Cross-border capital movements and the role of the International Monetary Fund

The liberalisation of international capital movements has made distinct progress in the past few decades. It has evolved in spurts, though, and has sometimes been limited to certain regions, individual countries or groups of countries. In addition, the liberalisation process has not been without its setbacks, and the measures were often controversial. Proponents of capital account liberalisation emphasise the contribution it makes to allocating the world's resources towards their most productive uses, thereby fuelling growth. By contrast, critics note the potentially destabilising impact of uncontrolled capital flows. What many fail to realise, however, is that in most cases economic policy mistakes are what engender crises. Therefore, national economic policies and financial systems need to be strengthened, and preparations should be made so that capital accounts can be opened up gradually. This is an area in which the International Monetary Fund (IMF) is equipped to play an important role within the framework of its macroeconomic surveillance and policy advice. A desirable alternative over the longer run, however, would be for the IMF to have a more comprehensive mandate. The IMF, by analogy with its powers in the framework of liberalising current account transactions, should be given a clear mandate to ensure the orderly liberalisation of capital account transactions.

International capital movements between controls and liberalisation

Bretton Woods agreement characterised by scepticism regarding unrestricted capital flows

At the Bretton Woods Conference in 1944, the IMF was assigned the task of promoting and monitoring an open, stable international monetary system. A key element of this monetary system is the obligation of member countries to liberalise current account transactions and to eliminate existing foreign exchange restrictions. However, the IMF's Articles of Agreement do not contain any similar obligation to liberalise capital transactions. Instead, it is basically at the discretion of member countries to either maintain restrictions they consider necessary or even to introduce new capital controls. Moreover, in some circumstances (say, to safeguard its financial resources in the event of a looming large or sustained outflow of capital from a borrower country) the IMF may itself demand that capital controls be imposed. The unequal treatment of current account and capital transactions in the IMF's Articles is a reflection of an attitude which was widespread as the IMF was established, namely that growth and employment-promoting effects were likely to be created by cross-border transactions in goods and services, in particular, and that uncontrolled capital movements in an environment of fixed exchange rates would tend to be disruptive. The preference for fixed exchange rates and scepticism regarding unrestricted capital flows were rooted in, among other things, the negative experiences those countries had had with devaluation races and the concomitant massive capital speculation in the period between the two world wars. In the fifties and early sixties, the international monetary system, which was based on fixed exchange rates and tight controls over capital flows, continued to function largely without friction. Monetary policy stability, expanding world trade and increasing prosperity during that period offered little reason to call the existing institutional rules into question.

Gradual loosening of controls on capital flows due to market forces

As the sixties progressed, however, the Bretton Woods parity system came under increasing pressure. Rising tension caused by diverging preferences among IMF member countries in economic and particularly anti-inflationary policy, attendant disparity in development, and the gradual disappearance of parities' credibility, all conspired to unleash phases of torrential outflows of foreign currency and waves of speculation. In 1973, they ultimately led to the breakdown of the Bretton Woods system of fixed exchange rates. No longer needing to stabilise the parity system through capital controls, yet also driven by market forces and the attendant competitive pressure, the industrial countries, in particular, began to gradually eliminate capital controls. International capital flows unstoppably became more and more a key feature of the world economy; this was accompanied by the increasing use of innovative financial instruments, and in many cases existing controls were circumvented. Cross-border capital transactions, whose cause was also aided by advances in information and communications technology, recorded virtually explosive growth in the nineties. It became increasingly clear that government regulation could not lastingly stifle the economic motives and mechanisms behind the capital flows. Moreover, it was becoming more and more obvi-

ous that capital movements could not be excluded from the process of deregulation which was being pushed in many countries and from the increasing interrelationships in the world economy.

Explosive growth of capital movements

In the beginning, growth of cross-border capital movements was concentrated on the industrial countries. In these countries, capital imports for direct investment purposes rose nearly thirtyfold between the mid-seventies and the end of the nineties. Inflows for portfolio investments even went up nearly fiftyfold. In the nineties, private capital flows to developing countries skyrocketed as well. Dynamic growth, and with it the hopes of attractive earnings, unleashed a strong ripple effect. In some cases, government privatisation programmes offered favourable opportunities for international investors to enter their markets. New direct investment in the developing countries, according to IMF data, went up more than fivefold, from just under US$ 40 billion as an annual average of the 1989–1992 period to just over US$ 200 billion in the 1997–1999 period. At the same time, inflows of portfolio investment picked up from just over US$ 27 billion to US$ 104 billion. Private capital has now become the dominant source of funding for an increasing number of developing countries and emerging economies.

Large transfers of capital in earlier times, too

The phenomenon of large cross-border capital flows, however, did not originate in the closing years of the twentieth century. In the pre-WWI economic boom, net capital exports of the then-leading industrial countries – as a percentage of GDP – were at times even

The IMF's Articles of Agreement, current and capital transactions

The key passage in the IMF's Articles of Agreement governing capital transaction controls is contained in Article VI, section 3:

> **Controls of capital transfers**
>
> Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions. ...

