CHAPTER

4 Ongoing Country Dialogue on Capital Account Issues

This chapter reviews the IMF's ongoing work in a sample of 14 countries for which outstanding issues on capital account liberalization and the temporary use of capital controls were documented during 2003–04. The countries are divided into two groups. The first group of nine countries were at different stages in the ongoing process of capital account liberalization during 2003–04, with some at an early stage and others at a relatively advanced stage. The second group of six countries (with Russia overlapping both groups) represent countries for which the IMF staff expressed a view on use of capital controls during 2003–04. The chapter first discusses the IMF's advice on capital account liberalization and then shifts to a discussion of how the IMF viewed the temporary use of capital controls.

Capital Account Liberalization

The evaluation reviewed the documents for nine countries that were moving toward greater capital account convertibility during 2003–04: China, India, the Islamic Republic of Iran, Kazakhstan, Libya, Morocco, Russia, South Africa, and Tunisia (Table 4.1). In addition, the evaluation looked at technical assistance reports for two other countries in the process of capital account liberalization: Lesotho and Tanzania. Not only were these countries at different stages of capital account openness, but they also differed in the way they interacted with the IMF during this period. Some had a more formally arranged dialogue on specific capital account liberalization issues with the IMF, while for others the IMF's inputs were limited to what it provided as part of routine Article IV consultation discussions. Seven of the nine countries reviewed here received an assessment of their financial systems under the FSAP. For each of these countries, we explain below the context in which advice on capital account liberalization was offered and the content of that advice.

In China, the IMF staff supported the country's gradual approach to capital account liberalization. The briefing paper for the 2003 Article IV consultation indicated that the staff's support for gradual liberalization was based on its view of "structural weaknesses in the financial sector." A staff note of March 2004 argued that capital account liberalization should come only after the establishment of a floating exchange rate system, whose introduction should be phased in order not to pose risks to the weak financial sector. The gradual introduction of exchange rate flexibility was viewed as helpful to create stronger incentives for developing the foreign exchange market and for currency risk management, which in turn could facilitate further capital account liberalization. Capital controls were seen to support this process. In this context, the importance of pursuing consistent policies was stressed. Clearly, in China, the staff's advice was intimately connected with its assessment of the financial sector.

Within the context of gradual liberalization (see Box 4.1), the Indian authorities considerably liberalized the capital account in 2002. The briefing paper for the 2003 Article IV consultation indicated that the mission welcomed these measures but expressed caution in proceeding with further significant opening, particularly in view of the large fiscal deficits and the still weak financial system. The back-to-office report suggested that, in this context, the mission reiterated the need for greater exchange rate flexibility, which would create incentives for risk hedging. Additional measures were taken in 2004 to liberalize the capital account, including easing resident firms' access to international capital markets, raising the ceiling on the stock of government bonds that could be held by foreign investors, and relaxing the limits on capital outflows by residents. During the 2004 Article IV consultation, the staff again expressed support for the government's gradual approach to capital account liberalization and stressed the importance of addressing fiscal and financial sector weaknesses before proceeding further. It thus appears that the IMF's advice on capital account liberalization in recent years was framed in its assessment of India's macroeconomic and structural conditions.

Direct investment flows into the Islamic Republic of Iran picked up significantly during 2002–04, in part as a response to a revision of the foreign direct invest-

Table 4.1. Policy Environments for Capital Account Liberalization in Selected Countries[1]

	1999	2000	2001	2002	2003	2004[2]
China	. . .	. . .	. . .	. . .	. . .	. . .
India[3]	. . .	FSAP	. . .	. . .	. . .	. . .
Iran, I.R. of	. . .	M, FSAP	. . .	. . .	TA	. . .
Kazakhstan	M	FSAP	. . .	TA	TA	FSAPu
Libya	. . .	. . .	. . .	. . .	. . .	. . .
Morocco	. . .	. . .	. . .	FSAP	. . .	. . .
Russia[3]	. . .	. . .	. . .	FSAP	. . .	. . .
South Africa[3]	. . .	IT, FSAP	FSAPu	. . .	. . .	. . .
Tunisia	. . .	. . .	FSAP	TA	. . .	. . .

Source: IMF database.

