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February 5, 1997

To: Members of the Executive Board

From: The Secretary

Subject: **Capital Account Convertibility and the Role of the Fund—Review of Experience and Consideration of a Possible Amendment of the Articles**

Attached for consideration by the Executive Directors is a paper on review of experience and consideration of a possible amendment of the Articles relating to capital account convertibility and the role of the Fund, which is tentatively scheduled for discussion in a seminar on Wednesday, February 19, 1997. Issues for discussion appear on pages 31 and 32.

Mr. Fisher (ext. 38755), Mr. Hagan (ext. 37715), Mr. Johnston (ext. 38980), or Mr. Wajid (ext. 37114) is available to answer technical or factual questions relating to this paper prior to the discussion.

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INTERNATIONAL MONETARY FUND

Capital Account Convertibility and the Role of the Fund: Review of Experience and Consideration of a Possible Amendment of the Articles

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

(In consultation with other departments)

Approved by François Gianviti, Manuel Guitián, and Jack Boorman

February 5, 1997

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Text Boxes

I. INTRODUCTION

1. With the growing integration of the world economy, the international monetary system is increasingly shaped by capital movements. This has raised the question of whether the present Articles of Agreement allow the Fund to discharge effectively its mandate of overseeing the international monetary system. Under the Articles, there is an asymmetry in the treatment of current and capital account restrictions. [1] While members have a general obligation to remove restrictions on the making of payments and transfers for current international transactions, the Articles specifically allow the maintenance of restrictions on capital movements. Notwithstanding this asymmetry, the Fund has in recent years sought to promote capital account liberalization in view of the benefits that can accrue from capital movements and their importance in the international monetary system.

2. In July 1995, [2] the Executive Board reviewed the recent experience of Fund members with capital account liberalization and discussed the Fund's role in promoting capital account convertibility. The Executive Board supported a strengthening of the Fund's surveillance and technical assistance activities in encouraging members to liberalize capital movements. In concluding that discussion, the Executive Board agreed to review the Fund's experience with the enhanced policies and procedures in this regard and to reassess the case for an amendment of the Articles to extend Fund jurisdiction to capital movements. [3] In September 1996, the Interim Committee requested the Executive Board to continue its analysis of capital flows and their implications, to examine possible changes in the Fund's Articles, and to report to the Committee at its next meeting in April 1997. [4] The Declaration on Partnership for Sustainable Global Growth, attached to the Committee's September 1996 Communiqué, also referred to the particular importance attached to encouraging "careful progress toward increased freedom of capital movements through efforts to promote stability and financial soundness".

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[1]For the purposes of this paper, "capital account" refers to the "BOP Financial Account and the International Investment Position" classification in the Balance of Payments Compilation Guide of the IMF. This terminology is used to provide continuity with previous discussions. As is discussed below, a number of items in the capital account fall within the Fund's broad definition of current payments contained in Article XXX(d).

[2]EBM/95/73 (7/28/95).

[3]"The Acting Chairman's Summing Up--Capital Account Convertibility--Review of Experience and Implications for Fund Policies", Executive Board Meeting 95/73, July 1995 (BUFF/95/83, 8/4/95).

[4]"Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund" (9/29/96).

3. This paper was prepared in response to the requests of the Executive Board and Interim Committee. It first discusses the existing environment for capital flows in light of the Fund's responsibility to oversee the international monetary system (Section II). Next, the paper reviews the Fund's present role in promoting capital account liberalization (Section III). Based on the analysis contained in the foregoing sections, the paper then assesses alternative ways in which the Fund could further intensify its efforts in this area, including the rationale for an amendment to the Articles that would give the Fund broader jurisdiction over capital movements (Section IV). A discussion of the scope of a possible amendment (Section V) is followed by a preliminary analysis of the structure of such an amendment (Section VI). Finally, Section VII presents issues for discussion.

4. There are three accompanying background papers: "**Review of Experience with Capital Account Liberalization and Strengthened Procedures Adopted by the Fund,**" (SM/97/32, Sup. 1, forthcoming), which provides more detailed information on countries' experiences with the liberalization of their capital accounts and the enhanced procedures adopted by the Fund. The second background paper "**Multilateral, Regional, and Bilateral Agreements and Initiatives in Capital Account Liberalization**" (SM/97/32, Sup. 2, forthcoming), reviews the role of other agreements and initiatives in liberalizing capital movements. The third background paper "**Capital Transfers: Legal Aspects of the Fund's Jurisdiction under the Articles**" (SM/97/32, Sup. 3, forthcoming) analyzes the coverage of capital movements under the present Articles.

II. CAPITAL FLOWS AND THE INTERNATIONAL MONETARY SYSTEM

5. The Articles give the Fund the mandate of overseeing the international monetary system [5] and recognize that "the essential purpose of [this] system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability." [6] Moreover, one of the purposes of the Fund is to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy. [7]

6. Over the years, the international monetary system and growth of world trade have become increasingly shaped by capital movements, which have become significant and, in some cases the dominant, components of fluctuations in members' balance of payments. The

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[5]Article IV, Section 3(a).

[6]Article IV, Section 1.

[7]Article I(ii).

orderly behavior of such movements has, therefore, become increasingly important for the achievement of the above-stated purposes and objectives.

7. ***The benefits of liberalization***—In recent years, countries have benefitted significantly from the global transfers of savings and technology associated with increased international capital flows. [8] Gross capital flows have increased globally and in all regions. Developing countries, in particular, have experienced large increases in both gross and net capital inflows. This is especially the case with inflows consisting of foreign direct investment and portfolio transactions (the latter term, as used in this paper, refers to both portfolio securities transactions and intermediated claims). [9]

8. At the time of the last Executive Board discussion of capital account convertibility, Executive Directors underscored the beneficial effects on growth and investment of the expansion of private capital flows.[10] Free capital movements facilitate a more efficient global allocation of savings and contribute to the channeling of resources into their most productive uses, thus increasing economic growth and welfare. An open capital account also supports the multilateral trading system by broadening the channels through which developed and developing countries alike can finance trade and investment and attain higher levels of income. International capital flows have expanded the opportunities for portfolio diversification and thereby provided investors with a potential to achieve higher risk-adjusted rates of returns.

9. The increase in capital mobility has resulted in closer integration of financial markets, but also in the more rapid transmission of changes in national policies and shocks to economic and financial conditions. At the same time, private capital flows and market assessments have come to play an increasingly important role in members' access to foreign financing. Normally, market forces can be expected to exert a disciplining influence on countries' macroeconomic policies. To the extent markets take too sanguine a view of a country's policies and prospects, however, this can weaken discipline and become disruptive, as in these

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[8]The advantages and disadvantages of capital account liberalization have been discussed in previous Board papers (see "Capital Account Convertibility: Review of Experience and Implications for Fund Policies" (SM/95/164, 7/10/95)). See also Manuel Guitián, "The Issue of Capital Account Convertibility: A Gap Between Norms and Reality" in *Currency Convertibility in the Middle East and North Africa*, Manuel Guitián and Saleh M. Nsouli, eds., (Washington: International Monetary Fund, 1996).

[9]The relative importance of portfolio and direct investment inflows has varied across regions with the former being more important in Latin America than Asia. Overall, net portfolio inflows to developing countries have grown more rapidly than net foreign direct investments since 1989 (see background paper, SM/97/32, Sup. 1, forthcoming). A gross total of $181 billion in foreign capital flowed to developing countries in 1995.

[10]See BUFF/95/83 (8/4/95).

circumstances market sentiment is likely to shift abruptly. This underscores the importance of international monetary cooperation.

10. ***Maintaining financial and economic stability***—Notwithstanding the benefits of capital movements, the potential volatility and volume of these flows can also occasionally undermine the "orderly underlying conditions" that are necessary for the stability of the international monetary system. Although the closer integration of financial markets has brought considerable benefits, the size and speed of international capital movements have tended to increase the potential for market driven swings in capital flows. Such flows may be destabilizing and can reflect bubbles in asset prices and bandwagon effects. Surges in *capital inflows* can complicate macroeconomic management, even if macroeconomic policies are judged to be broadly appropriate, and can also increase the strains on national financial systems. [11] *Capital outflows* can compound balance of payments problems and make more difficult the implementation of adjustment programs designed to address the imbalances, particularly where the policies need time to take hold and where the outflows make it more difficult to mobilize concerted financing. In addition, sharp swings in capital flows can result in greater volatility in interest rates and exchange rates.

11. The liberalization of capital flows underscores the importance of careful attention to the factors which could give rise to disruptive surges in capital flows. These include not only misalignments in interest and exchange rates stemming from an inappropriate policy mix, but also changes in confidence either in macroeconomic policies or the soundness of financial systems, and political developments. Therefore, both the pursuit of appropriate policies and the development of a sound domestic financial sector, in particular with respect to the domestic banking system, are key considerations in liberalizing capital flows. These factors are important for the ability of countries to attract international portfolio investments, for the efficient use of these resources, and for the avoidance of incentives that result in speculative and more volatile capital flows. Countries with weaker banking systems have been less able to withstand large capital outflows than those with relatively sound banking systems reflecting, in part, the strains that weaker banking systems place on the flexibility of monetary/exchange rate policy.

