Appendix

I

A More Detailed Assessment of Some Country Cases

This appendix presents four specific contexts in which the IMF interacted with member countries in terms of their capital account policies: (1) the Czech Republic, which liberalized the capital account relatively quickly in the mid-1990s; (2) Colombia, which introduced market-based controls to deal with large capital inflows during much of the 1990s; (3) Venezuela, which introduced controls on capital outflows in 1994 and 2003; and (4) Tunisia, which has pursued a gradual approach to capital account liberalization. These four cases are chosen for diversity of experience and are designed to illustrate what the role of the IMF was in each case and how the IMF viewed different policy issues regarding the capital account. Although we briefly explain the policy measures taken by the authorities to give context, the focus remains on the IMF.

The Czech Republic: Liberalization in a Transition Economy

Capital account liberalization

At the beginning of the transition process, Czechoslovakia was the most centrally planned economy in Central Europe (Bakker and Chapple, 2003). This in part explains the authorities' general propensity for rapid reforms, aided by recourse to foreign capital (Blejer and Coricelli, 1995). Following the division of the country into two republics, in 1993, the Czech authorities began to map the steps toward capital account liberalization. According to a number of former officials interviewed, the process was largely driven by the country's prospective accession to the OECD and the EU.[1] The liberalization of capital transactions, which initially proceeded through a progressively liberal application of existing controls (first on banks and then on firms), was virtually completed in October 1995 with the enactment of a new Foreign Exchange Act.

[1]The Czech Republic signed an association agreement with the EU in October 1993 and became the first transition country to join the OECD at the end of 1995.

Some restrictions did remain (mostly on the outflow side but some on inflows), including restrictions on the issuance of debt and money market securities abroad by residents and on foreign securities transactions executed through domestic agents. Moreover, the new Foreign Exchange Act enacted in 1995, while codifying the framework for a liberal foreign exchange regime, included a provision under which the authorities could introduce an unremunerated reserve requirement on nonresident deposits if necessary.[2]

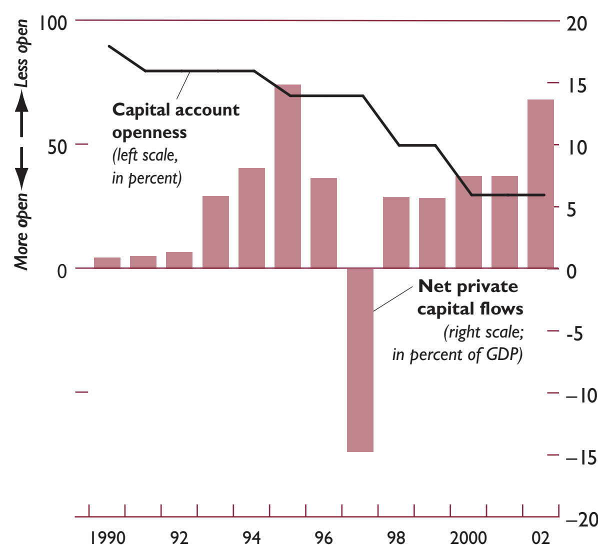
The remaining restrictions were eliminated within the framework of a plan agreed with the EU. In February 1996, the Czech Republic, in formally applying for EU membership, adopted a tentative five-year plan for full capital account liberalization, which was revised in mid-1998 in the light of the 1997 currency crisis (see below). The authorities lifted the restrictions on foreign security transactions in 1999, those on the issuance of debt securities abroad by residents in 2001, and the ban on purchases of agricultural land by nonresidents in 2002. In this manner, the Czech Republic virtually completed the full liberalization of the capital account before joining the EU in May 2004.

Policies to deal with capital flows

With the progress of capital account liberalization, a large amount of foreign capital flowed into the country (Figure A1.1). The authorities responded to the surge in inflows by taking various measures, including sterilization and increases in reserve requirements. Monetary policy assumed most of the burden of adjustment, however, and fiscal policy remained loose. In late 1994, the nature of capital inflows evidently turned more speculative, with a shift from long-term external borrowing by Czech companies to inflows of nonresident bank deposits. A staff memorandum of November 1994 stated that the authorities at this time considered introducing capital controls, though the idea was overruled by the

[2]This provision has never been activated.

Figure A1.1. Czech Republic: Capital Account Openness and Net Private Capital Inflows[1]



Sources: IMF database; and Appendix 5.

[1]Net foreign direct investment, net private portfolio investment, and net private other investment.

prime minister. In 1995, the authorities introduced measures targeting short-term speculative inflows:[3] a foreign exchange transaction fee in April and a limit on banks' net short-term liability positions to nonresidents in August.[4] These measures, however, remained largely ineffective, with net private capital inflows in 1995 amounting to as much as 15 percent of GDP.

In early 1996, capital inflows began to slow, coinciding with the decision by the authorities to widen the fluctuation band of the exchange rate peg in February (from 0.5 percent on either side of parity to 7.5 percent). Capital inflows continued to decline throughout 1996, and a sharp reversal in 1997 culminated in a currency crisis. Responding to the situation, in April 1997 the authorities announced a package of tight macroeconomic policies designed to restore internal and external balance. After a brief respite, the currency soon began to fall again, forcing the authorities to abandon the exchange rate peg[5] and to strengthen the macroeconomic policy package in May 1997. In the event, these measures allowed the Czech Republic to pull itself out of the crisis rather quickly despite the turbulence in East Asia, and the exchange rate stabilized after a modest depreciation of 10 percent from the original parity. The country was relatively unaffected by contagion from the subsequent East Asian and Russian crises.

When the economy recovered in 1998, the authorities revised their strategy toward foreign capital flows in favor of an explicit promotion of FDI. Recognizing the weak corporate governance and low productivity of firms that had resulted from a mass (voucher) privatization scheme, the authorities introduced measures to encourage more concentrated shareholding, followed by attempts to sell the entities to foreign strategic investors (OECD, 1996 and 1998). In addition, they introduced a foreign investment incentive scheme and offered subsidies to qualified greenfield projects. Thanks to the new FDI incentive scheme, the Czech Republic again began to receive large capital inflows, this time mainly driven by FDI, while there remained a net outflow of short-term capital.

The IMF's views of capital account measures

The process of capital account liberalization was initiated by the Czech authorities. As noted, it was in part motivated by the country's prospective accession to the OECD and the EU, and the explicit role of the IMF was consequently rather limited, except to endorse the decisions taken by the authorities. The country's first and only Stand-By Arrangement with the IMF, agreed in 1993 and treated as precautionary, made no reference to capital account liberalization.[6] The IMF, however, expressed a range of views on capital account measures taken by the authorities throughout the period.

In the early 1990s, in keeping with the predominant thinking of the time, the IMF was clearly encouraging the authorities to liberalize the capital account rapidly. By 1994, however, the attitude of the area department staff had become more cautious, particularly as the banking sector weaknesses came to the surface. A briefing paper of May 1994 supported the authorities' decision to liberalize the capital account "in a phased manner," given the problems in the banking system and the volatility of capital flows.[7] The area department's views became even more cautious following the Mexican

[3]In early 1995, there were signs of informal tightening of capital inflow controls. A staff memorandum, for example, noted a sharp decline in approved capital transactions.

[4]The first measure was abolished in May 1997 and the second measure in November of the same year.

[5]Inflation targeting was formally adopted in December 1997.

[6]The LOI included the intention of the authorities to "extend" current account convertibility by dismantling restrictions on current account transactions. In the context where the country had not yet accepted the obligations under Article VIII, the focus of IMF support was necessarily placed on the liberalization of the current account.

[7]Interestingly, the paper also noted that the authorities had adopted a gradual approach to capital account liberalization, "following a well-publicized debate."

crisis. A briefing paper of April 1995 expressed the view that "unduly quick liberalization [of capital outflows], for short-term easing of the capital inflow pressure" would create vulnerability to crisis and proposed that the mission not press for more ambitious liberalization of capital outflows than was then envisaged.

MAE and PDR, however, remained sanguine. From late 1994 to early 1995, MAE, through its technical assistance work, continued to emphasize the benefits of removing all remaining controls, citing their ineffectiveness. In February 1995, a technical assistance report stated that both administrative and market-based capital controls had proved to be ineffective except in the very short run, by appealing to the experience of other countries.[8] Commenting on the April 1995 briefing paper, PDR opposed the cautious approach of the area department and argued for a continued liberalization of remaining outflow restrictions. Management's comments on the paper emphasized the need to be pragmatic in order to avoid an early reversal of policies.

A similar evolution can be seen in the attitude of the area department staff toward use of capital controls. By 1995, when capital controls reemerged as a topic for policy discussion, the staff's earlier ambivalence was gone. The staff report for the 1995 Article IV consultation stated that "[given] the political constraints on the early use of other instruments of policy, the introduction of capital controls had become unavoidable." It added, however, that capital controls should be market based and nondiscriminatory across borrowers, and should be limited to short-term inflows; and they should be seen as a temporary measure intended to buy time for more fundamental correction in policy, "given the likely progressive leakages over time" and the associated allocative inefficiency.

The staff report for the 1996 Article IV consultation took the view that capital controls on short-term inflows had "helped lengthen the maturity of banks' foreign liabilities," though they had been "less successful in limiting the total volume of capital inflows." Judging from the comments on briefing papers and minutes of Board discussions, it appears that management was more skeptical of capital controls. The Executive Board, on the other hand, was generally more sympathetic, though several Directors questioned the effectiveness of capital controls and argued that use must be temporary.

Throughout much of this period, capital inflows were an important topic of discussion between the staff and the authorities.[9] In late 1994, the staff thought that the inflows were being mainly driven by large interest rate differentials and demand by Czech companies for long-term credit. On the grounds that these factors reflected the banking sector's limited ability to intermediate, it argued that the authorities should not only further liberalize outflow controls but also improve the banking sector. In the 1995 Article IV consultation discussions, the staff argued that there was room for sterilization, because capital inflows were no longer primarily driven by interest rate differentials. Throughout the period, the staff's consistent position was that tight fiscal policy was desirable.