[1]A shaded area corresponds to a period in which the country had a floating exchange rate (including a managed float). M and IT indicate the introduction of a monetary policy anchor and inflation targeting, respectively. FSAP (FSAPu) indicates the year in which an assessment of the country's financial sector was made (or updated) under the Financial Sector Assessment Program. TA indicates the year in which the country received IMF technical assistance with regard to capital account liberalization issues.

[2]As of the second quarter.

[3]There was a monetary policy anchor in these countries during the whole period.

ment law. In supporting the authorities' gradual approach to capital account liberalization, the IMF staff emphasized the importance of financial sector reform and, in this context, encouraged the authorities to open the banking system to foreign strategic investors. The staff consistently pressed the authorities to tighten fiscal policy, increase exchange rate flexibility, and improve monetary policy instruments in order to deal better with the rising capital inflows. It did not suggest an introduction of inflation targeting at this time, however, because of the Islamic Republic of Iran's weak institutions. The briefing papers for both the 2003 and the 2004 Article IV consultations expressed the view that the speed of liberalization should be linked to progress in addressing weakness in the financial system and improving fiscal and monetary policy coordination. This clearly indicated that the staff's view of capital account liberalization was based on its assessment of the Islamic Republic of Iran's overall macroeconomic, financial sector, and institutional conditions.

In Kazakhstan, the authorities indicated their intention gradually to liberalize the capital account, with technical assistance from the IMF, beginning in 2003 (Box 4.2). The staff supported the authorities' cautious approach to capital account liberalization, but stressed the need for supporting policies, including establishing effective consolidated prudential supervision and implementing sound risk management practices. The briefing paper for the 2003 Article IV consultation noted that the staff was more concerned with the authorities' ability to manage risks in the face of large capital inflows than with the potential for capital flight, and stated its intention to emphasize the importance of building a sound financial system "regardless of the pace of liberalization." The staff's discussions with the authorities during 2003–04 focused on the need for greater exchange rate flexibility. On the monetary policy framework, however, the staff in reviewing departments expressed doubt about the appropriateness or feasibility of inflation targeting in a country highly dependent on oil revenues and at Kazakhstan's stage of institutional development. The briefing paper for the 2004 Article IV consultation noted the same concerns but stated the staff's intention to discuss "plans to accelerate capital account liberalization in light of de facto openness of the capital account and strong macroeconomic fundamentals." Given Kazakhstan's strong fiscal position, however, little concern was expressed about fiscal policy.

The Libyan authorities expressed in 2004 their intention to open up Libya's economy to the global market and to move forward with the implementation of structural reforms with IMF support. In the staff report for the 2004 Article IV consultation, the staff outlined a preferred sequence for structural reform consisting of two phases. The first phase, which is to last 1–12 months, involves adopting a medium-term budget framework, lifting sectoral credit restrictions, gradually liberalizing interest rates, and finalizing the plan to restructure public banks. The second phase, which is to last another 12–36 months, involves the building of institutions for an efficient market economy, including accelerating the process of creating a sound investment climate, restructuring or privatizing public enterprises and banks, and developing money markets and monetary policy instruments. The staff report then suggested that, over the medium term, "capital account convertibility could be considered" once the first two phases have been sufficiently imple-

Box 4.1. India

In the early 1990s, India made a historic departure from the inward-looking and interventionist policies of the past to embark on outward-looking reforms (Ahluwalia, 2002). Trade was considerably liberalized over time, and liberalization of FDI received considerable attention. The reforms of 1991 removed many of the restrictions on FDI inflows. In 1993, foreign institutional investors were also allowed to purchase shares of listed Indian companies, opening a window for portfolio investment. Recognizing the link between current and capital transactions, however, the authorities included certain safeguards in foreign exchange regulations when current account convertibility was established (Jadhav, 2003). These were: (1) surrender requirements; (2) need to present documentary evidence; and (3) indicative limits for representative current account transactions.[1]

Along with current account convertibility, capital account transactions expanded substantially, and India experienced a surge in capital inflows from the end of 1993 through 1994. In view of the expansion in capital flows, it became an urgent priority for the authorities to determine the systematic approach they should take toward the capital account. It was against the backdrop of these developments that, in March 1997, the Reserve Bank set up a Committee on Capital Account Convertibility in order to "chalk out the road map and time frame for achieving capital account convertibility" (Tarapore, 1998; see also Reserve Bank of India, 1997). The Committee's report, released in early June 1997, concluded that India was "ready for a cautious and phased move" toward capital account convertibility and outlined a three-year program to meet a set of certain preconditions covering fiscal discipline, price stability, and banking system soundness.