This liberalisation requirement for current account transactions explicitly covers payment for such transactions, not the transactions themselves. The liberalisation of trade in goods and services is governed by other agreements (GATT, WTO). The idea behind this IMF rule is to ensure that in the case of permissible imports and exports (of goods and services) payments are permissible, too. Naturally, payments for current account transactions always affect items of the financial account (e.g. "claims on banks"). To that extent, the required liberalisation of current account transactions also implies freedom of financial operations. At the same time, (positive or negative) current account balances, and in that sense the transfer of savings, would be permissible.

Permission to regulate capital transactions under the Articles of Agreement covers "pure" capital movements where entry and counterentry exclusively affect capital and asset items, such as the purchase of securities, direct investment, or the depositing of short-term funds. The current account is not affected by any of this. Instead, the liberalisation of capital movements has more to do with the cross-border supply of and demand for a variety of financial items in the individual markets. Accordingly, the complete liberalisation of capital account transactions might have the following effects: bank balances obtained in current account transactions might be used for direct investment; short-term liabilities might be replaced by longer-term bond issues; or, simply, pure futures transactions might be concluded, in order to hedge subsequent transactions. All those types of transactions would help direct capital towards its most productive uses and would therefore probably have an optimising repercussion on current account balances.

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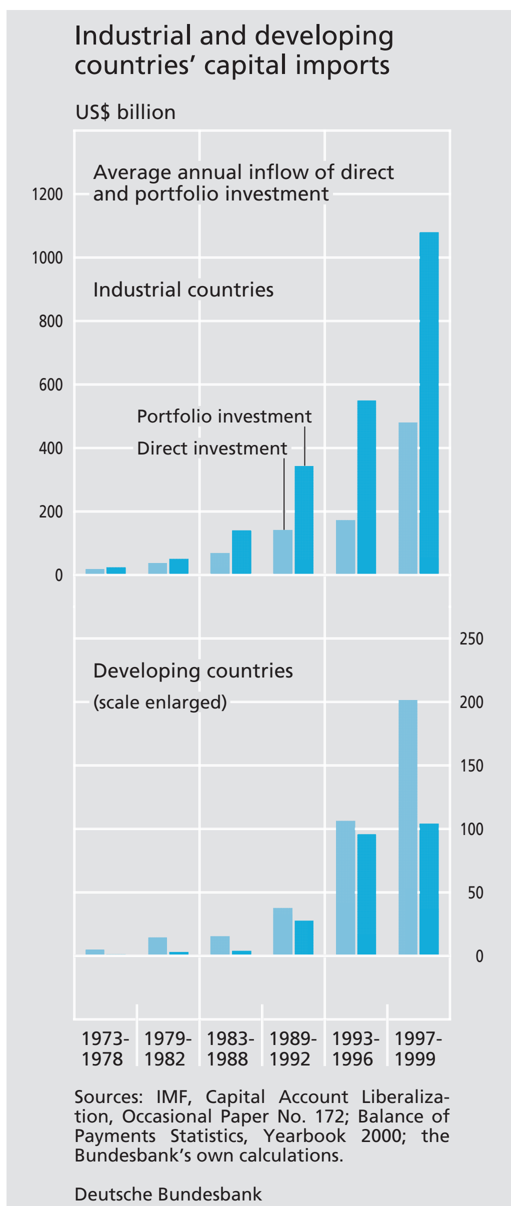

Sources: IMF, Capital Account Liberalization, Occasional Paper No. 172; Balance of Payments Statistics, Yearbook 2000; the Bundesbank's own calculations.

higher than in modern times. The reason lay in a massive transfer of resources from European countries, in particular, to the younger industrial countries and to what were then non-self-governing territories. By contrast, the character of capital movements has undergone considerable change since then. The spectrum of financial instruments being traded is nowadays much larger than in the past. In the past few decades, growth of international capital movements has been fed by institutional investors in particular.

Liberalisation of capital movements in industrial countries occurred in spurts and was not without setbacks

The liberalisation of capital movements over the past decades often took place in spurts; in many cases it was limited to certain regions, individual countries, or groups of countries. In addition, the process of liberalisation suffered occasional setbacks and was often the subject of controversy. The first attempts at liberalisation took place in the fifties; the process gathered momentum when, in 1961, the OECD adopted the Code of Liberalisation of Capital Movements. However, capital movements in many industrial countries initially remained subject to a large number of controls as well as institutional, legal and tax hurdles. When the European Monetary System was introduced in the late seventies, the liberalisation of capital movements in Europe distinctly gained momentum. The Single European Act, adopted in 1987, envisaged an unrestricted domestic market, including liberalised capital movements. The Maastricht Treaty basically deregulated capital flows in 1994, both within the European Union and vis-à-vis non-EU countries. However, the process of liberalisation in Europe has occasionally stalled. For instance, in reaction to the EMS crises of 1992-93, controls were temporarily reintroduced in some countries. That episode likewise made it clear that the coexistence of unrestricted capital flows and fixed exchange rates is generally only sustainable in those cases where the countries in question are consistent in terms of macroeconomic, and especially monetary, stabilisation; i.e., there should not be any sustained discrepancies in the rates of inflation ("synchronised stability").