As to exchange rate policy, the staff supported the authorities' policy of resisting any appreciation of the exchange rate.[10] In fact, the staff did not advise the authorities to increase exchange rate flexibility until 2000. As noted earlier (Chapter 3, the section "Temporary Use of Capital Controls"), part of this reflected the staff's assessment that most of the gains in competitiveness from the initial depreciation had been lost by 1995, and that any nominal appreciation should be avoided in order to maintain competitiveness. The staff did mention that an exchange rate band could be a useful exit mechanism from the peg, but did not consider that a period of large capital inflows should be the time to attempt an exit as it would surely result in further appreciation. The staff report for the 1995 Article IV consultation noted: "While the introduction of a band might provide some help in stemming the capital flows, it would result in an immediate stepped-up real appreciation of the currency that would further worsen the external balance."[11] As late as 1999, the staff continued to argue that "any significant upward pressures on the exchange rate (potentially arising from substantial foreign direct investment inflows related in part to the planned privatization) should be resisted."

[8]Monetary and Exchange Affairs Department, "Issues Related to External Liberalization," February 1995. The earlier back-to-office report noted that the mission had argued for a "more decisive" program of liberalization and helped "strengthen the hand of those in favor of more rapid liberalization."

[9]At least 12 staff memoranda were prepared on the subject between 1993 and 1997.

[10]The staff report for the 1995 Article IV consultation offered commentary on the reluctance of the Czech authorities to allow the exchange rate to appreciate: "They are very conscious of the experience in the 1920s when revaluation of the currency in response to heavy capital inflows induced by successful stabilization was followed by an export slump and banking crisis that required the Government to step in."

[11]In discussing this report, however, some Executive Directors disagreed with the staff assessment and called for greater exchange rate flexibility and an appreciation of the koruna. The staff report for the 1996 Article IV consultation notes that, following the Board discussion, the staff adopted "that position during follow-up discussions with the authorities in November 1995, after taking into consideration revised data that mitigated concerns about export performance," but it appears that the staff's support for exchange rate flexibility disappeared quickly.

Box A1.1. Hungary

Hungary took a gradual approach to capital account liberalization. It first liberalized FDI. Liberalization of portfolio investment began toward the middle of the 1990s in the context of OECD accession, which culminated in the Foreign Exchange Act of 1995. It continued, however, to maintain controls on short-term capital inflows, notably restrictions on purchases of short-term domestic instruments by nonresidents and restrictions on external lending to nonresidents by residents in the domestic currency. The authorities clearly stated at that time that the final step to full capital account convertibility should be taken only after the system of regulation and prudential supervision was firmly in place for banking and securities market activities. This was achieved in June 2001, when Hungary eliminated the remaining restrictions and at the same time widened the exchange rate band substantially (from 2.25 percent to 15 percent).

The process was largely defined by the country's political agenda and institutional capacity. In line with the established practice, none of the three successive IMF-supported programs with Hungary in the 1990s included conditionality related to capital account liberalization. However, the LOI for the 1991 extended arrangement included the authorities' intention to encourage foreign participation in the banking sector and in the privatization process. Likewise, the LOI for the 1993 SBA referred to the prospective Foreign Exchange Act, which would provide the basis for continuing "the process of liberalization of the trade and exchange system"; the LOI for the 1996 SBA indicated their intention to take measures to "facilitate a further liberalization of capital flows." In this manner, the IMF supported the country's overall strategy of capital account liberalization.

Some experts have argued that prolonged use of capital controls explains the resilience Hungary demonstrated through the turbulent years of the late 1990s (Nord, 2003). The country was little affected by the East Asian crisis, and it had little difficulty in managing the contagion from the Russian crisis. Others, however, have emphasized the importance of sequencing (Ishii and others, 2002). Hungary began banking reform from the late 1980s and allowed a significant presence of foreign banks from the beginning (Szakadat, 1998). Moreover, the negative legacy of the socialist era (characterized by large fiscal and external deficits) was much greater in Hungary than in other central European countries, causing the country to experience an economic crisis relatively early in the transition process, in late 1994. As a result, it was able to undertake many of the necessary but painful macroeconomic and microeconomic reforms before embarking on capital account liberalization.

The Hungarian experience is instructive not only for the sequencing the country took but also for illustrating how the IMF viewed capital account issues during this period. When there was a surge in short-term capital inflows in early 1996, the IMF staff considered the main cause to be the large interest rate differential under a narrow crawling peg. When the authorities began to consider introducing capital controls, the staff was divided on the issue. A staff memorandum of March 1996 suggests that the area department, along with PDR and RES, took an accommodating view of market-based controls, while MAE was adamantly opposed. When in early 1999 a law was enacted to allow the introduction of a reserve requirement on nonresident bank deposits, the IMF had already unified its position. The staff unanimously supported the right of the authorities to activate the measure in the event of a surge in short-term capital flows.[1] After the economic crisis of 1994, Hungary maintained reasonable fiscal discipline. This is why the IMF staff's advice of fiscal tightening was not as consistent as in many other countries. Rather, the staff consistently argued for a move to greater exchange rate flexibility.

[1]The reserve requirement was stipulated to be at below-market yields. In the event, this has never been activated, with the rate maintained at zero.

Assessment

The Czech Republic relatively quickly lifted most restrictions on capital inflows while its fiscal policy remained expansionary, its banking system was weak, and it maintained a fixed exchange rate regime. This experience can be contrasted to that of Hungary, which followed a more gradual and sequential approach to capital account liberalization (see Box A1.1). A number of experts consulted by the evaluation team have expressed the view that these factors, and not the mere fact that the capital account was liberalized, explain why a currency crisis took place in the Czech Republic in the spring of 1997. This is not to minimize the risk of opening the capital account with a weak banking system. As it turned out in the Czech Republic, the costs of bailing out the banking system amounted to more than 10 percent of GDP.

The IMF staff initially encouraged the Czech authorities to liberalize the capital account rapidly but it soon recognized that there were weaknesses in the banking system and pressed for banking reform from an early stage. The problem was that the staff did not translate this recognition of the banking sector weakness into operational advice on the pace and sequencing of capital account liberalization, for example, by suggesting that the authorities slow down

the pace of liberalization. The staff generally did not favor greater exchange rate flexibility before the currency crisis of 1997, in part owing to its view that the gains in competitiveness from the initial gains had been eliminated and that any movement would be in the direction of appreciation once the exchange rate was allowed to float.

The staff's country work in the Czech Republic reflected the changing views of the risk of capital account liberalization within the profession, much more quickly than the general policy guidelines emanating from the IMF's headquarters. Soon after the Mexican crisis, even before its full implications were widely discussed, the staff began to take a cautious approach to further capital account liberalization, particularly on the outflow side, and became more accepting of measures to control short-term capital inflows.

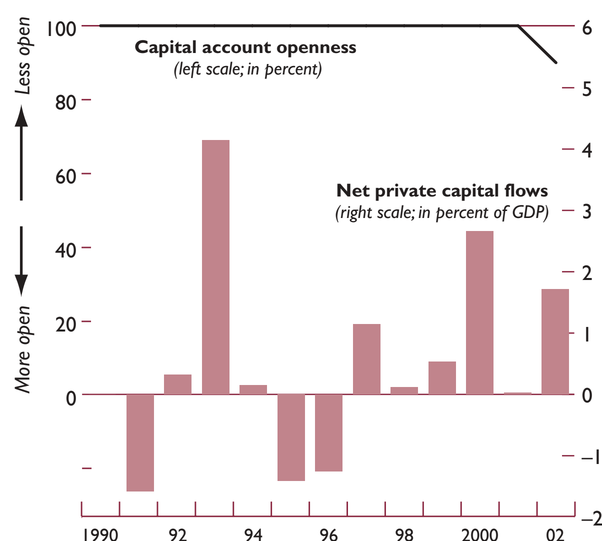
In terms of policies to deal with large capital inflows, the staff consistently advised the authorities to tighten fiscal policy, but to no avail. The staff should have given a greater warning about rapid capital account liberalization and begun to advise alternative policy measures, such as greater exchange rate flexibility, when it was evident that its preferred policy was unlikely to be followed. In retrospect, the staff underestimated the contribution of the fixed exchange rate to the capital inflows. The IMF staff should have argued for greater exchange rate flexibility in the mid-1990s when the pace of speculative inflows picked up, regardless of its fiscal policy advice.

Colombia: Market-Based Controls on Inflows

Colombia's unremunerated reserve requirement

In September 1993, the Colombian authorities introduced an unremunerated reserve requirement (URR) on external borrowing. At the time, the authorities were concerned with the large capital inflows, the pace of which had picked up as the authorities accelerated the opening of the economy (Figure A1.2). In 1991, for example, regulations on inward foreign investment were relaxed; in 1992, restrictions on long-term external borrowing as well as purchases of domestic assets by foreign investment funds were substantially eased. Responding to the surge in capital inflows, the authorities took various measures, including sterilization, further import liberalization, and easing of capital outflow restrictions. The authorities also allowed the Colombian peso to appreciate somewhat and, in 1991, introduced a 3 percent withholding tax on transfers and nonfinancial private services (the rate was increased to 10 percent in 1992), but the inflows increased sharply in 1993. It was under these conditions that the authorities introduced the URR, which was modeled after a similar measure introduced earlier by Chile.

Figure A1.2. Colombia: Capital Account Openness and Net Private Capital Inflows[1]



Sources: IMF database; and Appendix 5.
[1]Net foreign direct investment, net private portfolio investment, and private other investment.