The Indian authorities for the most part accepted these preconditions and embarked on a gradual approach to greater capital account openness. In this approach, controls have been applied more strictly for outflows than for inflows; for residents than for nonresidents; for banks than for institutional investors; and for individuals than for corporations (Jadhav, 2003). FDI has been encouraged by progressively expanding both the automatic and the case-by-case routes. Access to external long-term borrowing has generally been limited to corporations and development financial institutions, and subject to annual ceilings, but the threshold for automatic approval has been raised over time. Short-term borrowing is strictly controlled, except for trade-related purposes. Liberalization of capital outflows has just begun.

Various internal documents suggest that the IMF staff consistently supported India's gradual approach to capital account liberalization. The staff during the 1995 Article IV consultation, for example, endorsed the maintenance of an annual limit on external commercial borrowing, while suggesting that sufficient flexibility be retained to allow adequate financing for high priority infrastructure projects. The 1996 mission stressed the importance of sequencing, arguing that priority should be given to FDI and equity investment and that liberalization of restrictions on short-term debt capital and outward investment should be gradual.[2] At the same time, it cautioned the authorities against the risks of rapid capital account liberalization in the absence of a strong fiscal position and a more robust financial sector. In April 1997, the staff prepared a comprehensive note on the pace and sequencing of capital account liberalization in support of the just-formed Committee on Capital Account Convertibility, stressing the need to sequence capital account liberalization with other structural and macroeconomic policy measures to contain potential risks. It also emphasized the importance of exchange rate flexibility and the need to have market-based instruments for monetary control. The briefing paper for the 1998 Article IV consultation expressed the staff view that contagion to India from the East Asian crisis had been limited, in part because of its relatively closed capital account.

The Executive Board broadly endorsed these staff views. There were, however, always dissenting voices, particularly before the East Asian crisis. At the Board meeting to discuss the 1996 Article IV consultation, some Directors remarked that a more rapid pace of capital account liberalization could be beneficial in encouraging fiscal consolidation and financial reforms. At the 1997 meeting, while welcoming the proposal put forward by the Committee on Capital Account Convertibility, some Directors argued that there was considerable scope to move forward at an early stage to liberalize further equity inflows and FDI. Such views became rarer following the East Asian crisis. The summing up of the 1998 Board meeting simply noted: "Directors encouraged the authorities to persevere with the phased opening of the capital account."

[1]These limits were raised over time.

[2]From the point of view of promoting fiscal discipline, the mission further advised against liberalizing restrictions on foreign investment in government securities, even if such a measure could foster the development of the government securities market.

mented. The IMF staff strongly urged the authorities to take advantage of the window of opportunity provided by favorable macroeconomic and external conditions (with a budget surplus, a current account surplus, and low inflation) to pursue the needed reforms rigorously.

In Morocco, the Article IV consultation discussions in both 2003 and 2004 focused on the need

Box 4.2. Technical Assistance

During the 1990s, the IMF staff provided a number of countries with technical assistance (TA) on issues broadly related to capital account liberalization. For example, an Executive Board paper prepared by MAE in July 1998 stated that "about one quarter" of "the 54 countries that received technical assistance on exchange rate systems" during 1994–97 "received assistance on capital account liberalization."[1] However, an examination of TA documents and staff's explanation in Board papers indicate that the TA advice was quite broad and general. It was often given to help build supporting institutions for an open capital account, including the reform of the foreign exchange system, improvements in monetary control, the strengthening of domestic financial systems, and the preparation of new foreign exchange legislation. It was in the context of these more general discussions that the staff in some cases encouraged the authorities to make progress in capital account liberalization.

More specific TA on sequencing capital account liberalization—including on specific measures of institution building and coordination with other reforms—was not given until the very end of the 1990s. The first country to request such technical assistance on sequencing was Tanzania (1999), followed by Kazakhstan (2002), Tunisia (2002), the Islamic Republic of Iran (2003), and Lesotho (2003). To date, only these five countries have formally requested IMF technical assistance on sequencing capital account liberalization. Of these, technical assistance to Tanzania and Lesotho was given in the context of an IMF-supported program (Lesotho also underwent an assessment of the financial system under the FSAP, which included advice on capital account liberalization).

