International Financial Architecture, Capital Account Convertibility and Poor Developing Countries

Christopher L. Gilbert [1]

Gregor Irwin [2]

David Vines [3]

June 2000

This paper has been prepared for an ODI Seminar, "Capital Account Liberalisation: The Developing Country Perspective", Overseas Development Institute, London, 21st June 2000. We are grateful to Jan Dehn and Raul Hopkins for comments on an earlier draft. We alone are responsible for errors etc.

Address for correspondence: Christopher L. Gilbert: FEWEC, Vrije Universiteit, De Boelelaan 1105, 1081 HV Amsterdam, The Netherlands.

Email: cgilbert@econ.vu.nl

Web: http://www.econ.vu.nl/medewerkers/cgilbert/default.html

---

[1] Vrije Universitiet, Amsterdam; Queen Mary & Westfield College, University of London; CEPR; and Tinbergen Institute.

[2] Department of Economics and Lady Margaret Hall, Oxford University.

[3] Department of Economics and Balliol College, Oxford University; Australian National University; and CEPR.

1. Introduction

It is natural for market-oriented economists to regard capital market liberalisation as an integral component of the overall liberalisation process in developing countries. This was true of postwar adjustment in Europe, and has been extrapolated to the fast-growing Asian economies and now to the remainder of the developing world. Fischer (1998, p.2) wrote, "… capital account liberalisation is an inevitable step on the path of international development, which cannot be avoided and should be embraced. After all, the most advanced economies all have open capital accounts."

Up until the Asian Crisis, discussion of capital market liberalisation focused on sequencing issues, and speed, but the overall principle of liberalization was accepted. In the aftermath of the crisis, the emphasis has shifted to caution, and a number of influential commentators now even question the principle of liberalization. Within a cost-benefit framework, the benefits are seen as more modest than had previously been supposed, while the Asian Crisis has increased our estimates of the potential costs of liberalisation

In section 3, we survey the arguments for and against liberalisation. In the sections which follow we turn to sequencing issues - when in the process of liberalisation should capital account liberalisation be introduced? Section 4 looks at differences between Foreign Direct Investment (FDI) and portfolio investment in the context of poor developing countries. In section 5 we ask whether liberalisation is likely to stimulate increased levels of FDI and in section 6 we consider financial repression in relation to capital account liberalisation. In section 7, we turn to macroeconomic concerns about vulnerability and multiple equilibria, in particular in relation to countries which operate pegged exchange rates. In section 8 we look at the possible effects of contagion on the claimed macroeconomic benefits of capital account liberalisation. Section 9 is devoted to the sequencing or reform, and suggest that there are few likely benefits, and many potential costs, from liberalising the capital account while domestic markets and services remain protected, while institutions (courts, regulatory authorities etc.) remain weak, while industrial policy remains interventionist and while exchange rates are pegged. In sections 10 and 11 we turn to the role of the multilateral agencies, and how these agencies and their policies should evolve. Section 12 contains conclusions.

3. Benefits and Costs of Capital Account Liberalisation

A large number of different arguments have been advanced for capital account liberalisation. We have isolated the following broad classes of argument, although there may

be others:

1. Allocational arguments – "maximizing efficiency in the world's use of capital, a scarce resource" (Cooper, 1998, p.12). Capital account liberalisation reduces interest rate differentials across currencies and countries, and thereby reduces international differences in the cost of capital. As a consequence, investment becomes more efficient. This argument is identical to standard arguments on the gains from free trade in goods and services.
2. Individual freedom – "individuals should be free to dispose of their income and wealth as they see fit" (Cooper, 1998, p.12). In a liberal democracy, property owners should be free to dispose of their assets as and where they wish, provided that this does to involve illegal activities or tax avoidance or evasion. In particular, capital market controls prevent individuals from diversifying their asset portfolios. Abolition of controls facilitates risk reduction.
3. Macroeconomic discipline – "countries stand to gain by enlisting the capital markets in support of good policies" (Dornbusch, 1998, p.20). Because capital markets are forward-looking, the possibility of large inward or outward capital flows imposes an element of constraint on government policies, requiring that these be feasible over the longer term. This discipline is a means for obtaining commitment to sound policies from governments which may be subject to short term electoral or other political pressures.
4. Financial market discipline – "intense capital mobility puts greater burdens on a country to ensure that its financial system is well supervised and regulated" (Dornbusch, 1998, p.20). If countries are to compete in free international capital markets, they will be required to conform to international standards with regard to reporting and to financial regulation.
5. Infeasibility - "the scope for discretionary action has become extremely limited" (Dornbusch, 1998, p.20). Capital market controls may be evaded through exploitation of special provisions and loopholes or by black or grey market operations. The net effect of controls is therefore only to increase costs. This argument contradicts those that precede it – for example, if controls are ineffective, they cannot discipline government policy and is an attempt to finesse the entire issue. We shall take it that controls are sufficiently effective for governments to wish to maintain them, since otherwise there is no point any discussion. Furthermore, the evidence from Chile and Malaysia, among other countries,

demonstrates that controls can have significant effects.[4]

6. Corruption – "the discretion given to officials to give exceptions to general provisions on international capital movements, giving rise to favoritism and corruption" (Cooper, 1998, p.12). Corruption increases the arbitrariness arising from capital market controls and the costs associated with evading these controls.

Different commentators stress different arguments, but broadly the first (efficient capital allocation) and third (macroeconomic discipline) arguments receive greatest prominence. An important and seldom-stressed contrast between these arguments is whether capital market liberalization is seen as giving rise to direct benefits (capital market allocation, individual freedom), or whether it is instrumental in promoting other desirable objectives (macroeconomic and financial market disciplines, reduction of corruption).

