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Towards Capital Account Convertibility — Source link

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OECD DEVELOPMENT CENTRE

POLICY BRIEF No. 4

TOWARDS CAPITAL ACCOUNT CONVERTIBILITY

by

Bernhard Fischer and Helmut Reisen

- Advanced developing countries are increasingly encouraged to remove existing capital controls, but mixed experiences with capital account opening caution that reform must be carefully designed to increase efficiency and growth without compromising stability

- A gradual dismantling of capital controls is recommended, based on progress made in tax reform, exchange rate management, enforcement of bank competition and supervision, and solving domestic banks' bad-loan problems

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DEVELOPMENT CENTRE POLICY BRIEFS

In its research activities, the Development Centre aims to identifiy and analyse problems whose implications will be of concern in the near future to both Member and non-member countries of the OECD. The conclusions represent a contribution to the search for policies to deal with the issues involved.

The *Policy Briefs* deliver the research findings in a concise and accessible way. This series, with its wide, targeted and rapid distribution, is specifically intended for policy and decision makers in the fields concerned.

While most OECD countries have removed capital controls, these controls still persist even in the most advanced developing countries. This *Policy Brief* seeks to draw lessons from capital account opening in OECD countries, Latin America and Asia. Advocating a positive strategy for capital account liberalisation, this *Policy Brief* identifies impediments to liberalisation in developing countries and designs institutional and policy measures which should precede the abolition of various capital controls. The appropriate sequencing of capital account liberalisation is finally outlined.

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I. Introduction

The 1980s will be remembered as a decade of rapid integration of financial markets in the industrialised world. However, while most OECD countries have removed capital controls, these controls still persist even in the most advanced developing countries. Some of the advanced developing countries find themselves increasingly involved, albeit sometimes reluctantly, in a debate which urges them to remove existing capital restrictions without further delay. Since liberalisation failed in, for example, some of the Southern Cone economies of Latin America, views on capital account opening — a complex topic which does not lend itself to simple statements — have become increasingly diversified.

For those advanced developing countries considering future membership of OECD, the OECD Codes of Liberalisation may constitute another reason for ambivalence on financial opening. One of its first acts after the OECD was established in October 1961 was the adoption of the Code of Liberalisation of Current Invisible Operations and the Code of Liberalisation of Capital Movements. The Codes commit OECD Member countries to eliminate any restrictions between one another on the current invisible and capital movement operations listed in the Codes. Since 1989, the Codes cover all capital movements, including money-market and other short-term financial activities, as well as banking and financial services. The Codes now also contain provisions for "national treatment" of non-resident financial institutions. Although the "OECD Codes of liberalisation have the legal status of OECD decisions which are binding on all the members ... (they allow) ... reasonable scope for countries in different circumstances to move towards the ultimate objective in different ways and at varying speeds, taking account of the specific economic circumstances they face" (OECD, 1990, p. 13).

While the ultimate objective of financial reform is to increase efficiency and growth, the reform process must be carefully designed to achieve these results. This policy brief will explain:

— *why* it can be beneficial to liberalise capital movements;

— *when* different capital controls should be dismantled; and

— *how* the process of capital account liberalisation should be implemented.

The rationale for the liberalisation of capital movements (Section II.1) will be considered in the context of the mixed reform experiences in both OECD and non-OECD countries (II.2).

While there is general agreement on the desired results, the potential dangers during the opening process necessitate careful examination of the timing of reform (II.3). This policy brief identifies the most pertinent macroeconomic and financial sector constraints that must be removed to ensure the success of financial opening (III.1 and III.2). The impediments to capital account opening should not lead to delay in reform; rather, they should encourage the implementation of policies promoting financial openness.

The policy guidelines (IV.1-3) for financial openness will stress the need and suggest solutions for the:

— establishment of solid fiscal consolidation and prior stabilisation;

— problem of finding the right monetary-fiscal policy mix to dampen the loss of monetary autonomy, with emphasis on exchange rate management;

— building of primary and secondary securities markets for monetary policy implementation and financial stability;

— enforcing of domestic competition to foster allocative and operational efficiency within the financial sector;

— strengthening of prudential regulation and supervision, legal and accounting systems to cope with systemic risks of financial systems;

— restructuring of the domestic banking system to remove excessive bad loans, so enabling unfettered competition on level playing fields.

Most policy recommendations tend to assume that governments must liberalise all capital controls simultaneously. Instead, this policy brief recommends — based partly on OECD country experience — a sequential process of capital account liberalisation. At the outset, important distinctions of capital controls such as whether they impact on capital inflows or outflows, short-term or long-term (sustainable) flows, bank or non-bank relationships, have to be recognised. This policy brief identifies the best timing for each capital account liberalisation measure in view of progress made in the macroeconomic and domestic financial sector performance previously outlined. The aim is to avoid disruption and to ensure that financial opening achieves its ultimate objectives: to raise efficiency and growth without compromising stability.