12. In their July 1995 discussion, Executive Directors concluded that capital account liberalization should be undertaken subsequent to, or at least broadly simultaneously with, other reforms in the domestic financial system, including the strengthening of prudential regulations, and with adequate attention to differing conditions among individual countries. Subsequently, the Board has further emphasized the links between banking sector issues and the capital account.[12]

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[11] See "Recent Experience with Surges in Capital Inflows" (SM/93/113, 5/21/93).

[12]See "Summing up by the Acting Chairman, International Capital Markets—Developments,
(continued...)

13. ***Assessing the utility of capital controls***—In their July 1995 discussion, Executive Directors concluded that controls on capital movements had proved largely ineffective in preventing outflows of savings and sustaining inconsistent macroeconomic policies because of the difficulties of enforcing them in a world of highly integrated international capital markets. They noted, however, that controls could, on occasion, provide temporary breathing room in dealing with balance of payments difficulties, although the controls could not and should not substitute for fundamental policy adjustments. Similarly, in situations where inflows complicate macroeconomic management, temporary controls may provide breathing room while other policy responses take hold. In this context, Directors pointed to the potential distortionary effects of such measures as well as their growing ineffectiveness over time.

14. Controls on both inward and outward capital movements may be motivated not only by considerations related to balance of payments and economic management, but also by prudential considerations related to the state of financial sector development and sectorial policies. The structure of controls on portfolio capital movements in many cases reflects the degree of development of the financial sector and often takes the form of financial regulatory measures. The exercise of such controls can serve to discourage potentially destabilizing short-term capital flows into the banking system and thereby reduce countries' vulnerability to shifts in market sentiment. While some countries have maintained these restrictions for extended periods, there is a question of the extent to which their efficacy has been eroded over time. Attention has, therefore, to be given to the design and effects of such controls.

15. While it is generally accepted that controls on capital movements are inefficient, and should not be used to sustain inconsistent macroeconomic and exchange rate policies, they may nevertheless provide some protection against abrupt and sharp portfolio shifts by limiting capital mobility to the extent that it may be difficult to evade controls in the short run. Where such controls are adopted in response to sudden adverse developments, they should be undertaken as part of a comprehensive package of stabilization and structural reform, they should be temporary and, to the extent possible, market based and transparent. In addition, the use of controls should avoid defaults on debt obligations and disruptions to international commercial relations, which can have a substantial and lasting adverse impact on countries' access to international capital markets.

III. The Fund's Present Role in Promoting Capital Account Liberalization

16. Against the background of the increased importance of capital movements to the operation of the international monetary system, the Fund has become increasingly involved in encouraging the liberalization of such flows in a manner that does not undermine economic and financial stability; i.e., in the promotion of *orderly liberalization*. Its expertise and near-

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[12](...continued)
Prospects, and Key Issues", Executive Board Meeting 96/64, July 8, 1996 (BUFF/96/87, 7/12/96).

universal membership make it well placed to do so. Monetary/exchange rate and fiscal policies are key determinants of capital movements, and are the central feature of the Fund's dialogue with its members. More recently, the Fund has become increasingly involved in assisting members to ensure that liberalization is undertaken in a setting of financial soundness and in conjunction with the necessary structural reforms. It has also become more active in assessing when the maintenance of controls would be counterproductive. The assessment of the merits of controls is of particular importance to the international monetary system considering that controls imposed by one country typically affect others adversely (for example, by delaying necessary exchange rate adjustments, or limiting the repatriation of invested capital or financial market access) and can, therefore, be destructive of international prosperity.

17. The remainder of this section outlines how the Fund is currently utilizing its powers to promote the orderly liberalization of capital movements. These powers consist of surveillance, jurisdiction under Article VIII, the provision of financial resources, and technical assistance. As will be seen, the exercise of these powers has been circumscribed in a number of respects by the presence of Article VI, Section 3, which gives members the right to maintain capital controls.

A. Surveillance

18. Under Article IV, Section 3(b), the Fund has the mandate to conduct firm surveillance over members' exchange rate policies. The principles and procedures of surveillance are set forth in the 1977 Decision entitled *Surveillance over Exchange Rate Policies*, adopted in 1977 (the "Surveillance Decision"). [13] Although the principles set forth in the Surveillance Decision relate to members' exchange rate policies, this decision recognizes the "close relationship between domestic and international economic policies." [14] Consequently, Article IV consultations generally cover not only exchange rate policies, but also a broad range of macroeconomic and structural policies.

19. Because of their broad coverage, annual consultations under Article IV with the Fund's near-universal membership have proven to be an effective instrument for allowing the Fund to exercise its surveillance responsibilities over the international monetary system, and thereby to influence the conduct of economic policies in program and nonprogram countries alike, although it is recognized that the Fund tends to have a greater influence over members with a current or prospective need for balance of payments support. [15] The effectiveness of

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[13]Executive Board Decision No. 5392-(77/63), adopted April 29, 1977, as amended, *Selected Decisions, Twenty-First Issue*, pp. 8–13.

[14] Ibid., at p.10.

[15]The role of surveillance in helping members gain and deepen access to international capital
(continued...)

surveillance depends on the maintenance and effective application of the Fund's expertise, particularly in the areas of macroeconomic policies and financial and capital markets. The potential for international spillover effects of sharp and abrupt capital movements and the use of controls underscores the importance of addressing such externalities within the framework of both bilateral and multilateral surveillance.

20. In July 1995, the Executive Board encouraged the staff to enhance the Fund's role in the liberalization of the capital account through surveillance and technical assistance. In response, the staff undertook a number of initiatives centered on sharpening the focus on various aspects of capital flows in Article IV consultations, tracking systemic developments in capital markets and their implications for member countries, and building the Fund's information framework on the regulatory environment for capital movements. These initiatives are described in detail in SM/97/32, Sup. 1 (forthcoming). Specifically, they include: guidance to Article IV missions on strengthening analysis and discussion of capital account issues and assessing the scope for capital account liberalization; allocation of staff resources toward ongoing monitoring and assessment of financial and capital account developments; undertaking a pilot data collection project for 31 countries on the regulatory regimes governing cross-border capital movements, especially portfolio transactions; and the development of policy proposals regarding the Fund's role in promoting capital account liberalization.

21. Although it is too early to assess fully the effectiveness of these initiatives in promoting financial and capital account liberalization, a review of recent experience points to the following tentative conclusions:

- The attention to capital account issues in Article IV consultations has been generally commensurate with the significance of private capital flows in individual cases and has focussed primarily on the macroeconomic consequences of such flows. Treatment of the regulatory aspects of capital flows has been limited to cases where capital liberalization initiatives were underway or capital controls were introduced or considered.

- Fund recommendations on the problems created by capital flows have concentrated on macroeconomic adjustments, particularly on the flexible use of monetary/exchange rate policies and their impact on portfolio transactions. More fundamental policy adjustments, such as fiscal and structural policies, were called for where lack of confidence in domestic policies underpinned adverse capital flows and in cases where monetary policy was overly burdened.

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[15](...continued)
markets has been complemented by the Special Data Dissemination Standards, which guides members in their provision of economic and financial data to the public.

- The Fund has been supportive of capital account liberalization and has cautioned against the deleterious effects of prolonged use of capital controls. At the same time, there has been an acceptance of the temporary use of controls in the context of appropriate fundamental policies.

- Good progress has been made in the pilot data collection project on the regulatory framework for capital movements. Useful information has been gathered on the nature of controls maintained by members on their capital account, which could serve as a basis for establishing a more comprehensive framework for information and dialogue with members in this area.

22. Traditionally, the Fund's reviews of multilateral capital markets have focussed on the evolution of cross-border capital flows and the institutional environment in which such flows occur. The annual report on international capital markets regularly analyzes activities of major participants in capital markets in various countries, assesses developments in the regulatory frameworks and financial infrastructures in these markets, and draws systemic implications of such developments. The scope of these activities, however, is limited to the major industrial and selected developing countries' capital markets.

23. While the Fund is engaged in certain initiatives in these areas, the efforts thus far have extended to a limited set of countries rather than to the membership at large. Moreover, regulations relating to capital flows have not received the same ongoing scrutiny as that applied to exchange controls that are subject to existing Fund jurisdiction.