Capital account liberalisation also imposes costs on developing countries. There is widespread agreement that if capital account controls were the only "distortion", the first best policy would always be liberalisation. Arguments for the retention of capital account controls therefore inevitably invoke second best considerations (Dooley, 1996, p.640). In particular, arguments are generally posed within the Mundell-Fleming framework which assumes a degree of labour market stickiness. The following are among the most frequently articulated arguments against liberalisation:

1. Macroeconomic Policy: Capital account liberalisation complicates the conduct of macroeconomic policy, essentially by constraining the level of the domestic interest rate. This is just the counterpart of the macroeconomic discipline argument advanced as a benefit from liberalisation.
2. Exchange Rate Management: Many developing countries are committed to pegged exchange rate regimes. The viability of this type of regime is underpinned by capital account controls (Wyplosz, 1986). The Asian Crisis has shifted the majority view in the Economics profession towards a strong preference for floating rate regimes, but that transition requires a degree of central bank independence which can currently only be an aspiration in many developing countries.
3. Taxation: A characteristic of many poor developing countries is that they have a relatively narrow tax base. Capital market liberalisation has the potential to further reduce the tax base. This is first because it is difficult to tax overseas earnings, and this makes it attractive to countries to prohibit the export of domestic capital (Razin and Sadka, 1991).

[4] See also the evidence on black market exchange rates in Cooper (1999).

Secondly, there is empirical evidence that countries with capital controls tend to exhibit relatively high inflation (Dooley, 1996, p.656) resulting in lower real interest rates, and hence real service cots, on domestic debt. Capital account liberalisation therefore entails either increases in explicit tax rates or reductions in government expenditure (Giovannini and de Melo, 1993).

4. Scale of Benefits: There is little econometric evidence that capital market liberalisation has any effect on developing country growth (Rodrik, 1998).
5. Sequencing: The standard objection to capital account liberalisation is that it is often premature. The direct benefits of liberalization are undisputed, but there are arguments about the appropriate sequencing of reforms .In particular, it is argued that capital account liberalisation should follow, not precede, current account liberalisation and, since the Asian Crisis, the move to a flexible exchange rate regime.[5] These changes will themselves require a significant level of investment in institution-building.

Our assessment of the consensus among professional economists involved in this area is that capital account liberalisation is seen as a providing potential net benefits, even in the poorest developing countries, but that the sequencing arguments are very important. The dominant word is therefore "Caution".

4. Inward Capital Flows: Structure and Effects

It is conventional to break inward capital movements into three components:

i) Foreign Direct Investment (FDI),

ii) portfolio investment, and

other flows (which include loans, aid flows and official funding).

We will not discuss the third component in this paper.

Both FDI and portfolio investment rose dramatically during the nineteen nineties, with some decline from 1997 following the onset of the Asian Crisis. Both are now recovering, and there is every prospect that the first decade of the new century will show a continued high level of inward capital flows into developing countries. Both FDI and portfolio investment give countries access to international technology, enabling them to participate in a process of transformation and growth to an extent which would not be possible if confined to domestic technology. Both have the potential to raise growth rates and thereby reduce levels of poverty.

[5] For a contrary view, see Dornbusch (1998, p.20) who states 'Any question of sequencing is not one of trade versus capital, but rather of "cleanup" followed by opening.'

At the same time, the growth in both portfolio investment and FDI has been patchy, with many of the poorest countries receiving very little inward investment, and volatile, so that those countries which have been recipients have suffered from periodic "emerging market crises" during which flows dry up. Bosworth and Collins (1999, p.148) record that five countries accounted for nearly two thirds of financial flows into developing countries over the period 1990-95, of which only one (China) would be regarded as among the poorest developing countries.[6] Furthermore, FDI and portfolio investment flows are not significantly correlated – for example, China, which was the largest recipient of FDI obtained very little portfolio investment, while Brazil, which was the largest recipient of portfolio investment, obtained little FDI (Bosworth and Collins, 1999, p.151).[7]

The distinction between FDI and portfolio investment is important for two reasons:

a) Portfolio investment flows are much more volatile than FDI flows – it is much easier to sell shares in a Thai company and withdraw ones capital, than it is to sell a factory in Thailand with the same objective. Although FDI can decline in a crisis, it is unlikely to reverse.
b) Econometric evidence shows that FDI translates directly into fixed investment with a near unit coefficient. By contrast, the multiplier for portfolio investment is much smaller.[8]
c) Countries do not need to fully liberalise their capital accounts in order to benefit from FDI since both inflows and outflows can be accommodated through special provisions. Portfolio investment does, however, require capital account liberalisation.

Taken together, these remarks imply that openness to portfolio investment offers fewer benefits and imposes higher costs than does openness to FDI, and that many of the benefits access to FDI can be obtained without full liberalisation. Furthermore, we will argue in section 2.3 that liberalisation *per se* will do little to stimulate FDI. This is not to deny that capital account liberalisation should be an eventual objective, but only that the issue is not of binary, all-or-nothing, form.

With very few exceptions (South Africa being the most notable), the poorest developing countries are not recipients of significant portfolio investment. Indeed, most of these countries do not currently have stock markets. Inward portfolio investment is therefore

---

[6] The others were Mexico, Korea, Thailand and Brazil (in that order).

[7] The correlation coefficient between FDI and portfolio investment over the period 1978-95 was 0.01 in their sample, rising to 0.06 in the sub-sample of emerging markets.

[8] Bosworth and Collins (1999, p.162). Their panel estimates over their emerging market sample are 0.90 (standard error 0.22) for FDI and 0.15 (standard error 0.08) for portfolio investment.

not an issue.

5. FDI and Capital Account Liberalisation

FDI is driven by expected profitability, in relation to risk, as it affects shareholder values. We suppose that shareholders are interested in dollar returns. Since funds for FDI derive from international markets, capital account liberalization will have only minor effects on the costs of FDI. However, it will affect the perceived ability of investors to repatriate profits and the risk associated with repatriation. Investors will also interest themselves in the macroeconomic environment, so the indirect effects of liberalisation on macroeconomic policy will be important. Capital account liberalisation, together with the confidence that capital movements will remain free over the relevant investment horizon, should therefore contribute to FDI. However, it is doubtful that this is a major determinant of the direction of FDI, and there is a large number of examples of countries, the most notable of which is China, which are major recipients of FDI despite maintenance of capital market restrictions.