II. Why Liberalise, and When

1. The rationale for opening the capital account

Dismantling capital controls is generally presumed to generate economic benefits through increased opportunities for intertemporal trade and cross-border portfolio diversification in both assets and liabilities, by imposing macroeconomic discipline on national governments, and from the rising costs and ineffectiveness of controls as economic development proceeds.

Economists argue that gains from intertemporal trade occur because time and liquidity preferences differ across countries. What does that mean? It means, for example, that ageing economies tend to post excess savings and hence a surplus in the balance of payments on current account which they will run down later (when old) in the form of net inflows. Or, a country which receives a temporary shock (such as bad harvests) will prefer to run a current account deficit to smooth consumption over time, instead of keeping consumption at all times equal to current income. Opening capital markets relieves such liquidity constraints.

Allowing portfolios in assets and liabilities to be diversified across borders enables a country's borrowers to find lower funding costs and its savers prospects for higher yields. Benefits from increased competition may be even more important than static gains from financial integration. If opening breaks oligopolistic market structures, competition among financial intermediaries will be intensified. Intermediation margins are squeezed, costs of funds to borrowers decrease and returns to lenders rise. In addition, transaction costs for non-financial market participants decrease due to the dissemination of financial innovation initially developed in other countries. The quality of financial assets increases as a result of the greater liquidity due to the development of deeper markets with well capitalised market participants. Homogenous pricing as well as better tailoring in terms of liquidity and special-purpose instruments takes place through separation, hedging and risk spreading. For example, a Korean investor, whose portfolio is confined to Korean assets runs more risk than one who can diversify into international assets. The counterpart is the foreign investor who places some of his portfolio in Korean assets. Since international trade in financial assets is largely a wholesale market, improved asset quality and risk diversification mainly benefit institutional investors, such as pension funds.

Capital controls have often been used to preserve monetary autonomy. With fully floating exchange rates, the nominal money supply can be controlled at any desired level by the central bank, and balance of payments adjustment is achieved, in the main, through exchange rate movements. Hence, national monetarists claim that the government can enjoy simultaneously both monetary independence and external balance, provided they accept a pure float of their currency. In such a world, exchange controls are obsolete. When the exchange rate is fixed in nominal terms and capital is freely mobile, monetary policy independence is lost. Those in favour of abolishing exchange controls argue that such policy independence is actually undesirable: inflationary policies become untenable with free capital flows because capital flows abroad and official foreign exchange reserves run dry. As a result, greater discipline is imposed on both monetary and fiscal policy. Fundamental imbalances are never inevitable and capital flight provides a clear signal that policies must be changed. Conversely, when controls over capital inflows are used to maintain an undervalued exchange rate, large current account surpluses and the buildup of foreign exchange reserves are likely to pose policy problems. Opening the capital account helps dampen inflationary pressures arising from any inability to sterilise excess liquidity. The abolition of capital outflow controls provides new opportunities to invest, thus raising the return to (lower) investment at home and (higher) investment abroad.

There is a close link between capital controls and industrial policy which is often implemented through government credit allocation. However, as countries move from an early to an advanced stage of development, the industrial-policy rationale for capital controls gradually fades away. As countries move up the product cycle towards more complex and sophisticated goods, governments are less likely to pick winners better than the market and more likely to saddle the domestic banking system with nonperforming loans.

On a more pragmatic note, disillusion over the effectiveness of existing capital controls may be another reason for dismantling them. Growing trade integration and the increased presence of multinational businesses produce closer financial links, opening up many ways of circumventing existing controls. Consequently, capital controls may well not produce the desired effects; yet their very existence might generate uncertainty about the possibility of further tightening and thus stem capital inflows and induce outflows beyond the level envisaged by the authorities.

2. Goodbye financial repression, hello financial crash?

In the late 1970s and early 1980s, several countries in Latin America (Argentina, Chile and Uruguay) and Asia (Indonesia and Malaysia) embarked on financial deregulation as part of a broader liberalisation strategy. The results differed so much in each case that predictions about the effects of financial liberalisation in countries where financial repression prevails are hardly possible. Experience with financial opening of small open OECD economies (Australia and New Zealand) also indicate mixed results.

Having followed development strategies that were heavily biased towards protectionism and a high degree of government intervention, Uruguay, Chile and Argentina moved towards liberalising their economies, including their capital accounts, in the 1970s. The liberalisation episode of the Southern Cone ended with capital flight, generalised loan defaults, banking crises, falling output and massive unemployment. Capital controls were reintroduced. The Southern Cone experience is highlighted by sustained interest differentials inducing excessive capital inflows, appreciating real exchange rates which exerted a major profit squeeze on the traded goods sector, as well as financial institution failure and anything but increased growth.