Process of liberalisation is continuing

All in all, the process of liberalisation of capital movements in the industrial countries has by no means been completed. According to the IMF, 20 out of 29 industrial countries under review still had restrictions on direct investment in force at the end of 1999. In many of those cases, the main motive is likely to be keeping foreign investors away from enterprises having strategic or other eminent national importance or which are sensitive in terms of national security. In addition, 14 industrial countries have restricted non-residents' rights to purchase real estate. At this juncture it would be fruitless to discuss whether it is even necessary or realistic to remove all barriers in those areas.

Early liberalisation of capital movements in Germany

Germany is one of the few countries that at an early stage already introduced the policy of freedom of capital transactions with foreign countries.[1] As early as the end of 1958 the D-Mark became freely convertible, thus virtually ending all restrictions on capital exports. However, it was not yet possible to do entirely without controls of capital imports at the time. In the Bretton Woods fixed-rate system, the unrestricted inflow of foreign funds always harboured the danger of the Bundesbank being forced to provide the German economy with more liquidity than was advisable from a stability policy standpoint. Administrative attempts to stem the inflow of foreign exchange, such as requiring non-residents to obtain approval prior to purchasing domestic bonds and money market instruments, banning interest on foreigners' deposits with German banks, and instituting a cash deposit requirement for borrowing abroad, ended up not being particularly successful. The transition to largely flexible exchange rates and the abolition of the requirement to purchase dollars in March 1973 pushed capital inflows as the problem of an independent monetary policy into the background. The remaining restrictions on capital imports in Germany had been largely eliminated by 1981. At the end of 1999, Germany was one of the few countries not having capital controls in any of the IMF's categories under review. That notwithstanding, the parties to such transactions must continue to comply with numerous regulations under corporate law, financial supervisory law and tax law; however, these regulations apply generally and cannot be regarded as special capital controls.

Considerable potential for liberalisation in the developing countries

In the developing countries, too, the liberalisation of capital movements has not always been smooth, nor has it always been without setbacks. For instance, during the debt crisis at the beginning of the eighties, Latin America witnessed a pronounced rise in capital controls. As the eighties came to a close, and more so when the nineties were ushered in, the trend towards integration of national financial systems into international financial markets began to accelerate among developing and transition countries. The adjustment of exchange-rate regimes to greater capital mobility in those countries was not even. However, a certain trend towards a "bipolar" system of either fixed or flexible exchange rates is visible. A number of countries have chosen to peg their currencies fairly

1 See: Deutsche Bundesbank, Freedom of Germany's capital transactions with foreign countries, Monthly Report, July 1985, page 13 ff.

Controls on capital transactions in IMF member countries *

As at the end of 1999; number of countries

Item	Total	of which: 1		
		Industrial countries	Developing countries	Transition countries
Countries under review	185	29	129	27
Countries with controls on:				
Capital market securities	125	12	92	21
Money market instruments	110	9	81	20
Collective investment securities	103	8	76	19
Derivatives and other instruments	83	7	60	16
Commercial credits	108	5	86	17
Financial credits	113	5	89	19
Guarantees, sureties and financial backup facilities	93	2	77	14
Direct investment	147	20	106	21
Liquidation of direct investment	54	1	49	4
Real estate transactions	136	14	97	25
Personal capital movements	90	3	70	17
Provisions specific to:				
Commercial banks and other credit institutions	158	18	113	27
Institutional investors	83	20	49	14

Sources: IMF, Annual Report on Exchange Arrangements and Exchange Restrictions 2000; and the Bundesbank's own calculations. — * Including Aruba, Hong Kong (SAR) and the Netherlands Antilles; as at the end of 1999. — 1 Classification of countries by analogy with that in the World Economic Outlook, May 2001.

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tightly to an anchor currency, sometimes in what is known as a "currency board". However, many emerging economies, traumatised by their experience with the currency crises in the nineties, have chosen an exchange-rate regime affording greater flexibility for exchange rates. Despite all that, in the developing countries there is still considerable potential for further steps towards liberalising capital movements. According to IMF data, at the end of 1999 various barriers to cross-border capital transactions were still in place in most of the 129 developing countries under review. Direct investment, which is important for the development process, has also been particularly affected; in 106 of the countries being studied, there are restrictions on direct investment.

International capital movements – an engine of world economic growth

Increased growth through global allocation of savings

The central argument in favour of unrestricted international capital movements lies in their contribution to economic growth. In an environment of unfettered capital movements, national borders no longer stand in the way of the efficient allocation of savings, and thus of "capital" as a factor of production. Available financial resources are transferred to their most productive uses, i.e. where they promise the highest gains, thereby making the greatest contribution to growth. Enterprises which invest can take recourse to savings held abroad, and investors can go after those investment vehicles worldwide which match their desired combination of risk and return. Both the recipients of cap-

ital inflows and those countries with net transfers of savings abroad benefit from the interaction of internationally active capital suppliers and demanders.

