



# Sequencing Capital Account Liberalization

A country that is liberalizing its capital account faces the challenges of strengthening financial institutions to ensure they are capable of operating in a more market-oriented system and deciding how to achieve monetary aims and maintain macroeconomic stability in a freer, more open environment.

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**A**LTHOUGH fears about the risks associated with capital account liberalization have been reawakened by Asia's financial crisis, it is still a more attractive option for many developing countries than capital controls. First, there is much evidence that capital controls have not prevented outflows. Second, when countries eliminate controls, they usually experience stronger inflows, at least initially, as international investors and residents who had placed their capital abroad react to the improved investment environment. Capital inflows can improve a country's balance of payments, smooth temporary shocks to income and consumption, reduce borrowing costs, and spur economic growth.

Capital account liberalization is not without risk, however. If capital inflows are not used efficiently, the markets may question their sustainability and the capacity of the recipient country to service its external debt. A loss of confidence could trigger reversals of capital flows and, in their wake, balance of payments difficulties and currency and banking crises.

Capital account liberalization is not an all-or-nothing affair; there are as many ways to approach it as there are financial instruments and types of capital transactions (see box). Capital flows can, for example, be intermediated by the international capital markets (when local nonfinancial agents are permitted to borrow or place funds abroad); by the local capital markets (when nonresidents can access local financial markets and intermediaries); or a combination of both (when local financial intermediaries borrow or place funds abroad). Capital controls can take various forms—including outright prohibitions, licensing and approval procedures, and transaction taxes—each with a different effect on flows. A country may liberalize certain components of its capital account while maintaining controls on others.

Although many of the challenges posed by capital account liberalization are no different from those posed by the

liberalization of domestic financial systems, capital account liberalization adds an external dimension and urgency to financial sector reforms. Whether capital inflows are channeled through domestic intermediaries or compete with them, the intermediaries will need to be strengthened, either to ensure the efficient use of the capital inflows or because competitive pressures on—and the need to restructure—domestic financial institutions will increase. Moreover, capital account liberalization may induce banks and corporations to take on more foreign exchange risk.

## **Prudential regulation**

The liberalization of capital flows can thus be viewed as one aspect of financial sector liberalization, in which the role of the authorities is, first and foremost, to establish an appropriate regulatory framework. A comprehensive liberalization of capital transactions and transfers does not signify an abandonment of all rules and regulations applying to foreign exchange transactions. Regulations may have to be strengthened in a number of areas, including prudential regulations related to nonresident and foreign exchange transactions and transfers.

Prudential measures are generally defined as official actions (laws, regulations, and officially sanctioned policies or procedures) that (1) promote the soundness of individual financial institutions by ensuring adequate risk management and effective internal governance and by fostering market discipline, and (2) protect investors against fraud and deceptive practices and ensure that financial agents carry out their fiduciary responsibilities. However, prudential measures normally apply to the domestic and foreign activities of *financial* institutions only. With respect to investments that are not intermediated through financial institutions, prudential regulations tend to be limited to the admission and trading of investment instruments and the provision of related fiduciary services in the domestic market; they are

rarely used to protect investors purchasing instruments in foreign markets.

International transactions may involve certain types of risk that are not present in domestic transactions, including transfer risk (a foreign debtor may not be able to obtain the foreign exchange necessary to service its external debt on time), sovereign risk (a government may fail to service its external debt), and country risk (a substantial number of debtors in a particular country may have difficulty servicing external debt because of macroeconomic or political instability or other reasons). In recognition of national differences in supervisory and accounting practices, and in the enforceability of bankruptcy and other laws designed to protect investors, the standards that apply for licensing foreign financial institutions to operate in the domestic market or for authorizing the listing and trading of foreign securities in domestic markets may need to be different from those that apply to domestic agents.

