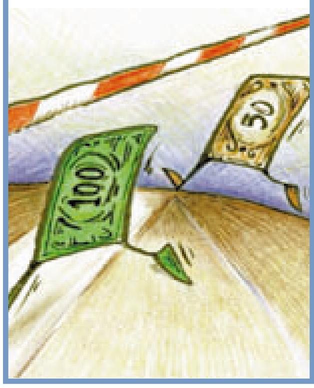


Capital Account Liberalization in the Southern Mediterranean

Saleh M. Nsouli and Mounir Rached

The debate on capital mobility has intensified in the wake of East Asia's recent financial crisis, largely because of the risk of sudden reversals. The crisis demonstrates the importance of a strong macroeconomic stance, sound institutions, and an orderly sequencing of reforms to maximize the benefits and minimize the risks of capital account liberalization.

OVER the past two decades, many countries in the developing world have benefited from relaxing restrictions on capital movements. In an increasingly globalized world, the Southern Mediterranean countries of Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia, and Turkey could also reap considerable benefits from establishing full currency convertibility in an orderly manner.

A country is said to have achieved full convertibility of its currency when residents and nonresidents are allowed to convert the currency, at prevailing exchange rates, into foreign currencies and to use the latter freely for international transactions. Full capital account convertibility paves the way for a more efficient allocation of savings and increases a country's attractiveness to foreign investors. The elimination of controls on capital transactions gives businesses and individuals access to foreign financial markets and increases the funding available for trade and investment. In addition, cross-border competition widens the choice of risk-adjusted rates of return open to investors, provides opportunities for portfolio diversification, and encourages domestic financial markets to become more efficient.

Net private capital inflows to the Southern Mediterranean countries have picked up in recent years, but they vary from country to country (Chart 1). Although many factors affect capital flows and growth, and it is difficult to establish causality, it is worth noting that Lebanon, which has virtually no exchange restrictions, has enjoyed massive net inflows, while Syria, the country with most restrictions, has received the smallest volume of inflows. Generally, the countries with the most exchange restrictions have had lower growth rates than those with more liberal exchange systems (Chart 2).

Exchange system restrictions

All the Southern Mediterranean countries listed above except Egypt (for technical reasons) and Syria have established current account convertibility by accepting the obligations under Article VIII of the IMF's Articles of Agreement. Egypt, Israel, Jordan, Lebanon, and Turkey have also achieved substantial capital account convertibility, while Algeria, Morocco, Syria, and Tunisia still have significant restrictions.

Except for Israel and Turkey, the countries in the first group above have virtually no restrictions on direct investment, while those in the second group regulate either inward or outward investment, or both. With regard to securities and money market instruments, fewer restrictions are imposed, in general, on inflows than on outflows, but the financial markets in most of the nine countries are not sufficiently developed to attract portfolio investment. Israel, Jordan, and Lebanon have the most liberal codes for capital and money market transactions, with no restrictions on either inflows or outflows. Although the other Southern Mediterranean countries generally do not prohibit foreign investment in domestic securities, they impose restrictions on outward flows, ranging from a requirement for prior approval to outright prohibition. Issuance of securities by nonresidents in domestic markets is unregulated in five countries (Egypt, Israel, Jordan, Lebanon, and Turkey), requires prior approval in Tunisia, and is prohibited in Syria. Only Tunisia regulates commercial borrowing from abroad, while Algeria, Lebanon, Syria, and Tunisia have restrictions on lending abroad. All the countries permit nonresidents to hold accounts in foreign and domestic currencies, but residents' accounts are subject to more regulation than nonresidents' accounts and are fully convertible into foreign exchange only in Egypt, Israel, Jordan, and Lebanon.

Present conditions

To maximize the potential benefits and minimize the risks of an open capital account, the Southern Mediterranean countries must pursue an orderly approach to establishing and sustaining full convertibility.

Fiscal policy. A prudent fiscal policy is an important element in achieving and maintaining capital convertibility. Large fiscal deficits that require financing through money creation may destabilize the exchange rate and discourage both foreign and domestic investment. Reliance on foreign loans with high interest rates creates debt-management problems, reduces creditworthiness, and weakens an economy's ability to manage external shocks. During 1996–97, of the Southern Mediterranean countries that had already achieved substantial capital account convertibility, only Lebanon and Turkey had relatively large deficits. The fiscal deficits of most of the countries that have significant restrictions on capital movements (Morocco, Syria, and Tunisia), though manageable, still need to be reduced (Chart 3). Algeria has a surplus.