The URR was a system requiring that a designated percentage of foreign loans with a maturity of less than a designated maximum be kept as a deposit at the central bank, at zero interest for a designated holding period (Ocampo and Tovar, 1999). Alternatively, the deposit could be redeemed immediately by paying the equivalent cost calculated at a preestablished discount rate. Initially, exemptions were made for certain loans and credit transactions, including loans to finance the import of capital goods, trade credits with a maturity of up to six months, credits to finance investment abroad, and capital inflows related to privatization and concessions. FDI was never subject to the URR.[12]

The URR was a market-based measure and, in this respect, was very much in line with the country's overall strategy of economic liberalization. In fact, as the authorities introduced the URR, they concurrently eliminated most remaining administrative controls on capital movements. For example, surrender requirements on services and transfers

[12]This exemption created an incentive to substitute FDI for debt, for example, by establishing a holding company in a tax-haven country. External borrowing by such holding companies and their transfer of funds to Colombian firms were regarded as FDI.

Table A1.1. Colombia: The Unremunerated Reserve Requirement, 1993–2000

		Deposits	
Effective Date	Maximum Applicable Maturity	Holding period (In months)	Applicable share (Percent of loan)
September 1993	18	12	47
March 1994	36	12	93
		18	64
		24	50
August 1994	60	Variable[1]	43–140[2]
February 1996	48	Variable[1]	10–85[3]
March 1996	36	18	50
March 1997	60	18	50
May 1997	Eliminated[4]	18	30
January 1998	. . .	12	25
September 1998	. . .	6	10
May 2000	. . .	. . .	0

Source: Banco de la República.
[1]Corresponded to the maturity of the loan.
[2]The maximum rate applied to loans with a maturity of 30 days or less.
[3]The maximum rate applied to loans with a maturity of 180 days or less.
[4]The URR was made applicable to all foreign loans irrespective of maturity.

(except for interest and profits) were eliminated. At the same time, surtaxes on remittances of earnings from foreign investments were reduced, and approval was granted to lending denominated in foreign currency and hedging operations by foreign exchange intermediaries.

Initially, the URR was set at 47 percent for one year, applicable to external borrowing with a maturity of up to 18 months. Depending on the strength of capital inflows, the URR was tightened from time to time (see Table A1.1 for details). During 1994, for example, the applicable maturity was lengthened to 60 months, and the share of a loan subject to the URR was raised to 43–140 percent.[13] After some easing in early 1996, in March 1997 the authorities raised the maturity of external borrowing subject to the URR back to 60 months. In May 1997, the system was switched to a Chilean-style URR (in which no maximum maturity is specified), with the loan share of 30 percent for 18 months (except that, unlike the Chilean system, the deposit needed to be made in domestic currency).[14] Following the East Asian crisis, in 1998, the authorities eased the URR and, in May 2000, reduced the applicable loan share to zero.[15]

[13]At the same time, all foreign investments unrelated to tourism or plant and infrastructure were prohibited.
[14]A senior official interviewed by the evaluation team gave simplicity as the reason for the change.
[15]Although the share of a loan subject to the URR is currently set to zero, the URR as a control system still exists.

The IMF's stance on the URR

Initially, IMF staff was not opposed to the URR itself. During a staff visit of early 1994, however, the mission cautioned the authorities against introducing any additional control measures in the absence of fiscal tightening. During the 1994 Article IV consultation, the mission took the view that the effects of the URR were likely to be limited in reducing inflation and preserving competitiveness. Thus, it argued for a tighter fiscal policy, further liberalizing trade and reducing labor market rigidities. The staff also suggested that restrictions on external borrowing were increasingly being circumvented, and that these could not only inhibit productive investment but also send a wrong signal to the markets. According to the Summing Up of the Executive Board meeting, "A few speakers encouraged the authorities to remove the recent restrictions on external borrowing, but others considered that capital controls—despite their shortcomings— would be an acceptable temporary response to capital inflows."

At the time of a staff visit in mid-1995, the mission argued that contagion from the Mexican crisis had been limited because of Colombia's tight monetary policy stance and restrictions on external borrowing introduced in August 1994. In view of the emerging pressure on the foreign exchange and stock markets associated with a political crisis, the staff recommended a tightening of both fiscal and monetary policies. During the 1995 Article IV consultation, the staff argued that, given the slowdown in cap-

ital inflows, the authorities could ease restrictions on external borrowing, while noting that if such a measure were reinforced by fiscal tightening, it would likely ease pressure on domestic interest rates. At the Executive Board meeting, some Directors argued for a phased relaxation of the restrictions on external borrowing, accompanied by a tighter fiscal policy.[16]

An intensification of political difficulties further diminished the prospect for fiscal adjustment in 1996, and the central bank came under intense pressure to ease liquidity conditions. The easing of the URR in early 1996 took place in this context. The situation, however, quickly changed as capital inflows seemed to pick up again toward the end of the year. In January 1997, the government announced a package of "economic emergency" measures, including a tax on capital inflows (which would be levied in addition to the URR). When the tax was ruled unconstitutional by the Constitutional Court in March 1997, the authorities immediately responded by tightening the URR.

In the briefing paper for the 1997 Article IV consultation, the staff expressed the view that the recurrent use of capital controls in Colombia had served mainly to crowd out the private sector and had only bought time for the policymakers to strengthen the fundamentals; but that tightening of restrictions on external borrowing could temporarily help ease upward pressure on the real exchange rate and shift the composition of borrowing in favor of longer-term maturities. During the consultation discussions, the staff noted that the effectiveness of capital controls was likely to be eroded over time and continued to argue for fiscal tightening, which would help create conditions for a gradual relaxation of the restrictions on external borrowing. At the Executive Board meeting, Directors emphasized that fiscal consolidation was critical to avoiding a further real appreciation of the currency, while some Directors expressed concern over the recent broadening of restrictions on foreign borrowing.

The East Asian crisis of 1997–98 drastically changed the external environment faced by Colombia. Owing to pressure on the peso, the country lost a substantial amount of foreign exchange reserves. During the 1998 Article IV consultation, the IMF staff encouraged an elimination of the tax on profit remittances and other restrictions in order to promote capital inflows. The staff and the Board welcomed the easing of the URR and the subsequent floating of the currency in September 1999.

[16]The Colombian representative stated at the January 1995 meeting that the restrictions on external borrowing would remain for some time because, as in the case of Chile, they could help deter short-term speculative inflows and thereby moderate an appreciation of the currency.

Assessment

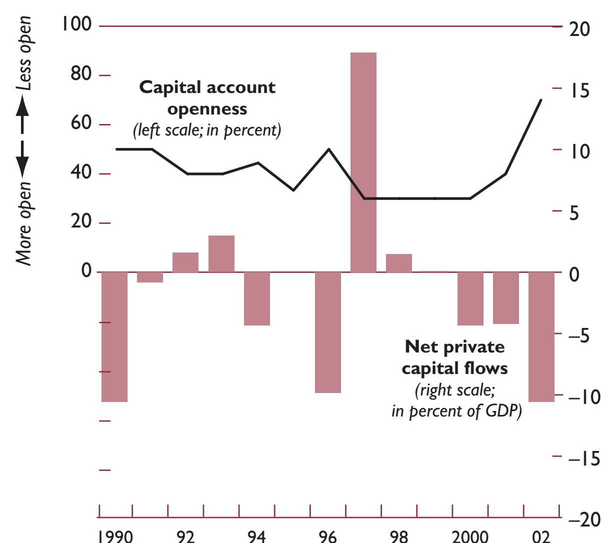
It is difficult to assess the effectiveness of the Colombian URR because its intensity changed over time and, while it was in place, fiscal policy was expansionary and some administrative controls on external borrowing remained.[17] The IMF staff's view of the URR seemed to moderate over time. It was not initially opposed to the URR. This may have reflected the staff's understanding that the URR in Colombia was a tool to manage the transition from an administrative control regime to a liberal one: the URR was introduced as a number of administrative controls were lifted.

The view then turned negative, and it was some time before the staff recognized the potential usefulness of the URR as a temporary measure, in line with the evolution of the institution's general thinking on the temporary use of capital controls. The Executive Board, on the other hand, was more consistent, although the composition of views may well have shifted: there were always some Directors who recommended a relaxation of the URR, while there were also others who were more supportive of the measure. The gradual moderation of the staff's negative view toward Colombia's URR, however, failed to highlight the fact that it was in fact used as a substitute for the needed correction in fiscal policy.

In fact, IMF staff consistently advised fiscal tightening as the most effective measure to mitigate the pressure on real appreciation created by the large capital inflows. Political constraints proved formidable, however, and did not allow the Colombian authorities to pursue successfully the IMF's preferred strategy. When this became evident, IMF staff could have suggested other policy options to complement fiscal tightening. Admittedly, that would have been a difficult task. To advise a tightening of the URR could have been counterproductive and highly distortionary, given the loose fiscal policy. On the other hand, to advise an elimination of the URR would not have served the purpose of controlling the capital inflows. Greater exchange rate flexibility—going beyond the crawling band of 7 percent introduced in January 1994—may well have been the only sensible policy alternative available at the time, and the staff could have pushed harder for this policy. In the event, it only continued to insist on fiscal tightening.

[17]If one could isolate the impact of the URR from those of other factors, it may well be that the URR was effective in limiting capital inflows and lengthening their composition when it was intensely applied. Some recent research seems to support such a conjecture (e.g., Ocampo and Tovar, 1999 and 2003; Villar and Rincon, 2003).

Figure A1.3. Venezuela: Capital Account Openness and Net Private Capital Inflows[1]



Sources: IMF database; and Appendix 5.
[1]Net foreign direct investment, net private portfolio investment, and net private other investment.

