# Conference on Capital Account Liberalisation: A Developing Country Perspective

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## Conference Report

## I. Introduction

In recent years, particularly following the crises in East Asia, Russia and Brazil, the opening up of the capital account has been a subject of intense debate with an emerging consensus on the need to manage the risks posed by rapid and large flows of short-term capital. Meanwhile, some of the poorer countries have already taken significant steps to liberalise their capital accounts but are now faced with the problem of trying to manage capital flows in a very liberalised environment. Although private capital flows to the poorer countries are negligible in absolute numbers, in some countries they are sizable as a ratio to GDP and gross fixed capital formation.

The Conference on 'Capital Account Liberalisation: A Developing Country Perspective' held at the Overseas Development Institute in London on June 21, 2000, brought together distinguished economists and policymakers from a wide range of governments, international organisations, research institutes, universities and non-governmental organisations. The aim of the conference was to set out the policy choices facing poorer countries and explore whether the lessons from middle income countries are relevant or not. Participants considered the effectiveness of capital controls, and practical-capacity building and policy implementation issues in the poorer countries, particularly in relation to issues around monitoring flows, the effectiveness of monetary policy and the ability to sterilise flows. The idea was to involve developing countries in the debate, to shift attention away from the recent crisis-ridden countries to other regions and to comprehend the problems that other countries have in the capital account liberalisation process.

The papers presented at the conference and the discussions that followed provided an excellent overview of the current debate on how and to what extent developing countries should liberalise their capital accounts.

Six main papers were presented at the conference followed by a panel discussion. Benu Schneider provided an overview of the issues in capital account liberalisation based on academic literature and country experiences and drew the main lessons for developing countries based on the analysis in her paper. She made a case for distinguishing between capital controls and prudential limits and highlighted the environment in which short-term controls can be useful whilst at the same time pointing out limitations. Benu Schneider also emphasised the importance of sequencing of the capital account while opening up the current account. Her paper discussed the preconditions and sequencing arguments and outlined three strategies for opening up of the capital account. John Williamson discussed the different forms of capital inflow (official, foreign direct investment (FDI), portfolio, and loans) and evaluated them along six dimensions (cost, conditionality, risk bearing properties, transfer of intellectual property, and their impact on investment and their vulnerability to sudden reversals). Christopher Gilbert (in a joint paper with Gregor Irwin

and David Vines) analysed the issues related to the international financial system, in particular the mechanisms for dealing with financial crises. These were followed by three case studies. Y.V. Reddy, the Deputy Governor of the Reserve Bank of India, discussed India's transition to capital account convertibility and the characteristics of its policy regime that seek to maximise the benefits of capital account convertibility while at the same time shielding the country from its potential costs. From the perspective of a small developing country, Louis Kasekende, the Deputy Governor of the Bank of Uganda, examined Uganda's experience with an open capital account. Wilson Banda, Reserve Bank of Malawi, discussed the problems in opening up the capital account in a small economy and drew lessons from some regional experiences.

This report is structured to present the main conclusions that emerged from the conference. Section 2 presents an overview of issues regarding sequencing and preconditions. Section 3 examines a variety of policy issues that bear upon capital account convertibility, such as transparency, monetary policy tools, capital controls and the functioning of the international financial system in times of crisis. Section 4 sums up some of the main policy conclusions.

## 2. Sequencing and preconditions of capital account convertibility in developing countries

### 2.1. Capital account liberalisation: what is it and is it reversible?

What is capital account liberalisation? In its report on capital account convertibility to the Reserve Bank of India, the Tarapore Committee provided a succinct and subtle definition:

> [capital account convertibility is] the freedom to convert local financial assets into foreign financial assets and vice-versa at market determined rates of exchange. It is associated with changes of ownership on foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on or by the rest of the world. [Capital account convertibility] can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions, which are of a prudential nature. (Reserve Bank of India, 1997)

The traditional policy regime in many developing countries has been to restrict cross-border movements through often elaborate systems of controls and regulations. The aim of these restrictions is to retain domestic savings in the economy for domestic investment and to insulate the economy from external shocks. In the 1980s and 1990s, a confluence of events, including diminishing levels of foreign aid, the expansion and integration of global capital markets and the collapse of the socialist bloc in Europe, served to undermine this policy regime. Some developing countries in sub-Saharan Africa became aware, as Louis Kasekende mentioned at the conference, that domestic savings were very low making their retention a relatively low priority to retain and that a more open capital account enabled them to access desperately needed resources. Benu Schneider pointed out that this may have been the case in Uganda and elsewhere in Sub-Saharan Africa (SSA), but liberalisation of the capital account without fulfilling the pre-conditions is problematic and domestic savings are needed, together with foreign savings, for sustainable growth. Furthermore, it has become apparent that a closed capital account does not ensure protection from external funding crises (as, for example, India discovered in 1991). Thus, a

mixture of structural changes in the world economy, ideological shifts and the urgent need for resources in developing countries all served to propel many developing countries towards greater liberalisation of capital account transactions.