The major reason for the likely small effect of capital account liberalisation on FDI is that it does not directly affect relative prices. It is a characteristic of many economies with low degrees of trade openness that distortions of relative prices in relation to border prices arise out of pressure to protect domestic industries rather than local factor abundances. It is unlikely that international investors will find investment in such environments attractive, particularly when indigenous firms maintain the ability to seek reinforcement of protection if they deems this necessary. This indicates that FDI will be more dependent on the liberalisation of goods and services, and on the strengthening of those institutions which will ensure a level playing field for indigenous and international firms. Capital account liberalisation can contribute to the stimulation of FDI, but the fact that this contribution will be small without institution-building and liberalisation of the markets in goods and services, indicates that it should fall relatively late in the sequencing of reforms.

Note that this argument does not imply that there are few benefits from capital account liberalisation, but only that the benefits arising out of better allocation of world capital are unlikely to be large until other reforms are at least in progress. However, if capital account liberalisation results, as it may if domestic markets remain heavily protected, in investment which would cease to be profitable at border prices, this may increase pressures on government to maintain these levels of domestic protection. In this case, premature capital account liberalisation may actually impede liberalisation of the market for goods and services.

These considerations are particularly important for the Least Developed Countries (the LDCs) which are almost definitionally the countries which receive the lowest amounts of FDI. The implication is that, for these countries, the allocational benefits of rapid capital account liberalisation are likely to be small.

Furthermore, if capital account liberalisation results, as it may if domestic markets remain heavily protected, in investment which would cease to be profitable at border prices, this may increase pressures on government to maintain these levels of domestic protection. In this case, premature capital account liberalisation may actually impede liberalisation of the market for goods and services.

6. Financial Repression

It is almost a truism that an acceleration of growth rates in the poorest developing countries will require a higher level of investment. Increased FDI is one route, but it is also natural to look to higher levels of domestic savings and investment – see, for example, King and Levine (1993) who show that financial sector distortions reduce growth rates. It is a characteristic of many of the poorest developing countries that saving is undertaken primarily by enterprises, rather than households, and is not intermediated (McKinnon, 1973; Shaw, 1973). This prompts us to ask what accounts for the low levels of savings and investment in poor developing countries, and how higher savings and investment might be encouraged.

Many poor developing countries have poorly functioning banking systems. In much of Sub-Saharan Africa, the coverage of the banking sector is actually lower than at the end of the colonial period, as the consequence of politicisation of bank lending. The presence of international banks goes some way in offsetting this, but these seldom extend their operations outside the capital city. Rural banking, in particular, is often very weak. Deaton (1992a, 1992b) shows that households attempt to smooth consumption, but poor access to liquid assets limits their ability to do this. In circumstances of this sort, household saving typically takes the form of the purchase of physical assets, with the consequence that windfall gains may be dissipated in asset price inflation (Bevan *et al*, 1990).[9] Households resort to social mechanisms for risk management (based on the village or extended family) – see Collier and Gunning (1999). There is little possibility of borrowing to finance investment.

Capital account controls reinforces financial repression of this sort by denying the

[9] Dehn (2000) shows that initial positive investment responses to temporary shocks fail to lead to permanent increases in growth, while large shocks are actually associated with declines in

possibility of overseas investment. In these circumstances, liberalisation would have ambiguous effects. Some capital which might otherwise be invested domestically will leave the country, but household sector savings will be stimulated, and some of this may subsequently return to fund domestic investment. Domestic banks will find themselves under greater pressure to compete and this may eventually result in the growth of a modern banking sector.

This appears to suggest a choice between financial repression, with low savings and growth, and the greater vulnerability induced by capital market liberalisation (Diaz-Alejandro, 1985). However, the suggested dilemma is too stark. Capital account liberalisation should be the goal, with the more immediate policies addressed to preparing institutions(in this case, domestic banking institutions) for liberalisation.

7. Vulnerability and Multiple Equilibria[10]

This section discusses what we have learned about how poorly managed capital account liberalisation can lead to crisis.

Dornbusch defines the term 'vulnerability' vividly, if imprecisely, clear when he says '[v]ulnerability means that if something goes wrong, then suddenly a lot goes wrong' (Dornbusch 1997, p. 21). There are many ways of making this general idea specific. Here we adopt a multiple-equilibrium interpretation. Seminal multiple-equilibrium analyses are to be found in Diamond and Dybvig (1983), which analyses bank runs, and Obstfeld (1986, 1991, 1994, 1995), who discusses exchange rate crises.[11] Both sets of papers present the following similar kind of 'problem'. If participants in some shared activity (bank depositors, or holders of a currency) expect a 'good' outcome (no bank run, no currency crisis) then they may take actions which increase the probability of the good outcome occurring. But if they expect a 'bad' outcome (bank run, currency collapse) then they may take actions which have the opposite effect. In these accounts, vulnerability consists of the possibility that the economy may flip from the good equilibrium to the bad one without any change in fundamentals. We envisage a situation in which there is a 'bad' equilibrium which exhibits a currency crisis. We will argue that this particular vulnerability can be caused by exposing an unreformed financial system to international capital flows.

Consider a financial system which functions by channeling domestic savings into

---

investment.

[10] This discussion follows Following Irwin and Vines (1999, 2000).

particular forms of investment and growth, via the banking system. Domestic credit is directed to particular privileged domestic sectors and firms, in the pursuit of various types (and degrees) of export-promoting industrial policy. Such a process of credit allocation can involve the extension of bank loans, often under state direction, the collateral for which can be – and was in the circumstances of Asian growth - little more than expected revenue growth, or even just the name of the borrower.