B. Jurisdiction

24. ***Freedom of current payments and transfers***—Under Article VIII, Section 2(a), members have an obligation to refrain from imposing restrictions on the making of payments and transfers for current international transactions. As will be discussed further in Section V of this paper, this obligation does not apply to restrictions imposed on the underlying current transactions themselves (which fall primarily under the jurisdiction of the WTO); rather, it is limited to the payments and transfers associated with these transactions. [16] As defined by the Fund's Articles, current payments and transfers extend not only to those relating to trade and services, but also to a number of investment-related outflows. [17] Specifically, current payments and transfers cover all interest on loans and net income from other investments, moderate

[16]The concept of payments and transfers for current transactions includes the "normal short-term banking and credit facilities" that are extended for such payments. To that extent, the Fund's jurisdiction extends to certain financial services transactions.

[17]Article XXX(d).

amounts for amortization of loans or for depreciation of direct investments, and normal short-term banking and credit facilities. [18]

25. Most payments and transfers related to international investments, however, are outside the scope of Article VIII, Section 2(a). First, regarding investments made by nonresidents, the Fund has no jurisdiction over the repatriation of the original capital and capital appreciation. [19] Second, payments and transfers relating to the making of such investments by nonresidents are outside Article VIII's coverage. Thirdly, this provision does not encompass payments and transfers relating to the making of investments by residents abroad. Moreover, as noted above, the Fund has no jurisdiction over the underlying transactions giving rise to international investment. [20]

26. Moreover, Article VI, Section 3, which gives members the right to impose controls on capital movements, has affected the interpretation of other provisions, which, on their face, are not limited to current payments. Specifically, although Article VIII, Section 3 contains a general prohibition against multiple currency practices and discriminatory currency arrangements, the presence of Article VI, Section 3 has led the Executive Board: (i) to conclude that the prohibition of discriminatory practices does not apply to capital movements, [21] and (ii) to withhold its judgement on the applicability of Article VIII, Section 3 to multiple rates for capital movements.[22]

27. The precise formulation of the obligations under Article VIII has made them a particularly useful tool for the liberalization of current payments and transfers. In contrast to obligations under Article IV (which are defined in terms of broad objectives), the specificity of obligations under Article VIII has provided well-defined and objective standards which lend themselves to uniform application and ongoing scrutiny by the Fund, as well as to integration into the Fund's financial functions. [23] In practice, while the Fund has never found a member to be in breach of its Article IV obligations, there are numerous examples of measures that have

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[18]A government's default on its own external obligations does not, however, constitute a restriction within the meaning of Article VIII.

[19]Except, as noted above, moderate amounts for amortization of loans or for depreciation of direct investments.

[20]Except normal short-term banking and credit facilities.

[21]Executive Board Decision No. 541-(56/39), adopted July 25, 1956, *Selected Decisions, Twenty-First Issue*, p.335.

[22]For further discussion, see background paper, SM/97/32, Sup. 3 (forthcoming).

[23] For example, the introduction of an exchange restriction during an arrangement of upper credit tranche conditionality results in the nonobservance of a performance criterion.

been found to be inconsistent with Article VIII, Section 2(a) and have been eliminated as a result of such findings. A country's acceptance of Article VIII provides confidence to the international community that the member will not impose restrictions on the making of payments and transfers for current international transactions without Fund approval and will, therefore, pursue policies that will obviate the need for such restrictions. [24] This reflects, inter alia, the Fund's policy of encouraging members to eliminate exchange restrictions before they accept Article VIII obligations. While some members have imposed restrictions without Fund approval, the ongoing scrutiny of such breaches of obligations further strengthens the signaling effect of a member's Article VIII status.

28. ***Transitional arrangements***—Members' obligations with respect to the freedom of payments and transfers for current international transactions are subject to important safeguards. Under Article XIV, a member may maintain and "adapt to changing circumstances" existing restrictions until its balance of payments position is sufficiently strong that reliance on exchange restrictions is no longer warranted. This provision has allowed the Fund to take account of the different starting positions of its members and has, at the same time, provided a framework for dialogue between the Fund and the member on the appropriateness of its restrictions and the policies and reforms that would be necessary to allow for their elimination. In recent years, the Fund has redoubled its efforts to encourage liberalization of payments and transfers for current international transactions. The effectiveness of this approach has been evident in the much-reduced reliance of countries on exchange restrictions and the recent acceleration in the acceptances of Article VIII. As of end-1996, a total of 136 members had formally accepted the obligations of the Fund's Article VIII, Sections 2, 3, and 4, compared with 67 at end-1990.

29. ***Approval of exchange restrictions***—Under Article VIII, Section 2(a), the Fund has the authority to approve restrictions on current payments and transfers. The Fund's policy of approving restrictions that are nondiscriminatory, temporary, and necessary for balance of payments purposes allows members temporarily to introduce exchange restrictions in order to relieve pressures on the balance of payments while corrective policies are elaborated and take hold, and financing is mobilized, possibly within the framework of a Fund arrangement. [25] However, the need for Fund approval and the conditions required by the Fund for the exercise of its approval policy discourage the unnecessary use of exchange restrictions, thus supporting the objectives of liberalization, and the adoption of appropriate macroeconomic policy adjustments.

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[24]The OECD has, for example, made Article VIII acceptance an effective condition for accepting new members; moreover, these obligations are specifically recognized in other international agreements.

[25]Restrictions may also be imposed for reasons of national or international security, Executive Board Decision No. 144-(52/51), adopted August 14, 1952, *Selected Decisions, Twenty-First Issue*, p.379.

30. Although the Fund's jurisdiction is limited to payments and transfers for current international transactions, this jurisdiction has also contributed to the liberalization of capital movements. The elimination of exchange restrictions on current international payments and transfers and the establishment of a multilateral trade and payments system have provided the conditions for a rapid increase in international capital movements. As noted above, the Fund's jurisdiction over payments and transfers for current international transactions includes some that are clearly related to capital account transactions. One example is payments and transfers related to the flow of income yielded by capital investments held by nonresidents. Moreover, as noted above, some capital movements, such as moderate amortization of loans, are regarded as current payments for purposes of the Fund's jurisdiction. Nevertheless, the bulk of flows on the capital account, as well as the underlying transactions, fall beyond the jurisdiction of the Fund, and this has limited the contribution of Fund jurisdiction to the liberalization of capital movements. As a result, the Fund's treatment of current and capital account transactions could not be, and has not been, uniform. The Fund's dialogue with its members on the use and elimination of particular capital controls has so far been much more limited than with respect to restrictions on current international payments and transfers, and a member can introduce restrictions on those capital movements that are not regarded as current payments without the approval of the Fund.

C. Conditional Use of Fund Resources

31. Fund resources are made available to address balance of payments difficulties caused by developments in either the current or the capital account. Such financing is designed, inter alia, to support adjustment that reduces the member's reliance on controls on current transactions and has often served to reduce reliance on capital controls. In addition, Fund financing catalyzes other creditor assistance, which may involve spontaneous access to international capital markets and/or concerted financing (e.g., exceptional support from official creditors, as well as restructuring of obligations to private creditors and new lending from such creditors). To the extent that such financing is mobilized, it can further reduce reliance on controls. However, as noted above, under certain circumstances, the Fund may approve the temporary imposition of restrictions on current international transactions; controls on capital outflows may also be appropriate in such circumstances. Over time, as policies take hold and members' creditworthiness improves, the Fund-supported adjustment program helps to lay the foundation for both a liberalization of controls and a deepening of, or return to, access to capital markets.

32. As is discussed in the background paper regarding the legal aspects of Fund jurisdiction over capital transfers (SM/97/32, Sup. 3, forthcoming), the presence of Article VI has an impact on the Fund's provision of financial assistance in at least two respects.

33. The first constraint relates to the Fund's policies on conditionality. As a matter of general policy, the Fund often requires that, as a condition for the use of its resources, a member liberalize trade in goods and services and the associated payments and transfers.

Indeed, Fund arrangements contain standard performance criteria which preclude the member from making purchases if a member introduces or intensifies restrictions in these areas. However, Article VI, Section 3 specifically confers upon members the right to maintain controls on capital movements. Moreover, Article VI, Section 1 only allows the Fund to request the imposition of capital controls, not their liberalization, as a condition for the use of its resources. Therefore, it would seem that the Fund could not adopt a general policy that would make capital account liberalization an explicit condition for the use of its resources. Such a policy would appear to contradict the intention of the drafters of the Articles and could be interpreted as meaning, in effect, that the Fund is exceeding its authority by requiring a member to waive one of its rights under the Articles as a condition for access to its general resources. [26]

34. This first constraint has not, however, prevented the Fund from extending its arrears policy to payments arrears arising from capital restrictions. This is because the elimination of existing arrears and the nonaccumulation of new arrears—irrespective of whether they arise from a restriction or a governmental default—have been viewed as a necessary means of safeguarding the Fund's resources, as is required under Article V, Section 3. By breaching its contractual obligations, a member undermines its creditworthiness and, therefore, its return to external viability.

