows, as well as increased exchange rate flexibility) designed to limit them while still maintaining an attractive environment for long-term inflows.

a. Reintroduction of controls on inflows

Prior to 1991, capital flows into Chile were reasonably free of restrictions, reflecting the economy's need for foreign savings, while most outflows were restricted. The restrictions on inflows in place then and now include: a 30 percent nonremunerated reserve requirement to be constituted for one year on all external liabilities, irrespective of their maturity, a minimum one-year holding period for all foreign investments (direct and portfolio investment) and a minimum amount and minimum rating requirement for all ADRs and bonds issued by Chilean companies. All foreign borrowing and investment flows are subject to prior authorizations by the Central Bank, although this regulation appears not to have been used for capital control purposes in the recent past.

Following the initial surge, in June 1991 a stamp tax of 1.2 percent was imposed on foreign borrowing, to equate the tax treatment of domestic and foreign borrowing, and a reserve requirement of 20 percent was applied to all new foreign borrowing (except trade credits). A phased extension of the reserve requirement to existing borrowing was introduced the following month. 1/ In January 1992, the reserve requirement was extended to foreign currency bank deposits at commercial banks. A further attempt to slow the expansion of private demand led to another round of interest rate increases between March and November 1992, as the Central Bank gradually raised the real annualized interest rate on its 90-day paper from 4.7 percent to 6.4 percent.

Other measures were taken concurrently. In January 1992, the official exchange rate of the peso was revalued by 5 percent, and the exchange rate band was widened to 10 percent on either side of the reference rate, allowing the exchange rate to appreciate immediately by about 3 percent. During 1991-92, the Central Bank conducted open-market operations to sterilize the monetary effects of the capital inflows. With international interest rates declining, however, short-term capital inflows surged again. In March 1992, in response to the continuing inflows, exporters were allowed to keep 10 percent of their export proceeds in foreign currency; and in May 1992, the reserve requirement on foreign liabilities of commercial banks was increased to 30 percent and some capital outflows were liberalized. The reserve requirement on direct foreign currency borrowing by nonfinancial enterprises was extended to 30 percent in August 1992 (further liberalization measures regarding outflows were introduced in July and October of that year).

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1/ The reserve requirement applies without interest for a one-year period, after which the Central Bank returns the funds.

b. Role of the controls

Net short-term private capital inflows recorded in the balance of payments declined in 1991, the first year of restrictions on inflows. However, both estimated misinvoicing and net errors and omissions may also reflect capital inflows. These flows increased sharply in 1991, so that the aggregate contribution of these items and short-term inflows to the capital account surplus increased, despite the introduction of the controls (Table 2). 1/ As noted, short-term inflows surged again in 1992, but then fell in 1993 (although they remained significantly positive). Both estimated misinvoicing and net errors and omissions also fell in 1993, while long-term inflows increased, indicating that the strengthened controls may have had some effect on the maturity structure of inflows, although total recorded capital inflows were little changed. 2/ Total capital inflows into Chile appear to have surged again in 1994. These developments may be taken to imply that the controls were of limited macroeconomic effectiveness.

The effectiveness of capital controls may be investigated by comparing offshore and onshore interest rates, to the extent that controls drive a wedge between these rates. 3/ Effective capital controls should allow the authorities to maintain higher real interest rates than would otherwise have been possible. Comparing the period after mid-1992, when the process of widening and intensifying the controls was completed, to that before, there is no discernible increase in real interest rates (Chart 1). On the other hand, interest rates were generally quite positive, and it might be argued that the size of any risk premium contained in real rates should have fallen during the period as the authorities' reform program proceeded and capital inflows occurred.

The impact of capital controls on interest rates can also be examined by looking at differentials between domestic and foreign interest rates adjusted for forward exchange rate premia or discounts, i.e., covered interest parity. As is the case with many developing countries, no forward foreign exchange

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1/ The method of calculation of estimated misinvoicing is stated in the footnote to Table 2.

2/ Another factor may have been a deterioration in the outlook for the peso as the current account went further into deficit, due in large part to a significant deterioration in Chile's terms of trade.

3/ Average nominal interest rates in Chile for terms of 30-89 days, deflated by inflation in the preceding 12-month period. (No data is available for offshore peso interest rates.) Alternative deflators (e.g., an average of the preceding and succeeding quarters' inflation) produce similar results.

Table 2. Chile: Estimated Trade Misinvoicing, Net Short-Term Capital Flows, and Net Errors and Omissions, 1988-93

(In millions of U.S. dollars; negative sign denotes outflow)

| | Estimated Misinvoicing 1/ | Net Private Short-Term Capital | Net Errors and Omissions | Total |
|---|---|---|---|---|
| 1988 | 532 | 41 | -109 | 464 |
| 1989 | -46 | 38 | -122 | -130 |
| 1990 | 44 | 927 | -32 | 939 |
| 1991 | 468 | 508 | 394 | 1,370 |
| 1992 | 664 | 1,368 | 359 | 2,391 |
| 1993 | 441 | 625 | -94 | 972 |
| Total | 2,102 | 3,507 | 396 | 6,006 |

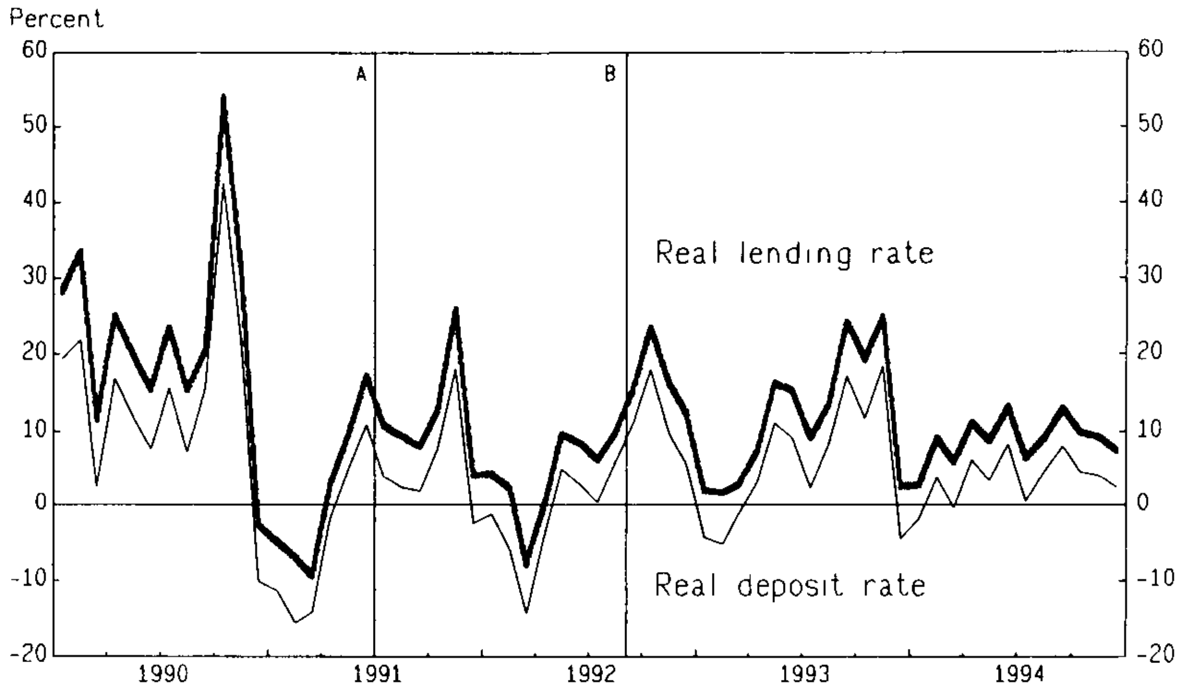
Sources: *IFS; Direction of Trade Statistics*; Chile--Recent Economic Developments; and Staff Reports.