Monetary policy. A sound monetary policy that complements and is facilitated by fiscal discipline is another critical element, because excess liquidity expansion will spill over into the external sector. In 1996–97, monetary performance was mixed in the countries with substantial capital convertibility. Monetary policy in Lebanon and Turkey appeared to be too accommodating of fiscal policy, whereas it seemed to have been more independent of fiscal policy in Egypt and Israel, and Jordan had a highly restrained monetary policy. None of the countries with substantial capital restrictions experienced an excessive growth in domestic liquidity.

Exchange rate and reserves. A market-clearing exchange rate is essential to ensure external balance. Furthermore, to avoid wide exchange rate fluctuations, prudent macroeconomic policies need to be coupled with adequate international reserves. Of the Southern Mediterranean countries with substantial capital account convertibility, Egypt was the only one to register a current account surplus in 1996–97, while Lebanon had a very large deficit. The deficit-to-GDP ratios of the other three countries in this group were in the low single digits. Of the countries with significant capital restrictions, two had current account surpluses and two had relatively modest deficits (Chart 4).

Israel and Turkey have flexible exchange rates, but their real effective exchange rates have risen slightly in recent years. Egypt and Lebanon, which have practically anchored their currencies to the U.S. dollar, witnessed sharp increases in their real effective exchange rates. Among the countries that maintain substantial capital controls, Algeria and Syria posted declines in their real effective rates, the former

Chart 1

Private net capital flows, 1996–97 average

(percent of GDP)

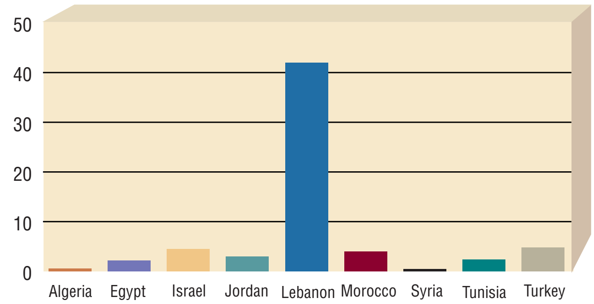


Chart 2

Growth rates, 1996–97 average

(percent change in real GDP)

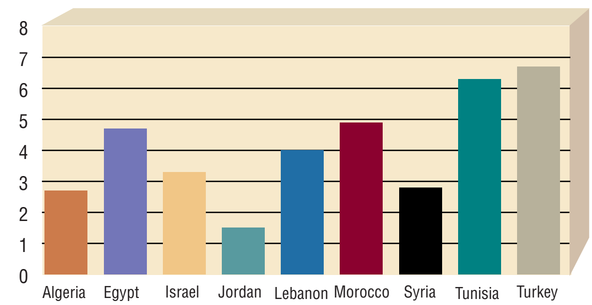


Chart 3

Central government balance, 1996–97 average

(percent of GDP)

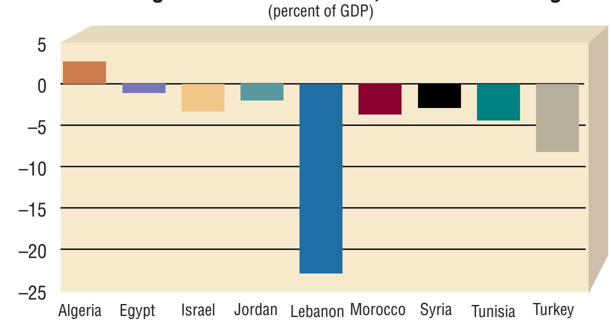
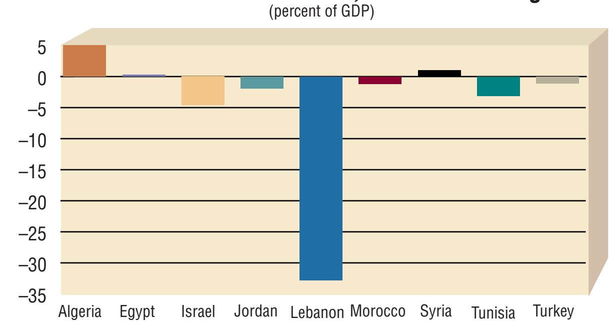


Chart 4

Current account balance, 1996–97 average

(percent of GDP)



Sources: International Monetary Fund. *World Economic Outlook: Interim Assessment* (Washington, December 1997); and country authorities.

because of an adjustment in the nominal exchange rate, the latter mainly because domestic prices rose more slowly than prices in its trading partners. Morocco and Tunisia have adopted a managed float that, in recent years, has essentially stabilized their real effective exchange rates. All the countries had reserves well in excess of three months of imports.