In providing advice to these countries, the staff advocated a gradual approach to capital account liberalization. While the staff argued that the benefits of capital account liberalization were large, it also highlighted the risks that would arise in the absence of supporting policies and institutions, particularly a sound financial sector and effective prudential regulation. In terms of order of liberalization, the staff's consistent position was that long-term flows should be liberalized before short-term flows, and that the internationalization of domestic currency should be limited at an early stage of the liberalization process in order to retain greater monetary autonomy.

Among the five countries, only two—Kazakhstan and Tunisia—have completed the initial objectives of the TA received. In the case of Tanzania and the Islamic Republic of Iran, on the other hand, data limitations prevented the staff from providing constructive advice, except to suggest strengthened efforts at better data collection and monitoring capacity. As to Lesotho, its special monetary relationship with South Africa complicated the domestic strategy for capital account liberalization; the staff's recommendation was therefore limited to stressing the need to establish an appropriate environment for liberalization, including larger foreign exchange reserves, a more sound financial sector, and more prudent fiscal policy.

In Kazakhstan and Tunisia, the staff devised a multistage strategy of starting with measures that could be implemented immediately before proceeding to those that required prior institution building. At the same time, it advised the authorities to introduce an early warning system to monitor speculative capital flows as the first line of defense, and to enforce such a mechanism by pursuing appropriate exchange rate and monetary policies. In particular, the staff urged the central banks to increase exchange rate flexibility and to expand the menu of monetary policy instruments (e.g., repo facilities and government securities). In the case of Kazakhstan, the staff even listed use of capital controls to complement these measures, by stating that capital controls on short-term flows could be reinstated "under very exceptional circumstances" in which monetary or financial stability was threatened by large capital flows.[2]

[1]Monetary and Exchange Affairs Department, "Developments and Issues in the International Exchange and Payments System," SM/98/172, July 7, 1998.

[2]Monetary and Exchange Affairs Department, "Kazakhstan: Capital Account Liberalization and Financial Sector Supervision," March 2002.

for fiscal consolidation, "a new monetary policy framework," and financial sector restructuring as the essential prerequisites for moving ahead with capital account liberalization. The 2003 FSAP report noted that, while the banking system was in a reasonably good shape, removal of capital account restrictions could put adverse pressure on banks. The staff consistently argued that a pegged exchange rate could not be sustainable in the absence of restrictions on capital account transactions. It advised the authorities to consider exiting from the peg over the medium term when the preconditions for capital account liberalization have been achieved. Under the existing macroeconomic conditions, the staff advised against attempting a greater integration of the Moroccan economy with world financial markets.

In Russia, a new law to liberalize foreign exchange transactions was submitted to the Duma in early 2003. This included the immediate reduction of surrender requirements to 30 percent from 50 percent and the replacement of the approval requirements by reporting requirements for many capital account transactions. The proposals also included the possibility of introducing unremunerated reserve requirements to discourage short-term capital flows (see the section "Temporary Use of Capital Controls"). The briefing paper for the 2003 Article IV consultation indicated that the staff welcomed these steps, but expressed concern over the weak state of the financial system if the capital account was to be opened quickly. The back-to-office report stated that the mission had advised the authorities that capital account liberalization should be carefully phased and had recommended, under the circumstances, only an early removal of controls on outflows. Further, the briefing paper for the 2004 Article IV consultation recorded the staff's view that a sound banking system was all the more important because of "the relatively ambitious schedule for liberalization of capital controls."

In South Africa, the IMF staff for a long time took a very cautious attitude toward capital account liberalization, particularly in view of the central bank's net open position in the forward exchange market. During the 2003 Article IV consultation, the mission reiterated its support for the gradual approach but suggested that, in view of the possible impact on exchange rate volatility, completion of the process should wait until international reserves had been built up to more comfortable levels.[1] The open forward position of the central bank was eliminated in February 2004, after which the staff's position clearly changed. The 2004 Article IV consultation report indicated that, given the relatively healthy banking system, the strength of the South African rand presented "an opportune time to move ahead" in relaxing controls, particularly on resident companies. The mission continued to support the authorities' gradual approach to capital account liberalization, but expressed the view that the current strength of the rand could be exploited to move more quickly with the removal of remaining controls.