1/ Chile's exports to the rest of the world minus rest of world imports from Chile plus rest of world exports to Chile minus Chile's imports from rest of world. Imports data are converted from c.i.f. basis to f.o.b. basis using c.i.f./f.o.b. factors from IFS.

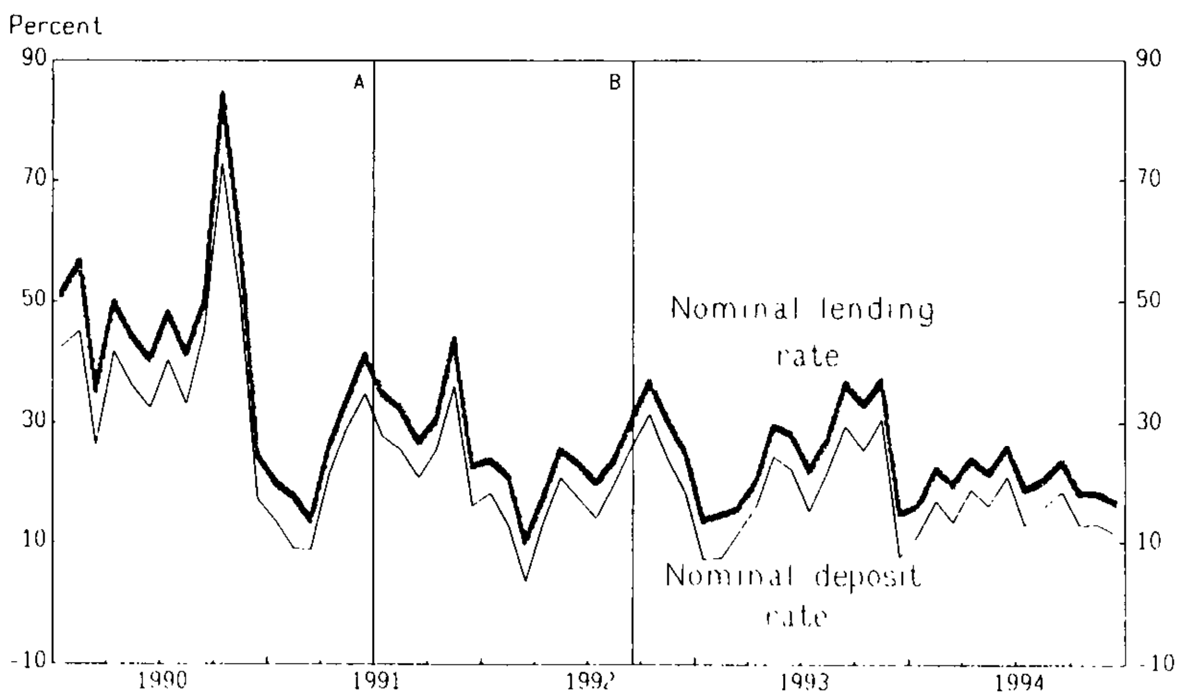
CHART No. 1

CHILE

Interest Rates




Interest Rates




A. Controls were introduced in June 1991.

B. Widening of controls was completed in August 1992

rate data are available for Chile, so that actual ex post exchange rate movement must be used as a proxy. 1/ Calculations on this basis for Chile show no clear shift, either upward or downward, in the adjusted interest rate differential following the introduction of the controls on capital inflows (Chart 2). 2/

Based on these developments, it is not possible to make a definitive statement regarding the effectiveness of Chile's capital controls. Real interest rates have generally not increased, but also have not fallen. Other factors, such as a deteriorating terms of trade and exchange rate appreciation, may have contributed to the slowdown of inflows in 1993 and any switching between categories of capital inflow may also be attributable to factors other than the controls. Moreover, it would appear from available data that inflows have surged again in 1994, despite continuing controls.

2. Colombia

In the mid-1980s, Colombia successfully undertook a comprehensive adjustment effort to deal with domestic and external imbalances. These policies and structural reforms that included liberalization of the external sector have helped to sustain relatively robust economic growth and a strong balance of payments position in recent years. Inflation has remained between 20-30 percent per year, owing initially to a generally accommodating monetary policy and, more recently, to a rapid increase in public expenditure.

Private capital inflows rose sharply in the early 1990s in response to a tax amnesty, financial liberalization, and higher interest rates. The authorities sought to sterilize these inflows through open market operations with a view to avoiding a real appreciation of the peso. The resulting increases in interest rates encouraged further capital inflows--also stimulated by improved investor confidence following the discovery of new oil fields--while sharply raising the Banco de la Republica's intervention costs. Recognizing that some degree of real appreciation was unavoidable in the light of economic fundamentals, policy was reoriented toward allowing more exchange rate flexibility, enabling monetary policy to be targeted at con-

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1/ This assumption that ex ante views are reasonably well reflected by ex post outturns is quite strong. Further, ex post movements in exchange rates can be quite abrupt, so that the adjusted interest rate differentials calculated in this way can exhibit significant volatility.

2/ Ineffective controls on capital inflows might also be expected to impact on the parallel foreign exchange market, which was legalized in April 1990 for all but a specified range of transactions, but official data on parallel market rates are available only since 1993.

trolling monetary aggregate growth. 1/ Continuing concerns regarding external competitiveness prompted the authorities to resort to increasingly restrictive controls on external indebtedness in 1993-94.

a. Introduction of controls on inflows

The authorities' policies were generally oriented toward a more liberal capital account in the early 1990s. However, in September 1993 in response to the strong capital inflows, the central bank imposed a tax on foreign borrowing in the form of a non-interest-bearing deposit requirement of 47 percent of the loan amount on all loans with a maturity of less than or equal to 18 months. In addition, the Banco de la Republica required that import payments be made within six months of the due date for the purpose of accelerating payments of outflows and increasing the cost of import financing. Import payments that were not settled during the six-month period were considered as debt and were subject to the deposit requirement. The non-interest-bearing deposit would be held at the Banco de la Republica for one year, but could be sold to the Bank at an annual discount rate of 13 percent. 2/

In the face of ongoing pressure toward appreciation of the peso, the restrictions on foreign borrowing were tightened twice during 1994. 3/ In March 1994, the deposit requirement was extended to foreign loans with maturities of up to three years. However, the borrower could choose to place a one-year deposit for 93 percent, an 18-month deposit for 64 percent, or a two-year deposit for 53 percent of the loan amount. In August 1994, the maximum maturity subject to the deposit requirement was extended to five years; the deposit as a percentage of the loan was also increased, ranging from 140 percent for loans with a maturity up to 30 days to 43 percent for loans with a maturity of five years (with a schedule of deposit ratios and maturities). These deposits would be held for a period corresponding to the loan maturity. In addition, the maximum period for payments of imports with-