Intertemporal allocation of consumption and saving between economies

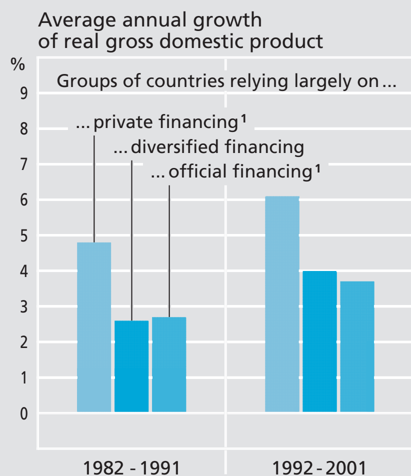
The welfare-enhancing effect of the free exchange of capital and assets is ultimately similar to international trade in goods and services. However, although the benefits of free trade in goods are for the most part easily understood, there is often difficulty regarding capital transactions. That may be because these are not only cross-border flows but also stocks. Yet this is where the actual benefit lies. Stock-holding is the vehicle driving intertemporal substitution. Over time some economies, owing to differences in structural features, develop different needs for financing, thus causing consumption and saving patterns to diverge. For instance, developing countries and emerging economies, in the process of economic recovery, need a larger volume of financing for investment purposes than can be raised through domestic saving and official development aid alone. For many industrial countries, unrestricted capital flows also open up the opportunity of taking account of problems relating to unfavourable demographic changes. During a period in which "baby boomers" are employed, savings can be formed abroad, the yields on which can be used at a later date. Globally integrated financial markets ensure that the diverging financing and investment needs are balanced out.

It is not only at the macroeconomic level but also in a sectoral view that unrestricted international capital movements can be expected to yield benefits. Nationally operating financial services institutions which used to be protected by national borders must now deal with intensified international pressure from the market and streamline their operating procedures if they want to remain competitive. This not only favours and accelerates the process of innovation in the financial sector; the other sectors of the economy benefit from an efficient financial sector as well. All the same, there is no denying the fact that the increasing influence of foreign financial institutions in the domestic financial industry encounters scepticism and resistance in some countries. However, in many cases there is hardly any alternative to the knowledge transfer that goes hand in hand with direct investment in the financial services sector (as well as in other sectors). At the international level, unrestricted capital flows help to realise benefits from the advantages of specialisation in the financial sector. As in goods manufacture, it is not always possible or profitable for a country's domestic institutions to provide the gamut of modern financial services. In many cases it is better to import selected financial services and to export other goods and services, thus exploiting comparative advantages. In the light of the accumulation of risk, however, the concentration which is sometimes a corollary of the liberalisation of capital movements is grounds for concern. Two things are important: cartel authorities must remain on their guard, and the risks incurred should be balanced out by an adequate "safety buffer" consisting of own funds (this is a matter for banking supervisors to deal with).

Growth through intensified competition in the financial sector

External financing and economic growth of developing countries *

Average annual growth of real gross domestic product



Source: IMF, World Economic Outlook, October 2000, page 197. — * Net debtor countries. — **1** A country is allocated to the private financing or the official financing group according to whether private or official financing accounted for more than two-thirds of their total 1994-98 external financing.

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Faster growth in developing countries relying mainly on private external financing

The positive effects of unrestricted capital flows exist not only in theory. In fact, there is some empirical evidence. Developing countries relying mainly on private financing achieved much faster growth in the past two decades than those countries which relied primarily on official capital transfers. This correlation is more marked during the nineties than in the eighties. According to IMF data,[2] net debtor developing countries relying mainly on private financing grew at an annual average of 6.1% in the 1992–2001 period, compared with 4.8 % in the 1982–1991 period. By contrast, developing countries relying mainly on official financing grew during the same periods by only 3.7 % and 2.7 %, respectively. The positive correlation between private capital inflows and growth is also testimony to the fact that countries with relatively healthy structures are more likely to attract international investment. Moreover, such investment promotes cross-border transactions in goods and services, thus addressing one of the main issues in the IMF's Articles.

Unrestricted capital transactions support monetary policy

In addition to the positive welfare effects described above, capital transactions in a regime of flexible exchange rates have another entirely different benefit. Capital transactions can be very effective in supporting monetary policy. In the seventies, particularly Germany's monetary policy benefited from unrestricted capital flows, after having been put in an awkward situation in the sixties owing to its stability-oriented stance in an environment of fixed exchange rates. Given unrestricted capital flows and flexible exchange rates, experience has shown that monetary policy takes effect relatively quickly. When interest rates are raised, for instance, this triggers a trend towards capital imports and currency appreciation. That curbs exports and stimulates imports, thereby increasing the domestic supply of goods, which in itself already has a dampening effect on prices. In addition, the direct price correlation is used in a stability-enhancing manner. The trend towards currency appreciation that goes hand in hand with capital imports puts downward pressure on import and export prices and thus has a direct dampening impact on domestic prices. Unrestricted capital movements, which are inherently also sensitive to interest-rate changes, and flexible exchange rates strengthen monetary policy over the longer run, too. Barring other influences, stability-

2 See: International Monetary Fund, World Economic Outlook, October 2000, page 197.

oriented policy is generally consistent with a lasting trend towards capital imports and appreciation. A relatively easy money policy, however, is usually accompanied by a tendency towards capital outflows and devaluation, thereby accelerating inflationary trends and penalising monetary policy in that respect.