As noted in greater detail in Appendix 1, the Tunisian authorities have been pursuing gradual capital account liberalization since the mid-1990s. The briefing paper for the 2004 Article IV consultation noted that the staff would advise the authorities to establish a new monetary framework as a nominal anchor and to increase exchange rate flexibility gradually in their phased movement toward capital account convertibility. At the same time, the need for a sound banking system was repeatedly stressed. During the discussions, the staff urged the authorities to address banking sector weaknesses to support the gradual liberalization of the capital account.

[1]A similar view had been expressed by the 2000 FSAP report.

Temporary Use of Capital Controls

During 2003–04, use or possible use of capital controls was on the agenda for discussion between the IMF staff and the authorities of at least six countries: Bulgaria, Colombia, Croatia, Romania, Russia, and Venezuela. In four of these countries (Bulgaria, Croatia, Romania, and Russia), the subject of policy discussion was market-based controls on inflows. In Colombia, a minimum stay requirement was introduced to limit short-term capital flows, while the controls in Venezuela were targeted at outflows and initially introduced as part of a system of comprehensive exchange controls covering both current and capital account transactions. We first discuss the four cases of market-based controls, followed by a discussion of the other cases of administrative controls.

Market-based controls

Bulgaria experienced a rapid credit growth financed by external borrowing within the context of a currency board arrangement. In the briefing paper for the 2004 Article IV consultation in March, the staff expressed its intention to advise the authorities to implement additional measures to contain credit growth if necessary, including market-based controls on capital inflows as a last resort measure. A similar view was expressed in the briefing paper for a staff visit in September as well as in the subsequent briefing paper for a Stand-By review.

Financed by external borrowing, private credit expanded rapidly in Croatia. In view of the authorities' commitment to the use of the exchange rate as a nominal anchor,[2] the IMF staff in its November 2003 briefing paper for a Stand-By review argued for a tight monetary policy while suggesting that the authorities consider raising the marginal deposit requirements on banks' liabilities or introducing market-based controls on capital inflows, if necessary.[3] In the briefing paper for the 2004 Article IV consultation, the staff repeated the same point but emphasized that capital controls should remain a last-resort and "stop-gap" option to deal with large and unexpected capital inflows "until other policies adjust or inflows abate." In the event, in July 2004, the authorities introduced a marginal reserve requirement, which required banks to deposit 24 percent of net increases in their foreign liabilities into a special inter-

[2]Croatia had a managed float, but the authorities were reluctant to allow greater exchange rate flexibility because of their success with exchange rate-based stabilization in the previous years.

[3]A new foreign exchange law, in May 2003, gave the central bank additional authority to restrict capital inflows.

est-free account held with the central bank, for an unlimited time period.[4]

Romania has also experienced a rapid credit growth in recent years. Romania, however, maintains restrictions on short-term capital inflows. In this context, in the November 2003 briefing paper for a request for a Stand-By Arrangement,[5] the staff's position was that the authorities should continue to restrict the access of nonresidents to short-term domestic currency instruments until price stability was firmly achieved.[6] As things turned out, while the growth of domestic currency credit slowed in 2004, foreign currency credit steadily grew. In the briefing paper for the first Stand-By review, the staff expressed its intention to discuss the possibility of introducing greater exchange rate flexibility.[7] Effective August 2004, the authorities raised the reserve requirements on foreign exchange liabilities to 30 percent from 25 percent. A briefing paper of January 2005 indicated the staff's intention to advise the authorities to extend the reserve requirements on foreign currency liabilities to those with a residual maturity of more than two years as a way of creating scope for limited monetary easing.[8]

In Russia, the law establishing an unremunerated reserve requirement (URR) on both inflows and outflows took effect on July 1, 2004. At the time, the Russian authorities abolished most of the existing administrative controls on capital movements (see also the section "Capital Account Liberalization"). The URR thus served as a device to liberalize the capital account while retaining safeguards against excessive flows. The IMF staff and management views were somewhat mixed. During 2003, when the provisions of the law were being discussed against the background of steady capital inflows, the staff had written in a briefing paper that it intended to recommend as a policy response to this situation fiscal tightening and possibly introduction of additional temporary controls on inflows. To this, management suggested that the staff should focus on the measures currently proposed by the authorities without advocating any new contingent capital control measures.