The participants at the conference were in general agreement that, for better or worse, the forces driving the movement towards greater capital account convertibility are not likely to diminish – barring a profound upheaval in the global economy – in the foreseeable future. The Mexican crisis of 1994, the Asian crisis of 1997-1998 and crises in Brazil and Russia have led many observers to question the stability of the global financial system, but none has resulted in any fundamental change in the underlying process. Instead, as at the conference itself, the policy debate has increasingly centred around the institutional and macroeconomic frameworks that must be put in place to limit the exposure of developing countries to sudden capital flow reversals. The transition process from a closed to an open capital account has come under closer scrutiny and a broad consensus – generally reflected at the conference – has formed around the institutional and macroeconomic preconditions that should be in put place before, or at least pursued simultaneously with, capital account liberalisation.

## 2.2. The pace and sequencing of capital account liberalisation

A persistent debate among economists has concerned the relative merits of a more rapid transition to a open capital account (the so-called “big bang” approach) and a more deliberate, gradualist approach that emphasises reforms in the real economy and financial system and the liberalisation of the current account before opening the capital account. An advocate of the former position has been MIT economist, Rudiger Dornbusch, who argues that since resources are lost through obstacles to free capital flows (as with any protectionist policy) the sooner it is liberalised the better. The latter view, which commanded almost uniform assent at the conference, stresses the instabilities generated by financial liberalisation before adequate institutional safeguards are put in place. It is, therefore, seen as advisable to move from reforms in the real sector, improved financial regulation and current account liberalisation before finally liberalising the capital account. However, as pointed out by Christopher Gilbert, although there are legitimate and important concerns about sequencing, there is also a danger that governments can use sequencing arguments to avoid implementation of decisions to which they are not fully committed.

The case studies of India and Uganda presented at this conference are examples of the “gradualist” and “big bang” approaches. As Y. V. Reddy describes in his article, India pursued an incremental and phased liberalisation process in the aftermath of the 1991 balance of payments crisis. Within a broad liberalisation process emphasis was placed upon introducing a market-determined exchange rate, containing the fiscal deficit, reforming the system of industrial licenses, placing bounds on the current account deficit and liberalising current account transactions. Capital account transactions remained tightly controlled and monitored. Non debt-creating flows were encouraged and short-term commercial borrowing remained restricted while capital outflows were only gradually liberalised.

Louis Kasekende describes a more rapid transition to capital account convertibility in Uganda. It is important to note however that the inability to enforce capital controls ensured that the capital account was *de facto* open long before the *de jure* announcement of full convertibility in July 1997. The Ugandan capital account regime has been noticeably looser

than its Indian counterpart, allowing, for example, both residents and non-residents to hold foreign exchange denominated accounts in the domestic banking system (a point which will be discussed later). Uganda has been successful in attracting foreign capital inflows, primarily in the form of foreign direct investment, which is more stable than either portfolio or loan flows. However, Uganda's strategy remains a risky one insofar as the country is in a politically unstable region and where countries remain vulnerable to potential external disturbances from South Africa.

Thus, given the potential benefits and costs of capital account liberalisation and the fact that the poorly developed institutional structure (primarily in the financial system) of developing countries heightens the risk of crisis, the balance of the evidence suggests that countries should adopt a gradual movement towards capital account liberalisation within a broad reform effort. There was notable consensus on this point in the conference and Karl Habermeier of the IMF stressed that his organisation has never advocated an immediate dismantling of capital account restrictions and that, furthermore, it has no authority over capital account restrictions. He argued that capital account convertibility was a learning process and that countries should "liberalise a little, learn, and then liberalise more". Participants also acknowledged that it was preferable to achieve liberalised (or substantially liberalised) current account transactions before moving on to opening up the capital account. At the same time, the sequencing of current and capital account, and restrictions on the current account in the intermediate stage are also important as capital can leave the country with leads and lags through the current account.

### 2.3. Preconditions for capital account liberalisation

Given their support for a more gradual introduction of a liberalised capital account in developing countries, it is not surprising that participants were also in broad agreement on the issue of the specific preconditions necessary for its realisation. There are a wide variety of policies and institutions whose implementation and establishment is often viewed as a precondition for capital account liberalisation. Many of these take on a greater importance in the developing country context given their heightened vulnerability to financial crises.

Benu Schneider explained the pre-conditions to capital account liberalisation. In terms of macroeconomic policy, fiscal consolidation, an independent monetary policy based on indirect policy tools and flexibility in exchange rate management are all-important conditions for a successful liberalisation effort. In India, Y. V. Reddy explained that the system of automatic monetisation of the fiscal deficit was replaced by a system of ways and means advances early in the reform process. Currently, a 'Fiscal Responsibility Act' is in the advanced stages of drafting and is expected to pass the Indian parliament. Similarly, Louis Kasekende pointed out that in Uganda the reduction of the fiscal deficit and its financing in a non-inflationary manner is a priority since it was a key precondition of capital account liberalisation. In terms of exchange rates, both speakers agreed to the importance of transforming fixed, multiple exchange rate regimes into floating unified-rate systems in their economies.