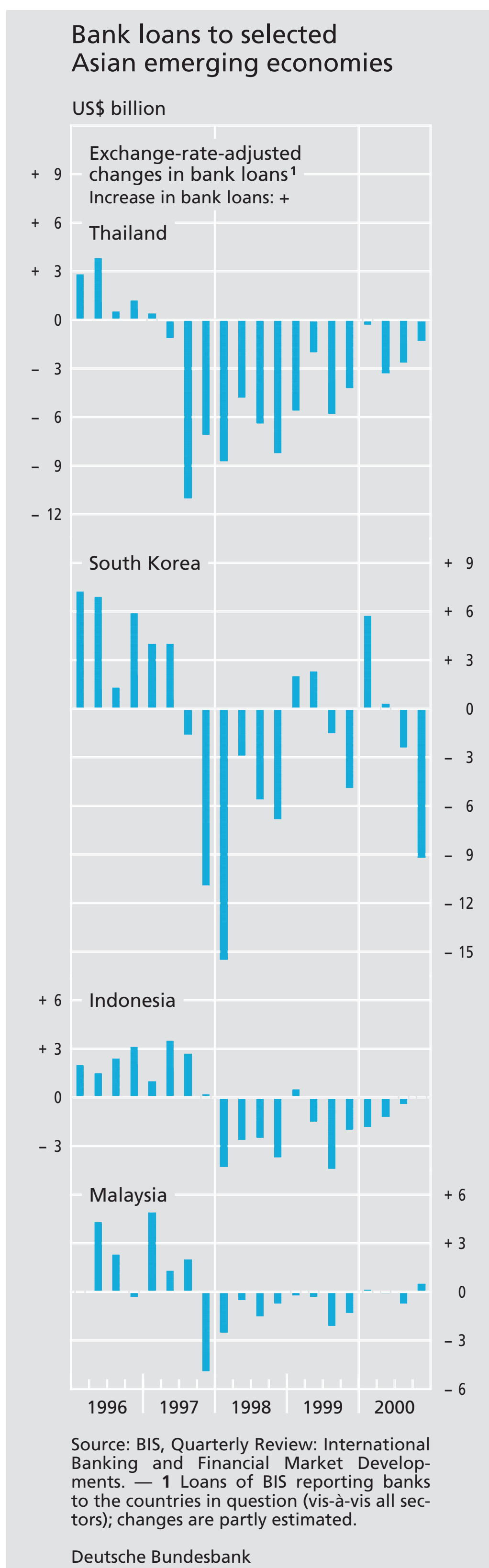
Liberalisation – a cause of financial crises?

Financial crises are caused mainly by failed policies ...

The financial crises of the nineties dampened the high expectations of liberalised capital markets at least in part. Suspicion became rife that the substantial risks inherent in opening domestic capital markets (too quickly) might have been underestimated. The fact that dynamic economies with seemingly sound macro policies (but mostly fixed exchange rates) encountered severe crises was seen by many as a sign that international financial markets had failed. The highly volatile nature of short-term capital flows bore the brunt of criticism. The fact that it was possible for crises to be transmitted to other countries which were apparently healthy was seen as being especially problematic. However, one issue is often overlooked: implicit loan and exchange rate guarantees, weak and undersupervised financial systems and political interference in the economy, to name a few factors, were what created the incentive for excessive capital inflows in the first place. In addition, imported capital was channelled to a considerable extent into projects which had no chance of meeting profit expectations, especially once implicit guarantees were eliminated. The Asian crisis was a vivid example of the interplay of those factors. Owing to the close links in some of those countries between domestic financial intermediaries and their governments, foreign lenders assumed in many cases that their loans were de facto officially guaranteed. Strong official support for a policy of stable exchange rates also contributed to foreign exchange risks of international lending business being underestimated. The governments' implied guarantees, given the undersupervised financial markets in many countries, led to the creation of a sizeable volume of foreign debt denominated in foreign currency – which was extremely short-term to boot. A large volume of capital imports found their way into the real estate sector, creating a price bubble, or were intentionally channelled through government influence into certain sectors of the economy, leading to overinvestment. Once financial markets realised that their assets were not matched by sufficiently productive investment, they began to withdraw their funds, which put massive pressure on domestic currencies and ultimately caused the currency crisis to break out.

... and intensified by market imperfections

Prior to and during the crises, market participants also made some bad calls and overreacted to other events. Incomplete or no account was often taken of political and structural deficits when deciding on whether to lend to the countries in question. In many cases, market players engaged in herding behaviour. Moreover, markets at times took an insufficiently differentiated view of the varying risk situations in individual countries. Thus, the outbreak of crises also placed pres-



Source: BIS, Quarterly Review: International Banking and Financial Market Developments. — 1 Loans of BIS reporting banks to the countries in question (vis-à-vis all sectors); changes are partly estimated.

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sure on countries which were merely part of the same group of countries or region as the crisis countries but which did not necessarily have similar economic or structural weaknesses. However, such misguided assessments were corrected relatively quickly. At all events, there is no record of contagion effects causing severe crises in countries with sound economies. Therefore, although unrestricted capital movements are capable of amplifying and accelerating crises, the root causes are located elsewhere. In 1999 the Bundesbank, in a detailed study of the most recent international financial crises, used econometric approaches to come to the conclusion that bad economic policy was particularly at fault.[3]

A return to regulated capital movements?