Venezuela: Use of Capital Controls on Outflows

Controls on capital outflows in 2003

In February 2003, the Venezuelan authorities introduced temporary comprehensive foreign exchange controls on both current and capital transactions. The decision was made in an environment of great political uncertainty and economic difficulties, which had resulted in large capital outflows (Figure A1.3), and followed an earlier decision to suspend foreign exchange trading temporarily in late January. At the same time, the exchange rate was fixed (to be devalued by 20 percent a year later), and price controls were also introduced. This was the second time Venezuela had introduced capital outflow controls in recent years, the previous occasion being in June 1994 (Quirk and others, 1995; Ariyoshi and others, 2000).[18]

The control regime worked in the following way. First, all foreign exchange proceeds needed to be surrendered to the central bank. Second, foreign exchange was allocated, with priorities given to the import of basic goods, foreign debt service, and repatriation of profits and dividends. In view of concerns over possible misuse of discretionary powers, the authorities made it clear that the system of foreign exchange allocation would be managed in a transparent manner. In addition, they stressed from the beginning that the imposition of foreign exchange controls was a temporary emergency measure and that the controls would be gradually relaxed and eventually eliminated as foreign exchange earnings from state oil exports were restored. The system was considerably eased in 2004, when a wider coverage of transactions was made eligible for foreign exchange allocation.

The 2003 system of foreign exchange controls was designed to minimize the problems encountered under an earlier system. In the system introduced in June 1994, the exchange controls also covered both current and capital account transactions; capital outflows unrelated to the amortization of external debt and the repatriation of capital by nonresidents were prohibited; foreign exchange earnings were to be surrendered to the central bank; and limits were set on the allocation of foreign exchange for education, travel abroad, and family remittances, and for transfers of profits from certain investments. However, there was considerable evasion of capital controls through permitted current account transactions. Thus, the authorities came to the conclusion that an effective system of controls over capital account transactions required a more comprehensive arrangement for monitoring all foreign exchange transactions.

How the IMF viewed the capital controls

According to a memorandum of February 2003, the staff thought that the new control regime would give rise to a parallel foreign exchange market and an arbitrary system of foreign exchange rationing that could be subject to political manipulation.[19] The briefing paper for a subsequent fact-finding mission noted the staff view that a flexible exchange rate system should be introduced and foreign exchange restrictions on current transactions eliminated. The staff, however, believed that capital controls might be necessary in the short run in order to reduce pressure on the exchange rate, the balance of payments, and the banking system.

In evaluating the IMF's views of the capital controls in Venezuela, it is important to keep in mind that the control regime also covered exchange controls on current account transactions, which are subject to IMF approval under Article VIII. In this respect, the position of the IMF staff in 2003–04 is strikingly different from the position taken earlier. During 1994–96, the staff took the position that all exchange controls—both for current and capital

[18]The first occasion was also in the context of political uncertainty, accented by an evolving banking crisis and declining oil prices.

[19]A parallel foreign exchange market did emerge, in part supported by residents' access to the ADR market in New York.

transactions—should be eliminated, along with the restoration of a flexible exchange rate regime.[20] While it was willing to accept a *gradual* elimination of capital controls as oil revenues were restored, its view on the desirability of restoring full capital account convertibility was unambiguous. In response to the concern of the authorities that an elimination of capital controls might lead to capital flight, the staff stated that capital outflows would not result if tight fiscal policy was maintained[21]—a view broadly endorsed by the Executive Board in its discussion of the 1994 Article IV consultation. In the context of a negotiation for a Stand-by Arrangement from 1995 to 1996, the staff proposed a "two-stage approach involving the immediate liberalization of most current account transactions accompanied by the gradual liberalization of capital transactions."[22]

In contrast, in 2003, the IMF staff was much more accommodating of capital controls, though it firmly opposed the maintenance of exchange controls for current transactions. As part of an overall strategy to eliminate foreign exchange controls, the mission supported a floating exchange rate mechanism for all current transactions, an export surrender requirement to the domestic interbank market (as opposed to the central bank), and, if necessary, explicit controls on capital outflows. The staff argued that, given the aim of capital controls to reduce capital flight, controls should focus on capital outflows, while other controls should be eliminated to reduce the adverse impact on domestic real activity.

During the 2004 Article IV consultation, the IMF mission urged the authorities to reinstate a floating exchange rate regime and to remove all restrictions subject to Article VIII or indicate a timetable for doing so. The mission also argued for a gradual elimination of most capital controls, stressing that the process must be well sequenced and supported by reforms in fiscal, monetary, and exchange rate policies, including the adoption of inflation targeting. Given the comfortable international reserve position, the mission urged the authorities rapidly to eliminate foreign exchange controls on all current account transactions and to develop a strategy for eliminating "the majority" of capital controls. The authorities in principle agreed with the staff position, though they preferred a somewhat slower pace of liberalization and stressed the importance of political developments in determining the precise timing. The elimination of capital controls would come later, except perhaps for controls on short-term flows.

[20]The back-to-office report of July 1994 expressed the initial reaction of the staff that the price and exchange controls would "introduce serious distortions without really restraining exchange rate and price pressures."

[21]From 1993 to 1994, Venezuela's fiscal deficit deteriorated sharply to 7.3 percent of GDP from 2.9 percent of GDP; inflation increased from 38 percent to 61 percent.

[22]In the event, in April 1996 the authorities eliminated all exchange controls on current and capital account transactions as part of an agreed economic program. In approving the program, Executive Directors commended the Venezuelan authorities on the elimination of all exchange controls.

Assessment

The IMF's position on the 2003 system differed from that on the 1994 system in an important respect. On both occasions, the IMF opposed the imposition of foreign exchange controls on current transactions, which are subject to IMF approval under Article VIII. In terms of controls on capital outflows, the IMF's position in 2003 was much more accommodating. The IMF staff was willing to see at least some of the control measures, particularly on outflows, as part of Venezuela's foreign exchange regime.[23] In 1994, on the other hand, the IMF had argued for a full elimination of capital controls, although it was pragmatic enough to recognize the virtue of gradual liberalization.

The positions taken by the staff on two occasions certainly reveal how the views of the IMF on the use of capital controls has changed over the years. At the same time, they also highlight the reluctance IMF staff now seems to feel about expressing its position forcefully on capital control issues. Not all capital controls can be appropriate tools of economic policy under all circumstances. The appropriateness of a particular capital control measure must be judged on the basis of an assessment of the overall macroeconomic policy and institutional framework under which it is introduced. In 1994, the staff had judged the capital controls to be inappropriate, given the unsustainable macroeconomic policies, and argued that their elimination would not lead to capital flight if supported by tight macroeconomic policies. In 2003, no such assessment of the place of capital controls in the overall macroeconomic policy framework was offered.

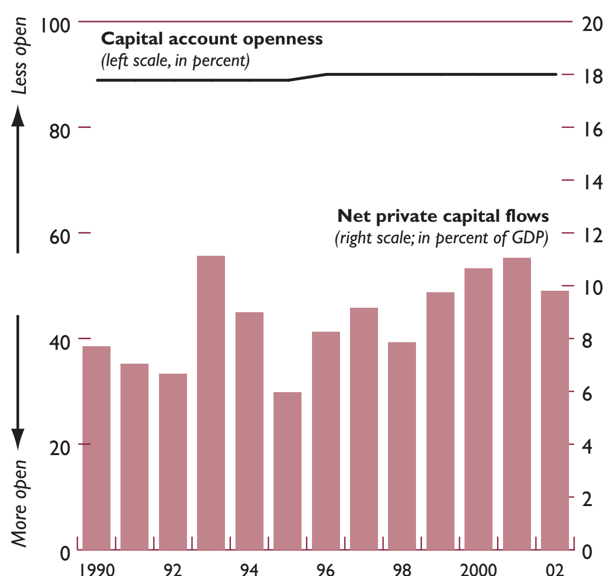
Tunisia: Gradual Liberalization

Capital account liberalization

Tunisia has pursued a gradual approach to capital account liberalization since the mid-1990s. Considerable de facto liberalization has taken place but, as

[23]In commenting on the draft report, the IMF staff stated that its accommodative stance, as expressed in the 2004 staff report, referred only to the need to retain foreign exchange surrender requirements for the state oil company, and should not be taken as a general endorsement of permanent capital controls.

Figure A1.4. Tunisia: Capital Account Openness and Net Private Capital Inflows[1]



Sources: IMF database; and Appendix 5.
[1]Net foreign direct investment, net private portfolio investment, and net private other investment.

indicated by the constant value of the index of de jure openness (Figure A1.4), restrictions remain on almost all categories of capital account transactions, particularly for residents. In terms of speed and sequencing, the experience of Tunisia is similar to that of India (see Box 4.1 in the main text). Unlike the case of India, however, capital account liberalization in Tunisia has taken place in the context of extensive IMF support, which included an assessment of its financial sector under the FSAP and technical advice on sequencing.

The Tunisian authorities have been engaged in a program of broad economic liberalization since 1986, aimed at reducing the role of government in the country's economic activities (Nsouli and others, 1993). The new development strategy has been decisively more outward looking and market oriented, and involved a gradual dismantling of restrictions on domestic financial and international transactions. Macroeconomic stability was achieved, and prudent macroeconomic policies have been maintained. The process of financial liberalization and financial market development began in the late 1980s, followed by the launch of banking sector restructuring in the early 1990s. The trade regime was liberalized from the outset of the reform process, with a focus on gradually reducing quantitative restrictions on imports.

Along with trade liberalization, progress was made toward currency convertibility. In terms of current account convertibility, the authorities gradually eased foreign exchange controls by decentralizing the allocation of foreign exchange, increasing exchange allocations for invisible transactions, and easing regulations on opening foreign currency accounts and using them for making payments abroad. Following these measures, in January 1993 Tunisia accepted the obligations under Article VIII of the IMF Articles of Agreement (Souayah, 1996).