Christopher Gilbert argued that capital account liberalisation probably spells the end of fixed exchange rate regimes since their viability is often underpinned by capital controls. Furthermore, fixed rates can encourage short-term, unhedged borrowing in foreign currency that can precipitate a crisis (note the genesis of the Thai crisis in the fixed rate regime and the liberalised access to short-term borrowing from abroad). Christopher Gilbert also

argued that fixed rate regimes and the consequent loss of monetary policy independence also make it difficult for a country to control a domestic economic boom resulting from tendencies to over-invest and over-consume. Floating rates, however, create a problem for countries seeking to generate nominal anchors for the domestic price level.

Benu Schneider argued that in moving towards capital account convertibility, governments must also ensure that inflation, the current account balance and foreign exchange reserves are maintained at acceptable levels. Any one of these variables can prompt a financial crisis if it is allowed to move seriously out of line and undermine confidence in the currency. The inflation objective can be aided by the creation of a strong, independent central bank that is relatively insulated from more populist pressures emanating from the political process. Maintaining adequate foreign exchange reserves becomes less pressing if floating rates are adopted but, as Y. V. Reddy argued, it is important for the central bank to have funds to intervene in the market to promote stability and reduce volatility and also to provide psychological reassurance to foreign investors.

One of the key conclusions to emerge from the conference is the central importance of financial sector reform, prudential norms and effective regulatory supervision. This is an area that is gravely deficient in many developing countries. Perversely, capital account liberalisation in several countries has made the situation worse since it has led states to retreat from effective regulatory oversight, information gathering and the enforcement of prudential norms for fear that they will be seen as the first step in a return to state control. However, as numerous crises have made clear, in an environment of liberalised capital flows, weaknesses in the financial system can cause great macroeconomic instability and crises. A healthy financial system is no guarantee that a crisis would not occur, but it would certainly reduce the incidence and extent of the crisis. The choice is therefore between a careful reform of the financial system before or during the process of liberalisation or emergency reforms after a crisis. The inexperience of many agents in the financial sectors of developing countries can lead them to become overexposed to interest rate of exchange rate risk. Thus, the authorities' ability to develop prudential norms and then create the information and enforcement systems to support them are central to financial sector reform. Benu Schneider outlined the key reforms in the financial sector and the need to integrate different segments of the financial market as a pre-condition to liberalisation of the capital account. She also pointed to the role of off-shore banks in the East Asian crisis and emphasised the reforms needed with respect to off-shore financial intermediation.

Louis Kasekende pointed out that Uganda pursued a financial sector reform programme before formally opening the capital account. Key aspects of this programme included removing interest rate controls, the dismantling of entry barriers to new banks, restricting the direct role of the government in allocating financial resources and strengthening bank supervision. Louis Kasekende mentioned the continuing problems of obtaining information on agents in the financial market (particularly with regard to inflows) and the issue of guarding against the exposure of the non-bank sector to exchange rate risk.

In India, Y. V. Reddy pointed out that early in the reform process, the Narasimhan Committee recommended the deregulation of the banking sector, greater use of open market operations in monetary policy, the deregulation of interest rates and the widening and deepening of financial markets. As an example of the kinds of prudential limits imposed by the central bank, Y. V. Reddy noted that Indian banks can invest abroad up to 15% of total capital, while beyond this threshold they must obtain approval from the

central bank. Similarly, for corporates, working transactions are reported through banks but capital transactions must be permitted by the central bank.

In detailing the Indian experience, Y. V. Reddy argued that the process of liberalisation was one of "mutual education" between the central bank and market participants – there was a mutual process of discovering what appropriate standards are and where it is most effective to regulate. Y. V. Reddy also enunciated perhaps the most succinct description of a widely-held view at the conference when he pointed out that "the more we liberalise the more we monitor."

## 3. Issues in capital account convertibility

### 3.1. Composition of capital flows

The composition of capital inflows is a key determinant of their susceptibility to sudden reversal and their beneficial impact upon the recipient country. The authorities must thus be aware of the composition of inflows and be prepared to limit exposure to more volatile classes of capital. At the conference, John Williamson presented a paper that considered the different kinds of capital flows – official, foreign direct investment, portfolio and bank loans – and their characteristics. He examined them along six dimensions – cost, conditionality, risk bearing properties, transfer of intellectual property, their impact on investment and their vulnerability to sudden reversals. John Williamson described an evolutionary process through which an economy moves from attracting only flows of official finance and FDI in natural resources, through inflows of FDI in non-resource extracting sectors and bank finance, to later stages of development in which it attracts portfolio equity and bonds and in which its companies can list their shares on developed country stock markets.

Foreign direct investment, John Williamson argued, is the costliest form of inflow for the recipient country, but it is also the most beneficial in terms of development since it is stable, translates completely into an increase in investment and brings with it access to intellectual property. In contrast, bank lending is less expensive (especially on short-term maturities) but does not have the beneficial investment properties of FDI and is far more unstable. John Williamson therefore concluded that it is worthwhile for developing countries to encourage FDI, despite its cost, in order to reap its benefits in terms of economic growth. The susceptibility of developing countries to financial and currency crises and the real costs that these impose on the real economy, John Williamson argued, mean that over the longer term it is worthwhile to pay the higher cost associated with more stable flows and encourage FDI.