In this environment, firms become highly geared. They, and the banks which lend to them, become exposed to the effects to a revenue downturn; and in aggregate the whole of the financial system becomes so exposed. In countries experiencing very rapid growth the possibility of such a downturn can be seriously underestimated. Firms, and the financial system that lends to them, suppose that they are implicitly guaranteed against such bad outcomes, as a quid pro quo for participating in this system of industrial policy. Liberalisation, without reforming the financial system, implies that foreign suppliers of capital can get access to these guarantees. The consequence is that the stock of implicit guarantees to the financial system increases markedly.

We can think (see Krugman 1998) of an emerging economy as having a downward-sloping demand curve for capital, and facing a given world interest rate. Government guarantees ensure some form of bailout for investments that make losses. As a result of these guarantees, investment will be pushed beyond the point at where the expected value of the marginal product of capital has fallen to the given world interest rate.[12] The effect of capital liberalisation in these circumstances is to help to unleash an investment boom. If domestic savings are unresponsive to interest rates, government guarantees simply drive up the interest rate, without much effect on the actual quantity of investment undertaken- guaranteed projects crowd out non-guaranteed projects. After capital account liberalisation, the supply of foreign funds available to finance investments is elastic at the lower world interest rates resulting in an investment boom financed by borrowing from abroad.

It is possible for this economy to exhibit multiple equilibria. There will be a 'good' equilibrium in which the government can afford to pay all the guarantees into which it has entered, irrespective of the size of any adverse shock. But there may also be a bad, crisis, equilibrium, if foreign lenders believe that there is a range of productivity shocks sufficiently

---

[11] See Davies and Vines (1998) for the simplest possible multiple-equilibrium currency crisis model.

[12] For a more formal explanation of how capital account liberalisation, banking-sector guarantees, and poor financial sector supervision can result in excess investment see McKinnon and Pill (1996) and (1997).

bad that the government might renege on its guarantees. In this equilibrium, firms will pay a higher interest rate reflecting the probability of government defaulting on guarantees. But this in itself increases the cost to government of meeting its guarantees. Investors perceptions about the likelihood and size of adverse shocks will determine which of the two equilibria is observed. A shift in perceptions to a more pessimistic shock distribution could trigger a move from the good to the bad equilibrium. Such a shift may be unrelated to fundamentals in the country itself. Furthermore, if, as seems plausible, shock distributions are correlated across different emerging markets, there could be simultaneous shifts from the good to the bad equilibrium across a range of countries. Such shifts may be incorrectly attributed to contagion.

A high proportion of poor developing countries operate pegged exchange rates. Pegged exchange rate exacerbate vulnerability once the capital account is liberalised because they result in a large outstanding stock of unhedged foreign debt.

It is easy to see why private investors should fail to hedge - a fixed exchange rate reassures investors that the exchange rate will not be devalued. The fact that foreign debt is unhedged raises the domestic-currency value of the stock of outstanding government guarantees to the financial system in the event of a currency depreciation making it more expensive for government to meet these guarantees. With a liberalised capital account, fears that the government may renege may trigger depreciation. Adding currency depreciation to the bad equilibrium implies a wider range of circumstances in which the bad equilibrium will be selected.

In addition, a pegged exchange rate makes it more difficult for government to control a boom. The Mundell-Fleming model shows that the fixed exchange rates and autonomous national monetary policy can be combined if there are not open international capital markets. That combination worked, in the presence of capital controls. However, with a liberalised capital account, the boom stimulates capital inflow, as companies and banks borrow abroad at lower dollar interest rates, leaving the economies with a large outstanding stock of unhedged foreign debt. There may also be a consumption boom.[13]

The implication for developing economies is that capital account liberalisation can significantly complicate governments' macroeconomic management problems, particularly

[13] This has been documented by Warr (1998) for the case of Thailand who shows how the pre-crisis boom was not choked off by an appreciating exchange rate precisely because of the exchange rate peg. He then argues that the consequence of this boom was that cost price increases were unchecked, making the export sector increasingly uncompetitive.

when governments are committed to pegged exchange rates. There are merits in moving to a floating rate regime, but the requirement on governments to generate their own nominal anchors is demanding. We note that a number of developed market economies have experienced difficulties in this regard. This seriously qualifies the macroeconomic discipline argument for capital market liberalisation, and suggests that for many poor countries, it will be a long term rather than an urgent objective.

The Asian Crisis has provided an important learning opportunity both for the countries concerned and for the Economics profession. We believed that the Asian experience teaches that openness is a valuable development strategy but that completion of this strategy with capital account liberalisation has to be managed with care. There are two key pitfalls to manage.

- It is a mistake to continue implicit government guarantees to underwrite certain sectors of the economy, into a period of era of liberalisation in which the financial sector remains poorly regulated. In a system underwritten by guarantees, financial liberalisation can cause excessive investment, which can leave the economy vulnerable to a financial crisis.
- It is also a mistake to continue, into an era of liberalisation, with a pegged exchange rate regime. Fixing the exchange rate may be undesirable for two interrelated reasons. First, the fixed exchange rate acts as a particular kind of guarantee to the financial sector, that it can borrow abroad at low foreign interest rates; in the presence of such borrowing, the possibility of collapse of a fixed exchange rate peg greatly increases the possibility of multiple equilibria, and therefore of vulnerability to crisis. Second, fixing the exchange rate reduces the ability of the monetary authority to choke off any economy-wide boom resulting from the foregoing tendency to over-invest.

8. Contagion

This section discusses how capital market liberalisation, far from having the positive effect of constraining governments from adopting poor policies and causing them to adopt sustainable economic policies, may instead impose negative effects on governments which have adopted sustainable policies.

The argument that capital market liberalisation will constrain governments to adopt sustainable economic policies makes very strong assumptions about the operation of financial markets. If these assumptions fail, financial markets may constrain governments to sub-optimal decisions. This is the view expressed most cogently by Rodrik (1998). If this

criticism is valid, the issue ceases to simply one of sequencing, but becomes a question of the desirability of full capital account liberalisation.

A widespread observation during the Asian crisis was that financial markets appeared to exhibit contagion. Cooper (1998, p.15) writes "… the large outflows from Malaysia following the Thai crisis in July 1997 was a case of pure contagion; it was economically disruptive, with little useful allocative or signaling effect. From London or New York, all of South-east Asia is a blurred spot in the world and traders … issued their sell orders before asking discriminating questions".