The scope and content of prudential measures and procedures are changing dramatically worldwide, as techniques for identifying, measuring, and managing financial risk are updated and as the need for global harmonization of supervisory approaches grows. Various international groups of supervisors are developing a growing body of generally accepted principles, standards, guidelines, and best practices to provide guidance on the proper treatment of capital flows. Because the emphasis in risk management is shifting away from reliance on quantitative limits and toward greater oversight of institutional capacity to manage risk and increased public disclosure of information, the application of generally accepted best practices involves little, if any, restrictive impact on capital movements. Such generally accepted practices also highlight the importance of managing foreign exchange exposures and liquidity.

In countries with weak or embryonic financial systems, both the pace of capital account liberalization and the design of prudential measures become more complex. Local financial institutions may have limited capacity to assess and manage risks associated with large capital inflows, and regulatory authorities may have limited supervisory capacity. For prudential reasons, such countries may need to develop financial institutions, markets, and instruments before they can durably liberalize their capital account. Countries may also need to adopt international standards of corporate accounting and the timely disclosure of information. Countries with weak financial systems or limited supervisory capacity may have to adopt crudely designed measures to achieve legitimate prudential objectives, and these measures may have a restrictive impact on capital flows.

Particular attention may have to be paid to strengthening the banking sector. In many developing countries, banks are the major financial intermediaries for capital flows (this was the case in Korea and Thailand, two of the countries hit hard

## Types of capital transactions that may be subject to controls

### Capital and money markets

- Shares or other securities of a participating nature
- Bonds or other debt securities
- Money market instruments
- Collective investment securities
- Derivatives and other instruments

Controls on capital and money market transactions may apply to purchases made locally by nonresidents or sales or issues carried out abroad by residents (inflows), or to sales or issues carried out locally by nonresidents or purchases made abroad by residents (outflows).

### Credit operations

- Commercial credits
- Financial credits
- Guarantees, sureties, and financial backup facilities

Controls may apply to inflows (credits provided to residents by nonresidents) or outflows (credits provided by residents to nonresidents).

### Direct investment and real estate transactions

Controls may apply to inward and outward direct investment, liquidation of investment, or purchases and sales of real estate made locally by nonresidents and purchases of real estate made abroad by residents.

### Provisions specific to commercial banks

Controls may be applied to nonresident deposits and bank borrowing abroad (inflows) and to foreign loans and deposits (outflows).

### Personal capital movements

Controls may be applied to deposits, loans, gifts, endowments, inheritances, legacies, and settlements of debts.

### Provisions specific to institutional investors

Controls may include limits on the purchase of securities issued by nonresidents.

by the East Asian crisis). Banks' interest rate and credit policies can have a strong influence on the composition of capital flows—for example, wide deposit-lending spreads may encourage corporations to borrow overseas, while underpricing of credit and maturity transformation risks may distort the yield curve. There is ample evidence that allowing weak banks to expand their balance sheets will lead to banking crises. Measures to strengthen banks include raising capital-adequacy ratios and loan-loss-provisioning requirements; improving credit assessment, liquidity management, risk pricing, and bank management; increasing foreign participation in the banking sector; and conducting rigorous on-site inspections.

More direct measures may need to be taken to curb the growth of bank balance sheets (for example, placing limits on international borrowing by banks) in countries whose banking sector weaknesses are underestimated by financial markets or in countries that are perceived to guarantee,

explicitly or implicitly, banks' overseas borrowing. In these cases, it would be risky to liberalize banks' access to foreign finance until systemic weaknesses have been addressed, appropriate supervisory standards adopted, and concerns about moral hazard addressed. (The same concerns apply to corporate borrowers believed by foreign lenders to be backed by government guarantees.)

## Monetary and exchange rate policy

With greater freedom of capital movements, domestic short-term interest rates will increasingly be determined by foreign short-term interest rates and expectations for short-term movements in the exchange rate—that is, the covered-interest-rate-parity condition. Attempts by a country to set interest rates and exchange rates that are inconsistent with the interest-rate-parity condition could trigger sizable inflows or outflows of short-term capital. Thus, the country's capacity to use monetary and exchange policies to achieve separate macroeconomic targets will be increasingly constrained as capital becomes more mobile. If monetary policy targets inflation, the exchange rate cannot be used, for example, to achieve current account objectives (although fiscal policy can be used to influence the savings-investment balance to achieve such objectives). Conversely, if the exchange rate is targeted to achieve current account objectives or if the exchange rate is fixed, monetary policy will not be autonomous enough to serve as a tool for achieving domestic stabilization or managing the consequences of short-term capital inflows.