Christopher Gilbert made a very important related point when he argued that it is not necessary for a country to have a liberalised capital account in order to attract FDI. He argued that FDI can be accommodated through special provisions that enable the repatriation of profits. Furthermore, while capital account liberalisation should encourage FDI he doubted whether it is a major determinant of the direction of FDI. Rather, FDI is driven, among other factors, by expected profitability, relative prices, confidence in macroeconomic policy, political stability and the quality of contracting and legal enforcement. John Drage of the Bank of England also underlined the importance of an adequate legal structure, especially contract law and bankruptcy law, for encouraging direct investment.

It is pertinent to note that among developing countries, China has attracted large inflows of FDI and it has retained a very restrictive capital account regime (although it must be pointed out that a large component of this inflow is Chinese funds seeking to take advantage of preferential treatment of FDI). Louis Kasekende argued that FDI has been the major component of Uganda's capital inflows since 1987 and this has served to reduce their volatility. He also argued that much of this FDI has come from returning Asians who were driven out and expropriated under the Amin regime. Thus, echoing Christopher Gilbert's point, the return of expropriated property and the establishment and protection of property rights – along with capital account liberalisation - has been a key element in encouraging FDI.

John Williamson also discussed a proposal to establish a special foreign exchange market for pension funds. Pension funds are captured in small domestic markets with little scope for diversification of risks and returns and are vulnerable to collapses in commodity prices. Therefore, he proposed a system in which pension funds can go out to the extent that foreign funds come in. A special rate for pensions that would go to a discount during a crisis and a premium during periods of large inflows might, he argued, be useful in ameliorating their effects. Louis Kasekende argued that a major problem with this proposal was that it ran counter to the IMF article against multiple exchange rate systems. John Williamson agreed but he argued that the IMF was too theological in their opposition to multiple rates and that perhaps if countries successfully experimented with using special rates for pension funds (and not to discriminate among current account transactions) this article could be amended. Christopher Gilbert agreed that the treatment of pension funds was an important issue.

### 3.2. Capital controls

An important conclusion to emerge from the conference was the desirability of some forms of capital control in the developing country context. The vulnerability and fragility of financial systems in many countries and the negative properties of short-term flows means that countries must take a pragmatic stance towards capital controls. Benu Schneider, in her opening paper, stressed the distinction to be made between controls that hinder efficient international financial intermediation and those that can be viewed as prudential controls designed to contain the potential risks of international capital flows. She made a case for using prudential limits in the transition period.

In the transitional period towards a more open capital account, controls may play a role in insulating the economy from volatile capital flows or allowing time for the strengthening of financial market institutions and other initial conditions. At the conference, Christopher Gilbert argued that it was necessary for countries to retain the right to impose controls on capital outflows during a crisis (such as those Malaysia implemented in 1998). He also speculated that in the future standstill agreements enforced by such controls might become part of IMF policy.

Undoubtedly the most widely studied example of price capital controls is Chile (1991-1998). Chilean policymakers sought to limit the country's exposure to a surge in capital inflows, minimise exchange rate appreciation, lengthen the maturity structure of external liabilities and discourage volatile short-term flows. It is important to note that Chile selected a price-based control, the unremunerated reserve requirement (URR), in preference to more

quantitative controls and a minimum holding period. Louis Oscar Herrera of the Central Bank of Chile claimed that studies show that the controls did not restrain the appreciation of the exchange rate and that over time the control regime lost effectiveness, but they also indicate that the controls provided room for some monetary independence by maintaining an interest rate differential and altering the composition of inflows. Thus, when the Asian crisis hit, Chile had only a small exposure to short-term flows. Participants discussed the kind of prudential control regime implemented in Chile, which was supported by John Williamson who said that in his view the controls probably did have some affect on total inflows as well. Benu Schneider raised the point that price controls were effective only in the short-run in changing maturity structures but the impact on total flows was unclear.

There was widespread agreement at the conference that prudential controls on short-term flows were desirable. Benu Schneider argued in her opening paper that developing countries had difficulties intermediating funds from the short to the long end of the yield curve, which left them vulnerable to maturity mismatches in their external accounts. John Williamson agreed and pointed to the systemic vulnerability of developing countries to reversals of confidence that develop because of exposure to short-term funds. He cited the example of the Bangkok International Banking Facility (BIBF) that had encouraged large-scale inflows of unhedged, short-term loans into Thailand. He argued that limits on the foreign exchange exposure of the banking system should be carefully regulated and monitored. Y. V. Reddy argued that early in the Indian reform effort the Rangarajan Committee placed an emphasis on non-debt creating flows and advised that no short-term debt be permitted at all. Subsequently, the Indian regime has been characterised by close monitoring and severe quantitative controls on short-term borrowing (excepting those strictly related to trade) that has resulted in short-term debt accounting for only 4% of total debt in June 2000. Karl Habermeier of the IMF argued that it was difficult to maintain the distinction between short- and long-term flows in an environment of highly developed financial markets. For example, he argued that even with FDI flows, agents could borrow domestically and short the currency.