A step-by-step approach was taken to the liberalization of capital account transactions. Among the first to be liberalized were transactions related to the resident export sector and nonresident FDI in certain export-oriented sectors. However, many restrictions remained on inward portfolio investment by nonresidents and outward capital transactions (except for export-oriented activities and enterprises). It was only in 1995 that the Tunisian authorities initiated a concerted effort to liberalize the capital account.[24]

The pace of capital account liberalization, however, has been slow. In part, this reflected Tunisia's consensus-building culture. The authorities adopted a particular liberalization measure only after it had received broad sociopolitical support and they were certain that it would not be reversed.[25] The back-to-office report of November 2000 stated that the authorities were concerned about the risks of unstable portfolio flows. Yet the authorities have publicly stated on a number of occasions that achieving full capital account convertibility remains the official policy of the government.[26] This is still an ongoing process.

The IMF's early views on Tunisia's capital account liberalization

The IMF supported Tunisia's economic reforms through a series of financing arrangements, and has maintained a highly collaborative relationship with the Tunisian authorities. Exchange of views on capital account liberalization over the years has taken place within the context of this broad policy dialogue.

Responding to the authorities' expressed intention to pursue capital account liberalization, in June 1995, the IMF staff suggested the following sequence for removing restrictions on external capital

[24]In the same year, Tunisia signed an Association Agreement with the EU, which implied the eventual goal of full trade liberalization and capital account convertibility.

[25]A point emphasized in a March 1997 back-to-office report by an IMF mission.

[26]For example, see the statement of the central bank governor, "La Convertibilité Totale du Dinar," May 24, 2001. In this statement, the governor listed five preconditions to be met before full convertibility was established: (1) strengthening of the country's productive capacity; (2) continuation of sound and sustainable macroeconomic policies; (3) maintenance of a sustainable balance of payments position; (4) a sound banking and financial system; and (5) sufficient international reserves.

transactions: (1) FDI, (2) portfolio inflows, (3) foreign borrowing, and finally (4) outward portfolio investment. The staff also stressed the need to pursue prudent fiscal and monetary policies, encourage financial sector reform, and improve the domestic financial markets. Executive Directors agreed with the staff and encouraged the authorities to take further steps toward full currency convertibility, while noting the preconditions to be satisfied. Both the staff and Executive Directors welcomed the association agreement with the EU as a signal of the authorities' commitment to full integration with the global economy. From 1996 through 1998, the staff clearly favored a faster pace, with an immediate and complete liberalization of inward FDI, while acknowledging the importance of further financial sector reform. A briefing paper of September 1998 added to the list of preconditions the privatization of the provision of forward foreign exchange cover.

The staff's position turned clearly more cautious in 1999. The briefing paper for the 1999 Article IV consultation expressed the view that the restrictions on the capital account had helped Tunisia weather the East Asian crisis by limiting its exposure to short-term capital flows, and hinted that the staff might reconsider the whole liberalization strategy. Moving further in this direction, the briefing paper for the 2000 Article IV consultation stated that limited capital mobility had allowed monetary policy autonomy and "had served Tunisia well." During the consultation discussions, the staff cautioned against significant further capital account liberalization until additional progress was made toward strengthening the banking system. While the staff continued to support the lifting of restrictions on outward FDI, it raised the fragile banking sector, undeveloped domestic financial markets, and uncompleted trade liberalization as reasons to argue against broader capital account liberalization. Executive Directors broadly supported the staff's position.

The IMF's inputs in the ongoing process

Since 2001, the IMF has played a more explicit role in Tunisia's capital account liberalization. In early 2001, the Tunisian authorities requested an assessment of its financial sector by the IMF and the World Bank under the jointly administered FSAP. The resulting report, issued in November 2001, noted that the series of measures taken since the early 1990s had significantly liberalized the regulatory framework for capital account transactions in favor of export-oriented activities and corporations, but that other transactions, including inward direct and portfolio investments, were still subject to a large number of restrictions. The report then concluded that a wide-ranging capital account liberalization would be premature before a "financial market economy" emerged. The 2001 FSAP assessment subsequently formed the basis for the IMF's advice on sequencing capital account liberalization.

In September 2001, the staff and the authorities agreed that the focus of the 2002 Article IV consultation discussions would be on (1) sequencing and pace of capital account liberalization and (2) exchange rate policy in the context of capital account liberalization.[27] As agreed, the 2002 Article IV consultation involved intense discussions on capital account liberalization, in which the authorities expressed their preference for a gradual approach. The staff agreed, stressing the importance of proceeding with caution, and encouraged the authorities to prepare ground work by (1) making further progress in establishing a monetary policy framework that could provide a nominal anchor to inflation and exchange rate expectations, (2) allowing market conditions to play a greater role in determining the exchange rate, and (3) reducing the existing vulnerabilities of the banking system.[28]

The background paper prepared by the staff, drawing on the 2001 FSAP assessment, spelled out achievements and remaining challenges in the areas of (1) macroeconomic stabilization, including exchange rate policy; (2) financial sector liberalization, including financial sector supervision; (3) systemic liquidity framework (meaning availability of market-based monetary policy instruments); (4) government securities market; (5) corporate sector restructuring; (6) legal framework; and (7) gaining access to international capital markets (emphasizing the need to diversify sources of balance of payments financing by giving the private sector greater access to external financing). The paper then drew on previous work by MAE staff to argue that long-term capital account transactions needed to be liberalized before short-term movements; FDI inflows should be among the first categories of transfers to be liberalized; and the transfer and use of domestic currency abroad should be limited in the early phases of liberalization.[29]

In terms of specific sequencing, the background paper advocated a three-phase approach to capital account liberalization. The first phase included steps that could be taken immediately, such as removing restrictions on FDI by nonresidents and long-term loans to listed firms, and allowing limited nonresident investment in local currency government securities. The second phase involved steps that pre-

[27]Back-to-office report for a staff visit, September 20, 2001.

[28]Briefing paper for the 2002 Article IV consultation.

[29]The paper, entitled "Liberalization of the Capital Account in Tunisia—Progress Achieved and Prospects for Full Convertibility," was included as Chapter 2 of the Selected Issues paper for the 2002 Article IV consultation. SM/02/155, May 2, 2002.

sumed the attainment of a solid banking system, a flexible exchange rate regime, and a market-based monetary policy framework, such as liberalizing outward FDI, portfolio investment by institutional investors, and inward portfolio investment in debt instruments. The third and final phase entailed steps requiring a robust financial sector and a resilient balance of payment position, such as lending by residents to nonresidents. Some Tunisian officials interviewed by the evaluation team indicated that they found the paper's exposition of various country experiences to be particularly useful, although the overall approach lacked operational specificity. The broad conceptual scheme of the staff advice, however, received wide support when it was discussed by the Executive Board.

During the 2003 Article IV consultation, the staff reviewed progress under the capital account liberalization plan. The staff stressed the need for a floating exchange rate regime to preserve independent monetary policy, while noting the importance of adopting a "monetary reference target" to provide a nominal anchor as steps were taken to further liberalize the capital account.[30] Executive Directors welcomed the planned move to a floating exchange rate regime but stressed that full capital account liberalization should be delayed until the proposed monetary policy framework was established and the transition to a floating exchange rate complete.

Assessment

The case of Tunisia illustrates how the IMF has applied the new conceptual framework of sequencing to a specific country context. Indeed, it is one of only a few examples of the IMF's new "integrated" approach in operation. The IMF staff has warned the authorities of all potential risks involved in moving toward full capital account convertibility; it has in some cases discouraged the authorities from moving further until banking sector problems were better addressed; and it has spelled out how institutional and regulatory constraints could condition the pace and sequencing of removing restrictions. This new approach has received wide support from the Executive Board and also appears to be accepted by most IMF staff members.

The IMF staff has assessed Tunisia's macroeconomic policies as being broadly prudent, and viewed its recent structural reforms as generally successful. At the same time, the staff considered the state of the banking sector to be still insufficient to support a fully open capital account. Given the government's publicly stated commitment to achieving full convertibility of the dinar, however, one cannot avoid the impression that the recent involvement of the IMF has not had much impact on the pace of capital account liberalization, which began almost 10 years ago. How quickly to liberalize the capital account (as well as how much risk to tolerate in the process) must remain the decision of a sovereign government and, given Tunisia's consensus-building culture, there may not be much the IMF could have done to alter the pace of liberalization, in line with the commitments Tunisia made in its association agreement with the EU. However, part of the problem may also be the lack of clear priorities in sequencing in the IMF's new approach (see Box 4.3). By emphasizing all the potential interlinkages without identifying a hierarchy of risks, the integrated approach may have created an inevitable tendency to err on the side of caution. Despite the staff's encouragement, and despite the government's stated intention and international commitments, the process of capital account liberalization has been painstakingly slow.

[30]In this monetary framework, base money was to serve as an operating target. The system would be replaced by inflation targeting when conditions were met.

Appendix 2 Staff Research

The IMF staff prepared more than 100 research papers on capital account issues between the early 1990s and the early 2000s. The volume of research output in this area increased significantly in the second half of the 1990s. The findings of staff research in this area broadly corresponded to the views expressed in multilateral surveillance (see Chapter 2, the section "Multilateral Surveillance"), indicating that there was considerable synergy between these two areas of activity. Research consistently found that permanent capital controls were ineffective, while staff research began to see the temporary use of capital controls in a more favorable light over time, at least as a short-term measure. The review of staff research provided below is not meant to be comprehensive, but to cover only those studies that either reflected or influenced the evolution of ideas within the IMF.