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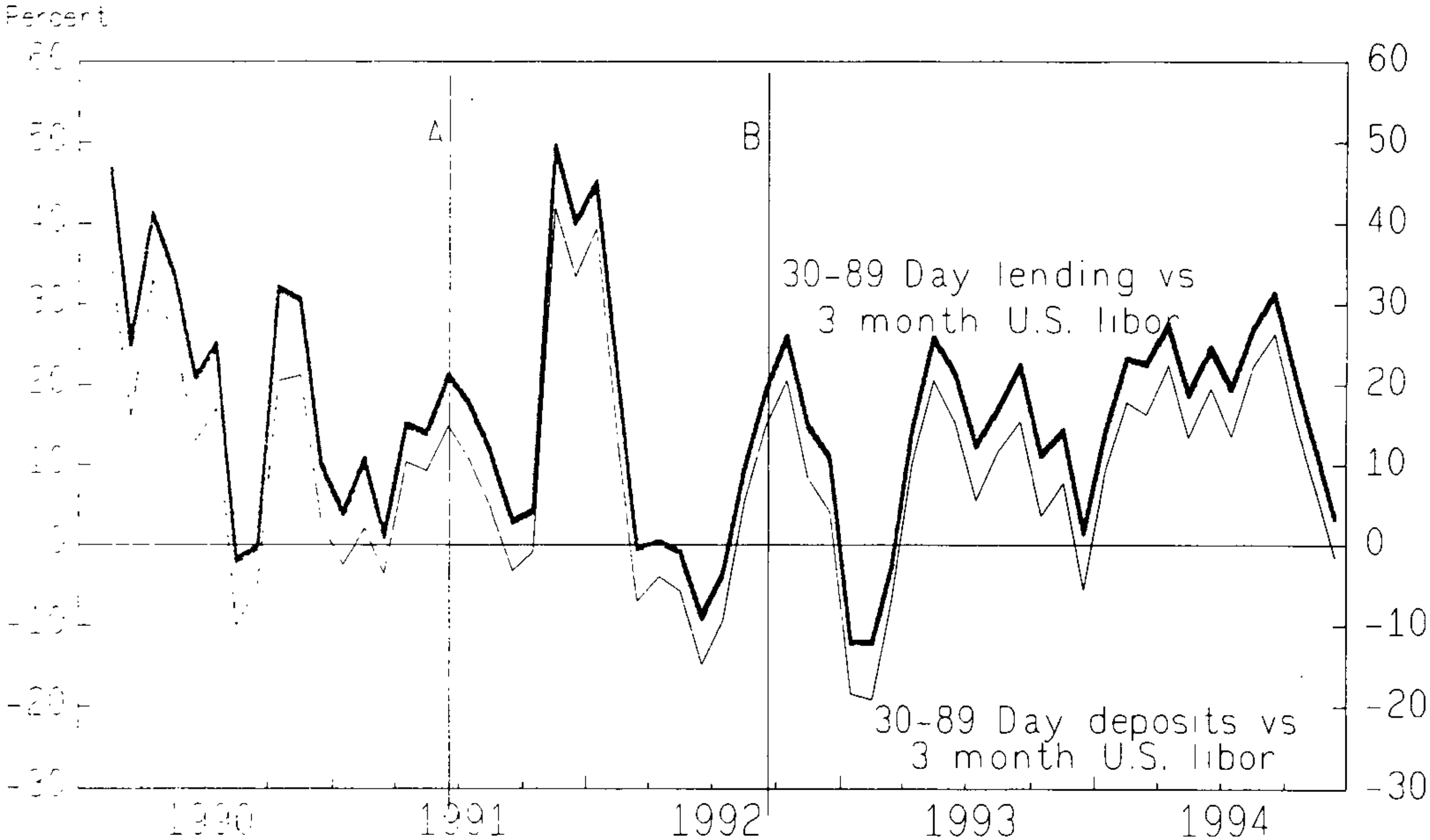
1/ A crawling peg policy was followed up until 1991. In June 1991, however, a market-determined regime was introduced, based on the trading of U.S. dollar-denominated certificates arising from export and other foreign exchange receipts which could be exchanged for foreign exchange to make external payments. The central bank continued to prevent the exchange rate from appreciating past a certain point, however, by setting a floor price for repurchase of the certificates before their one-year maturity at a 12.5 percent discount.

2/ Certain exemptions from the deposit requirement were granted, mainly for credits associated with imports of capital goods, as well as specific short-term loans and credits.

3/ In addition to these tightened restrictions, a managed floating exchange regime was introduced in January 1994, with the peso being allowed to float within a 14 percentage point band. In 1994, the midpoint of this band (in peso/U.S. dollar terms) was expected to increase by 11 percent during the year.

CHART No. 2

CHILE
Interest Rate Differential
(adjusted for exchange rate change)




A. Controls were introduced in June 1991
B. Widening of controls was completed in August 1992

out incurring a deposit requirement was shortened from six to four months. Further, rules for foreign borrowing for real estate purposes were also tightened in March 1994, when a minimum maturity for such loans was raised from two to three years, whereas in August all borrowing related to real estate transactions was prohibited.

b. Role of the controls

Despite the controls and the other changes in policy, capital inflows strengthened sharply from US$2.4 billion in 1993 to an estimated US$3.3 billion in 1994. The overall balance of payments surplus declined as the current account shifted into deficit during these years (Table 3). The recorded composition of these net capital inflows changed as borrowers moved further toward long-term maturities to avoid the deposit requirements; foreign direct investments and other long-term capital rose from US$1.6 billion in 1993 to US$4.5 billion in 1994, while short-term private sector capital net inflows declined from US$0.9 billion to US$0.1 billion.

The lack of availability of offshore interest rates for the peso also makes analysis of the impact of the capital restrictions on domestic interest rates problematic, although some indication may be obtained by examining whether the authorities were able to maintain higher real interest rates than would have been the case otherwise. A comparison of data for the period preceding September 1993, when controls were first introduced, and the subsequent period, suggests that both nominal and real interest rates have risen during the period when capital controls were used (see Chart 3). The rise commenced in the first quarter of 1994, around the time of the first round of tightening of the controls. It is difficult, however, to separate the possible impact of capital controls from other factors contributing to higher real interest rates, because the change in the exchange regime which took place at the same time allowed monetary policy to be directed more toward containing the growth of monetary aggregates.

An alternative view of the effectiveness of the measures in Colombia may be obtained by examining the differential between domestic and foreign interest rates, adjusted for the forward premium. In Colombia, no forward market rate exists, hence the actual ex post change in the spot rate has been used as a proxy for the forward rate. Chart 4 shows that the "covered" differential (thus measured) initially stayed stable following the introduction of the first set of controls in September 1993, but appears to have increased since December 1993. 1/ Once again, a qualification must be made due to the change in exchange regime and monetary policy stance in early 1994.

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1/ The increase in volatility in the differential since December arises because actual ex post exchange rates are used as a proxy for the forward expectations, and so discrete changes in the exchange rate are reflected by large changes in the adjusted interest rate differential.

Table 3. Colombia: Summary of Balance of Payments, 1990-94

(In millions of U.S. dollars)

| | 1990 | 1991 | 1992 | 1993 | Estimate 1994 |
|---|---|---|---|---|---|
| Current account | 581 | 2,306 | 735 | -2,242 | -3,189 |
| Capital account | 16 | -256 | 591 | 2,395 | 3,300 |
| Official capital (net) | -195 | -291 | -1,018 | -842 | -1,479 |
| Financial sector (net) | -890 | 587 | -599 | 796 | 243 |
| Private sector (net) | 1,101 | -552 | 2,208 | 2,441 | 4,537 |
| Direct investments | 484 | 433 | 740 | 769 | 1,410 |
| Long-term capital | -176 | -10 | 43 | 805 | 3,041 |
| Short-term capital 1/ | 793 | -974 | 1,425 | 867 | 86 |
| Overall balance | 597 | 2,049 | 1,326 | 153 | 111 |

Sources: Banco de la Republica, and Fund staff estimates.

1/ Includes errors and omissions.

Table 4. Colombia: Selected Data, 1990-94

| | 1990 | 1991 | 1992 | 1993 | Estimate 1994 |
|---|---|---|---|---|---|
| REER (1990=100) | 100 | 104 | 113 | 119 | 133 |
| Reserves minus gold 1/ | 4,212 | 6,029 | 7,389 | 7,552 | 7,750 |