When the law was enacted, the staff considered the introduction of the URR as a significant improvement over the previous system of administrative controls. At the same time, it viewed the large capital inflows as being caused largely by Russia's exchange rate policy[9] and considered that fiscal policy was too loose, which burdened monetary policy with the task of controlling inflationary pressure. Under these circumstances, the staff thought that there was no need to activate the URR if appropriate adjustment was made in exchange rate and macroeconomic policies. According to the back-to-office report for the 2004 Article IV consultation, the mission argued that while the URR was appropriate as a transitional measure from the system of permits and controls, its effect on capital inflows would be only temporary and its main effect would be to raise the cost of capital for small and medium-sized domestic borrowers. It then noted that controls should not be a substitute for tight fiscal policy and the adoption of a more flexible exchange rate policy. In the case of Russia, the staff's assessment of capital controls was clearly framed within its assessment of the authorities' macroeconomic strategy.[10]

Administrative controls

In Colombia, faced with a sharp and sustained appreciation of the Colombian peso, in December 2004 the authorities introduced a one-year stay requirement for inward portfolio investment by nonresidents, while allowing the profits from these investments to be repatriated freely. Interviews suggest that the IMF staff, while skeptical of the effectiveness of the capital control in arresting aggregate capital inflows (given its limited coverage), understood the political economy context in which it was introduced. The issue was not raised in negotiations for a Stand-By Arrangement in early 2005.

As explained in greater detail in Appendix 1, the Venezuelan authorities introduced "temporary" comprehensive foreign exchange controls in February 2003, covering both current and capital account transactions. While the staff recommended that all restrictions on current transactions be eliminated, it expressed its understanding that capital controls

[4]In February 2005, the authorities raised the deposit requirement to 30 percent from 24 percent; in March 2005, they announced that they would liberalize controls on capital outflows.

[5]The Stand-by Arrangement was to be treated as precautionary.

[6]Under EU accession agreements, the authorities had made a commitment to allow nonresidents to hold domestic currency deposits, tentatively from April 2005, and to liberalize the treasury bill market in 2007. In early 2004, however, the authorities made a decision to delay by 12 months the implementation of their commitment to this schedule of capital account liberalization under EU accession agreements. This decision was supported by the IMF staff.

[7]Romania abandoned the de facto (unannounced) crawling band in November 2004.

[8]This measure was taken in February 2005.

[9]From early 2003, the authorities allowed the ruble to appreciate against the U.S. dollar but temporarily discontinued this policy in early 2004. The ruble's appreciation resumed later in the year.

[10]There was a contradiction in the staff assessment at a different level. In 2003, the staff's position was that Russia should only gradually dismantle administrative controls on capital flows, in view of its weak banking system and weak enforcement of prudential norms. In 2004, however, the staff took a position against the URR which had been introduced to replace the administrative controls, while the macroeconomic situation had not materially changed from 2003.

Box 4.3. The IMF's "Integrated" Approach to Capital Account Liberalization

The IMF's "integrated" approach, developed from the late 1990s to the early 2000s and as outlined in Ishii and others (2002), was discussed in an Executive Board seminar in July 2001.[1] Although the Board has never endorsed it as official policy, it nonetheless appears to enjoy wide acceptance among the IMF staff as representing the institution's current thinking on capital account liberalization.

The approach is called "integrated" because it considers capital account liberalization as part of a comprehensive program of economic reforms in the macroeconomic policy framework, the domestic financial system, and prudential regulations. In terms of sequencing, the policy paper sets forth ten general principles: (1) capital account liberalization is best undertaken with sound macroeconomic policies; (2) those reforms that support macroeconomic stabilization should be given priority; (3) reforms that are operationally linked should be implemented together; (4) domestic financial reforms should be complemented by prudential regulation and financial restructuring; (5) sequencing should take account of the concomitant risks of various types of instruments; (6) pace should take account of conditions in the nonfinancial sector; (7) reforms that take time should be started early; (8) reforms need to take account of the effectiveness of the controls in place; (9) the pace, timing, and sequencing of liberalization need to take account of political and regional considerations; and (10) the arrangements for policy transparency and data disclosure should be adapted to support capital account opening (see Ishii and others, 2002, pp. 16–18).