Demands for capital controls never completely silenced

Irrespective of the longer-term advantages associated with unrestricted capital mobility, and in the light of recent international financial crises, time and again there are calls for a return to regulation of cross-border capital movements. Such demands are often born of the opinion that unrestricted capital mobility curtails autonomy in economic policy. In particular, proponents of this opinion feel that in a system of fixed exchange rates, there would be very little leeway for interest rate policymakers to pursue independent policy goals regarding stability, employment or growth. One motive for maintaining or reintroducing

3 See: Deutsche Bundesbank, The role of economic fundamentals in the emergence of currency crises in emerging markets, Monthly Report, April 1999, page 15 ff.

capital controls is also to hold savings hostage in the home country to ensure that the government can obtain finance at favourable rates or that government funding for projects can be guaranteed. The desire to shield one's domestic economy from the potential for disruption emanating from volatile international financial markets is not infrequently cited as a reason for maintaining or reintroducing capital controls. Moreover, in view of the recent financial crises, unrestricted capital movements are considered by some to be simply "too dangerous".

Reintroducing capital controls is costly

The spectrum of possibilities for capital controls ranges from general prohibitions to quantitative restrictions to price-based measures such as taxing cross-border transactions. One prominent example of a pricing instrument often discussed as a way of mitigating capital market volatility is the Tobin tax. This is an international tax on foreign exchange transactions. In making foreign exchange transactions more expensive, thus reducing the profitability of speculation, this tax is designed to reduce the incentive to indulge in short-term foreign currency speculation, thereby limiting the volatility of exchange rates and avoiding destabilising effects on the domestic banking system and the domestic economy. However, short-term capital transactions cannot be classified as undesirable or dismissed as economically dubious speculation out of hand. Certain short-term capital movements, such as arbitrage transactions, are, in fact, an integral element of efficient financial markets. In addition, trade credits, another form of short-term capital movements, play an important role in financing current account transactions and help expand world trade. A general limitation of short-term capital transactions would therefore impair the optimal deployment of available resources and could engender considerable economic costs in the form of growth losses. Besides, it would be difficult, maybe even impossible, to introduce such a tax on a global scale and to record all relevant foreign currency transactions. In addition, experience has shown that controls can become ineffective very quickly over time because market participants tend to shift their transactions to non-regulated areas using non-regulated instruments. If controls are then expanded further, their distortionary effects and the commensurate welfare losses increase.

Controls offer no protection from the consequences of bad policy

In many cases, the demand for maintaining or reintroducing capital controls is voiced by those who want the advantages of capital mobility without having to accept the market discipline which this entails. Integration into international financial markets involves losing a certain degree of autonomy in forming economic policy. International capital flows are relatively sensitive to economic policy mistakes. Capital outflows are often a sign that financial markets have little confidence in the will and the ability of policymakers to undertake the necessary reforms and to make them successful. However, it would be wrong to conclude that capital mobility undermines policy freedom or imposes a policy straitjacket. What capital mobility does is to expose existing policymaking deficits and the costs they entail, thus putting pressure on the responsible policymakers to explain their actions. It is true that policy mistakes make ad-

justment inevitable sooner or later, even in an environment of restricted capital mobility. However, in a system of free capital mobility, such deficits are more difficult to conceal, and adjustment pressure ensues more rapidly and with greater force. It comes as no surprise, therefore, that criticism of free capital mobility and calls for the introduction of capital controls are always loud in those situations where economic policy mistakes are revealed and policymakers are forced to realise that they are ultimately not above the laws of economics and their incentive mechanisms. It is therefore all the more important that the function of unrestricted capital mobility in imposing economic policy discipline not be impaired.

The need for an orderly process of liberalisation

Addressing the causes of financial crises – instead of reversing liberalisation

Even if the severe financial crises that occurred in the nineties might not have been possible without unrestricted capital movements, it still does not make sense to call for a reversal of liberalisation. Those who do ignore the fact that such a reversal would lead to growth-related gains being surrendered, and that the discipline imposed by markets tends to have more advantages than disadvantages in the long run. Therefore, the goal must be to make use of the advantages afforded by capital mobility while at the same time reducing the probability and the extent of future financial crises. The solution lies in avoiding errors in economic policy and in strengthening the underlying framework. The creation of an efficient banking supervisory structure is a key element of such a solution. At the same time, obstacles impairing market economy steering mechanisms should be removed. Trade barriers, government guarantees, and rigid exchange-rate arrangements all need to be reexamined. In most of the countries hit by recent crises, there is still much to be done in that regard. Finally, it is also important that the international community avoid distorting incentive structures for market participants. Therefore, the IMF and other public donors should not offer large financial assistance packages in the event of financial crises. If the private sector is not sufficiently involved in the resolution of financial crises, that will lay the basis for the misdirection of capital and for later crises to occur.

Greater emphasis on sequencing in the process of liberalisation

In future, it will be particularly important to create a sound institutional framework prior to liberalising capital movements. However, calling for an orderly sequencing does not mean that liberalising cross-border capital movements should only begin once the process of deregulating the domestic financial sector has been completed. Instead, the opening up of cross-border capital flows and domestic reforms are linked together. There are no one-size-fits-all solutions, for all countries are different in terms of their level of macroeconomic development, the "maturity" of their financial sector and their institutional structures. However, there are some general principles which may serve to ensure that capital account liberalisation is successfully sequenced. In the case of long-term capital flows, and especially direct investment, there is less danger of them being withdrawn quickly in the event of economic difficulties.