Real interest rates in the Southern Cone stayed extremely high after financial opening, reaching 40 per cent in Chile. Theory predicted that domestic liberalised interest rates would converge to world levels. Several micro- and macro-explanations have been advanced to explain sustained interest differentials. First, there was a substantial increase in demand for credit, triggered by an increase in perceived wealth due to overall liberalisation and improved private property rights. Second, domestic credit market segmentation prevented interest arbitrage between specialised lending institutions and across sectoral uses of funds: the spread between lending and borrowing rates was not reduced and reflected oligopolistic price behaviour. Third, lack of supervision and interlocking ownership between banks and firms led to the accumulation of bad loans; as a consequence, banks increased interest charges on viable borrowers to compensate for losses. Fourth, nonperforming loans caused further distress borrowing and added to credit demand. Fifth, because of increasingly overvalued currencies, foreign lenders and domestic residents eventually perceived greater exchange risk and demanded higher returns.

A central accompanying feature was a substantial real appreciation of the exchange rate following massive capital inflows in response to sustained interest differentials. Real exchange rates in the Southern Cone became overvalued once attempts were made to stabilise inflation expectations by pre-announcing future devaluation rates below current inflation rates (active crawling peg). Anchoring inflationary expectations to the exchange rate did not work: excessive capital inflows exceeded the sterilisation capacity of the central bank and loosened fiscal and wage discipline, hence eroding the very foundations on which the nominal anchor approach is built.

The highly publicised experiments by the Southern Cone countries with financial opening ended in financial crash. Other country experiences indicate, however, that financial opening can be beneficial, although it always involves substantial risks. Proponents of early capital account liberalisation point to the experiences of Malaysia and Indonesia.

Singapore's financial centre has traditionally been to Indonesia and Malaysia what the informal curb market is to so many developing countries. Hence, capital controls could not have been effective in these two countries. The Indonesian and Malaysian authorities simply had to cope with open capital accounts. Both countries have been successful in fostering growth, diversifying exports and keeping inflation at low levels. While open capital accounts have certainly imposed restraints on fiscal and monetary policies in both Indonesia and Malaysia, they imposed a healthy discipline, notably on government budgets, which maintained macroeconomic stability.

The sequencing of reform in Indonesia defies all orthodoxy established in the development literature. The capital account was opened first (1971), trade was gradually liberalised in the early 1980s, interest rates were freed in 1983 and institutional aspects of the financial system were deregulated in 1988. Only since then does one observe a pattern of events familiar from other reform episodes (in both OECD and non-OECD countries) which can be stylised as follows. "True" financial reform relieves the existing liquidity constraints for consumer and construction borrowing. Rising prices produce a positive wealth effect, further raising demand for credit. Eventually, the Central Bank worries about rising money supply and tries to stabilise. Interest rates rise and companies borrow offshore to avoid high interest rates at home. The country's current account deficit rises, but a rising country risk premium is not sufficient to curb offshore (distress) borrowing. If the Central Bank sustains its stabilisation programme, real activity slows down, unveiling the first business failures. Banks now find out that some of their assets are doubtful and that they are overexposed in some areas, typically in half-empty real estate. Only now does the government start to worry about bank supervision and prudential regulation.

It is worth noting some institutional explanations for Malaysia's and Indonesia's success in keeping inflation low and exchange rates competitive in spite of open capital markets. In the past, both governments controlled a large share of foreign exchange earnings from oil and gas exports. These could be used to counteract movements in the private capital account of the country. On the other hand, until recently the Indonesian private sector in particular lacked creditworthiness in offshore markets. Growing exports have allowed Indonesian companies to gain international credit standing while the government share in foreign exchange has been shrinking. These developments increased the need to manipulate the liquidity of the domestic banking system.

In such a situation, it helps if the LDC central bank commands a large share of domestic financial assets, either through state banks or through public enterprises if the latter run financial surpluses. Recently, the Indonesian authorities withdrew large amounts from the bank deposits of state-owned companies and used the funds to buy Bank Indonesia certificates. These quantity-oriented directives (as opposed to price incentives) to reduce domestic credit have been effective (though not efficient) in defending the Indonesian rupiah. In Malaysia, institutions such as the Employee Provident Fund (which holds 20 per cent of domestic financial assets) have also played a crucial role in the management of domestic liquidity. This did not prevent a sharp recession in the early 1980s from turning into a generalised financial crisis. These events galvanised the government, so that Malaysia now serves as a model for bank supervision and prudential regulation.