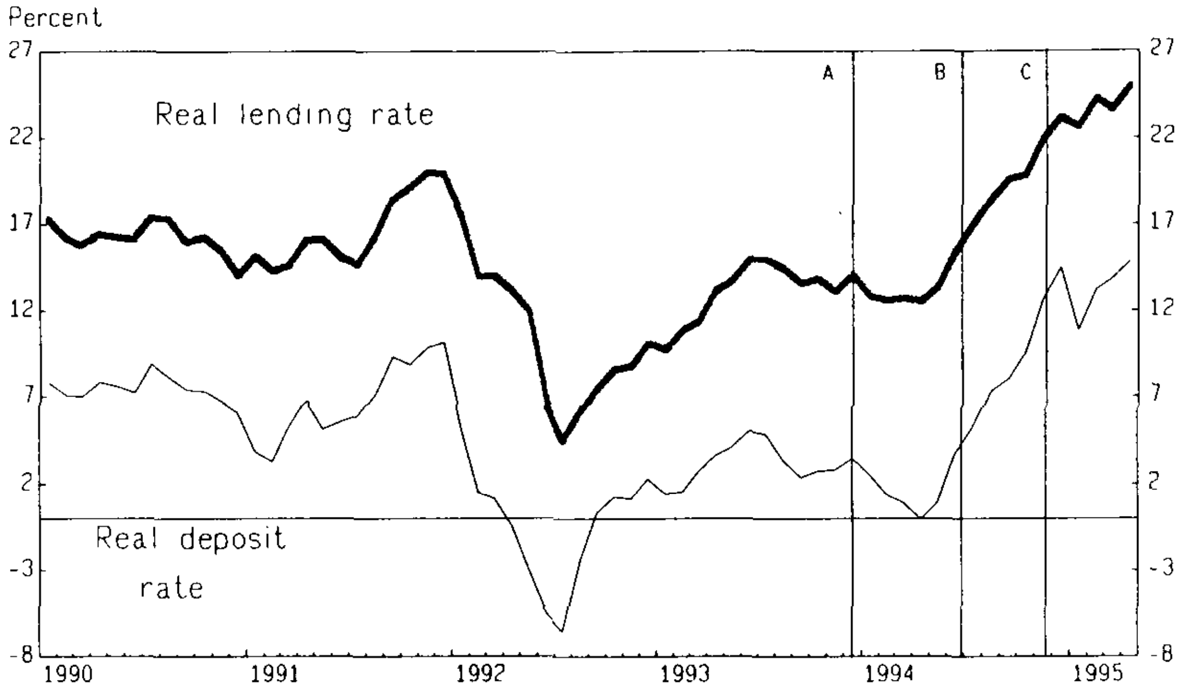
Source: IFS Statistics, April, 1995.

1/ In millions of U.S. dollars.