The fact that a number of countries simultaneously experience similar problems does not in itself imply contagion – see section 2.4. However, one does not need to subscribe to the view that traders in the world's leading investment institutions are less bright than academics to understand the possibility of contagion. The crucial elements in a model which has this implication are set out by De Long *et al* (1990) – see also Shleifer (2000). In common with many other models in contemporary finance, De Long *et al* assume a group of noise traders who are poorly informed about the likely return distribution. In the De Long *et al* model, these traders are typically over optimistic about equity market returns, but in the Asian application, they may be seen as the agents who regard South-east Asia as homogeneous. Informed traders (investment banks, hedge funds etc.) are aware of the different circumstances of different countries, but are also aware of noise-traders misperceptions. Provided the informed traders collectively have sufficiently long horizons, they will take advantage of any mispricing resulting from the noise traders sales to buy the mispriced assets. This strategy would be profitable eventually. However, there is a danger that mispricing will increase before it is eliminated, and this creates what De Long *et al* describe as "noise trader risk". This risk is exacerbated if noise traders form expectations extrapolatively. De Long *et al* show that, if informed traders are constrained to produce returns over short horizons, perhaps because otherwise their investors will reallocate funds, the market price becomes a weighted average of the fundamental price and the price expected by noise traders. In this case, the informed traders speculate not only on the fundamental, but also on likely future noise trader positions. This model is reminiscent of the Keynesian "beauty contest".

Can countries with liberalised capital accounts avoid contagion? The examples of Singapore, and to a lesser extent Hong Kong, suggest an affirmative answer. The crucial element is to reduce public misperceptions with regard to asset values. The Asian countries which suffered most from contagion were those which scored relatively poorly on corporate transparency and financial supervision. Lack of transparency increases the scope for misinformed trading while poor financial

supervision can make it difficult for investors to distinguish between problems arising out of inadequate liquidity and from those deriving from low profitability. But although capital market liberalisation requires financial discipline, it appears doubtful that this will ever completely insulate a country from contagion.

9. Sequencing in Poor Developing Countries

The costs and benefits of capital account liberalisation will vary across countries. We have argued that the poorest countries are unlikely to find that capital account liberalisation will *per se* stimulate large amounts of additional FDI. Instead, the benefits are likely to be felt more in terms of the freedom given to citizens to dispose their assets where they choose, and a reduction in the scope for corruption. For these countries, capital market liberalisation should therefore be seen as much as a part of their political transformation into liberal democracies, as their economic transformation into modern market economies.

If the benefits of capital market liberalization are smaller for the poorest countries than for middle income countries, the same is probably also true of the costs. Countries which have poorly developed domestic financial markets and which attract relatively little FDI (and virtually no portfolio investment), will be correspondingly less prone to withdrawal of foreign funds. The contagion and multiple equilibrium phenomena discussed in sections 2.3 and 2.4 will be less acute than in middle income countries. Indeed, if these problems arise, it will be through the vehicle of domestic capital flight and it is this possibility which will impose macroeconomic discipline on liberalising governments.

There are thus clear benefits to poor developing countries from capital account liberalisation but there are also clear costs. Sequencing considerations arise both in relation to realization of the allocational benefits of capital account liberalization, and also in relation to macroeconomic and financial market discipline. McKinnon (1992) examined the order with which the process of economic liberalisation should occur. He argued that financial liberalisation should come last – after fiscal reform, liberalisation of the domestic capital market, and current account liberalisation. In our discussions we have suggested that what matters most importantly for growth is foreign direct investment rather than capital account liberalisation. We have argued that there are few likely benefits, and many potential costs, from liberalising the capital account while domestic markets and services remain protected, while institutions (courts, regulatory authorities etc.) remain weak. We have also argued that there are risks in liberalising while industrial policy remains interventionist and whilst exchange rates are pegged. It would be tempting to make the simple argument that countries

should delay liberalisation until they can be sure that the benefits out-weight the costs. That argument is too simple, because it supposes that liberalisation is a binary, all-or-nothing, matter. Instead, the challenge is for governments to devise capital market controls which minimise the costs of controls, encourage FDI, but yet do not expose countries to the full force of international gales. The implication is that developing country governments should ask what form capital account controls should take, not whether there should be such controls.

10. The Role of the Multilateral Agencies

The argument of this paper is that capital account liberalisation requires caution and must be pursued with the appropriate sequencing. The relevance of this for international architecture is four-fold.

1. It is essential that advice from international institutions, and from the IMF in particular, is in line with this caution.
2. At the same time, there is a danger that governments will show excessive caution in hiding behind sequencing concerns. It is important that the multilateral agencies maintain a commitment to eventual capital account liberalisation and attempt to move reluctant governments in this direction.
3. The multilateral agencies have an important role in strengthening institutions.
4. Even with stronger institutions and the best possible sequencing, mistakes will be made and crises will occur. There is a need for the appropriate crisis resolution machinery as a response to this.

Vines (2000) reviews four broad reasons why the IMF is inevitably important as a source of research and policy advice on the choice of exchange rate regime, capital account liberalisation, crisis resolution, and other related issues.

1. Many national governments of poorer countries cannot afford or cannot get access to the necessary resources themselves. Thus the advice becomes a form of technical assistance.
2. There are significant economies of scale and scope in the provision of such analysis and this analysis is also an international public good (because the theory of macroeconomic policy is partly comparative).
3. Fund advice, to be useful, must frankly stress both weaknesses and required remedies;
4. Fund assistance, when successful, consists in working with a country to help it solve its problems, including through the building of policy credibility, which involves not merely one-off advice, but continuing policy assistance.