Benu Schneider and Louis Oscar Herrera both mentioned, however, that controls are no substitute for a sound macroeconomic policy and strong institutional fundamentals and should not be seen as a substitute for reform. Louis Oscar Herrera argued that there was nothing fundamental about the control regime in Chile and it was simply a practical policy device that was dropped when inflows began to slow in the wake of the Asian crisis. Christopher Gilbert added that good macroeconomic policy is both a requirement and an outcome of liberalisation. Capital account liberalisation can discipline macroeconomic policy. The difficulty is that it requires efficient capital markets: the investors in London and New York must be able to distinguish between the quality of Indonesian and Malaysian macroeconomic policy. Even if this is true of some investors, the fact that others regard all emerging markets as a more or less homogeneous “asset class” will discourage the more informed investors from backing their views with money. There is therefore a degree of arbitrariness about the discipline imposed by financial markets – the innocents tend to be punished with the guilty.

Regarding the efficacy of controls, Benu Schneider argued that controls on outflows are generally ineffective compared with inflow controls. This was demonstrated by estimates of capital flight from a large group of countries. Y. V. Reddy made a similar point when he argued that inflows are easier to control since investors generally want legal title to their assets in a foreign country. He argued that some controls were a good idea but much

uncertainty remained as to which controls were effective and feasible. Benu Schneider argued that certain institutions can be effectively regulated to prevent outflows, among these were banks, pension funds and authorised dealers.

Several participants at the conference also raised the issue of foreign exchange-denominated accounts in the domestic financial system of developing countries. Christopher Gilbert argued that it was far from clear that residents should be permitted to hold foreign exchange denominated accounts, unless they can show evidence of the underlying transaction. Y. V. Reddy had a more unequivocal stance and argued that large-scale dollar-denominated assets within a country can precipitate a crisis by creating destabilising balance sheet changes in response to changes in exchange rates. Consequently, no dollar-denominated transactions are allowed between residents, foreign currency accounts can be used only for external payments and if they are required for local payments they must be converted into rupees. Louis Kasekende acknowledged that this was a potential problem and argued that both residents and non-residents are permitted to hold foreign exchange denominated accounts in the banking system. Foreign exchange accounts accounted for one-quarter of broad money (M3) in Uganda in April 2000 and there has been a continuing clear preference for these accounts in the domestic system.

### 3.3. Corporate balance sheets

Several participants at the conference raised the issue of “hidden” foreign exchange risk on corporate sector balance sheets. John Drage brought attention to the case of Korea where the huge foreign currency exposure of the corporate sector was revealed after the collapse of the currency in 1998. Louis Kasekende argued that the problems that Uganda faces as a result of capital account liberalisation are largely associated with the seasonality of export receipts and the resulting speculative behaviour, which makes management of the exchange rate difficult. This exposes firms that have taken positions in foreign currencies. He thus argued that there was a need to develop instruments to deal with private sector, non-bank exposure. Part of the solution, he suggested, resides in advice from the commercial banks and increased education. In the Indian system, Y. V. Reddy argued that the Reserve Bank closely monitors developments in corporate sector balance sheets and requires that corporates obtain permission for capital transactions.

An underlying question that emerges, but was not fully discussed at the conference, was who bails out the non-bank corporate sector in the event of a crisis?

### 3.4. Transparency

At the conference, Jaime Sanz, Director of Sovereign Ratings at Fitch, argued strongly for predictable, commitment-based policy regimes in developing countries. He pointed to Argentina’s currency board arrangement, South Africa’s multi-annual budgeting and Brazil’s privatisation program as examples of the kinds of policies that would successfully attract foreign capital. He argued that policy flexibility was overrated since there was little room for manoeuvring in policy in any case. Christopher Gilbert took issue with the contention that Argentina’s currency board was a desirable model for other countries since it imposed significant costs on the domestic economy. Jaime Sainz argued that, although it was painful, the only other option was a return to the forced devaluations of the past, which had not worked.

Jaime Sainz argued that information and transparency are central to successful policy in developing countries. Precise, regular information is essential to attracting investors to countries. In particular, he said that the marginal product of information in Africa was still very high given the poor record of disclosure there and investor ignorance of the region. He acknowledged, however, that the provision of information could backfire since it could highlight faults that are shared by many countries but publicised by only a few. Amlan Roy of Credit Suisse argued that the vulnerability of developing countries to self-fulfilling crises emerges because their lack of transparency leads to herd-like behaviour in the financial markets. Karl Habermeier of the IMF also highlighted the central role of accurate and widely disseminated information in the liberalisation process.

Benu Schneider raised the question of whether the role of information was being exaggerated, noting that transparency alone cannot avert a crisis. Christopher Gilbert, in his discussion of contagion, argued that there is a distinction between fully informed traders who follow fundamentals and less informed "noise traders". In the Keynesian "beauty contest" world, informed traders anticipate irrational trading by noise traders since it is not a question of what one's own beliefs or knowledge regarding fundamentals are but rather that of the common perception. Information may help ameliorate this situation but it is unlikely to eliminate it entirely.

### 3.5. Multilateral institutions and the international financial architecture

Christopher Gilbert argued that the adjustment policies pursued by the IMF during the Asian crisis did not address the panic that had taken over financial markets. Fiscal contraction served to exacerbate the output fall caused by the collapse in investment. The collapse of the pegged exchange rate nominal anchor was not replaced by an effective framework for monetary policy that could take its place. In its place, a restrictive fiscal policy was adopted. This highlights the need to establish alternative nominal anchors in macroeconomic policy.