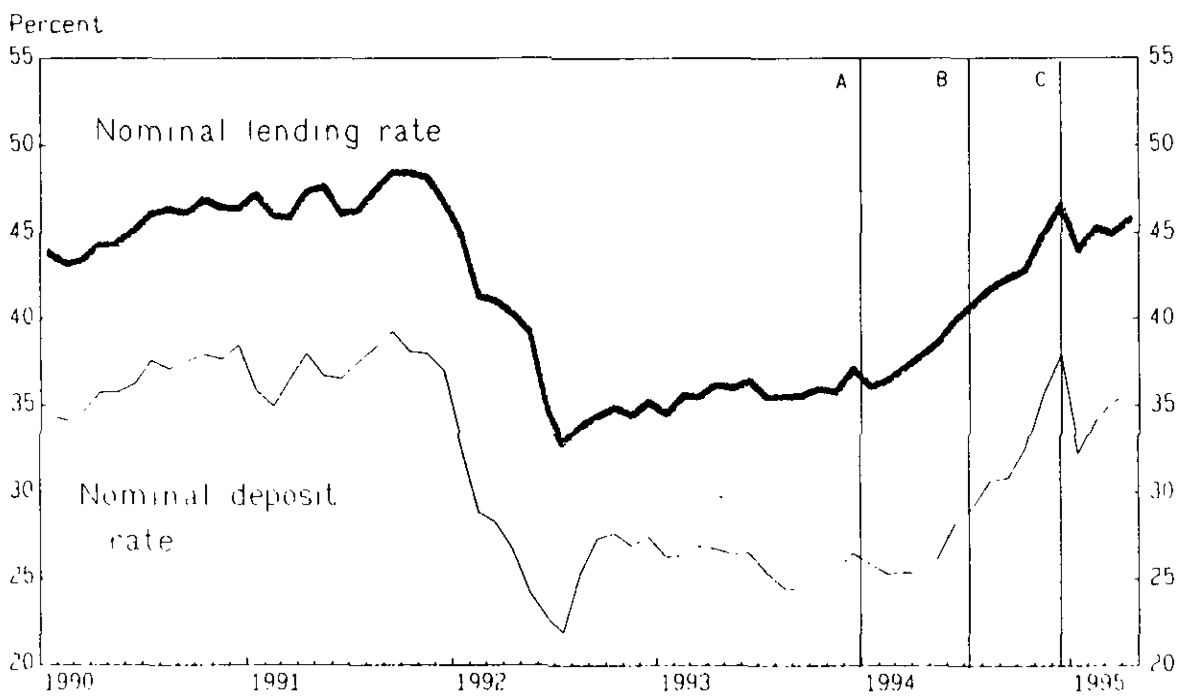
CHART No. 3

COLOMBIA

Interest Rates




Interest Rates




A Controls were introduced in September 1993

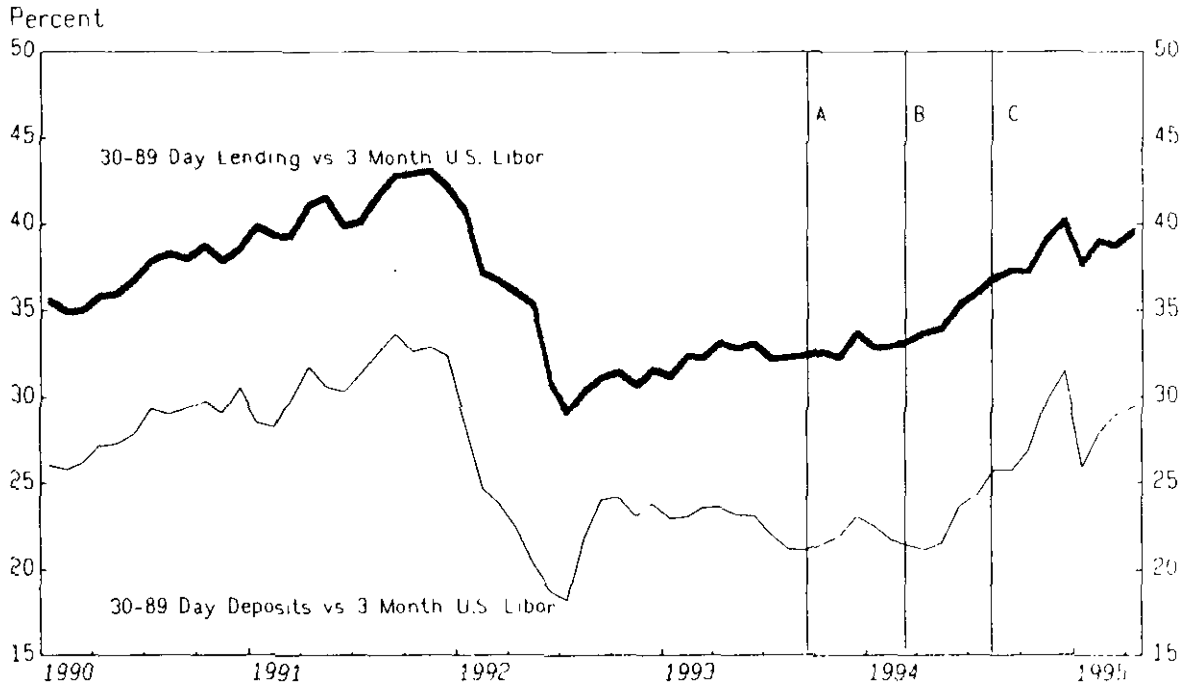
B Controls were tightened in March 1994

C Controls were tightened in August 1994

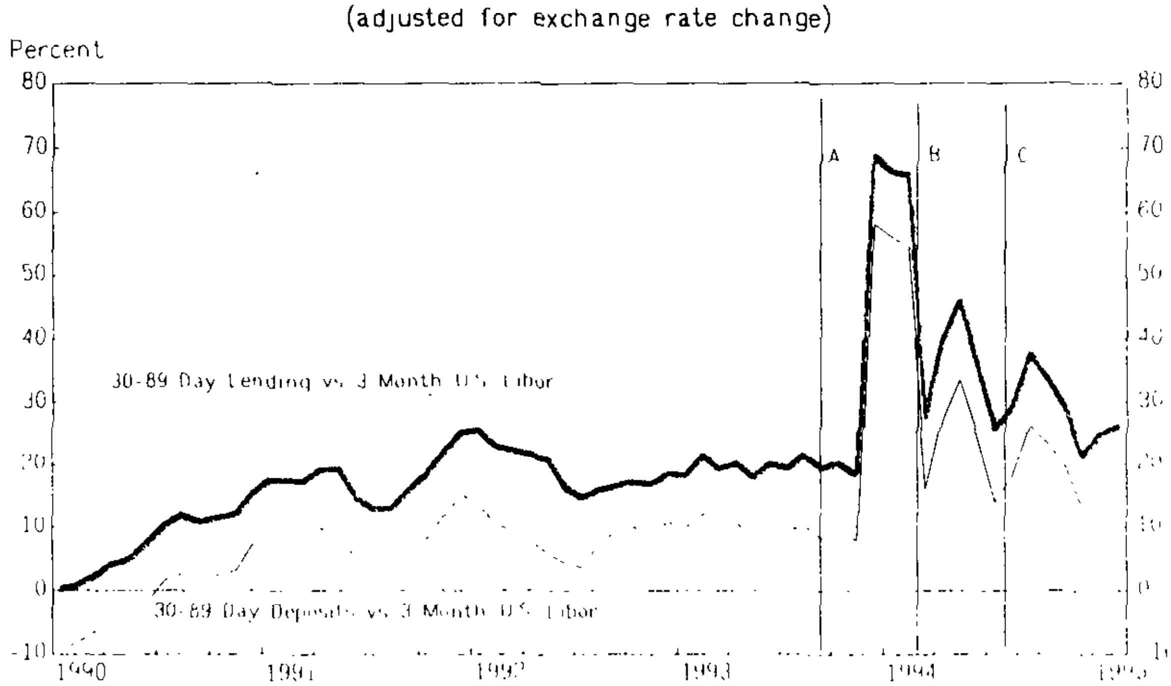
## CHART No. 4

## COLOMBIA

### Interest Rate Differential




### Interest Rate Differential
(adjusted for exchange rate change)




A Controls were introduced in September 1993

B Controls were tightened in March 1994

C Controls were tightened in August 1994

In summary, the evidence concerning the effectiveness of the capital controls in Colombia is inconclusive. While recorded short-term flows dropped following their introduction, this drop was more than offset by increased long-term inflows, contributing to further strong growth in monetary aggregates, while the real effective exchange rate appreciated further. If the aim of the controls was to slow the overall rate of capital inflows, they would not seem to have succeeded. If the goal was to alter the structure of inflows toward longer-term maturities, then it appears that they might have had some impact. However, simultaneous changes in exchange rate and monetary policies make it difficult to attribute the impact conclusively to capital controls.

### 3. Malaysia

Malaysia has been one of the fastest growing Southeast Asian economies since the 1960s, with high rates of domestic and foreign direct investment. Starting from the mid-1980s, as part of a policy package in response to the 1985-86 recession, the Government significantly liberalized international capital transactions. This package, together with an improving external situation, brought about an investment-led recovery starting in 1987, with real GDP growth subsequently averaging over 8 percent and inflation less than 4 percent. The positive economic climate attracted increasing foreign capital inflows starting in 1989, reflecting renewed interest in the Malaysian stock market, expectations of an appreciation of the ringgit, and a positive interest rate differential in favor of Malaysia. The surplus on the capital account grew rapidly. Foreign direct investment flows were very strong in 1989-91, especially from Japan and newly industrialized economies in the region, but levelled-off in 1992-93 when the capital account was dominated by a surge in short-term capital inflows. Errors and omissions in the balance of payments, seen by the authorities as unrecorded funds destined for the stock market, were almost as large as recorded short-term flows in 1993. The process culminated in particularly large overall balance of payments surpluses in 1992-93 (equivalent to 15 percent of GNP).

Bank Negara initially attempted to offset the effects of the foreign inflows on domestic liquidity by stepping up direct borrowing from the money market, selling Bank Negara bills, issuing long-term savings bonds, transferring government and other deposits to the central bank, and raising the statutory reserve requirement. Nevertheless, liquidity conditions eased during 1992-94, under the influence of the capital inflows. At the end of 1993 and in the first two months of 1994, Bank Negara managed a devaluation of the ringgit.

#### a. Reintroduction of controls on inflows

Limited controls on capital transactions were initially imposed in June 1992 when nontrade-related swaps by commercial banks were subjected to limits. As liquidity continued to grow substantially and capital inflows were sustained, more extensive controls were introduced in January and February 1994 and remained in effect through August 1994. These comprised:

(i) a ceiling on nontrade and noninvestment-related foreign liabilities of banking institutions; (ii) a prohibition on residents from selling short-term monetary instruments to nonresidents; (iii) an obligation for commercial banks to deposit at Bank Negara the ringgit funds of foreign banking institutions (vostro accounts of nonresident banking institutions) in non-interest-bearing accounts; 1/ and (iv) a prohibition of all non-trade related swap transactions and outright transfers on the bid side with nonresidents.

The Bank Negara Malaysia *Annual Report of the Board of Directors* for 1994 stated that the reliance on administrative measures was intended to be short-term in nature. Furthermore, "it was recognized that if such measures remained as a permanent feature in the system, possible market distortions could emerge, resulting in an inefficient allocation of resources". Consequently, other measures were introduced concurrently. The one-month interbank interest rate was reduced from 6.5 percent at the beginning of 1994 to about 4.5 percent in September 1994. As international interest rates were rising at the same time, the interest rate differential swung from about 3 percentage points in favor of Malaysia to about a ½ percentage point in favor of the United States from May onward (one-month Malaysian interbank market interest rate vis-à-vis U.S. one-month LIBOR) (Chart 5). After depreciating in January and February 1994 under the managed floating regime, the ringgit exchange rate appreciated from March to May 1994 and was stable thereafter. On balance, the ringgit appreciated against the U.S. dollar by 5.6 percent in 1994 (Chart 6).

The objective of containing price pressures by contracting liquidity was achieved by the end of 1994. The deceleration in money growth was underpinned by the turnaround in the overall balance of payments to a deficit equivalent to about 5 percent of GNP. This reflected the reversal of short-term flows, as corporate long-term capital inflows remained strong.

b. Role of the controls

The developments described are consistent with a role for the capital controls in stemming short-term capital inflows. However, there was also a pronounced change in macroeconomic policy that led to a sharp decline in domestic interest rates, together with exchange rate appreciation during most of 1994, that strongly influenced yield-sensitive short-term capital.

Examination of parallel exchange market developments is similarly inconclusive. The annual average parallel market premium for the ringgit has generally remained positive and below 1 percent, consistent with differences in transaction and information costs (Chart 6). However, a sizable positive premium emerged in mid-1992 and a negative premium