The paper argues that these general principles on sequencing are to be applied in a specific instance in such a way as to reduce or better manage various types of credit, market, and liquidity risks that are typically magnified by cross-border transactions. In particular, the paper identifies a number of risks associated with different types of capital flows and suggests key policy measures to manage those risks. The operational "methodology" would first make a diagnosis of the existing regulations and institutions and, on the basis of this diagnosis, develop a three-stage plan for sequencing and coordinating capital account liberalization with other policies: (1) the first stage involves achieving a high degree of macroeconomic stability and developing markets and institutions, fostering good risk management by banks and other economic entities, and remedying the most important shortcomings in prudential regulation, with low-risk capital flows (such as FDI) being allowed to take place first; (2) the second stage entails a consolidation and deepening of the progress made in the first stage, with considerable further capital account liberalization taking place; and (3) in the third and final stage, all remaining capital controls are lifted, as macroeconomic and financial sector conditions have improved to the point where risks are effectively managed.

As a statement of general principles, few would disagree with the prudence and judiciousness of the integrated approach, and its emphasis on the need to tailor the pace and sequencing to particular country circumstances is welcome. However, while the paper states that "a gradual approach would not by itself guarantee an orderly liberalization," there is an unmistakable bias toward gradualism in this approach. More importantly, by emphasizing all of the potential interlinkages without any clear approach to identifying a hierarchy of risks, this approach may inadvertently create a false notion that a country can achieve full capital account convertibility only when it has fully developed all relevant markets, institutions, and regulatory frameworks. In this connection, a group of Asian experts have described the IMF's integrated approach as including "virtually every conceivable aspect of microeconomic, institutional, and macroeconomic policy possible," "unnecessarily complex," and "unoperational, as it lacks a clear hierarchy of priorities" (Asian Policy Forum, 2002). While this assessment is perhaps too severe, the principles, while giving some—albeit incomplete—indications on prioritization, do not provide criteria for judging what reforms are more critical than others overall. It is certainly true that such judgments would have to be made in the context of country-specific circumstances. However, because the approach identifies a complex set of risks and the requisite measures without clear criteria for balancing those risks, it has proven to be difficult to apply in practice.

[1] A further elaboration of this approach is given by Karacadag and others (2003).

might be necessary in the short run, mainly on capital outflows. In 2004, the staff advised a gradual approach to liberalize capital account restrictions, which had to be well sequenced and supported by macroeconomic and institutional reforms.

Assessment

In ongoing country work, the IMF staff has in general been accommodating of the authorities' policy choices when they have involved a gradual approach to capital account liberalization or temporary use of controls. In terms of capital account liberalization, the IMF staff was sometimes more cautious than the authorities (for example, in Russia in 2003) when their preferred policy was rapidly to liberalize the capital account. In most cases, it appears that the staff took a medium-term perspective and emphasized the importance of meeting certain preconditions, the most important of which were fiscal consolidation, a sound financial system, and the adoption of a floating exchange rate (usually with inflation targeting). The staff's generally cautious attitude toward capital account liberalization is in part a reflection of the new "integrated" approach (Box 4.3), which has been more fully applied in countries that have requested technical assistance from the IMF.

In terms of advice on temporary use of capital controls, the IMF staff seldom challenged the authorities' decision and even had a positive attitude toward market-based controls, if only as a temporary measure. There was, however, a slight difference in emphasis across countries. In some cases (as in Russia in 2004), the staff expressed a view quite forcefully that capital controls, no matter how useful they might be in the short run, could not be expected to be effective over time and should not be used as a substitute for appropriate adjustment in macroeconomic and exchange rate policies. In others (as in Colombia), the use of controls introduced by the authorities did not figure prominently in policy discussions. In still other cases (as in Bulgaria and Croatia), the staff recommended a market-based control as a last resort measure.

Clearly in some countries (for example, China and India), the IMF's advice on the sequencing of capital account liberalization was framed in its assessment of the countries' macroeconomic or financial sector conditions. In other cases (as in the Islamic Republic of Iran, Kazakhstan, and Libya), its cautious approach was conditioned by its assessment that the requisite institutional infrastructure for an open capital account was not yet in place. In one case (South Africa), on the other hand, a favorable assessment of the overall macroeconomic situation prompted the staff to suggest that the remaining controls could be removed quickly. In terms of temporary use of capital controls, the staff proposed market-based instruments in the form of marginal reserve requirements on banks' foreign exchange liabilities when it saw a limit to the effectiveness of conventional macroeconomic policy tools to deal with large capital inflows. These are indications that the staff is giving greater attention than previously to the overall economic policy environment and institutional constraints of the countries concerned in providing advice on capital account issues.