Priority should be given to establishing a domestic financial market and the commensurate institutions and supervisory bodies. Opening the market to short-term capital flows is something which should be handled with care. Therefore, this should be done more towards the end of the liberalisation process. On the whole, the recent financial crises could have been mitigated or even avoided entirely, if a functioning supervisory structure had been in place (for instance, regarding the hedging of short-term foreign currency liabilities).

Capital controls are worth consideration only in exceptional circumstances

On the road towards liberalised capital movements, capital controls may at best act as a "temporary substitute" for still-underdeveloped supervisory and risk management systems. In that context, reference is often made to Chile's success with its often cited tax-like capital import restrictions. However, it has not been conclusively proven that Chile's economic stability in the nineties was due to the existence of those controls. There are many signs that the stability-oriented macroeconomic policy (including the timely transition to flexible exchange rates) and sound financial market supervision played a key role. Temporary restrictions on capital movements may also be called for in exceptional circumstances in order to give a country some breathing room to implement necessary and confidence-building reform measures in a crisis situation. Panic-induced capital flight can thus be avoided. However, such controls should only be introduced as part of a comprehensive programme of economic policy reform which is supported by both the country in question and the IMF. Restrictions on capital movements cannot take the place of the necessary adjustment and reform measures. In addition, the controls should have a time limit and should be explicitly advertised as an exceptional measure. That is the only way to avoid losing much of the confidence of international investors and the commensurate long-term loss of access to the capital market. In 1998 Malaysia introduced capital controls as part of a programme to resolve a financial crisis – though without collaboration with the IMF. It is not yet possible to make a final pronouncement on the costs and benefits of those measures. However, initial analyses seem to indicate that the outcome of those measures was better than many observers had originally expected. Capital outflows were reduced for some time, thus giving the country the necessary breathing room to conduct reforms. The price, though, was a relatively sharp rise in international financing costs, with inflows of foreign direct investment remaining sluggish. However, Malaysia deserves some credit for having overcome the crisis without massive official assistance.

The IMF's role

Intensifying economic policy surveillance

The financial crises of the nineties demonstrated that, given a great degree of capital mobility, the effects of bad economic policy and an insufficient framework can be much more serious than had been the case in the past. Therefore, crisis prevention through intensified bilateral and multilateral IMF surveillance is of prime importance. In particular, deficiencies in member countries' economic policies must be identified at an early stage. This

includes monitoring macroeconomic developments and their core areas of monetary and fiscal policy, including the soundness of the exchange-rate regime. Rigid exchange-rate arrangements in an environment of unfettered capital movements can not only undermine the goal of a stability-oriented monetary policy but can also contribute greatly to heightening the potential for a crisis to break out. Macroeconomic indicators, though able to give early warning of looming crises, cannot take the place of a comprehensive country-specific analysis. As part of its macroeconomic surveillance and policy advice, the IMF should also intensify its reviews of the institutional structures in member countries as to how capable they are of absorbing capital inflows and transferring them to productive uses. In that context, an efficient and stable financial sector and an effective supervisory authority are especially important. The same applies to the multilateral surveillance of globalised financial markets. The convening of a "Capital Markets Consultative Group" by the IMF Managing Director as a forum for dialogue with private market players and the fusion of capital market-relevant divisions within the IMF to form an independent International Capital Markets Department can help enhance the Fund's expertise in capital market affairs and strengthen its multilateral surveillance function.

Enhancing the functional viability of financial markets

The quality of financial market players' decisions rests in particular on the extent to which they are based on reliable information on economic developments in the countries in question. Inadequate or erroneous information causes capital allocation to be suboptimal and, in crisis situation, may lead to overreactions. It is primarily each investor's individual responsibility to properly assess the available information. The IMF can play a supporting role by promoting the provision of meaningful and timely information. In addition, an important instrument for improving the general level of transparency is the development of standards and codes for financial and economic activities. The IMF, whose membership virtually spans the globe, is predestined to play a prominent role in the formulation and monitoring of important standards and codes. With its "Reports on the Observance of Standards and Codes" (ROSCs), it has a suitable instrument at its disposal. However, there is already a large and growing array of standards and codes. Even compliance with the twelve standards defined by the Financial Stability Forum is a very ambitious project. It is therefore imperative to set priorities in terms of timing and content. Not every standard is of equal importance to all countries in every situation. Moreover, adopting more and more standards and widening their scope does not as such guarantee a stable financial system. Applying standards and codes can support a sound macro policy, yet they are naturally not a substitute for it.

No IMF financial support for liberalisation

The IMF can also contribute to the necessary financial sector reforms and to the establishment of a suitable regulatory framework through its technical assistance. Close cooperation and coordination with other national and international institutions (especially the World Bank) is necessary in order to use scarce resources properly and in a results-oriented manner. Further-reaching IMF finan-

Interim Committee Statement on Liberalization of Capital Movements Under an Amendment of the IMF's Articles, as Adopted, Hong Kong SAR, September 21, 1997

1. It is time to add a new chapter to the Bretton Woods agreement. Private capital flows have become much more important to the international monetary system, and an increasingly open and liberal system has proved to be highly beneficial to the world economy. By facilitating the flow of savings to their most productive uses, capital movements increase investment, growth, and prosperity. Provided it is introduced in an orderly manner, and backed both by adequate national policies and a solid multilateral system for surveillance and financial support, the liberalization of capital flows is an essential element of an efficient international monetary system in this age of globalization. The IMF's central role in the international monetary system, and its near universal membership, make it uniquely placed to help this process. The Committee sees the IMF's proposed new mandate as bold in its vision, but requiring cautious implementation.