35. The second constraint is the prohibition on Fund financing of "large or sustained" capital outflows.[27] Indeed, the Fund may request a member to exercise controls to prevent such use of its general resources, and failure by the member to impose such controls could lead to a declaration of ineligibility. [28] Regarding the concept of "large or sustained", no quantitative limits have been identified for the purpose of applying this provision. Rather, it has been applied on a case-by-case basis, taking into consideration, inter alia, the size of the member's quota, the Fund's liquidity, the cause of the outflows, and an assessment of whether the member's policies would contribute to—rather than delay—the resolution of the difficulties.[29] Notwithstanding the flexibility in the application of this provision, the limitation it imposes may make members hesitate to undertake capital account liberalization.

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[26]See background paper, SM/97/32, Sup. 3 (forthcoming).

[27]Article VI, Section 1(a).

[28]Article VI, Section 1(a).

[29]See "Fund Policies with Regard to Currency Stabilization Funds—Further Considerations" (EBS/95/109, 6/30/95), pp.9–11.

D. Technical Assistance

36. The Fund has supported capital account liberalization as part of technical assistance on financial sector reform. [30] This reflects the importance of the proper functioning of financial and foreign exchange markets and of banking soundness in successful capital account liberalization. Traditionally, the Fund has played an important advisory and technical assistance role in assisting member countries in establishing appropriate exchange rate regimes, liberalizing exchange controls and developing money and foreign exchange markets and operations. Such assistance has been expanded to promote the regulatory, institutional, and operational conditions which, inter alia, help facilitate the liberalization of the financial and capital account.

37. Specifically, technical assistance has focussed on developing domestic financial markets, introducing indirect instruments of monetary control, and assisting central banks to develop their operational capacity, as may be necessary to achieve monetary and exchange policy objectives consistent with a more open capital account. In addition, technical assistance has increasingly emphasized strengthening banking systems through enhancing bank supervision procedures and promoting internationally recognized bank supervisory standards and practices, thus supporting the capacity of countries' banking systems to manage larger capital flows.[31] Attention is being paid to the development of appropriate legal and regulatory frameworks, and assistance has increasingly sought to integrate analysis of the domestic financial regulatory framework with the regulatory framework for capital movements taking into account the use of financial and prudential type regulations to control capital movements.[32]

IV. Further Fund Involvement: Possible Approaches

38. As discussed above, the international monetary system is increasingly shaped by capital movements. Against this background, a more central role for the Fund in the orderly liberalization of these movements would strengthen the Fund's ability to discharge its mandate of overseeing this system. To achieve this end, two initiatives could be envisaged. First, the Fund could further intensify and make more systematic its efforts under surveillance and technical assistance; second, the Articles of Agreement could be amended to make capital account liberalization a purpose of the Fund and to give the Fund jurisdiction over capital

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[30]See background paper, SM/97/32, Sup. 1 (forthcoming), and SM/95/164, Sup. 1 (7/10/95).

[31]The role of the Fund on banking sector issues and the capital account was emphasized during the Executive Board discussion on recent developments and trends in international capital markets (see BUFF/96/87, revised: 7/16/96).

[32]See background paper, SM/97/32, Sup. 1 (forthcoming).

movements. These initiatives are not mutually exclusive; indeed, as discussed below, they could be complementary.

A. Further Intensification of Surveillance and Technical Assistance

39. The staff's initiatives following the July 1995 Executive Board discussion were described above. The scope of these efforts was limited, and it would be desirable to broaden them. This would involve making an assessment of the economic effects of members' regulations governing capital inflows and outflows a standard feature in Article IV consultations. It would be complemented by the efforts already underway on broadening the collection of information on regulations affecting capital movements to cover all Fund members, which could serve as the basis for identifying restrictive regulations, and making recommendations for removing specific restrictions.

40. Strengthening capital account surveillance along these lines would allow the Fund to exercise judgement and focus attention on cases in which controls had particularly harmful economic effects. This approach would build on the existing flexible and collaborative Article IV process, which emphasizes analysis and persuasion. In particular, it would facilitate appropriate sequencing of capital account liberalization through a broad assessment of members' macroeconomic and structural policies, taking into account the circumstances of individual members. Because of the close connection between capital control regimes and financial regulatory frameworks, strengthened capital account surveillance would also help strengthen surveillance over the financial system and vice versa.

41. Given the broad scope of issues considered in Article IV consultations, such consultations could also include more detailed discussion of capital account restrictions. While strengthening capital account surveillance and technical assistance efforts without extending jurisdiction would recognize and extend the rapid progress already achieved in capital account liberalization, it would rely primarily on persuasion without the application of specific obligations.

42. Seeking capital account liberalization through strengthened surveillance as outlined above could be facilitated by objectively–defined and uniformly–applied standards for assessing the restrictiveness of capital controls, or for distinguishing between controls imposed for balance of payments reasons and those which, for example, serve a prudential function. One possibility in this regard might be to adopt such standards through Executive Board decisions (which would be nonbinding) that would specify the types of restrictions that are considered to have particularly harmful externalities, and the conditions that would justify their imposition.

43. The need to evaluate members' regulatory systems in light of such nonbinding standards would be similar to that under an extension of Fund jurisdiction to capital movements and would involve similar commitments of staff resources. While this course of action could make an important contribution to promoting orderly liberalization, it would not

bring all the advantages of an approach based on jurisdiction, discussed below. Moreover, while greater emphasis on the freedom of capital movements in the context of surveillance and technical assistance would have its benefits, such emphasis would highlight the tension with—and incongruity of—Article VI, Section 3, which specifically confers upon members the right to maintain controls on capital movements.

B. Extension of Jurisdiction

44. Given the Fund's mandate, there would be a number of potential benefits of amending Article I to make the liberalization of international capital movements a central purpose of the Fund. To assist the Fund in achieving this purpose, other Articles would also be amended in order to extend Fund jurisdiction to capital movements, thereby giving the Fund the same instruments that have enabled it to make an effective contribution to the orderly liberalization of current payments and transfers. The potential benefits of such an extension are outlined below.

45. ***The effectiveness of specific obligations as a means of achieving liberalization***—As has been demonstrated in the exercise of the Fund's present jurisdiction over current payments and transfers, the establishment of specific obligations regarding the liberalization of capital movements could provide the Fund with an effective means of promoting the elimination of restrictions on capital movements. Under an amendment, such restrictions would be identified on the basis of objectively–defined and uniformly–applied rules and would be subject to ongoing monitoring, irrespective of their economic significance at any given time. In contrast with surveillance, therefore, capital controls, *per se,* would become a subject of scrutiny. The Fund's experience with the application of Article VIII, Section 2(a) has shown that the continuous monitoring of specific obligations regarding the avoidance of restrictions can also have a preventive effect, in that such monitoring reduces the possibility that restrictions will be re–imposed. As under the Fund's present Articles, these obligations would, presumably, be subject to certain exceptions, in that the amendment could include transitional provisions and could also permit the Fund to establish policies regarding the approval of restrictions for specified reasons.

46. ***Establishing a universal code***—By virtue of its near universal membership, the Fund is well placed to assist in the establishment of a multilateral and nondiscriminatory system of payments, which is one of its purposes. The system envisaged by the present Articles, however, is limited to current transactions. In light of the importance of capital movements, the removal of this limitation would assist the Fund in its continued oversight of the international monetary system. Jurisdiction over capital movements would also serve to extend to such movements one of the key principles of the postwar trade and payments system—the principle of nondiscrimination. Such an extension would facilitate the establishment and application of a universally–applied code that promotes orderly liberalization of capital movements, paying due regard to the structural, macroeconomic, and balance of payments position of its members.

47. The extension of Fund jurisdiction would complement rather than duplicate existing bilateral, regional, and multilateral agreements and initiatives in this area. While these agreements serve to liberalize capital movements, their coverage is somewhat limited (either in the scope of transactions or in the scope of membership) and, accordingly, there is no uniformly–applied set of rules for international capital movements (see Box 1 and background paper, SM/97/32, Sup. 1 (forthcoming). Moreover, many of the existing treaties address liberalization exclusively from the perspective of investor protection and, therefore, do not take account of the broader considerations noted above. Given its mandate, it is important that the Fund be in a position to determine when the macroeconomic, structural, and balance of payments considerations support adherence to—or permit exemptions from—obligations relating to capital account liberalization. This is of particular importance in light of the fact that the Fund also has the responsibility of financing the balance of payments problems that are caused by capital movements, subject to the limitation imposed in the existing Articles regarding the financing of "large or sustained" capital outflows. Based on the Fund's experience with other treaties (e.g., during the preparation of the GATS), the Fund's assessment of whether controls are justified is more likely to be deferred to if it has jurisdiction over such controls.

48. ***The signaling effect***—When a member notifies the Fund that it accepts the obligations of Article VIII, this notification (which is publicized) represents a clear commitment by the member that restrictions on current payments and transfers will not be imposed unless they have been approved by the Fund, i.e., such restrictions must be temporary, nondiscriminatory, and imposed for balance of payments reasons.[33] Acceptance by members of such obligations with respect to capital movements could, depending on the scope of the amendment, send a clear signal to the international financial community concerning capital movements and could serve to strengthen members' access to international capital markets.