The initial policy response to strong capital inflows in countries with a pegged exchange rate has generally been sterilized intervention. However, such intervention involves quasi-fiscal costs and is usually of limited effectiveness because it keeps domestic interest rates high, attracting further inflows. In some cases, pegged exchange rates have also led borrowers to underestimate the risks attached to loans denominated in foreign currency. Therefore, as capital account liberalization has progressed, a number of countries have moved toward greater exchange rate flexibility to discourage shorter-term capital inflows that are due solely to interest rate differentials.

Some countries have adopted a strong nominal exchange rate anchor, subordinating monetary policy to the maintenance of the anchor, and allowed interest rates to adjust in response to capital movements. This has enabled them to avoid capital flow reversals that would have been provoked by uncertainty about the exchange rate. Because they cannot use exchange rate policy to reduce short-term capital inflows, they have paid greater attention to prudential standards to reduce the risks associated with potential reversals in capital flows.

Other countries have targeted the exchange rate (hence, monetary policy) to maintain competitiveness and relied on fiscal consolidation to achieve domestic stabilization and offset the effects of large capital inflows. However, because fiscal

policy is fairly inflexible in the short term, the authorities have had to resort to other measures—capital controls, in particular—to deal with volatile flows. Generally, such controls are effective primarily as temporary measures.

**Monetary targets and instruments.** Increased capital mobility has implications for the design of monetary policy frameworks and the use of different monetary instruments. Under fixed or managed floating exchange rate regimes, the external counterpart of the money supply may become more volatile and the demand for domestically defined monetary aggregates, more sensitive to international interest rate differentials. As a result, it may be more difficult to identify a monetary aggregate that is stable enough to be used to predict the evolution of other nominal economic variables. Capital account liberalization thus reinforces the trend toward adopting more eclectic monetary frameworks and giving more weight to exchange rates in monetary assessments.

When capital is very mobile, the effectiveness of different monetary instruments is altered. For example, instruments such as credit or interest rate ceilings or high nonremunerated reserve requirements that impose high costs or administrative constraints on banks may be circumvented by disintermediation through the capital account and lose some of their effectiveness. In contrast, monetary instruments that affect the cost of money or credit in financial markets may be transmitted more rapidly to credit and exchange markets, allowing the central bank of a country to influence the decisions of financial institutions and markets that use the national currency in both local and international operations.

Although a number of countries have reduced—or even eliminated—reserve requirements, others still rely on them to influence supply and demand in the market for bank reserves (bank deposits with the central bank). However, nonremunerated reserve requirements act as a tax on the banks that are subject to them and therefore encourage disintermediation to financial institutions and markets that are not subject to such requirements. Although some countries avoid this potential problem either by remunerating reserve requirements at rates that are close to market rates or by reducing or eliminating reserve requirements, others have retained selected capital controls—for example, on the issue of certificates of deposit locally by nonresident banks—to safeguard the effectiveness of their reserve requirements. The expectation is that limiting foreign banks' access to a particular instrument would also limit disintermediation.

Open market operations play a core role in steering interest rates, managing liquidity in the market, and signaling the stance of monetary policy. In a context of free capital movements, the central bank is able, through open market operations, to influence conditions in both the domestic and the external markets for the national currency. Standing facilities, rediscount quotas, and public sector deposits are frequently used to support open market operations, particularly to guide interest rate movements, and to transmit the central bank's message quickly and clearly to

markets. The adoption of indirect monetary controls has thus supported moves toward capital account convertibility.