Early Work on Capital Controls and Capital Flow Management

Mathieson and Rojas-Suarez (1990), Mendoza (1990), and Calvo and others (1992) were among the first to analyze capital controls. Mathieson and Rojas-Suarez (1990) showed that exchange rate policy would be affected by the removal of capital controls as the economy would become more vulnerable to foreign shocks, but that there was no single optimal exchange rate regime consistent with a particular process of liberalization. Mendoza's theoretical study (1990) showed that the use of capital controls had little, if any, impact on the output, consumption, and welfare of a small open economy facing balance of payments problems. Calvo and others (1992) argued that a case could be made for the policy mix of a tax on short-term inflows, exchange rate flexibility, and an increase in marginal reserve requirements, and noted that capital controls could be effective only in the short run because investors could find a way to evade them over time.

Two significant policy-oriented papers were issued as Occasional Papers during 1993.[1] First, Mathieson and Rojas-Suarez (1993) advanced the idea that capital controls had lost effectiveness in the 1980s with the liberalization of exchange and trade controls. They identified channels of evasion such as under- and over-invoicing, transfer pricing policies, and leads and lags. This does not mean that capital controls cannot affect certain types of capital transactions and market participants, but the authors argued that, given the distortionary effects, adjustment of macroeconomic policies was generally more appropriate than imposition of capital controls when faced with large capital movements. They then concluded that, in order to support capital account convertibility, efforts should be made to strengthen the prudential supervision of financial institutions, establish more flexible interest rates, and restructure and recapitalize domestic financial institutions. The "consistency of macroeconomic, financial, and exchange rate policies is more important for sustaining an open capital account than is the sequencing of the removal of capital controls."

The other Occasional Paper, by Schadler and others (1993), was an analysis of how countries had responded to surges in capital inflows. In particular, it used the recent experiences of Chile, Colombia, Egypt, Mexico, Spain, and Thailand to document the policies adopted and the effectiveness of these measures. It argued that tight fiscal policy was the only means to prevent overheating and avoid a real appreciation "regardless of [the] cause" of the inflows. Its assessment of sterilization, the most common policy tool, was generally negative because its quasi-fiscal cost and its effect on the level of interest rates made it infeasible on a sustained basis. The authors were cautious toward exchange rate flexibility because a

[1]Compared with Working Papers, Occasional Papers tend to be more department driven and less individually motivated, and have greater internal status and outside visibility. Some Occasional Papers are initially written as Board papers and are discussed by the Executive Board in a formal meeting or an informal seminar before they are published.

change in the equilibrium real exchange rate might not be warranted. They recognized a case for capital controls when "bandwagon effects are important or there are doubts about the capacity of the economy to absorb inflows efficiently," but found little evidence to argue for their effectiveness. Instead, they argued that the easing of the external constraint provided an ideal opportunity to address structural weaknesses by liberalizing trade, moving toward capital account convertibility, and reforming the financial sector.

Later Work on Capital Controls

Studies that appeared in 1994 and later reinforced the argument that capital controls were ineffective. For example, Johnston and Ryan (1994) argued that capital controls were not effective in developing countries, and caused problems in macroeconomic management with little effect on the balance of payments. The authors then advocated rapid capital account liberalization, given its positive impact on capital inflows and domestic financial development. A review of theoretical and empirical literature by Dooley (1996) concluded that controls were somewhat effective in creating a wedge between domestic and international interest rates, but there was little evidence to show that they were effective in significantly affecting the volume of capital flows. At the same time, the study noted that capital controls previously employed by many industrial countries had been effective (relative to developing country experience), and concluded that administrative capacity was a critical factor in determining the effectiveness of controls. Once the apparatus of control was removed, however, reintroducing controls in a liberalized regime would be unlikely to be effective.

As the experience of Chile with market-based controls became widely known (see Boxes 1.2 and 2.2), some on the IMF staff began to see temporary use of controls in a more favorable light. In 1996, Galbis (1996) argued that there were grounds for the temporary use of a tax on capital inflows, while noting that quantitative controls on capital flows were inefficient and discriminatory and should be the first to be removed. Laurens and Cardoso (1998), however, stressed that Chilean-style controls could be a policy option only for a limited number of developing countries because of the high level of enforcement capacity required for its implementation. On the other hand, Lopez-Mejia (1999) argued that the capital controls in Chile, Colombia, and Malaysia had proved useful in lengthening the maturity of capital inflows.

Determinants of capital controls received some attention in IMF research. The seminal work of Grilli and Milesi-Ferretti (1995) used a large sample of over 60 countries to find that capital controls were more likely to be present in a country if it was less open, its income lower, its public sector larger, its central bank less independent, its exchange rate less flexible, and its current account deficit larger. The authors found little evidence that capital controls were associated with higher economic growth, but controls tended to be associated with higher inflation and lower real interest rates. Likewise, Johnston and Tamirisa (1998) identified additional factors to explain the imposition of capital controls by governments, including balance of payments reasons, macroeconomic management, weak domestic regulatory systems, and the stage of economic development.

Work on Sequencing

As early as 1994, staff research, while supporting capital account liberalization, was already aware of the need for sequencing, which was well known from the literature on the order of economic liberalization. For example, Quirk (1994) argued that capital account liberalization should be implemented with credible fiscal policy. Galbis (1994) argued that "a pragmatic approach to the sequencing issue [was] necessary as there [were] only a few general principles valid for all countries." He added that a case could also be made from the literature that an early introduction of capital account liberalization in the reform process could promote acceleration of domestic financial reforms. The conventional wisdom from the literature was reiterated by the previously cited work of Galbis (1996), who listed fiscal consolidation, noninflationary finance of public deficits, macroeconomic stability, an appropriate monetary-fiscal policy mix, and a strong domestic financial sector as preconditions for capital account liberalization. Surprisingly, however, exchange rate flexibility was not accorded the same emphasis it receives today as desirable for an open capital account.[2]

An Occasional Paper by Quirk and others (1995) was much more explicit on sequencing. The paper included the idea that one must consider a set of preconditions and the sequencing of liberalization in moving toward capital account convertibility, and highlighted the danger of opening the capital account too rapidly without supporting policies. It then noted that the most important precondition was domestic financial market reforms, including

[2]An earlier expression of the view intimating the need for exchange rate flexibility under high capital mobility is found in Goldstein and Mussa (1993), who argued that greater capital flows have "made the conditions more demanding for operating durably and successfully a fixed exchange rate arrangement."

strengthened prudential regulations. In terms of sequencing, it suggested that (1) with a strong balance of payments position, exchange rate pressure could be minimized by liberalizing capital outflows before inflows; and (2) one might also want to limit potentially more destabilizing short-term inflows by first liberalizing long-term inflows, such as direct investment. The authors, however, added that "such fine-tuning" might be difficult in practice as "liberalization of one component of the capital account" would create pressure to liberalize all capital transactions.

Toward the end of the 1990s, even before the East Asian crisis, staff research began to focus on the pace and sequence of capital account liberalization in a more explicitly operational way. Johnston and others (1997) documented the sequence of financial sector reforms and capital account liberalization followed by Chile, Indonesia, Korea, and Thailand, and suggested that the speed should depend on macroeconomic and exchange rate policies. Likewise, Johnston (1998) argued that prudential measures should not be considered to be equivalent to capital controls because they were not meant to restrict capital flows directly, but were designed to support the gains achieved in moving toward capital account convertibility by providing safeguards. These and other contributions were later compiled as a book, which was published by the IMF (Johnston and Sundararajan, 1999). An influential Occasional Paper by Eichengreen and others (1998) discussed the role of sequencing in a broader context of discussion on the risks of capital account liberalization and the need for sound macroeconomic and prudential policies to minimize those risks.

In the early 2000s, there was a proliferation of work on pace and sequencing. For example, Karacadag and others (2003) considered hierarchy and interlinkages among financial markets, and made a proposal on the modality of sequencing. In particular, the authors emphasized the importance of undertaking central banking reforms and other measures that would allow a more effective conduct of monetary and exchange rate policies, and the need to implement technically and operationally connected measures simultaneously. Kaminsky and Schmukler (2003) were skeptical of the need to follow a particular order of liberalization, but nevertheless acknowledged the importance of doing institutional reforms before opening the capital account. Duttagupta and others (2004) used country experience to argue that attaining exchange rate flexibility before capital account liberalization had the advantage of enabling the economy to absorb capital account shocks at a lower cost to the real economy. The authors also argued that a transition to exchange rate flexibility should involve a gradual elimination of existing asymmetries (if any) in capital account openness between outflows and inflows in order to facilitate an orderly correction of any potential misalignment in the exchange rate.

More Recent Work

The areas of research on capital account issues also expanded in the early 2000s. We review here two strands of research covering (1) the impact of capital account liberalization and (2) analyses of market dynamics. First, among recent studies to quantify the effect of capital account liberalization on economic growth or policy discipline, Edison and Warnock (2003) supported the view that removal of restrictions provided developing countries with increased access to international capital markets, but found no evidence that capital controls created a bias in favor of domestic capital. An Occasional Paper by Prasad and others (2003) found no strong relationship between capital account openness and growth (but suggested the importance of the quality of domestic institutions in defining that link), while Tytell and Wei (2004) suggested no robust or causal relationship between liberalization and fiscal discipline (although there was a weak discipline effect on inflation).

A number of recent studies have investigated the working of financial markets, particularly as it relates to international linkages through capital flows. For example, Arora and Cerisola (2001) provided a quantitative indication of how U.S. monetary policy influenced sovereign bond spreads in emerging market economies, and concluded that the spreads were influenced not only by country-specific fundamentals but also by the stance and predictability of U.S. policy. Herding among international institutional investors was the topic of empirical studies by Borensztein and Gelos (2000) and Gelos and Wei (2002); a literature review on herd behavior was provided by Bikhchandani and Sharma (2001). More recently, Chan-Lau (2004) analyzed, among other things, the main determinants of the emerging market asset allocation of pension funds in industrial countries, while Ong and Sy (2004) showed the importance of foreign investor presence in securities markets in emerging market economies and how asset allocation decisions by mature market funds could possibly affect emerging market countries.