49. ***Supporting the Fund's other functions***—The extension of Fund jurisdiction over capital movements would facilitate the use of Fund conditionality as a means of achieving liberalization. For example, as is presently the case with current account restrictions, the imposition of restrictions on capital movements during the period of an arrangement could result in the nonobservance of performance criteria. Moreover, in accordance with the principle of nondiscrimination discussed earlier, Fund jurisdiction would serve to provide for uniform treatment among creditors; such uniformity would help facilitate the mobilization of external financing that is necessary to support members' adjustment programs.

50. Fund jurisdiction over capital movements would also serve to complement the surveillance process. Under the existing surveillance decision, almost all consultation discussions and decisions regarding restrictions subject to approval under Article VIII or

[33]As noted above, approval is also given for restrictions imposed for national or international security reasons.

Box 1. Other International Agreements and Initiatives Relating to Capital Account Liberalization

There are a number of other initiatives and agreements that seek to liberalize capital movements. However, there are important differences between the focus of these treaties and that of the Fund.

First, there is a range of *foreign investment treaties and initiatives* that exist on the bilateral, regional, and multilateral levels (including the continuing discussions on a multilateral agreement on investment (MAI)). These treaties focus on the protection of foreign investments, particularly foreign direct investments. In particular, they create obligations to ensure the freedom of transfers associated with the investments covered by the agreements, including the repatriation of the original capital invested, and fair and equitable treatment of existing investments in the local market. They do not, however, establish obligations regarding a signatory's treatment of its own investors, e.g., they do not liberalize outflows by residents. Moreover, concerning the liberalization of the admission of foreign investments, many of these agreements do not include specific obligations in this regard. Although it is too early to determine whether the MAI will include obligations for the admission of all foreign investments, its primary focus is likely to be direct investment and, in any event, the MAI will not liberalize resident outflows. Most bilateral and regional investment treaties do not include a balance of payments safeguard clause (a notable exception is NAFTA), and this issue is still under discussion in the context of the MAI. The implications for the Fund of the absence of such a clause in the MAI is discussed in "The Relationship Between the Multilateral Agreement on Investment and the International Monetary Fund" (EBD/96/113, 8/30/96).

Second, *the liberalization of services* is promoted through the General Agreement on Trade in Services (GATS) and the Financial Services Chapter of the North America Free Trade Act. The liberalization of services serves to promote capital liberalization in at least two ways. First, it liberalizes foreign direct investments by creating obligations to allow foreign service suppliers to provide services through the establishment of a commercial presence in the territory of another signatory. Secondly, obligations to liberalize the provision of cross-border financial services could potentially give rise to international capital movements where these are an integral part of the provision of the service (e.g., the making of a loan). However, the range of capital movements covered is limited by virtue of the fact that WTO members are not prevented from restricting the overseas activities of their local service suppliers (e.g., credit extended by resident banks to nonresidents). Moreover, under the GATS, members only incur obligations to remove restrictions if they have made specific commitments in the service sector in question. The GATS includes a balance of payments safeguard clause and specifically defers to the Fund with respect to payments and transfers that fall under the Fund's jurisdiction.

Third, and in contrast to the above agreements, the *OECD Code of Liberalization of Capital Movements* focuses comprehensively and exclusively on the liberalization of international capital movements (although the *Treaty of Rome*, as amended, also removes restrictions on capital movements between members of the European Union, it also provides for the harmonization of domestic laws as a means of establishing an internal market). The Capital Code establishes obligations with respect to the ability of residents to make foreign investments and the ability of nonresidents to make local investments. Moreover, it covers almost all types of capital transactions. Finally, the obligations apply not only to the making of the underlying transactions on the financial and capital account, but also to the payments and transfers associated with these transactions. Members are permitted to lodge reservations with respect to the liberalization of specific transactions under the Code on joining the OECD, or at any time with respect to a schedule of certain financial transactions that are considered short term in nature. Members can also set aside temporarily their obligations for reasons of balance of payments difficulties or because of "serious economic and financial disturbances."

maintained under the transitional provisions of Article XIV take place in the context of the Article IV discussions. This procedure would also apply to consultations involving capital restrictions that would be subject to the Fund's jurisdiction under the amended Articles. The Fund's role in discussing capital account issues with members in the context of surveillance and technical assistance would be enhanced if the Fund had jurisdiction over capital. [34]

51. If it were considered desirable to amend the Articles to remove the asymmetry in the Fund's treatment of current and capital restrictions, such an amendment would need to consist of more than just an elimination of Article VI, Section 3, which gives members the right to impose capital controls. While the deletion of this provision would, for example, clarify that all discriminatory currency arrangements and multiple currency practices are subject to the Fund's jurisdiction, the Fund would still not have jurisdiction over capital restrictions and most of the benefits discussed above would, therefore, not be realized. Accordingly, the discussion of the scope of a possible amendment set forth in the remainder of this paper examines issues associated with such an amendment that would provide not just for the elimination of Article VI, Section 3, but would also establish specific obligations regarding the elimination of controls on capital movements. As will be discussed below, the degree of impact on capital account liberalization will depend on the breadth of coverage of such an amendment.

V. Scope of a Possible Amendment to Extend Jurisdiction

52. If the Articles are to be amended to make the liberalization of capital flows a purpose of the Fund and to provide for obligations relating to capital liberalization, the appropriate scope of these obligations would have to be considered. Two possible approaches could be envisaged.

53. Under the first approach, which will be described as the ***narrow approach***, members' obligations would apply to the making of payments and transfers associated with capital transactions, but would not apply to the underlying capital transactions themselves. This approach would be designed to achieve symmetry with the Fund's existing jurisdiction over restrictions on current payments and transfers. Under the second approach, the ***broad approach***, obligations would apply not only to all capital payments and transfers but also to underlying capital transactions.

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[34] An amendment that would provide symmetry in the Fund's treatment of restrictions on current and capital transfers would also serve to remove jurisdictional distinctions that are becoming increasingly anomalous. Given the importance of capital flows, it is difficult to justify from an economic perspective why, for example, multiple currency practices and discriminatory currency arrangements that arise from current transactions are subject to the Fund's jurisdiction under Article VIII, Section 3 while similar practices that involve capital transactions are not. As is noted in the paper on legal aspects, this distinction was made to reflect the right of members to maintain controls on capital movements.

54. This section will analyze the above approaches in general terms: Section VI examines further aspects of a possible amendment. More specific issues would be addressed once the Executive Board has given guidance on the desirability and general contours of such an amendment.

A. The Narrow Approach

The existing jurisdiction over "payments and transfers"

55. Under the Fund's existing jurisdiction, members may not impose restrictions on the "making of payments and transfers" for current international transactions. As a general rule, however, they may restrict the underlying transaction itself.[35] For example, a member breaches its obligations under the Articles if it either: (i) limits the ability of a resident to pay a nonresident for an import ("payment"); or (ii) limits the ability of the nonresident to repatriate the proceeds of this payment ("transfer"). The member is, however, free to prohibit the resident from making the import in the first place. Moreover, if the making of the import is prohibited, a restriction on payments and transfers made with respect to this import would also be permitted under the Fund's Articles, since the authorities are not required to permit payments arising from illegal transactions.

56. The application of the above principle has the consequence that, as a general rule, a member wishing to restrict the availability of foreign exchange for balance of payments reasons will not be prevented from doing so under the Articles if it imposes the restriction on the underlying transaction (e.g., through the requirement of an import license) rather than on the payment and transfer for that transaction.[36] When the Fund confirmed this important limitation over 35 years ago, it did so primarily in order to maintain a clear delineation between the jurisdiction of the Fund and the GATT. If the Fund had interpreted its jurisdiction as extending to any measure that had the purpose or the effect of restricting the ability of residents to make payments and transfers for current transactions, it was recognized that such jurisdiction would have covered a number of trade measures that fell within the jurisdiction of the GATT.[37] As a result, it has been the *nature* of the measure (i.e., whether it is a trade measure, which limits the underlying transaction, or an exchange measure, which limits the

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[35] Moreover, as will be discussed below, a member may restrict the "receipt" of payments and transfers.

[36] An exception to this general rule is where the import license is constrained by a mandatory foreign exchange budget, in which case it is regarded as an exchange restriction subject to Fund jurisdiction.

[37] See "Legal Aspects of Article VIII and Article XIV" (SM/59/73, 11/18/59), pp. 27–35.

payment or transfer), rather than its *purpose* or *effect* that determines whether a measure falls under the jurisdiction of the Fund.