An international lender of last resort facility is unlikely to emerge in the near future. The principles underlying a LOLR facility are problematic to implement at the international level and the funds of the IMF are grossly inadequate to fulfil the task. The need to draw in lending from advanced countries is uncertain and subject to political constraints.

Workouts and bail-ins are a critical element in crisis resolution. Crisis resolution can be dealt with through (i) an international lender of last resort or the imposition of capital controls, (ii) "middle way" solutions such as standstill agreements, and (iii) the limited lender of last resort facility subject to pre-qualification outlined in the Meltzer Commission report. The problems with a full-fledged lender of last resort have been discussed above.

Christopher Gilbert argued that the Meltzer Commission recommendations were seriously flawed. The emphasis upon pre-qualification begs the question of what would happen in the case of a crisis in a significant non-qualifying country. It is likely that it would be easier to intervene to ameliorate the crisis rather than to combat contagion to other economies. In addition, the recommendations also fail to adequately address what would happen if a crisis were caused in a qualifying country by 'irresponsible' policies. Restrictions on IMF lending also could create uncertainty and deepen a crisis. According to Christopher Gilbert, the fundamental objection was that in view of the pervasive uncertainty about future crisis it

was necessary to maintain flexibility, which he argued was precluded by the concept of pre-qualification in the Meltzer Report.

Christopher Gilbert agreed with John Williamson that a payments standstill sanctioned by the IMF was a better solution since creditors would incur a write-down or usually stretch out in their assets and the claim on IMF financing would be restricted to smaller amounts than in either the full or partial LOLR facilities envisioned in the other options. The IMF will, in the foreseeable future, lack the resources to act as a non-discretionary LOLR. While true, this suggests that national central banks do provide a non-discretionary LOLR facility. Alternatively, one might argue that the difference between the Fund and national central banks, is the scale of funds they have available. The IMF cannot be expected to have the funds to unilaterally mount a major rescue – see, for example, Mexico in 1995. But the same was also true of the Fed in relation to LTCM in 1998. So perhaps the difference comes down to one of political stance: the IMF's shareholders prefer to encourage the view that the IMF cannot be expected to acts as an LOLR in order to discourage reliance on an implicit Fund guarantee. This relates to the pre-qualification discussion earlier: pre-qualification would limit the IMF's discretion with regard both to qualifying (reduced ability to say no) and non-qualifying countries (reduced ability to say yes).

Christopher Gilbert argued that in view of the risks inherent in capital account liberalisation, the advice from multilateral agencies must reflect this caution. However, he argued that they should be encouraged to entertain their commitment to eventual liberalisation and must encourage reluctant governments towards this objective. Stephany Griffith-Jones of the Commonwealth Secretariat, however, disagreed and argued that in view of the questionable benefits and obvious risks involved, there must be no attempt by multilateral agencies to push countries towards convertibility and their function should be purely an advisory one.

### 3.6. Capital account liberalisation and growth

A number of participants at the conference commented on the linkage between capital account liberalisation and economic growth. There was no clear consensus on this point, although it does appear that the effects are modest.

Stephany Griffith-Jones argued that there was little evidence that growth rates improved in countries that liberalised the capital account. Karl Habermeier of the IMF admitted that there was no clear evidence that capital account convertibility is beneficial and he argued that in the academic literature the measures of the intensity of controls are either crude or only available for short time spans. He believed that while the theoretical literature does suggest benefits, the overall magnitude is probably not highly important. In his view, capital account liberalisation was a 'second-order' problem and sound macroeconomic policy and effective supervisory and prudential structures are more important. In contrast, John Williamson argued that studies that show no effect of capital account convertibility on growth use a yes/no measure of convertibility, while the one study that does show a positive effect of capital account liberalisation on growth distinguishes between different degrees of convertibility.

### 3.7. Capital account liberalisation and Africa

The prospects and implications for capital account liberalisation in Africa were discussed widely at the conference. Some countries in this region liberalised because of the pressures introduced by massive capital flight and still did not have adequate systems and pre-conditions in place to deal with an open capital account. Another aspect to be taken into consideration is that it is important to look not only at the absolute inflows of foreign capital into a country but also at their relative size. As more African countries have moved towards liberalisation of capital account transactions, some of them have attracted large inflows of funds relative relative to GDP and gross fixed capital formation.

As on the question of the relationship of capital account convertibility to growth, there was a division of opinion on the benefits of liberalisation for Africa. Christopher Gilbert argued that convertibility is unlikely to stimulate large FDI flows to African countries. The benefits would be felt largely in the freedom of residents to invest their funds where desired (especially relevant for pensions) and in the encouragement it would provide to the development of the banking system. He argued that the benefits and costs of capital account convertibility are lower for the poorest countries compared to the middle income countries. Other participants argued that there are gains to be made from increasing competition for the domestic financial sectors and the greater possibilities of tapping international capital markets.

A potential danger in the African context was the possibility of shocks from South Africa. Louis Kasekende argued that the interconnections between many countries in Sub-Saharan Africa and South Africa were very strong in view of the prominent position of South African investors in their economies. Developments in the South African stock market are thus of prime concern to the rest of Africa. He pointed out that this interdependency should make co-ordination of policies on the regional level an important policy priority. Wilson Banda of the Central Bank of Malawi also emphasised this dependence on South Africa, in particular the importance of worker remittances from South Africa.