2. International capital flows are highly sensitive to, among other things, the stability of the international monetary system, the quality of macroeconomic policies, and the soundness of domestic financial systems. The recent turmoil in financial markets has demonstrated again the importance of underpinning liberalization with a broad range of structural measures, especially in the monetary and financial sector, and within the framework of a solid mix of macroeconomic and exchange rate policies. Particular importance will need to be attached to establishing an environment conducive to the efficient use of capital and to building sound financial systems solid enough to cope with fluctuations in capital flows. This phased but comprehensive approach will tailor capital account liberalization to the circumstances of individual countries, thereby maximizing the chances of success, not only for each country but also for the international monetary system.

3. These efforts should lead to the establishment of a multilateral and nondiscriminatory system to promote the liberalization of capital movements. The IMF will have the task of assisting in the establishment of such a system and stands ready to support members' efforts in this regard. Its role is also key to the adoption of policies that would facilitate properly sequenced liberalization and reduce the likelihood of financial and balance of payments crises.

4. In light of the foregoing, the Committee invites the Executive Board to complete its work on a proposed amendment of the Fund's Articles that would make the liberalization of capital movements one of the purposes of the Fund and extend, as needed, the Fund's jurisdiction through the establishment of carefully defined and uniformly applied obligations regarding the liberalization of such movements. Safeguards and transitional arrangements are necessary for the success of this major endeavor. Flexible approval policies will have to be adopted. In both the preparation of an amendment to the IMF's Articles and its implementation, the members' obligations under other international agreements will be respected. In pursuing this work, the Committee expects the IMF and other institutions to cooperate closely.

5. Sound liberalization and expanded access to capital markets should reduce the frequency of recourse to Fund resources and other exceptional financing. Nevertheless, the Committee recognizes that, in some circumstances, there could be a large need for financing from the Fund and other sources. The Fund will continue to play a critical role in helping to mobilize financial support for members' adjustment programs. In such endeavors, the Fund will continue its central catalytic role while limiting moral hazard.

6. In view of the importance of moving decisively toward this new worldwide regime of liberalized capital movements, and welcoming the very broad consensus of the membership on these basic guidelines, the Committee invites the Executive Board to give high priority to the completion of the required amendment of the Fund's Articles of Agreement.

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cial support for the process of liberalisation is neither justifiable nor necessary. IMF financial support is meant to cover a balance of payments need as part of an adjustment programme and not merely to subsidise policy improvements. An orderly and properly sequenced liberalisation process should not entail the need for additional financing. The use of IMF funds as an incentive for orderly liberalisation should be rejected as well. Not only is it up to the countries themselves to create the regulatory framework for the liberalisation of capital movements, but such independent action is in each country's own best interest.

Amendment of the IMF's Articles of Agreement is still welcome

In the light of the increasing speed of international capital flows and the benefits of orderly liberalisation, a debate was launched in the mid-nineties as to whether, and if so how, the IMF's Articles of Agreement should be adapted to fit those realities. The debate culminated in a statement issued in autumn 1997 by the Interim Committee (now the International Monetary and Finance Committee) inviting the IMF Executive Board to complete its work on a proposed amendment of the IMF's Articles that would make the liberalisation of capital movements one of the Fund's tasks (see text box on page 29). The IMF's jurisdiction should, where necessary, be extended by means of carefully defined, uniformly applied commitments to liberalise capital movements. That would end the asymmetrical treatment of current account transactions and pure capital account transactions in the IMF's Articles. Except for clearly defined situations, the imposition of capital controls by member countries would be prohibited from then on, as a matter of principle.

Clear mandate of the IMF is necessary

Such an amendment of the IMF's Articles would give a clear legal basis to the Fund's activities and would enable a distinct delineation to be made between its role and that of other international institutions. It would also ensure that all member countries are equally committed to liberalising capital movements. However, as a consequence of the recent financial crises, member countries' support for a comprehensive IMF mandate in the liberalisation of capital movements has been waning distinctly as of late. Since it does not seem possible at present to find a majority in favour of extensively amending the IMF's Articles, the possibility of the Fund having a less far-reaching role has already been discussed as a sort of second-best solution. In this scenario, the liberalisation of capital movements could be included in the Articles as a purpose of the Fund, but it would be at the discretion of member countries to decide on the timing, extent and pace of the process of liberalisation. Only the reintroduction of controls would require IMF approval. Although this approach would not go as far as giving the IMF comprehensive jurisdiction in the liberalisation of capital movements, it would still be a step in the right direction compared with the existing legal situation. Over the longer run, there is probably no alternative to amending the IMF's Articles of Agreement in such a manner as to take due account of the economic importance of unrestricted capital mobility and to eliminate the present asymmetry in the treatment of current account and capital account transactions.