Extending jurisdiction to capital payments and transfers

57. If one wished to extend the existing principle of "making of payments and transfers" to capital through an amendment, the Fund's jurisdiction would cover the following:

- *Nonresident outflows*—Jurisdiction would cover restrictions on "the making of payments and transfers" associated with the repatriation of the proceeds of investments that nonresidents have lawfully made with residents. Since the Fund's existing jurisdiction already covers net income outflows associated with such investments (interest on loans, dividends, etc.), moderate amounts of debt amortization and depreciation of direct investment, the items that would be brought within the Fund's jurisdiction under an amendment would consist of: (i) with respect to loans that have legally been made by nonresidents to residents, all principal repayments (including bullet repayments) made by residents, and (ii) with respect to other investments that have legally been made by nonresidents, the repatriation of the original capital and capital appreciation.

- *Resident outflows*—The amendment would also cover all restrictions on "the making of payments and transfers" made by residents in connection with investments that residents are legally permitted to make with nonresidents. For example, if a member permitted a resident to agree to lend an amount to a nonresident, the member would be precluded from restricting the resident from actually disbursing the loan amount to the nonresident. In addition, members that have permitted nonresidents to borrow from residents in such members' capital markets would, following an amendment, be precluded from restricting the proceeds of that borrowing from being transferred abroad.

Assessing the narrow approach

58. By extending the Fund's jurisdiction to the making of capital payments and transfers, the narrow approach has the merit of establishing symmetry in the Fund's treatment of current and capital transactions. The shortcoming of such an approach, however, is that its ability to further the objectives of the amendment would be limited in at least two important respects.

59. The ***first limitation*** arises because, as a matter of practice, controls on capital movements are often imposed on the underlying transaction rather than on the associated payment and transfer. In cases where, for purposes of husbanding foreign exchange, the authorities wish to preclude a resident from transferring funds abroad, they have, in most cases, specifically prohibited the underlying capital transaction rather than the payment or transfer. For example, residents may be prohibited from acquiring securities abroad or

establishing deposits with nonresident banks. Moreover, if the authorities wish to restrict a nonresident from borrowing in their domestic securities market, they have generally prohibited the nonresident from issuing, listing, or selling securities locally. They have generally not chosen to permit the issuance, listing, or sale, while preventing the transfer of the proceeds.

60. The restrictions described above on the underlying transactions would not be covered under an amendment that was limited to payments and transfers. Moreover, in those cases where the prohibition is expressed in terms of the payment and transfer rather than the underlying transaction, Fund jurisdiction could be circumvented by shifting the locus of control to the underlying transaction. While this problem also exists with respect to the Fund's existing jurisdiction (members can move the control from import payments to the import itself), the impact has been mitigated by the existence of the GATT—and now the WTO—which has jurisdiction over these underlying current transactions. As noted in the previous section, however, there is no equivalent, widely-applied set of rules for underlying capital transactions that would minimize the incentive to shift controls on payments and transfers to the underlying transaction.

61. The ***second limitation*** of the narrow approach would be its failure to liberalize inflows; i.e., investments made by nonresidents with residents. Under the present Articles, the "making" of payments and transfers is covered but not their "receipt". Accordingly, under the narrow approach, the authorities would be free to prohibit a resident from receiving the loan amount that it has borrowed from a nonresident. It should be noted that this second limitation—the failure to cover inflows—would not be rectified by merely covering the "receipt" of capital payments and transfers under an amendment. This is because controls on capital inflows are also predominately imposed on the underlying transaction rather than the receipt of such payments by residents. If the authorities wish to restrict overseas borrowing by residents, they will generally prohibit the loan rather than the receipt of the loan amount by the resident. Similarly, if the authorities wish to restrict nonresidents from purchasing local securities, they will generally prohibit the purchase and not the inward transfer of the funds to make the purchase. Thus, as in the case with outflows, meaningful liberalization could only be achieved if the authorities were also precluded from imposing restrictions on the underlying transactions.

62. The failure to cover inflows under an amendment would be significant given that the factors influencing international capital mobility depend as much on the regulations maintained by the country receiving the investment (the host country) as those of the country of the investor, and that controls on capital inflows are as prevalent as those on outflows. If the objectives of free capital movements are to be achieved, it would be desirable, therefore, to liberalize both capital inflows and outflows.

63. As a general matter, the coverage of the existing international agreements that deal with capital movements serves to demonstrate that, for purposes of liberalizing capital movements, it is necessary to establish obligations with respect to both the underlying

transaction and the associated payment or transfer. For example, under its charter, the OECD is charged with liberalizing "capital movements". [38] To this end, it has established the "Code of Liberalization of Capital Movements" (the "OECD Capital Code"). Although the term "movements" suggests merely the flow of funds, the Code regulates both the underlying transactions and the related payments and transfers. The OECD Capital Code covers both outflows and inflows, i.e., both investments made by residents with nonresidents and investments made by nonresidents with residents. In their previous discussion, the Executive Board agreed that the OECD Capital Code was generally appropriate for the Fund's intensified focus on capital account regulatory issues. [39]

B. The Broad Approach

64. In view of the important limitations of an amendment that would only cover the "making" of capital payments and transfers, consideration could be given to an amendment that would, in addition, cover: (i) the "receipt" of payments and transfers (i.e., inflows); and (ii) underlying capital transactions between residents and nonresidents. The scope of those transactions covered under a possible amendment could be similar to those covered under the OECD Capital Code.

65. The OECD Capital Code's coverage of international capital movements is comprehensive in a number of respects. First, it establishes obligations with respect to the ability of nonresidents to engage in transactions in the local market and with respect to the ability of residents to engage in such capital transactions abroad. In this respect, it serves to liberalize the making of both inward and outward investments. Second, it covers all types of capital transactions. Third, the obligations apply to the making of transactions but also to the payments and transfers associated with these transactions.

66. The coverage of a similarly broad set of capital transactions under an amendment would recognize the importance of all types of capital flows for a member's economic performance and balance of payments and, thereby, the international monetary system. It would include foreign direct investment (including real estate transactions) which, because it facilitates the transfer of technology, managerial skills and the development of export markets, promotes sustainable economic growth. It would also comprise all credit transactions between residents and nonresidents, including trade and nontrade related credits and deposit transactions, transactions in securities and other negotiable financial claims. Such flows are particularly relevant to the Fund in view of their sensitivity to economic policies, their short-term impact on a member's balance of payments and, accordingly, the effectiveness of the

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[38] Article 2(d), Convention on the Organization for Economic Cooperation and Development.

[39] BUFF/95/83 (8/4/95).

Fund supported adjustment programs. A coverage based on the OECD Capital Code would also include, inter alia, personal capital movements. [40]

67. It is recognized that some of the transactions that would be covered under the broad approach would be associated with potentially more volatile capital flows (e.g., interbank deposits and other short-term instruments); this would seem appropriate in view of the implications of these flows for the stability of the international monetary system. Moreover, given the Fund's responsibility as a financial institution charged with assisting members to deal with the balance of payments implications of volatile outflows, it would seem appropriate for the Fund to play a central role in determining when circumstances warranted the imposition of controls on such flows. As will be discussed below, the Fund would develop approval policies that would enable a member to introduce restrictions on such flows when circumstances warranted.

68. Notwithstanding the wide coverage of an amendment that would follow the broad approach, Fund jurisdiction would be limited by the application of three well-accepted principles, all of which are also applied by the OECD Capital Code.

69. First, under the amendment, a member would be obliged to allow nonresidents to carry out capital transactions in its territory under terms that are no less favorable than those that it applies to its own residents ("national treatment"). Accordingly, if a member does not permit its residents to engage in capital market transactions with each other, it may also restrict a nonresident from doing so. It is not required to give preferential treatment to nonresidents. [41]

70. Second, as under the Fund's existing jurisdiction, the concept of a "restriction" would require the imposition of a governmental measure upon a third party. Accordingly, resident companies could, on their own volition, discriminate in their contracts and activities against nonresidents. Moreover, proprietary actions taken by the government on its own account (e.g., sovereign borrowing) that discriminate against nonresidents would not be viewed as a

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[40]A detailed discussion of the coverage of the OECD Code is provided in the background paper, SM/97/32, Sup. 2 (forthcoming).

[41]With respect to the overseas trnasactions of its residents, however, members would be required to permit their residents to engage in transactions in the territory of other members, irrespective of whether such transactions are permitted in its own territory. This approach is also followed by the OECD Capital Code. Accordingly, while a member could prohibit a nonresident from issuing certain securities domestically on the grounds that such transactions are not permitted among its own residents, it could not prohibit it own residents from engaging in such securities transactions in the territory of another member which permits such transactions.

restriction and, therefore, would not fall within the Fund's jurisdiction.[42] Thus, if a government precluded nonresidents from purchasing government-issued securities in the primary market, this measure would not give rise to a restriction.[43] Similarly, in the context of the privatization of public assets, the government (or one of its wholly-owned companies) would be free to restrict the sale of these assets to residents or nationals. This approach is also followed by the OECD Capital Code.