APPENDIX

3 Public Communications

This appendix reviews public speeches and statements of IMF management during 1990–2004, in order to see what messages were communicated to the public on capital account issues. Much of the information in this appendix relies on various issues of the *IMF Survey*.

In the early 1990s, IMF management viewed capital account liberalization, along with macroeconomic discipline and IMF financial support, as essential ingredients of sustained growth for developing countries. Management, however, was explicit in spelling out the potential risks of capital account liberalization. In 1994, for example, the Managing Director stated: "The Fund encourages countries to liberalize their capital account restrictions, while adopting policies that ensure that the risks involved are avoided and the potential benefits fully realized."[1]

Following the Mexican crisis, management focused on the need for strong financial institutions, a competitive domestic financial system, and effective supervision and regulation; it opposed use of capital controls, including market-based ones. In 1995, the Managing Director stated that the IMF's response to the challenges of globalization was to strengthen surveillance and to secure appropriate resources to assist countries. Surveillance needed to be strengthened, particularly in terms of attention to capital account developments and financial flows. At a seminar held in April 1995, the First Deputy Managing Director said that the pace of capital account liberalization depended on the liberalization process of the domestic financial sector and that a strong financial system was a prerequisite.

In September 1995, in responding to criticisms that the IMF was an impediment to capital account liberalization, the Managing Director wrote an article for the *Wall Street Journal* emphasizing that freedom of capital movements is "an objective that the IMF seeks to promote." At the same time, he stated that, in the absence of certain prerequisites, "open capital accounts may impose considerable costs in terms of financial and economic instability, and risk costly reversal" and listed as the necessary prerequisites a strong financial system and macroeconomic stability. He then noted that, in the circumstances of some developing countries, "certain kinds of measures to discourage capital inflows or influence their character might be appropriate" (*Wall Street Journal*, September 27, 1995).

In 1997, there was a marked change in management's view of capital controls. While fiscal discipline and greater exchange rate flexibility remained the preferred policies, the First Deputy Managing Director stated that market-based controls were less harmful than administrative ones, which were ineffective and costly. He continued to advocate liberalization of outflows as a tool to manage capital inflows. In 1998, he again reiterated the same views, namely, that controls on outflows should be removed as the country circumstances became appropriate, but market-based controls could be retained to discourage short-term inflows.

At the same time, management began to pay more attention to sequencing and gradualism. The Managing Director emphasized the importance of sound macroeconomic policies, a strong domestic financial system, phased capital account liberalization, properly sequenced reforms, and timely and accurate dissemination of information. At a meeting of the Pacific Basin Economic Council held in May 1999, the Managing Director stated that controls were more effective on inflows than on outflows, and that they worked best when they were market-based and temporary. He then added that stronger macroeconomic policies and banking sectors—not the controls per se—were the key factors behind the success of the countries that imposed controls after the crisis.

The Managing Director, at the January 2001 Asia-Europe Meeting of finance ministers from Asia and Europe, conceded that there had been excessively rapid capital account liberalization in some emerging market countries, and emphasized the need for preconditions to be met before proceeding with full liberalization. At the same time,

[1]Transcript of remarks made at a meeting of financial and business leaders in Korea in October 1994.

he advised countries with open capital accounts not to reimpose controls, but rather to strengthen institutions. He then noted the mixed experience with the use of capital controls and called for "further research and analysis to assess the costs and benefits of controls in particular circumstances." In 2003, at the January Asia-Pacific Economic Cooperation meetings, the Managing Director stressed the need for sequencing, saying: "Ensuring careful sequencing, particularly in relation to the development of well-regulated and well-managed financial sectors, is a critical ingredient to success."

APPENDIX
4
Cross-Border Capital Transactions and Capital Account Openness in Selected Countries, 1989–2002

	Private Capital Flows[1] (Annual Averages)											
	As a percent of GDP						In billions of U.S. dollars					
	1989–93		1994–97		1998–2002		1989–93		1994–97		1998–2002	
	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets
Average	2.9	–0.3	6.1	–0.5	5.4	–1.4	2.4	–0.4	5.9	–1.7	4.9	–2.7
Bulgaria	0.40	–2.34	1.39	–4.76	7.62	0.71	0.76	–0.04	0.15	–0.42	1.05	0.11
Chile	6.50	0.16	8.86	–0.76	7.15	–5.03	2.60	0.03	6.30	–0.57	5.19	–3.68
China	2.38	–1.24	6.55	–1.53	4.21	–3.05	12.09	–5.80	48.43	–12.47	45.85	–31.74
Colombia	1.36	–0.58	0.85	–1.56	2.61	–1.72	0.83	–0.31	0.91	–1.53	2.23	–1.48
Croatia	1.66	–0.93	6.01	2.23	11.37	0.22	0.10	–0.11	1.18	0.43	2.30	0.09
Czech Republic	1.44	0.71	7.54	–3.53	7.42	0.66	0.61	0.22	4.10	–2.06	4.67	0.55
Estonia	1.55	0.00	16.50	–6.41	12.95	–5.21	0.02	0.00	0.69	–0.26	0.77	–0.31
Hungary	4.44	–0.28	7.36	–1.09	9.38	–1.01	1.66	–0.08	3.21	–0.51	4.65	–0.52
India	1.81	0.50	2.40	–0.04	2.20	–0.15	5.24	1.41	8.58	–0.14	10.16	–0.74
Israel	2.49	–2.14	5.02	–1.09	5.33	–4.36	1.41	–1.27	3.97	–0.77	5.77	–4.72
Latvia	3.18	0.00	14.79	–5.27	12.98	–4.15	0.21	0.00	0.78	–0.31	1.03	–0.34
Lebanon	1.20	4.81	–0.46	32.30	–1.93	15.51	0.00	0.36	–0.22	3.98	–0.33	2.58
Lithuania	–2.15	0.00	7.77	–1.22	9.33	–0.89	–0.06	0.00	0.65	–0.11	1.09	–0.10
Malaysia	11.12	–0.60	6.73	–2.57	–5.32	–1.51	6.44	–0.52	6.38	–2.43	–4.49	–1.30
Mexico	5.52	–1.17	4.64	–0.87	2.95	0.26	18.24	–3.20	16.47	–2.83	16.13	1.80
Peru	1.61	0.45	8.35	–0.50	1.55	0.42	0.55	0.16	4.41	–0.24	0.86	0.22
Philippines	2.73	0.58	8.20	1.82	5.20	–2.35	1.31	0.26	6.21	1.46	3.83	–1.73
Poland	–2.29	–1.88	–1.17	0.92	6.30	–1.13	–2.21	–1.24	–0.24	1.69	10.83	–1.93
Romania	1.34	–0.27	4.52	–0.52	4.95	0.10	0.16	–0.08	1.54	–0.16	2.05	0.04
Russia	0.17	0.54	4.18	–5.45	2.57	–6.25	–1.38	1.00	16.08	–19.92	6.44	–16.33
Slovak Republic	0.71	0.59	11.82	–2.72	11.51	–1.11	0.12	0.09	2.40	–0.60	2.53	–0.21
Slovenia	–0.21	–0.71	3.78	–0.96	6.75	–2.76	0.02	–0.10	0.73	–0.18	1.40	–0.58
South Africa	0.02	–0.70	5.65	–3.05	4.69	–3.35	0.04	–0.84	8.31	–4.48	6.22	–4.43
Thailand	10.47	–0.03	5.69	0.24	–4.53	–0.84	9.89	0.13	9.92	0.28	–5.30	–0.95
Tunisia	6.91	–0.24	9.73	–1.63	12.85	–3.03	0.99	–0.03	1.76	–0.30	2.60	–0.61
Ukraine	4.31	0.00	3.14	0.13	2.48	–2.10	1.60	0.00	1.12	0.06	0.88	–0.75
Venezuela	8.39	–3.51	4.62	–4.62	2.52	–6.68	4.35	–1.81	4.19	–3.43	2.55	–6.94

Sources: IMF, WEO and other IMF databases.

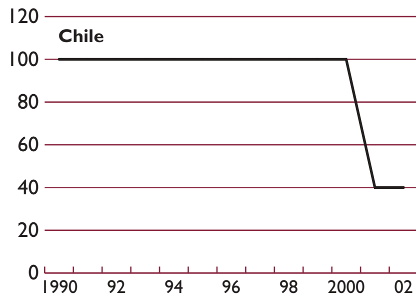
[1]Portfolio investment, other private investment, and foreign direct investment. Excludes government borrowing.

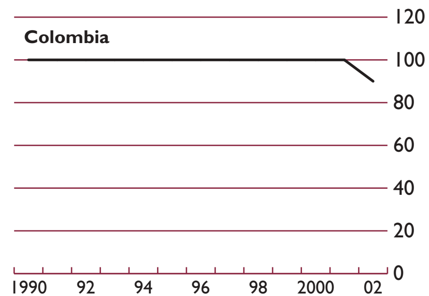
[2]Taken from IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions,* various issues. The index indicates the number of restricted categories divided by the total number of capital control categories. A smaller number means a smaller number of existing restrictions on capital account transactions.