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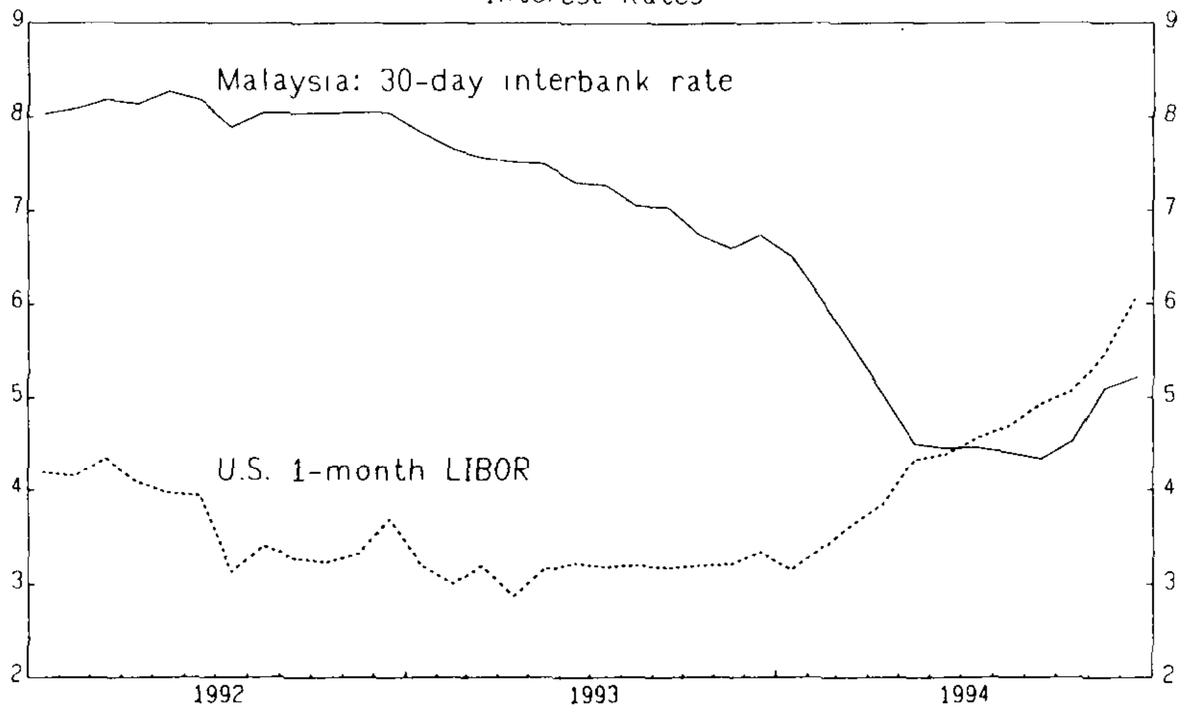
1/ In the period February-May 1994, these ringgit funds were also included in the eligible liability base for the calculation of required reserves, resulting in a negative effective interest rate on these balances.

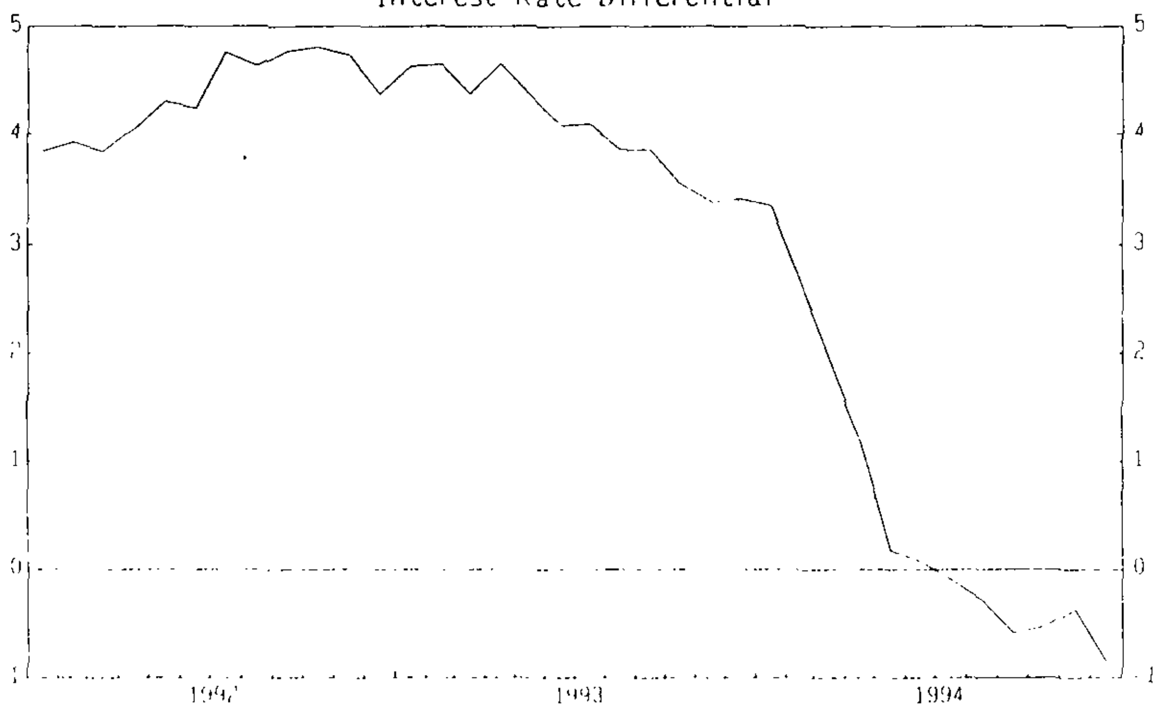
# CHART 5

## Malaysia

### Interest Rates




### Interest Rate Differential

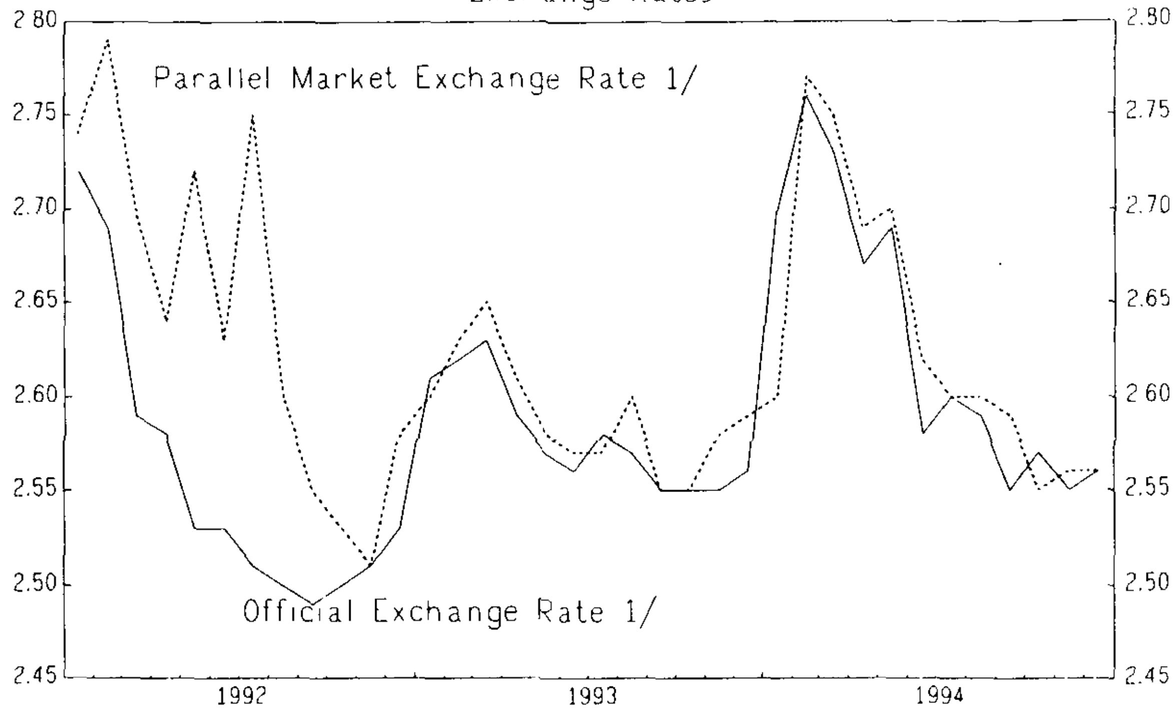



Source: The Asian Wall Street Journal; and IMF International Financial Statistics.