71. Third, under its existing jurisdiction, the Fund's focus is limited to payments and transfers for current international transactions that directly affect a member's balance of payments, i.e., payments and transfers between residents and nonresidents. The coverage of transactions under the broad approach would not alter the Fund's existing focus on cross-border transactions and would also be consistent with the approach followed under the OECD Capital Code. For example, if a member imposed a restriction upon the ability of a nonresident to acquire a controlling interest in a resident enterprise, this restriction would be subject to the Fund's jurisdiction. If, however, the authorities allow the nonresident to acquire the resident enterprise, but impose restrictions on the domestic operations of that foreign-owned enterprise (which differ from restrictions imposed on locally-owned enterprises), such a restriction would not be subject to the Fund's jurisdiction because the restricted operations would be domestic, i.e., between two residents. The member's treatment of the foreign-owned enterprise would continue to be determined by those foreign investment treaties that focus on the treatment and protection of foreign-owned enterprises (including expropriation and dispute resolution) rather than the liberalization of capital movements between residents and nonresidents.

C. Approval Policies

72. Under the Articles, the Fund has the authority to approve the imposition of restrictions on the making of payments and transfers for current international transactions. As noted above, any amendment should also give the Fund the authority to approve restrictions on capital payments or transactions, as the case may be. As with the Fund's existing approval powers, the criteria for approval would be specified in policies of the Executive Board (as adopted from time to time) rather than in the Articles. With respect to the formulation of such policies in the context of capital movements, the following is of particular relevance:

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[42]Under the Fund's existing jurisdiction, a government's default on its own obligations does not give rise to a "restriction". Directions given by central governments to entities would also be proprietary to the extent that such direction is exercised through the government's ownership interest in the public entity, rather than through regulations of general applicability.

[43] However, restrictions imposed by the authorities on securities transactions involving securities issued by foreign governments would be covered by the amendment.

73. *Temporary approval*—As under the existing temporary approval policy for restrictions on current payments, approval of restrictions on capital movements would be granted by the Executive Board only when such restrictions are temporary, nondiscriminatory, and imposed for balance of payments purposes. Although similar criteria could be used for capital outflows, the criterion of "balance of payments purposes" would require elaboration in the case of inflows. Specifically, restrictions on capital inflows would be justified if an assessment was made that: (i) the inflows in question pose major difficulties for macroeconomic management, and (ii) the stance of policies is otherwise judged to be broadly appropriate, or is judged to be being brought on track by the authorities..

74. *Other approval policies*—Under the Fund's existing policies, approval is generally granted on a temporary basis and for balance of payments reasons. The only exception is the Fund's policy of approving restrictions that are imposed solely for the preservation of national or international security. This policy would be extended to cover restrictions on capital movements that are imposed for similar reasons.

75. Given the nature of the existing measures that regulate capital movements, it may also be necessary for the Fund to approve the imposition of restrictions designed to change the composition of capital inflows for a more extended period. This could be justified in circumstances where the state of development of the member's financial system constrains its ability to achieve monetary and exchange rate policy objectives consistent with a more open capital account. As with other controls, however, to the extent that they are in place when the amendment enters into force they would, in any event, be protected under the transitional provisions, which are discussed below.

76. Moreover, if the broad approach is adopted, consideration would need to be given to the establishment of policies that would permit the maintenance of restrictions for a number of reasons that are unrelated to balance of payments and macroeconomic management. For example, although inward foreign direct investment is a particularly beneficial form of capital flow from the perspective of promoting growth, and the Fund has encouraged members to liberalize such transactions, it is recognized that many members maintain restrictions on the ability of nonresidents to acquire a controlling interest in a domestic enterprise as a result of concerns relating to social, sectorial, and strategic considerations. Restrictions on the acquisition of real estate are often imposed for similar reasons. It could seem appropriate for the Fund to adopt a liberal approval policy with regard to restrictions motivated by such concerns.[44] Such a liberal approach to restrictions imposed on inward FDI for social, strategic, and security reasons would differ from the approach followed in the OECD Capital Code, where members are generally precluded from imposing new restrictions on such transactions.

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[44]The approval could be granted on a case-by-case basis or by general decisions that would apply to all members.

77. Special approval policies would also be necessary for prudential and investor/consumer protection reasons. For example, restrictions on the *admission of securities* into domestic markets are often maintained for investor protection and prudential reasons, rather than for reasons of balance of payments and macroeconomic management. Specifically, regulators are concerned that they are unable to assess the safety and soundness of securities issued by enterprises over which they have no regulatory control and supervision. For this reason the Fund could adopt a liberal approval policy which would enable members to maintain such restriction.[45] It should be noted that a measure imposed by the authorities limiting the admission of nonresident securities would only give rise to a restriction (and therefore would only require approval) if the measure discriminated against nonresident securities. The authorities would be free to limit the admission of any—or all—classes of securities, as long as such limitations also applied to securities issued by residents.

D. Transitional Arrangements

78. In view of the importance of capital flows, and the need, for some countries, to avoid unsustainable liberalization ahead of necessary macroeconomic adjustment and structural reforms, the amendment should allow members to avail themselves of transitional arrangements similar to Article XIV. Restrictions in place at the later of the date of the amendment and the date of membership would be "grandfathered." However, such restrictions, once removed, could not be reimposed without Fund approval.

79. Given the importance of ensuring consistency of structural and macroeconomic policies with capital account liberalization, further consideration would need to be given to the conditions under which a member would be required to give up the protection of the transitional arrangements. The unnecessary delay of a member's acceptance of its liberalization obligations would undermine the objectives of the amendment to liberalize its capital account. At the same time, however, the premature acceptance of these obligations could undermine economic and financial stability. For these reasons, it might be appropriate for the Fund to play a more active role than it does under the existing Article XIV in determining when members should no longer avail themselves of these transitional provisions for balance of payments purposes. For example, the amendment could specifically provide for the adoption of Fund policies that would provide a framework for an assessment of when a

[45] It should be emphasized that, as a general matter, the range of prudential measures that would require the application of such a "nontemporary" approval policy would be rather limited. This is because a number of prudential measures would not, in fact, constitute "restrictions". For example, prudential limits that are imposed on the open foreign exchange position of financial institutions would not, on their face, give rise to restrictions because such limits do not specifically restrict credit transactions between residents and nonresidents. Rather, by focussing on the "net" open position, they merely minimize the foreign exchange risk of individual banks. See background paper, SM/97/32, Sup. 1 (forthcoming).

member's macroeconomic and structural policies no longer justify the maintenance of controls.

80. It is recognized that a more active role for the Fund in the application of the transitional provisions, as discussed above, may not be appropriate in all circumstances. Just as the Fund would adopt liberal approval policies that would allow a member to impose certain restrictions for social, sectorial, and strategic reasons, so it would adopt policies under the transitional provisions that would give members considerable discretion with respect to restrictions imposed for such reasons. Given the fact that almost all members maintain restrictions on inward FDI for these reasons, such a liberal policy would clearly be necessary.

E. Surrender and Repatriation Requirements

81. Regardless of which approach is considered preferable—the broad approach or the narrow approach—one issue that would require further consideration would be the treatment of surrender and repatriation requirements under an amendment. Under the Fund's existing jurisdiction, members have the right to impose such requirements. In one sense, such a requirement would seem incompatible with members' obligations to liberalize outward investments made by residents. However, to the extent that a surrender or a repatriation requirement is imposed for the purpose of monitoring a resident's compliance with its laws, it would not necessarily be problematic. Even in an environment where all outward investments are legally permissible, there may be circumstances where repatriation is utilized for the purposes of assessing compliance with tax or other laws.

82. In view of the above, one possible conclusion would be to treat repatriation and surrender requirements as restrictions under the amendment but provide that they would be approved under a general policy of the Fund if they did not give rise to unreasonable delays, constraints, or financial costs in the making of payments and transactions that have been liberalized in accordance with members' obligations under the amended Articles.

F. Implications of an Amendment for Other Provisions Relating to Capital

83. As has been noted earlier, the liberalization of capital restrictions would be expected to deepen members' access to capital markets. From this perspective, therefore, an amendment could tend to reduce members' need to use the Fund's resources. On the other hand, however, greater freedom of capital movements may increase the magnitude and volatility of capital outflows. Although corrective policies would normally be the primary means of addressing these outflows, in some cases members may require greater balance of payments support from the Fund.