The second and third features mean that it is difficult to see how private suppliers could effectively provide this technical assistance to any large degree if it were not provided by the Fund. Economies of scale and scope, and the need for a continuing relationship, suggest that any attempt to substitute in this way would be dogged by market failure. If the governments of advanced countries were to attempt to provide their advice directly, the result would be direct bilateral relationships of a quite possibly unacceptable kind. The Fund is a multilateral institution: one which gives the richer countries - in particular the United States - legitimacy when they assist in the solution of policy problems in developing countries.

Over the past three years, the IMF has been debating the stance it should take on capital market liberalisation. We take it that it is unlikely that IMF member governments will ever concede the power to require capital account convertibility to the Fund, in the way that, under Article VIII of the Fund's Articles of Agreement, governments have conceded the power to require current account convertibility . The practical issue therefore becomes whether and how the IMF should promote capital market liberalisation – see Pollak (1998).

We suspect that if professional economists were to be surveyed on this issue, there would be a clear positive correlation between those who approve of the IMF's exercise of its mandate during the Asian crisis, and those who would be happy to see an extension of the IMF's remit to capital account liberalization. Since capital account liberalisation has costs as well as benefits, many more sceptical economists might suspect that the IMF would push capital account liberalisation in circumstances in which the costs exceed the benefits. For these economists, this would be a further case of the IMF's medicine being worse than the disease for which it is prescribed. Others would point to the successful recovery of many of the previously ailing Asian economies to argue that IMF policy did, broadly, have the desired effect, and that IMF advice was sensitive to diverse circumstances in different countries. They might also add that the IMF was obliged to learn the rules of crisis management on the job.

Like other institutions, the IMF must operate by consent. Whatever the merits of the different positions taken over the Fund's recent performance, these differences imply that it will necessarily have to tread warily in assuming new responsibilities. That suggests that it is appropriate, in the post-Seattle environment, to move carefully. The argument of this paper is that the are vital issues to do with capital account sequencing. Within an overall context in which relaxation of capital account controls is viewed favourably, the IMF should work with governments in devising regimes which mesh with their continuing movement towards market liberalisation but which do not jeopardise the conduct of macroeconomic policy.

11. Growth and Institution Building

Sequencing arguments stress the reforms that should precede capital account liberalisation. The multilateral agencies have an important role in aiding these reforms, in addition to advertising the eventual benefits of full liberalisation. Among the reforms we have stressed as important precursors to capital account liberalisation are

a) *Current account liberalisation*: If trade in goods and services remains on a managed basis, capital account liberalisation could exaggerate rather ameliorate distortions. FDI will only be stimulated if relative prices provide the appropriate incentives.
b) *Ending of industrial subsidies and implicit guarantees*: The Asian Crisis demonstrated that industrial subsidies and (explicit or implicit) loan guarantees can result in a tendency towards over-investment. By encouraging further investment, capital account liberalisation may further exaggerate this tendency. In addition, foreign investors will wish to be reassured that there will be no favouritism towards indigenous or other established companies.
c) *Central Bank independence*: Capital account liberalisation almost certainly spells the end to pegged exchange rate regimes. In floating rate regimes, the nominal anchor must be provided by the Central Bank's monetary policy. There is a large body of evidence which suggests that this is best guaranteed by an independent central bank.
d) *Banking system development*: Domestic savings are a much more reliable source of finance for investment than foreign inflows, particularly for small and medium sized projects. In countries where there is a high degree of financial repression, creating or rebuilding the domestic banking system is a high priority.

These various areas of activity do not partition neatly among the various multilateral agencies. While the IMF is the natural agency to lead on central bank conduct and organisation, the World Bank and the regional development banks may be the more appropriate lead agencies with regard to industrial policy. In development of domestic banking, there is a very clear role on which the IFC should be encouraged to lead. The overall message, however, is that the target of capital account liberalisation increases the urgency of reforms which are desirable on their own merits, and the various multilateral agencies should work together to encourage and assist governments in moving in this direction.

12. Crisis Resolution

However good the advice given on sequencing may be mistakes will be made and crises will occur. There is a need for the appropriate crisis resolution machinery as a response to this. There are currently three problems in relation to this machinery.

1) *Adjustment Policies*: Countries in crisis need adjustment policies. Exactly what adjustment polices are required remains problematic. It has become apparent that the Fund's traditional remedies of macroeconomic tightening did not directly address the panic problems of the Asian crisis. The problems which needed to be addressed were not problems of excess domestic spending. Instead core requirements for policy were (i) to prevent an excess currency fall from leading to inflation and (ii) to mitigate the output fall caused by the fall in investment as growth collapsed. Crucially, however, these requirements conflict. Although at the time fiscal stringency seemed essential to guard against the inflationary effects of currencies in free fall, it is now widely agreed that fiscal expansion was a necessary part of a policy directed to the latter objective. In retrospect, nevertheless, it has become evident that the absence of a clear framework for monetary policy to take the place of the pegged-exchange-rate nominal anchor, once that was abandoned, made the prevention of currency free-fall exceptionally difficult. This seemed to require that fiscal policy be harnessed to this task. The more progress which can be made on the issue of alternative nominal anchors for macroeconomic policy - an issue to which reference has already been made - the more this conflict will be able to be resolved.
2) *Lender of Last Resort*: Countries with adjustment policies in place ideally need lender-of-last resort (LOLR) financing to tide them and their creditors over a panic period. The IMF is not in a position to provide this. A lender of last resort is one which lends freely against good collateral at a penal rate. "All three aspects of this principle – "lending freely", "good collateral", and a "penal rate", are problematic at the international level." (King, 1999) In particular an effective LOLR must be willing to lend whatever it takes to prevent a liquidity run. The current resources of the IMF - between $125 billion and $150 billion depending on how they are measured – are wholly inadequate for an ILOLR, and the need to concert, beyond this, lending from a group of countries will be subject to significant political uncertainty. (King, 1999)
3) *Workouts, Bailins and Moral Hazard*: It has become apparent that the Fund's provision of financial assistance effectively enabled lenders - in particular international banks - to escape without bearing a significant proportion of the losses which the crises caused. The

problem is that there is no speedy and orderly workout procedure available which would ensure that losses were borne by those who made the mistakes. In the Korean case, a decision was made - in conjunction with the IMF - for essentially full repayment of foreign loans, with the result that Korean taxpayers have born the losses. This has been consistent with extremely rapid recovery. By comparison, debt restructuring negotiations in the worst-hit case of Indonesia, and to a lesser extent in Thailand, continue to be drawn out, with significant legal obstacles to the necessary workout process.[14] It thus appears that significant moral hazard exists in the international system - because a failure to repay is so costly that lenders will continue to expect bailout with a high probability and so will continue not to take sufficient care in advance of lending, imposing the costs of crisis on the borrowing countries. (See discussion by King, 1999)

All commentators agree that external intervention may be needed. But exactly what form this intervention may need to take, and how to avoid the associated moral hazard, is far from clear.