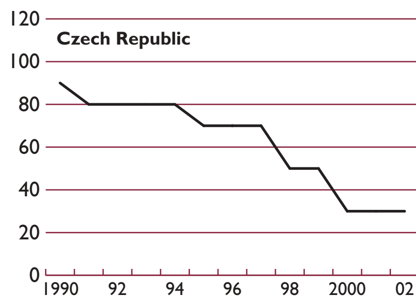
Capital Account Openness[2]				Memorandums	
Global ranking in 2002	Openness index			IMF-supported programs (1990–2002)	Technical assistance in banking and external sectors (1990–2002)
	1995	2002	Change		
81	0.7	0.6	–0.1		
97	0.9	0.8	–0.1	Yes	Yes
58	1.0	0.4	–0.6	Yes	Yes
132	0.9	1.0	0.1	No	Yes
114	0.9	0.9	0.0	Yes	Yes
114	0.9	0.9	0.1	Yes	Yes
44	0.6	0.3	–0.4	Yes	Yes
44	...	0.3	...	Yes	Yes
1	0.8	0.0	–0.8	Yes	Yes
132	1.0	1.0	0.0	Yes	Yes
1	0.8	0.0	–0.8	No	No
31	0.2	0.2	0.0	Yes	Yes
83	0.3	0.7	0.5	No	Yes
31	0.4	0.2	–0.2	Yes	Yes
114	0.8	0.9	0.1	No	Yes
83	0.9	0.7	–0.2	Yes	Yes
1	0.2	0.0	–0.2	Yes	Yes
114	0.9	0.9	0.0	Yes	Yes
83	0.9	0.7	–0.2	Yes	Yes
73	0.8	0.6	–0.2	Yes	Yes
97	0.8	0.8	0.0	Yes	Yes
132	0.7	1.0	0.3	Yes	Yes
73	0.8	0.6	–0.3	Yes	Yes
114	0.9	0.9	0.0	No	Yes
97	0.6	0.8	0.2	Yes	Yes
114	0.9	0.9	0.0	Yes	Yes
114	1.0	0.9	–0.1	Yes	Yes
83	0.3	0.7	0.4	Yes	Yes

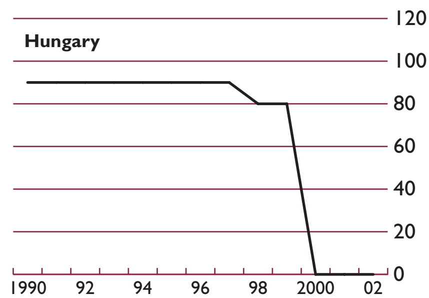
APPENDIX
5

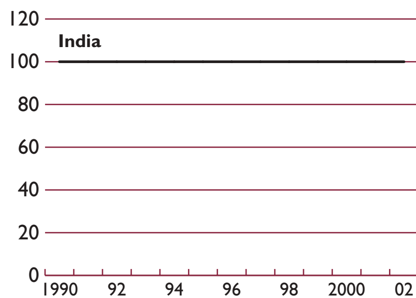
Capital Account Openness in 12 Sample Countries, 1990–2002

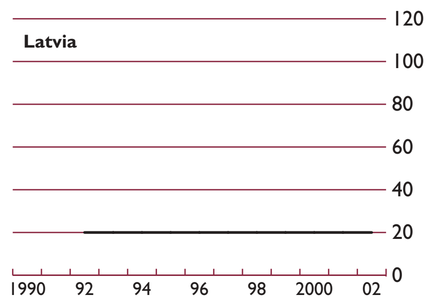


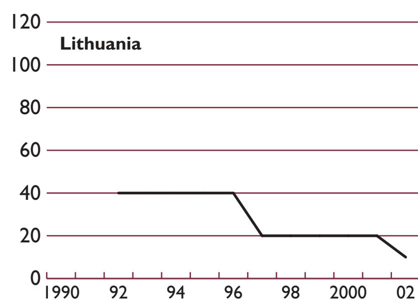


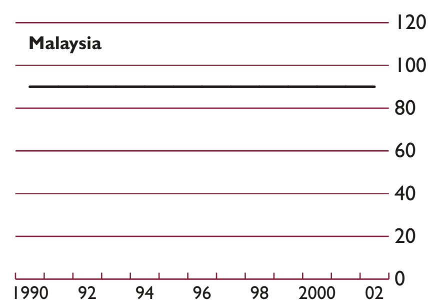


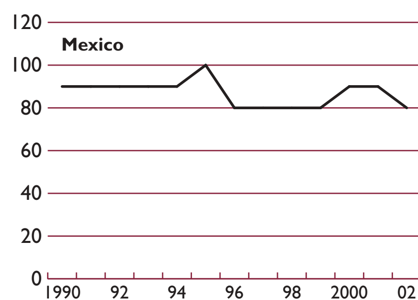


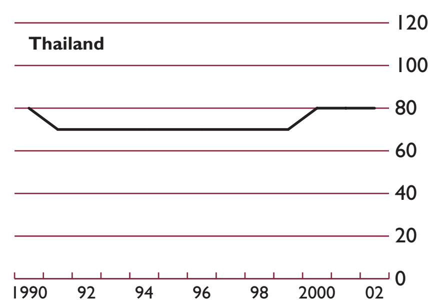


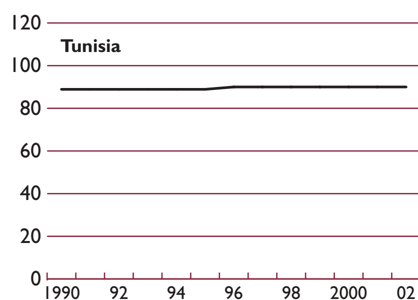


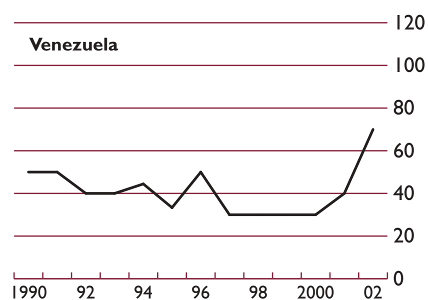












Sources: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)*; Miniane (2004); and IEO estimates.

[1]The index shows in percentage terms how many of the 10 types of capital account transactions are subject to restrictions; a lower value indicates greater capital account openness.

Appendix 6

List of Interviewees

The IEO team has spoken to more than 30 current and former members of IMF staff and the Executive Board. In addition, the following individuals have provided their views to the IEO, mostly through personal interviews but also through seminars and workshops. We express our gratitude for their time and apologize for any errors or omissions. They assume no responsibility for any errors of fact or judgment that may remain in the report.

Former and current officials of international and regional organizations

Bank for International Settlements

David Archer
Madhu Mohanty
Philip Turner
Benjamin Cohen
Ramon Moreno
Augustin Villar

European Commission

Maria-Rosario Areizaga
Ken Lennan
Heliodoro Temprano
Maurice-Pierre Guyader
Oliver Schmalzriedt

Organization for Economic Cooperation and Development

Robert Ley
Pierre Poret
Paul O'Brian

United Nations Conference on Trade and Development

Yilmaz Akyuz
Heiner Flassbeck
Andrew Cornford
Benu Schneider

Current and former officials of member countries

Chile

Jorge Cauas Lama
Nicolas Eyzaguirre
Leonardo Hernandez
Luis Eduardo Escobar
Ricardo Ffrench-Davis
Luis Oscar Herrera
Esteban Jadresic
Carlos Massad
Bernardita Piedrabuena
Claudio Soto
Rodrigo Valdes
Manuel Marfan
Felipe Morande
Klaus Schmidt-Hebbel
Kathleen Uribe

Colombia

Gerardo Hernandez
Guillermo Perry
Herman Rincon
Miguel Urrutia
Salomon Kalmanovitz
Jose Antonio Ocampo
Jose Dario Uribe
Leonardo Villar

Czech Republic

Oldrich Dedek
Tomas Holub
Jan Miladek
Petr Sedlacek
Joseph Tosovsky
Vladimir Dlouhy
Pavel Mertlik
Petr Prochazka
Pavel Stepanek
Jiri Vetrocsky

Hungary

Laszlo Akar
Akos Peter Bod
Tibor Erhart
Agota Repa
Gyorgy Szapary
Lajos Bokros
Sandor David
Klara Kamaras
Gorgy Suranyi

India

Montek Singh Ahluwalia
Surjit Bhalla
Shyamala Gopinath
Narendra Jadhav
Ashok Lahiri
Kirit S. Parikh
Y.V. Reddy
V.K. Sharma
R. Bannerji
Himadri Bhattacharya
Sujan Hajra
F.R. Joseph
Rakesh Mohan
Rajiv Ranjan
Ajay Shah
S.S. Tarapore

Latvia

Helmuts Ancans
Juris Kravalis
Zoja Medvedevskiha
Uldis Osis
Uldis Cerps
Andris Liepins
Einars Repse
Guntis Valujevs

Mexico

Pedro Aspe
Alfonso Guerra
David Madero Suarez
Miguel Mancera
Manuel Ramos Francia
Alberto Torres
Alejandro Werner
Samuel Alfaro
Javier Guzman
Javier Maldonado
Roberto Marino
Julio Santaella
Jesus Marcos Yacaman

Tunisia

Badreddine Barkia
Samir Brahimi
Habib Essafi
Samira Ghribi
Belhadj Jameleddine
Aloui Messaoud
Ali Ridha Ben Achour
Abdelhamid Triki
Negib Bouselmi
Habib El Montacer Sfar
Chedly Ezzaouia
Brahim Hajji
Golsom Jaziri
Mohamed Rekik
Monia Saadaoui

Other countries

Bryan Chapple
Marco Committeri
Ignazio Visco
Lorenzo Bini Smaghi
Giorgio Gomel
Vicenzo Zezza

Academics and other individuals

Jacques Ardant
Tahar Ben Marzouka
Mauricio Cardenas
William Cline
Christian Gardeweg
Laszlo Halpern
Faycal Lakhoua
Ashwini Mehra
Christian Moreno
Aditya Narain
Bandi Ram Prasad
Ricardo Rocha
Mohan Shenoi
Edwin Truman
John Williamson
Suman Bery
Slah E. Bouguerra
J.B. Chandradhara
Michael Dooley
Morris Goldstein
Joseph Joyce
Rohini Malkani
Abdelhamid Miladi
Michael Mussa
Indranil Pan
Shubhada Rao
Girts Rungainis
Kanhaiya Singh
Fabio Villegas Ramirez