Financial sector. An efficient and sound financial sector is an essential ingredient of capital account convertibility, enabling banks to invest capital inflows prudently and weather shocks. Efficiency requires market-based monetary instruments and a liberal regulatory framework. The sector's soundness depends on, among other things, effective banking supervision and observance of prudential ratios.

All nine Southern Mediterranean countries have reformed, to varying degrees, their monetary instruments and banking systems. Countries that have already opened their capital account rely more heavily on indirect instruments and on market-based interest rates. In Egypt, Israel, Lebanon, and Turkey, indirect instruments play an important role in determining market interest rates. The treasury bill rate, determined through auctions, and the discount rate have a strong influence on deposit and lending rates. The monetary authorities in these countries also rely, in part, on the sale and redemption of treasury bills to regulate bank reserves and credit expansion. Interest rates in Jordan have been less flexible, although the country has made some progress in using indirect monetary instruments.

In contrast, in the countries that have substantial capital restrictions, deregulation of financial markets is a relatively recent phenomenon. Since 1994, Algeria has begun to rely more on indirect instruments, including auctions of treasury bills and repurchase agreements. In Morocco, reform of the financial sector has been in progress for nearly a decade, with most interest rates being freed. Tunisia has liberalized lending rates for nonpriority sectors and recently freed most interest rates. Syria continues to allocate credit according to an annual plan, however, and to set interest rates.

Many of the Southern Mediterranean countries have undertaken reforms of their banking systems, although data deficiencies hamper analysis of bank performance in most of them. Furthermore, with few exceptions, data on prudential indicators are either unpublished or unavailable. Nonetheless, it is possible to make some limited observations. In Egypt and Jordan, progress has been made in increasing the capital base of banks and meeting international prudential standards. The capitalization of Israeli banks is adequate, although their rates of return are among the lowest in the region. Lebanon's banks have regained profitability since its civil war ended, and their capital-adequacy ratio has risen steadily.

A striking dichotomy exists in Turkey's banking system. The overall capital-adequacy ratio surpasses the minimum set by the Basle Committee on Banking Supervision, but state commercial banks are undercapitalized. In addition, banks have experienced persistent losses and liquidity problems associated with direct lending at subsidized rates. In recent years, private banks have strengthened their capitalization, but remain exposed to maturity mismatches of their assets and liabilities and open net foreign exchange positions.

Morocco and Tunisia have well-established systems of bank supervision and prudential standards. Moroccan banks are, on average, adequately, though unevenly, capitalized, and their loan-loss provisions are sufficient to counter a high ratio of nonperforming loans. The profitability of Tunisia's banking sector, while high, has fluctuated considerably, reflecting the ongoing recapitalization by public and private banks. In Syria, banks remain undercapitalized.

Market orientation. A well-functioning price mechanism is essential to avoid distortions that reduce the efficiency of resource allocation, affect capital flows adversely, and hinder growth. Thus, subsidies, tax concessions, and price controls need to be phased out. All of the Southern Mediterranean countries except Syria have taken measures to decontrol prices. Jordan and Lebanon have fairly liberal regulations on labor markets, but rigidities remain in the other countries. Although several countries have made progress in privatizing and reforming public enterprises, Algeria, Egypt, Morocco, Syria, Tunisia, and Turkey still have some way to go.

Tariffs that generate distortions between international and domestic prices can also adversely affect resource allocation and capital flows. Several of the countries in the region have liberalized trade by reducing tariffs and eliminating or reducing quantitative restrictions. Among the countries with substantial capital convertibility, Israel has the lowest average tariff rate, at about 7 percent, and Egypt the highest, at 28 percent. Among the others, Morocco has the lowest average rate, at 20 percent, and Syria the highest, at 35 percent.

Meeting conditions for convertibility

Three conclusions can be drawn from this review. First, the Southern Mediterranean countries differ significantly in the degree to which they restrict capital transactions. Second, some countries—even among those that have already achieved substantial capital convertibility—need to strengthen their economic and financial performance to sustain that convertibility. Third, among the countries with significant restrictions on capital transactions, Algeria, Morocco, and Tunisia need to reinforce their policies, and Syria will have to make a major effort to meet certain conditions before it can open its capital account.