One response to such problems (noted by King, 1999) is to seek extreme solutions - the creation of a fully fledged LOLR (see Fischer, 1999, for a review of the issues involved) or the resort to quasi-permanent capital controls, which seem neither desirable nor feasible.

A second response, represented by the proposals in King (1999), some of the suggestions by Williamson (2000), and Knight *et al* (2000), involve attempts to find "middle-way" solutions to these problems.

A third response to these problems is to identify the Fund's discretion to act as part of the problem rather than as part of the solution. The IFIAC Report ("Meltzer Commission") has this feature: the Report is in favour of quasi LOLR lending in the case of macroeconomic imbalances and of financial crisis, but it presents a list of qualifications which would hedge in this lending. The restrictive features which are proposed are as follows.

i) There would be pre-qualification for assistance and no negotiation of policy reforms upon the onset of crisis; no conditionality attached to lending programmes.

ii) Lending would be for a short term only "e.g. a maximum of 120 days with only one allowable rollover".

---

[14] Similarly, in the Latin American debt crisis of the early 1980s, partial default and rescheduling took place, but this led to a debt overhang problem which took ten years to solve - Latin America's "lost decade". Resolution took so long both because of free-rider problems - each lender seeking to profit from concessions made by competitors - and because creditors held out for injection of funding from the governments of advanced countries.

iii) Lending would be confined to solvent countries with "fundamentally sound policies and finances".

iv) Credit limits would "restrict the amount of assistance that a country can receive from the IMF". These would "reflect the capacity of the sovereign to repay its debt to the IMF". "A borrowing limit equal to one year's tax revenues might be a reasonable credit limit".

v) The report proposes that to deal with moral hazard, investors and governments should be left to resolve claims when crises occur, unimpeded by the IMF; the Report's authors believe that the outcomes would be speedy.

A fourth set of proposals - the outcome canvassed in Williamson (2000) and our own preferred solution - goes in the opposite direction. Williamson argues that the restricting of Fund lending - as proposed in the IFIAC Report to finite amounts, for short term periods, would make creditors unsure whether a country would be able to meet its obligations and so would, unwittingly, serve to deepen and to lengthen crises. As to the moral hazard problem, Williamson convincingly argues that the possibility of a payments standstill, sanctioned by the Fund, is a better way to deal with the threat of this - creditors would know that if a payments standstill were declared they would suffer write-downs At the same time this would restrict the amount of emergency financing required from the Fund to manageable amounts.

From the point of view of the poorest countries, there is little likelihood that any crises they experience will be regarded as having systemic implications. It is therefore unlikely that they will have the possibility of availing themselves of an LOLR facility. One of the successes of the IMF's handling of the Asian Crisis was that, in the end, there was no Brazilian or Argentine crisis. Poor countries in Africa can take little comfort for this, and those (such as the CFA countries) which operate pegged rate systems may be excused if they prefer the security of their current arrangements backed by less than full capital account convertibility.

13. Conclusions

In this paper we have discussed the sequencing issues which arise both in relation to realization of the allocational benefits of capital account liberalization, and also in relation to macroeconomic and financial market discipline. We have suggested that what matters most importantly for growth is foreign direct investment rather than capital account liberalisation. We have argued that there are few likely benefits, and many potential costs, from liberalising the capital account while domestic markets and services remain protected, while institutions

remain weak. We have also argued that there are risks in liberalising while industrial policy remains interventionist and whilst exchange rates are pegged. Urgent priorities include reinforcing central bank independence and rebuilding domestic banking institutions.

This all has implications for international architecture. There is a need to ensure that advice and assistance from the IMF - which many countries will inevitably need - is in line with this caution. Second, there are roles for the entire set of multilateral agencies in the institution building process. Third, even with the best possible sequencing, mistakes will be made and crises will occur. There is a need for the appropriate crisis resolution machinery as a response to this.

References

Aghion, P., Bachetta, P. and A. Banerjee (1999) 'Capital Markets and the Instability of Open Economies', in R. Agenor, M. Miller, D. Vines and A. Weber, *The Asian Financial Crises: Causes, Contagion, and Consequences*, Cambridge University Press, Cambridge.

Bevan, D., P. Collier and J.W. Gunning (1990), *Controlled Open Economies: A Neo-Classical Approach to Structuralism*. Oxford, Oxford University Press.

Bosworth, B.P., and S.M. Collins (1999), "Capital Flows to Developing Countries: Implications for Savings and Investment", *Brookings Papers on Economic Activity*, 1, pp. 143-180.

Collier, P., and J.W. Gunning (1999), "Explaining African Economic Performance", *Journal of Economic Literature*, 37, pp.64-111.

Cooper, R. (1998), "Should Capital-Account Convertibility be a World Objective?", in "Should the IMF Pursue Capital-Account Convertibility", *Essays in International Finance*, 207, Princeton University.

Cooper, R. (1999), 'Should Capital Controls be Banished?', *Brookings Papers on Economic Activity*, 1, pp. 89-141.

Davies, G and D Vines (1998), 'Ripe for Attack and Attackable: When are Self Fulfilling Currency Crises Possible?', Institute of Economics and Statistics, Oxford, mimeo.