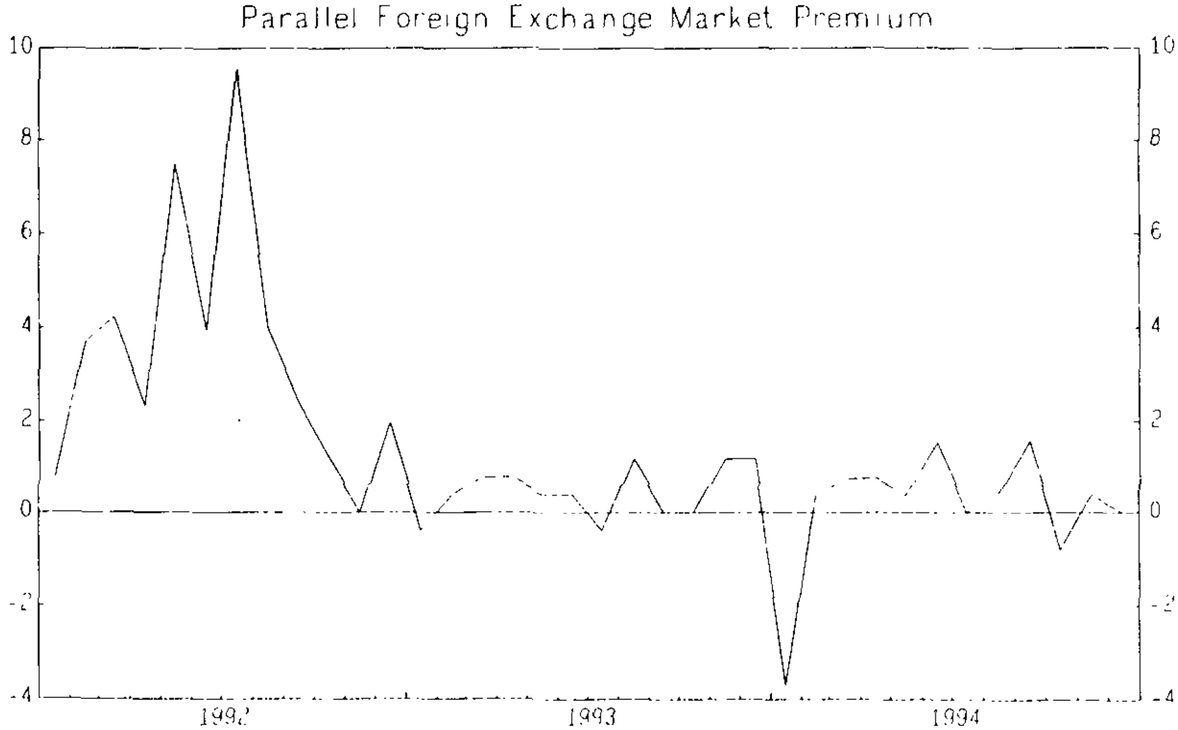
# CHART 6

## MALAYSIA

Exchange Rates




Parallel Foreign Exchange Market Premium




Source: IMF International Financial Statistics; International Currency Analysis, Inc., and International Reports.

1/ Ringgit per U.S. dollar.

(discount) of about 4 percent for one month at the end of 1993 when heavy intervention by Bank Negara was aimed at depressing the value of the official ringgit. 1/ If the introduction of the controls had shifted the demand for ringgit to the parallel market, a significant discount (negative premium) should have emerged in that market. However, the discount evident briefly before the reintroduction of controls did not re-emerge, an outcome which is consistent with the hypothesis that other factors, such as interest and exchange rate developments, reduced foreign inflows. This conclusion rests on the assumption that the controls would not be fully effective, so that some demand would be displaced to the parallel market.

The capital controls can also be examined by looking at interest rate differentials adjusted for forward exchange rate premia or discounts, i.e., covered interest parity. In the case of Malaysia, no forward foreign exchange rate data are available, so that actual ex post exchange rate movement must be used as a proxy. Calculations on this basis suggest that the covered interest rate differential has been declining since 1991, and that this trend continued in 1994 despite the introduction of the capital controls, suggesting that they were not effective (Chart 7).

4. Venezuela

Venezuela's financial performance improved sharply in 1990 when activity recovered strongly from an earlier downturn, inflation declined, and the balance of payments strengthened. However, performance subsequently deteriorated as a fiscal imbalance re-emerged in 1991 and widened in 1992, due to a decline in oil export revenue and delays in instituting reforms to expand the non-oil tax base. In addition, political instability and erratic monetary policy contributed to a decline in the growth of financial savings, runs on the bolivar, and large losses of international reserves in 1992.

The economy contracted in 1993, reflecting the effects of political uncertainty on consumer and investor confidence and a further drop in oil export prices. Although the interim Government maintained control over public expenditure and introduced a value-added tax (VAT), a large fiscal imbalance remained and significant public sector arrears accumulated. Before the general elections of December 1993, exchange pressures intensified, net international reserves (NIR) fell sharply, and the 12-month rate of inflation increased to 46 percent (compared to 32 percent at end-1993). In January 1994, a banking crisis developed, with the collapse of the second largest bank, and the fiscal situation worsened. These developments adversely affected confidence and accompanied by a loose monetary policy, contributed to sizable capital outflows, an acceleration of inflation, and a large depreciation of the bolivar exchange rate during the first half of the year.

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1/ The positive premium which emerged in 1992 appears to be due to a lagged response of the parallel market exchange rate at a time of rapid exchange rate changes.

a. Introduction of exchange controls

In the face of heavy reserve losses, the crawling peg exchange rate policy implemented in late 1992 was abandoned in April 1994 and replaced by a system of managed foreign exchange auctions. Pressures on the currency continued, however, leading to a depreciation of about 10 percent against the U.S. dollar through mid-May 1994, and a cumulative depreciation from the beginning of the year of 24 percent. The restrictive nature of the auctions led quickly to the development of a parallel market. Consequently, in late May, the authorities liberalized the auction system. While this move was successful in eliminating the parallel market, pressures on the currency continued. At the end of June 1994, a comprehensive set of exchange controls was introduced and the exchange rate was fixed at Bs 170 per U.S. dollar (compared with the prevailing parallel market rate of Bs 200 per U.S. dollar). The official rate was maintained at this level for the rest of 1994, resulting in the reversal by end-1994 of the real effective depreciation that had occurred during the first half of the year. Despite substantial penalties for parallel market trading in foreign exchange, it is reported that an active market has developed, with the premium over the official rate widening to close to 30 percent by end-1994.