Removal of restrictions. Restrictions that need to be removed in some of the countries with substantial capital account convertibility include those on foreign direct investment (Israel and Turkey), residents' deposits abroad (Egypt and Israel), and resident and nonresident account convertibility (Turkey). The countries with substantial restrictions on capital transactions need to focus on liberalizing outflows: Morocco and Tunisia have the fewest restrictions to remove, followed closely by Algeria, while Syria faces the greatest challenges.

Policies. To sustain convertibility in countries that have already substantially liberalized their external accounts and to remove remaining restrictions in the others, actions need to be taken in various areas.

With regard to *fiscal policy,* Lebanon and Turkey need to take strong measures to address their large fiscal deficits. Among the countries with substantial capital account restrictions, Morocco, Tunisia, and Syria will have to pursue fiscal reform.

Lebanon and Turkey need to review the coherence of their *monetary policies* with other policy instruments. These countries' fiscal problems are reflected, in part, in the substantial positive differentials between their domestic deposit rates and the Eurodollar interest rate in London. For the countries with significant controls, the differential is generally smaller, given the constraints on capital flows; it is notable that a high differential exists in Algeria, probably reflecting a determined effort to keep monetary policy tight.

Turning to *exchange rate policy,* Egypt and Lebanon, which have pegged their currencies to the U.S. dollar in recent years, have witnessed large increases in their real effective exchange rates. While this indicator does not necessarily suggest that the countries' currencies are overvalued, the steady upward trend underscores the importance of carefully monitoring exchange rate policy. The real effective exchange rates of countries with significant restrictions have been stable. However, if these countries were to open their capital accounts, they would have to review their exchange rate systems carefully.

With regard to the *financial sector,* Syria is the only country that has yet to adopt indirect monetary instruments. As regards the soundness of banking systems in the region, the lack of data for several countries is a major weakness. Greater transparency is essential to maintaining orderly capital accounts in countries with substantial capital convertibility and to enabling the countries with significant restrictions to move to capital convertibility in an orderly manner. The countries for which some data are available—Lebanon, Tunisia, and especially Syria—need to raise the capital-asset ratios of their banking systems.

Turning to *market orientation*, Syria has the widest array of controls to dismantle, followed, at a considerable distance, by Algeria. Most of the countries still have much work ahead of them in privatizing and reforming their public enterprises—Algeria and Syria, in particular, and, to a lesser extent, Egypt, Morocco, and Tunisia. Labor markets still need to be liberalized in all the Southern Mediterranean countries except Jordan and Lebanon. Finally, all the countries except Israel need to reduce their import tariffs significantly, and Syria needs to eliminate quantitative import restrictions.

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Speed and sequencing

Two basic questions arise for countries that still have restrictions: (1) how fast should the capital account be liberalized, and (2) in what order should the necessary steps be taken?

To achieve an orderly move to capital account convertibility, each country has to find, subject to various financial and structural constraints, the adjustment path that will maximize its welfare over time. Syria's financial constraints suggest that it would need to move faster than Algeria, Morocco, and Tunisia to establish capital account convertibility. Indeed, the latter three countries are servicing their external debt in an orderly manner and have adequate reserves; although Syria also has adequate reserves, it has experienced difficulties servicing its external debt and has considerable external arrears. Morocco and Tunisia have the fewest structural constraints, Algeria has many, and Syria has the most. Thus, looking solely at structural constraints, the move to full convertibility could be fastest in Morocco and Tunisia, followed by Algeria and, at a considerable distance, by Syria. Given its financial constraints, however, Syria would need to launch a significant package of structural reforms immediately while implementing supportive macroeconomic adjustment policies.

The appropriate sequencing of reforms will be determined by each country's conditions. The following generalizations can be made, subject to the caveat that an integrated and coherent package of policies should be in place. Syria would have to give priority to addressing the structural constraints on its incentives system, strengthening the banking sector, and moving to indirect instruments of monetary control, while putting in place a market-determined, unified exchange rate. Algeria would need to give priority to reforming its financial sector and privatizing its public enterprise sector. The appropriate sequencing in Morocco and Tunisia would involve strengthening and reforming their banking systems and privatizing their public enterprises. For the Southern Mediterranean countries to be able to identify more specific measures that would enhance banking soundness and increase transparency, they would all have to include the improvement of banking system data in their initial action packages. F&D

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