De Long, J.B., A. Shleifer, L. Summers and R. Waldmann (1990), "Noise Trader Risk in Financial Markets", *Journal of Political Economy*, 98, pp. 703-38.

Deaton, A. (1992a), "Saving and Income Smoothing in Côte d'Ivoire", *Journal of African Economics*, 1, pp.1-24.

Deaton, A. (1992b), *Understanding Consumption*. Oxford, Oxford University Press.

Dehn, J. (2000), "Commodity Price Uncertainty and Shocks: Implications for Investment and Growth". D.Phil. thesis, University of Oxford.

Diaz-Alejandro, C. (1985), "Good-bye Financial Repression, Hello Financial Crash", *Journal of Development Economics*, 19, pp.1-24.

Diamond, D.W, and P.H, Dybvig (1983), 'Bank Runs, Deposit Insurance, and Liquidity', *Journal of Political Economy*, 91(3), pp. 401–419.

Dooley, M.P. (1996), "A Survey of the Literature on Controls on International Capital

Transactions", IMF Staff Papers, 43, pp.639-87.

Dornbusch, R. (1997) "A Thai-Mexico Primer" *The International Economy* September/ October, pp 20 - 23 and 55.

Dornbusch, R. (1998), "Capital Controls: An Idea Whose Time is Past", in "Should the IMF Pursue Capital-Account Convertibility", *Essays in International Finance*, 207, Princeton University.

Fischer, S, (1998), 'Capital Account Liberalization and the Role of the IMF' in "Should the IMF Pursue Capital-Account Convertibility?", *Essays in International Finance*, 207, Princeton University.

Fischer, S (1999), "On the need for an International Lender of Last Resort". Paper presented to the annual meetings of the American Economic Association, http://www.imf.org/external/np/speeches/1999/010399.HTM

Giovannini, A., and M. de Melo (1993), "Government Revenue from Financial Repression", *American Economic Review*, 83, pp.953-63.

IFIAC (2000), Report of the International Financial Institution Advisory Commission, Washington: Department of the Treasury.

Irwin, G. and D. Vines (1995), 'The Macroeconomics of the Mexican Crisis: A Simple Two-Period Model', CEPR Discussion Paper No. 1241, London

Irwin, G. and D. Vines (1999), 'A Krugman-Dooley-Sachs Third Generation Model of the Asian Financial Crisis', Global Economic Institutions Working Paper No. 46, London.

Irwin, G. and D. Vines (2000), 'Government Guarantees, Investment, and Vulnerability to Financial Crisis' CEPR Discussion Paper, forthcoming, London.

King, M (1999) "Reforming the International Financial System: The Middle Way", Speech delivered to a session of the Money Marketeers at the Federal Reserve Bank of New York, 9 September 1999.

King, R.G., and R. Levine (1993), "Finance, Entrepreneurship and Growth", *Journal of Monetary Economics*, 32, pp.523-42.

Knight, M. L. Schembri, and J. Powell (2000), "Reforming Global Financial Architecture: Just Tinkering Around the Edges?", paper presented to the meeting on Reforming the Architecture of Global Economic Institutions, Bank of England, May 5th and 6th 2000.

Krugman, P. (1998a), 'What Happened to Asia'. http://web.mit.edu/krugman/www/DISINTER.html.

Krugman, P. (1999a), 'Balance Sheets, the Transfer Problem, and Financial Crises'. http://web.mit.edu/krugman/www/FLOOD.pdf .

Krugman, P. (1999b), *The Return of Depression Economics*, Penguin.

Kumar, M., P. Masson and M.Miller (2000), "Global Financial Crises: Institutions and Incentives", mimeo.

McKinnon, R.I. (1973), *Money and Capital in Economic Development*. Washington DC, Brookings Institution.

McKinnon, R.I. (1992), The Optimal Order of Economic Reform, Baltimore, Johns Hopkins University Press.

McKinnon, R.I. and H. Pill (1996), 'Credible Liberalisations and International Capital Flows: The Overborrowing Syndrome, in T. Ito and A. Krueger (eds), *Financial Deregulation and Integration in East Asia*, Chicago University Press, 7-45.

McKinnon, R. and H. Pill (1997), 'Credible Economic Liberalizations and Overborrowing', *American Economic Review*, 87 (2), 189-203.

Obstfeld, M. (1986), 'Rational and Self-Fulfilling Balance-of-Payments Crises', *American Economic Review*, 76(1), pp. 72–81.

Obstfeld, M. (1991), 'The Destabilising Effects of Exchange-Rate Escape Clauses', NBER Working Paper No. 3603, Cambridge, MA.

Obstfeld, M. (1994), 'The Logic of Currency Crises', NBER Working Paper No. 4640, Cambridge, MA.

Obstfeld, M. (1995), 'Models of Currency Crises with Self-Fulfilling Features', NBER Working Paper No. 5285, Cambridge, MA.

Razin, A., and E. Sadka (1991), "Efficient Investment Incentives in the Presence of Capital Flight", *Journal of International Economics*, 31, pp. 171-81.

Robinson, D., Y. Byeon, R. Teja, and W. Tseng (1990), 'Thailand: Adjusting to Success: Current Policy Issues', International Monetary Fund Occasional Paper No. 85.

Rodrik, D. (1998), "Who Needs Capital-Account Convertibility?", ", in "Should the IMF Pursue Capital-Account Convertibility", *Essays in International Finance*, 207, Princeton University.

Shaw, E.S. (1973), *Financial Deepening in Economic Development*. New York, Oxford University Press.

Shleifer, A. (2000), *Inefficient Markets*, Oxford, Oxford University Press.

Warr, P (1998) 'Thailand', in R. McLeod and R. Garnaut (eds) *East Asia in Crisis: From being a Miracle to Needing One*, Routledge.

Williamson, J (2000) The Role of the IMF: A Guide to the Reports. Mimeo, Institute for International Economics

Wyplosz, C. (1986), "Capital Controls and Balance of Payments Crises*", Journal of International Money and Finance*, 5, pp.167-79.