Valpy Fitzgerald of Oxford University noted the volatility of donor flows and the fact that they are often highly pro-cyclical. Donors generally “lend into success”. Louis Kasekende agreed that Uganda was an example of this phenomenon. Valpy Fitzgerald also noted that often in African countries large shares of deposits are donor funds that have not been disbursed and thus create liabilities for the domestic banking system.

Wilson Banda enunciated what in his view were the reasons for the restrictive capital account regimes in many African countries. He argued that the dependence of many economies on a few main commodities, and the resultant vulnerability to their volatile price fluctuations, greatly increased the risks to large capital outflows if there was full convertibility. The seasonality of export receipts depicted in the case of Uganda by Louis Kasekende is also a more general phenomenon across Africa and leads to instabilities in the exchange rate and balance of payments. Endemic political instability in many countries can also encourage panic and precipitate large outflows. Undeveloped and illiquid financial markets are also vulnerable to panics and crashes that can often be caused by the actions of only a few individuals. Furthermore, weak macroeconomic conditions (including large fiscal imbalances) in the 1980s and 1990s have not made these economies conducive to retaining capital. He argued that in the case of Malawi, liberalisation would probably result

in a flight of funds to South Africa given the greater development of its financial markets and their more extensive investment possibilities.

Wilson Banda argued that there was the possibility that Malawi may end up in the situation of Zambia who after an economic crisis in the early 1990s was left with "nothing left to control" and rapidly threw open the economy. While this move was perhaps inevitable and has brought some benefits (foreign investment in the copper industry), it has also greatly heightened the vulnerability of the country to adverse shocks. Benu Schneider argued that there were bad reasons (and bad conditions) under which to open the capital account because they completely neglected preconditions. This problem is particularly acute in Africa where collapsing control regimes lead to *de facto* liberalisation.

## 4. Conclusions

The main conclusions emerging from the conference can be summarised as follows:

- The forces leading to globalisation and moves towards greater liberalisation of capital account transactions are irreversible. Capital account liberalisation is not a choice. It is part of prudent policy to work out an orderly opening of the capital account instead of reforming under duress once a crisis has hit the economy. Many capital control regimes in developing countries also failed to prevent balance of payments crises from developing and inhibited access to international financing and diversification.
- While liberalisation is generally beneficial, it also greatly heightens a country's vulnerability to reversals in capital flows that can precipitate severe currency and balance of payments crises.
- The risks inherent in capital account convertibility thus justify a gradual approach to liberalisation. Gradualism also allows time for the learning curve in developing countries. It is important that countries focus on the pre-conditions for liberalisation. Especially prominent among these are fiscal balance, the right mix of instruments to manage capital flows, exchange rate policy and financial sector reform and bank supervision. It is also necessary to integrate different segments of the financial market in developing countries.
- Liberalisation of the controls on the current account combined with a relatively closed capital account leads to the loss of capital through leads and lags in the current account. Some restrictions on the current account are needed in the transition phase to give the country time to reform without dealing with the problem of capital flight through this channel. The decision to open up the capital account because of pressures introduced by the opening of the current account is a poor policy decision. The volume of capital lost through leads and lags, it must be mentioned, is likely to be smaller as that through an open capital account under unsuitable conditions.
- The fear that an opening up the capital account will lead to massive flight of capital can be dealt with by identifying the conditions that lead to round-tripping of capital flows and/or one-way resource transfer in a particular country and introducing necessary changes while working out the pre-conditions to capital account liberalisation.

- Capital account liberalisation requires that central banks have effective regulatory, supervisory, enforcement and informational structures in place. Liberalisation must not be seen to require the authorities to retreat from these essential functions.
- The need to regulate short-term flows arises from the inability of financial systems in developing countries to intermediate capital from the short-end to the long end and cannot therefore bear the risk of financial intermediation. The management and monitoring of short-term inflows must be a central concern.
- Authorities must be concerned not only with the foreign exchange exposure of the financial system but also that of the non-bank private sector. Experience has shown that these "hidden" exposures can be a prime source of national exposure to currency depreciations.
- The composition of capital flows must also be closely monitored. FDI flows are in general more costly but also more stable and beneficial to development. At the other end of the spectrum, short-term borrowing is highly volatile and more likely to underwrite consumption rather than productive investment.
- Capital controls must be viewed pragmatically. A distinction must be made between capital control and prudence. Many controls are inefficient and ineffective. However, a distinction must be drawn between these controls and controls that serve a prudential function. In particular, authorities wishing to limit exposure to sudden capital reversals must consider some quantitative restrictions and controls on short-term flows such as those in Chile. Price controls on short-term flows are only effective in the short-run in altering maturity transformation and provide monetary autonomy in the short-run, they cannot be used to insulate monetary and exchange rate policy. Controls must be carefully targeted to where they are most effective and must make distinctions between various classes of agent (resident, non-resident, and bank, corporate, individual). In the transition phase, restrictions on certain class of institutions, such as banks, pension funds and authorised dealers are generally effective. In the transition phase, depending upon conditions both price controls and prudential limits can be used. Efficient administrative machinery is needed for their effectiveness. Controls must not, however, be used to put off essential reforms directed at structural imbalances and the financial sector.
- Foreign currency deposits in the domestic financial system are a source of instability in the transition phase and central banks should make it a priority to reduce their level and enact regulations to discourage them.
- Whether countries opt for a managed floating exchange rate regime or an exchange rate band, depending upon their circumstances, flexibility of the exchange rate is important with an open capital account.
- Greater transparency of central bank, financial sector and corporate balance sheets is a desirable objective for developing countries. However, it should not be seen as a cure-all for instability.
- Offshore centres can play a role in financial crisis and create havoc for a developing country. Harmonisation of tax regimes, financial liberalisation under prudential oversight and capital account liberalisation can reduce the appeal of offshore centres. A process of co-ordination between onshore and offshore centres will also contribute to financial stability in the world economy.