**Discriminatory reserve requirements.** One measure frequently used to reduce capital inflows, or to change their composition, is the imposition of differential reserve requirements on short-term borrowing from nonresidents. Although it is sometimes referred to as a “Chile-type” measure because it was adopted by the Chilean authorities in 1991, it actually has a long history of use in other countries.

Various empirical studies of such measures have concluded that they have a temporary effect that can be eroded quite quickly, depending on the scope of controls and the stage of development of financial markets and instruments. Financial derivatives, as well as traditional instruments not covered by exchange regulations, can be used to circumvent controls on short-term capital. Moreover, if the differential reserve requirement is not applied to all short-term foreign capital inflows, it may encourage larger short-term inflows through instruments not subject to the requirement. The danger is that, to avoid controls, capital flows will be channeled through riskier, less regulated financial intermediaries; instruments and institutions may be created specifically to circumvent the controls. Over time, Chile found it necessary to extend its reserve requirement to all short-term capital inflows. More recently, when faced with capital outflows, Chile eliminated its discriminatory reserve requirements.

## Sequencing

To maximize the benefits of capital account liberalization while minimizing the risks, much thought must be given to pace and sequencing. The conventional view of sequencing emphasizes the importance of achieving macroeconomic stability and developing domestic financial institutions, markets, and instruments before liberalizing the capital account. According to this view, capital account liberalization should occur late in a country’s economic reform program. An alternative view stresses constraints on reforms and the limited capacity of countries to reform themselves in the absence of external pressures for reform; this view favors early capital account liberalization, which can serve as a catalyst for broader economic reforms and overcome vested interests’ opposition to reforms. A middle view is that capital account liberalization should be part of a concurrent, integrated, and comprehensive approach to macroeconomic and structural reform; in this view, the coordination of reforms in the domestic and external sectors is the key issue.

The benefits, costs, and risks of each of these three strategies will vary from country to country, depending on starting conditions and economic objectives. One approach would be to focus on the contribution each strategy would make to the



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broad objectives of improving efficiency in resource mobilization and allocation, and promoting financial and macroeconomic stability. Thus, to the extent that a specific reform improves resource allocation and helps to achieve—or at least does not undermine—financial and macroeconomic stability, it should be undertaken.

Reforms that increase diversity in the financial system (for example, by introducing new technologies and instruments, as well as new skills and risk-management capabilities), strengthen the capital structures of financial institutions, and promote competition would enhance efficiency. Liberalizing access to international capital markets—when it leads to the adoption of new accounting and disclosure requirements and increases incentives to revise outdated regulatory structures and ineffective supervisory arrangements—could improve

financial discipline. The introduction of new instruments for hedging and managing risks and the diversification of funding sources and asset distribution would also strengthen financial systems. (Because hedging instruments have no reason to exist in the absence of price uncertainty, their development will not occur until interest and exchange rates have been freed.) Finally, in choosing which financial intermediaries to liberalize, countries should, in the interests of efficiency and stability, consider those that are subject to the most developed regulatory framework, have the strongest governance, and pose the least risk of moral hazard.

Regulatory changes that might not enhance efficiency include those that support existing monopolies and inefficient financial structures—for example, by allowing only the dominant domestic financial institutions to access foreign sources of funding or by encouraging concentration, rather than diversification, of assets, funding sources, and risks.

Although certain rules about sequencing capital account liberalization—for example, countries should liberalize long-term flows before short-term flows, and foreign direct investment before portfolio investment—have the appeal of simplicity, the fungibility of capital makes their practical application difficult. The maintenance of restrictions on certain types of capital transactions may serve primarily to buy time for the more fundamental restructuring of financial markets, the adoption of appropriate prudential standards and supervisory arrangements, and the development of the necessary indirect monetary instruments. **F&D**

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*This article is based on R. Barry Johnston, 1998, “Sequencing Capital Account Liberalizations and Financial Sector Reform,” IMF Paper on Policy Analysis and Assessment 98/8 (Washington: International Monetary Fund).*