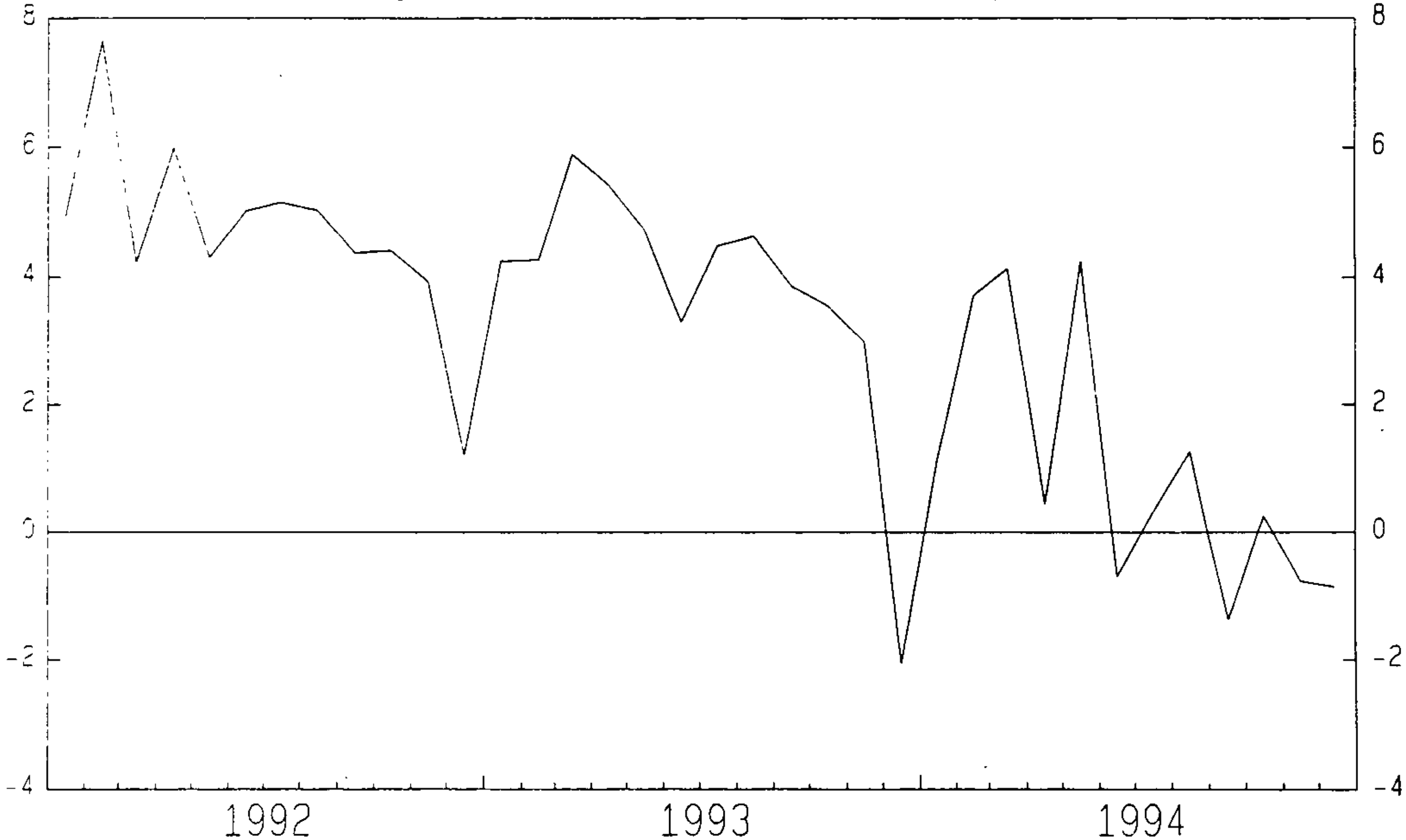
The exchange control system gave rise to substantial delays in foreign exchange sales by the Central Bank as the threat of substantial penalties against fraud slowed down processing of requests by banks, and may have contributed to a recovery of about US$2.7 billion in NIR in the second half of the year. Limits were introduced on the allocation of foreign exchange for education, travel abroad, and family remittances, and were maintained for remittances of profits from certain investments. As a result, private sector external arrears are estimated to have increased by U$0.4 billion during the third quarter of 1994, only part of which was settled toward the end of the year (in addition, public sector arrears increased by over U$0.5 billion in 1994). Foreign export credit guarantee agencies responded by taking Venezuela off cover and access to private capital markets was curtailed.

In addition to establishing exchange controls, in June 1994 the Central Bank raised interest rates on zero-coupon bonds from an average of close to 50 percent during the first five months of the year to 68 percent, in an effort to stem the international reserve losses through monetary tightening. However, monetary policy was subsequently eased sharply. The Central Bank reduced its rediscount rate from 73 percent to 45 percent in July, and the yield on 91-day zero-coupon bonds dropped to an average of about 34 percent in the last five months of 1994. In addition, as NIR recovered in the second half of the year, banking system liquidity increased sharply and interest rates declined to negative real levels. Bank deposit rates fell to an average of about 29 percent during the third quarter of 1994, despite an increase in the minimum deposit rate to 10 percentage points below the yield on zero-coupon bonds; the maximum bank lending rate remained at 15 percentage points above the zero-coupon bond rate. Notwithstanding an improvement of the external current account equivalent to 10 percentage points of GDP

CHART 7

**MALAYSIA**

Interest Rate Differential
(adjusted for exchange rate changes)




Source: The Asian Wall Street Journal; and IMF International Financial Statistics.

(imports dropped by 30 percent) brought about by the sharp contraction in economic activity (nominal GDP fell by 6.5 percent and unemployment rose to 11.5 percent in early 1995), NIR fell by more than US$1.1 billion during 1994, reflecting large capital outflows in the early part of the year and reduced availability of external financing. Fiscal measures adopted in mid-1994 were not sufficient to stabilize the economy and at the end of 1994, the 12-month inflation rate reached 71 percent.

b. Role of controls

In order to assess the impact of exchange controls on capital flows, it is informative to look at several indicators. Net short-term private capital flows, which deteriorated sharply in early 1994, turned positive in the third quarter following the introduction of controls, the tightening of monetary policy and the build-up in private sector arrears (Table 5). This turnaround was short-lived, however, as private capital outflows recommenced in the December 1994 quarter and strengthened in the first quarter of 1995. A similar pattern is evident in misinvoicing of trade (estimated as the difference between the trade balance as reported by Venezuela and that reported by trading partner countries), which may also be taken as an indicator of capital flows. After deteriorating in 1993, estimated mis-invoicing improved significantly in the third quarter of 1994, although remaining negative, indicating a continued capital outflow. The sum of estimated misinvoicing, net private short-term capital, and net errors and omissions is shown in Table 5.

Another indicator frequently used to measure the effectiveness of exchange controls is changes in the difference between offshore and onshore interest rates. In the case of Venezuela, there is no information on offshore rates. As mentioned above, domestic interest rates, which are not market-determined, have become sharply negative in real terms. The 12-month inflation rate, as of mid-1995, was about 70 percent, while savings deposit rates were about 20 percent per annum.

While the official exchange rate has remained fixed at Bs 170 per U.S. dollar, the parallel market rate 1/ has depreciated from about Bs 200 per U.S. dollar in June 1994, when the exchange controls were established, to about Bs 230 per U.S. dollar (Bs 190 the selling rate and Bs 280 the buying rate), by early June 1995.

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1/ This parallel rate is presently quoted by currency dealers in the United States (Washington D.C. and Miami). The dissemination of information on black market operations is prohibited in Venezuela. The rate prevailing for transactions in the parallel market operating in Cucuta, at the border with Colombia, and reported by Reuters, ranged between Bs 220 and Bs 240 per U.S. dollar in early June 1995.

Table 5. Venezuela: Estimated Trade Misinvoicing, Net Short-Term Capital Flows, and Net Errors and Omissions, 1992-95

(In millions of U.S. dollars: negative sign denotes outflows)

| | Estimated Misinvoicing 1/ | Short-Term Capital | Net Errors and Omissions | Total |
|---|---|---|---|---|
| 1992 | -88 | -815 | -295 | -1,198 |
| 1993 | -1,511 | -168 | 407 | -1,272 |
| 1994 | -630 | -2,748 | -463 | -3,841 |
| 1994 QI | -350 | -2,918 | 833 | -2,435 |
| 1994 QII | -166 | -937 | -786 | -1,889 |
| 1994 QIII | -73 | 1,212 | -318 | 821 |
| 1994 QIV | -41 | -105 | -192 | -338 |
| 1995 QI | n/a | -854 | -520 | -1,374 |

Sources: *IMF: International Financial Statistics*, and Direction of Trade, and Central Bank of Venezuela.

1/ Venezuela's exports to the rest of the world minus rest of world imports from Venezuela plus rest of the world exports to Venezuela minus Venezuela's imports from rest of the world. Trade with other western hemisphere countries has been excluded as these data also reflect substantial misinvoicing in some countries, complicating interpretation of Venezuela's data.

Although no definite conclusions on the role of exchange controls on capital outflows in Venezuela can be drawn from the information available, the deficit of the capital account of the balance of payments widened in the first quarter of 1995 mainly reflecting larger private outflows. In addition, the large spread between the official and the parallel exchange market rates would indicate the expectation of a significant devaluation of the bolivar and constitute an incentive for capital outflows. The information on misinvoicing would indicate that hidden capital outflows, after declining in 1990, have picked up since 1991. Finally, the estimated quarterly breakdown of total private short-term capital flows since 1994 suggests that exchange controls may have been effective in reversing the outflows during the first quarter following their imposition, but that capital outflows resumed subsequently.