- Country experiences suggest that there are three strategies for opening the capital account and that it is practical and feasible to be at different points along the spectrum leading to a fully convertible capital account.

  i. *The opening up of the capital account based on distinctions between residents and non-residents* (an approach followed by India and South Africa). In both these cases the assumption seems to be that outflow of capital by residents can cause a crisis since opening up is more cautious for the resident sector. There is some basis for this. In the 1994 Mexican crisis, domestic residents moved out of Tesobonos first setting a signal for foreign institutional investors (FIIs). However, country experiences show that FIIs are equally likely to exit from a country based on their perceptions about the economy

  ii. *Opening first the inflow side and later liberalising outflows (same as (i) but the opening up is not restricted between residents and non-residents.) After liberalisation of inflows and outflows, management of the open capital account with the aid of price instruments (when required) that are designed to alter the maturity structure of inflows and their impact on monetary and exchange rate policy* (an approach followed by Chile, Colombia and Malaysia). The experience of these three economies points to the importance of overall supportive policies to make these controls work.

  iii. *A 'big bang' approach that simultaneously liberalises controls on inflows and outflows* (an approach followed by Argentina, Peru and Kenya).

The country experiences described in this paper suggest that either option (i) or (ii) is preferable for most developing countries. Each country has to decide on the degree of capital account convertibility based on its own conditions. If a country decides on a given degree of capital account convertibility, over time it should move towards greater openness consistent with its overall reform process.

- The *relative* size of inflows into many poor economies is very high by world standards. Therefore, further research must be directed at the process of capital account convertibility in the context of these economies. Further work is needed to analyse the issues raised here in the context of economies, such as those in Sub-Saharan Africa, where recourse to indirect instruments of monetary policy, hedging interest rate risk and exchange rate risk is constrained by the lack of depth in the financial market. In this context, other bottlenecks are the limited number of market participants. The development of the financial market and its structure may be constrained by the size of the economy. The degree of capital account convertibility and the management of the capital account will need a new focus because of the paucity of financial instruments and the inadequate financial infrastructure, which was less acute in other economies. Problems can also be foreseen in the dilemmas posed by floating exchange rate regimes. In the face of these a strategy for smaller economies to manage capital flows and the degree of capital account convertibility needs to be debated and researched.

- An effective international lender of last resort facility is unlikely to emerge in the near future. The principles underlying a LOLR facility are problematic to implement at the international level and the funds of the IMF are grossly inadequate to fulfil the task. The need to draw in lending from advanced countries is uncertain and subject to political constraints.

- Workouts and bail-ins are a critical element in crisis resolution but are subject to moral hazard since they allow lenders to escape without bearing a significant proportion of losses. Moral hazard can be dealt with through (i) an international lender of last resort or the imposition of capital controls, (ii) “middle way” solutions such as standstill agreements, and (iii) the limited lender of last resort facility subject to pre-qualification outlined in the Meltzer Commission report. The Meltzer Commission recommendations were seriously flawed. The emphasis upon pre-qualification begs the question of what would happen in the case of a crisis in a significant non-qualifying country. It is likely that it would be easier to intervene to ameliorate the crisis rather than to combat contagion to other economies. In addition, the recommendations also fail to adequately address what would happen if a crisis were caused in a qualifying country by “irresponsible” policies. Restrictions on IMF lending also could create uncertainty and deepen a crisis. The uncertainty about future crisis required flexibility, which was precluded by the concept of pre-qualification in the Meltzer report.
- A payments standstill sanctioned by the IMF was a better solution since creditors would incur a write-down in their assets and the claim on IMF financing would be restricted to smaller amounts than in either the full or partial LOLR facilities envisioned in the other options.
- The conference clearly revealed the promise and the risks inherent in capital account convertibility. Participants emphasised the need for gradualism and preconditions in laying a strong foundation on which to base full convertibility. Without this foundation, the chances of a severe crisis are greatly heightened. The conference concluded on the note that each country has to work out the degree of capital account liberalisation based on its own pre-conditions and move along the spectrum as the economy undergoes reforms and enters a dynamic process of change and progress. Prudential limits and regulation can be used to work out the transition phase. Experience reveals that a gradual approach to capital account convertibility is an achievable and largely beneficial policy objective for developing countries to pursue.