84. Under Article VI, Section 1 of the Fund's Articles, the Fund is precluded from financing large or sustained capital outflows. In many respects, this is a corollary of the existing right of a member to impose capital controls pursuant to Article VI, Section 3 and the

Fund's authority to request the imposition of such controls as a condition of its assistance. Since members are free to impose capital controls, it was envisaged that balance of payments problems created by large or sustained capital outflows would be addressed, if needed, by reliance on such controls in conjunction with policy adjustments rather than through the use of the Fund's resources. This would limit the Fund's exposure in such circumstances and ensure that its limited resources would be used primarily to support the performance of members' obligations relating to current account convertibility. If freedom of capital movements is to become an obligation under the Articles, the view could be taken that this limitation should also be removed so as to achieve symmetry with respect to the Fund's financial support for obligations relating to the current and capital account. Nevertheless, given the potential magnitude of capital outflows and the impact that they may have on a member's balance of payments and, thereby, on the revolving character of the Fund's resources, it would be desirable to retain a constraint on the financing of such flows. This would help to ensure that the Fund would have available adequate resources to fulfill its ongoing mandate to help finance temporary balance of payments difficulties associated with current transactions. In addition, this would serve to limit the extent to which Fund resources could be used to facilitate a withdrawal by other creditors, and thereby provide a safeguard for the temporary use of those resources. It is recognized, however, that this may raise a question of whether such a limitation would constrain the Fund's ability to provide members with confidence to undertake capital account liberalization.

85. In view of the above, one possible approach would be to retain the existing limitation on the financing of large or sustained outflows in the Articles. A variant of this approach would be for an amendment to provide the Fund with the authority to modify the extent to which it would finance large or sustained outflows pursuant to policies adopted by the Executive Board by an 85 percent majority. Such policies could be reviewed from time to time in light of a number of factors, including the evolving experience, the Fund's liquidity, and its portfolio profile. (Decisions on individual arrangements would continue to be made by a simple majority.) Another approach would be to remove this limitation from the Articles, but limit the financing of large or sustained capital outflows through the application of Article V, Section 4, which provides the Fund with authority, as a means of safeguarding its resources, to impose limitations with respect to purchases that would cause the Fund's holdings of a member's currency to exceed 200 percent of quota. Such limitations would be imposed by a simple majority.

86. If it were decided to retain a limitation on the Fund's ability to finance large or sustained capital outflows in the Articles themselves, the question would also arise as to whether the Fund's existing authority to request a member to impose capital controls under Article VI, Section 1 should also be retained. [46] To the extent that the financing limitation is based on concerns regarding the magnitude and the volatility of capital outflows and the

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[46]The Fund has never found it necessary to formally request a member to impose capital controls.

impact that they can have on a member's balance of payments and the Fund's resources, one could argue that the authority to request such controls would still be of value. However, since such a request would be made only in the context of the use of the Fund's resources, it would appear that the imposition and approval of controls could, where necessary, be ensured through the design and monitoring of the member's program, i.e., in the context of the Fund's policies on conditionality, without the need for a specific provision in the Articles.[47] Therefore, there would appear to be no need to retain a provision in the Articles that specifically gives the Fund the authority to request a member to impose capital controls.

87. It is recognized that a possible amendment raises a number of complex issues which would require further consideration. In addition, it is understood that the extension of jurisdiction would involve human resource implications for the Fund and that, accordingly, efforts will have to be made to ensure that the Fund's new role in this area does not distract it from the performance of its other responsibilities.[48]

VI. Structure of a Possible Amendment

88. As noted above, if it were decided to proceed with an amendment, Article I would be modified to include a reference to the objective of liberalizing capital movements as one of the specific purposes of the Fund. Since discussions regarding the desirability and scope of an amendment to cover capital movements are still at a preliminary stage, the text of the "core" provisions of the amendment set forth below which would extend the Fund's jurisdiction to capital movements are provided for illustrative purposes only. As can be seen, this draft places all of the provisions regarding the regulation of capital movements within a revised Article VI. The text of Article VIII, Section 2(a), which sets forth members' obligations regarding current payments and transfers, would not be revised. As with other provisions of the Articles, the text below is drafted with considerable compression; much of the explanatory text would be contained in the commentary. Another approach would be to combine all of the provisions on current payments and capital movements (together with the provisions on multiple and discriminatory practices and official convertibility) into a single Article.

89. The revision of Article VI as set forth below may, of course, require revisions of other provisions of the Articles. Moreover, the meaning of other provisions of the Articles may be affected—even if their text is not actually revised. For example, the deletion of the provision

[47] In this context, it should be noted that approval of capital controls by the Fund would not be specifically recognized under the GATS. Under the terms of the existing provisions of that treaty, only a request made by the Fund under Article VI for a member to impose capital controls will excuse a member from the performance of its obligations under the GATS (Article XI of the GATS).

[48] It should be noted that further intensification of surveillance along the lines suggested above would also have human resource implications.

that presently gives members the right to maintain controls over capital movements would imply that multiple currency practices and discriminatory currency arrangements arising from capital transactions are subject to the Fund's jurisdiction under Article VIII, Section 3.[49]

Illustrative Text of an Amendment

Article VI **Capital Movements**

Section 1. *Avoidance of restrictions on capital movements*

Subject to Section 2 of this Article, members shall not, without the approval of the Fund, impose restrictions on [the making of payments and transfers for capital international transactions] [50] [capital international transactions and related payments and transfers].[51]

Section 2. *Transitional arrangements*

Any member may, upon notification to the Fund, maintain and adapt to changing circumstances restrictions inconsistent with Section 1 of this Article that were in effect on the later of the effective date of the Fourth Amendment of the Articles or the date on which it became a member; provided that a member availing itself of this provision shall remove such restrictions when, and to the extent that, the Fund determines, in light of the member's circumstances, that they are no longer necessary. The Fund shall adopt policies specifying the procedure and criteria it shall apply for making such a determination.

[Section 3. *Use of the Fund's general resources for capital transfers* [52]

(a) A member may not use the Fund's general resources to meet a large or sustained outflow of capital except as provided in (c) below or in accordance with policies adopted by the Fund by an 85 percent majority of the total voting power [, and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund. If, after receiving

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[49] However, since the conclusion would change the existing legal situation (at least for discriminatory currency arrangements), it would have to be decided whether Article VIII, Section 3 should apply to capital movements during the transitional period preceding the removal of existing restrictions. This could be clarified in the commentary of the amendment.

[50] Narrow approach.

[51] Broad approach.

[52] Article VI, Section 3 would be included if it was determined that there should be a limit within the Articles on the ability of the Fund to finance large or sustained capital outflows.

such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund.][53]

(b) Nothing in *(a)* above shall be deemed:

(i) to prevent the use of the general resources of the Fund for capital transactions of reasonable amounts required for the expansion of exports or in the ordinary course of trade, banking, or other business; or

(ii) to affect capital movements which are met out of a member's own resources, but members undertake that such capital movements will be in accordance with the purposes of the Fund.

(c) Notwithstanding the limitation in *(a)* above, a member shall be entitled to make reserve tranche purchases to meet capital transfers.]

VII. Issues for Discussion

90. As discussed, the growth of international capital movements has important implications for the policies of Fund members and the international monetary system. Is it the view of Directors that, with the growth of international capital movements, the present Articles give the Fund sufficient powers to discharge effectively its mandate in overseeing the international monetary system?

91. In response to the Executive Board's request, the Fund has intensified its surveillance and technical assistance activities in promoting capital account liberalization and expanded the information collected on the regulatory framework for capital movements. Do Executive Directors agree that one initiative for intensifying the Fund's efforts in this area would be to increase attention to the role of specific controls on capital movements, and the circumstances under which these controls could be eliminated or cases where the use of controls could be appropriate?

92. Executive Directors may wish to discuss whether the Articles should be amended to make the liberalization of capital movements a specific purpose of the Fund. To enable the Fund to achieve such a purpose, would Directors support the removal of the asymmetry of the treatment of current and capital restrictions, thus strengthening the Fund's capacity to oversee the international monetary system? If so, an amendment would need to go beyond the elimination of Article VI, Section 3 (which allows members to maintain controls for capital movements) in order for the Fund to have jurisdiction over capital movements. Do Directors consider that it would be desirable for the Fund to have such jurisdiction?

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[53]The square-bracketed language contained in Section 3(a) would be included if it was decided to retain the Fund's ability to request a member to impose controls on capital outflows.

93. Regarding an extension of jurisdiction, do Executive Directors believe that the principle applied to its existing jurisdiction for current payments should be extended to capital; should jurisdiction only cover outflows (as is presently the case) or also be extended to inflows? Should it be confined to payments and transfers, or also be extended to underlying transactions?

94. If Fund jurisdiction is extended to underlying transactions, do Directors consider that a broad coverage, as applied by the OECD, would be appropriate?

95. Do Executive Directors agree that the obligations with respect to capital would be subject to certain exceptions, including transitional arrangements and Fund approval of restrictions on capital movements? Do Directors agree that the Fund would need to develop approval policies for such exceptions that would go beyond balance of payments considerations to cover capital inflows and to authorize prudential measures, as well as restrictions imposed for social, sectorial, and strategic reasons? Should the Fund develop policies as a means of implementing the transitional provisions?

96. Executive Directors may wish to consider whether any limitations on the use of Fund resources for financing large or sustained capital outflows should be retained and, if so, how this should be achieved. Directors may also wish to consider whether the Fund's right to request the use of capital controls as a condition for the use of Fund resources should be retained in the Articles.