The evidence of financial fragility in the reforming countries does not necessarily imply that financial crises are the inevitable price of financial liberalisation. The causes of financial crises have been manifold, including severe external macroeconomic shocks, extremely high real interest rates, imprudent or fraudulent behaviour of bank management, inadequate regulation and supervision of financial institutions, deposit insurance, new entrants with no bank experience and concentration through conglomerate takeovers.

The fear of financial institution failure has slowed the process of financial opening in economies such as Korea and Taiwan. Their authorities take a cautious approach towards capital account opening, in line with the experience of many OECD countries. Indeed, the OECD countries' move towards financial market integration has been neither straightforward nor uniform. During the Bretton Woods period (up to 1973) with fixed but adjustable exchange rates, only a few countries such as the United States, Canada, Germany and Switzerland operated without significant capital controls. During the 1960s and 1970s, even liberal OECD countries continually resorted to capital controls. A well known example is the interest equalisation tax which the United States introduced in 1964 to deter capital outflows. Widespread measures to defend exchange rates and autonomous monetary policy during the Bretton Woods days included dual exchange rates, closed-circuit payments channels and restrictions on the overall foreign position of financial institutions. Long after the breakdown of the Bretton Woods system, a number of countries still introduced temporary measures to dampen capital inflows: for example, Japan, Germany and Switzerland in 1977 when speculative pressures developed against the US dollar and Spain in 1990 to dampen the rise of the Peso. It was only during the 1980s that the majority of OECD countries achieved comprehensive financial opening.

Financial opening of most OECD countries has been *gradual*. A speedy transition from rather restrictive to open financial regimes occurred only in the United Kingdom (1979), Australia (1983) and New Zealand (1984). These countries first tried to maintain monetary autonomy through a pure float of the exchange rate. They finally understood, however, that a regime of purely floating rates does not reduce economic interdependence with open capital markets; it only alters the form of interdependence. The stylised experience of financial opening, accompanied by a pure float of the exchange rate, is overshooting exchange rates following stabilisation which burdens export performance often with persistent effects. Japan, by contrast, represents the gradual approach to financial opening. Maintaining extensive restrictions when it joined the OECD in 1964, Japan gradually removed its capital controls during a period which lasted until 1980. First to go were restrictions on foreign direct investment, securities transactions and personal capital movements; then real estate operations, Japanese direct investments abroad and commercial lending were liberalised; finally, all remaining restrictions were removed in December 1980. The process of gradual financial opening was achieved in most European OECD countries in the second half of the 1980s, reflecting the efforts by the European Community to establish complete freedom of capital movements across EC member States.

The country experiences summarised here — in particular those in OECD and Asian countries — show that capital account opening does not inevitably lead to real exchange rate appreciation or to financial crash. Much depends on the timing of capital account opening relative to prerequisite institutional and policy measures.

3. Timing of reform

What are the indicators available to the policy maker with which to judge the appropriate moment for opening up the capital account? A major rationale for liberalising capital flows in the OECD areas was the move to generalised exchange rate floating in 1973. At that time, the (now discredited) majority view was that flexible exchange rates would buy economic independence. Indeed, a number of OECD countries dismantled most of the temporary restrictions (mostly on inflows) they had imposed during the final years of the Bretton Woods system. Those countries which maintained controls were increasingly disillusioned over their effectiveness.

In particular, the dismal performance of the Southern Cone countries has provided the policy makers in developing countries with more lessons on the appropriate timing of reform. There is little disagreement in the so-called "sequencing" literature (on how best to sequence different reform steps) that stabilisation, both fiscal and monetary, as well as domestic financial liberalisation should precede external liberalisation. High inflation reduces the information content of prices, so worsening the allocation of resources. Excess demand, resulting in unsustainable current account deficits or exchange rate fluctuations, reduces the credibility of liberalisation measures. The problem of weak government finances (often implying a weak tax effort in developing countries) has to be addressed first to obviate the need for domestic financial repression.

Many economists have been concerned about real exchange rate overshooting that may occur during the liberalisation of the capital account, and the risk of falling output in the manufacturing sector (deindustrialisation). Since capital markets in developing countries are far from perfect, temporary appreciation causes excessive investment (which is costly to reverse) in the nontraded sector.

Another objection to early capital account liberalisation is unrelated to exchange rates. As long as distortions in domestic commodity markets prevail, capital inflows into the distorted economy may be "immiserising". Thus the reduction of distortions should precede capital account liberalisation to prevent foreign capital from flowing into industries with high private but low social profitability. All these considerations lead to the mainstream advice that stabilisation, domestic price deregulation, financial sector reform and foreign trade liberalisation should all be well under way before the capital account is opened up.

One deficiency of the sequencing literature is that it is apt to discourage liberalisation and to ignore policies needed to prepare the ground for successful opening. The nature of the capital controls is rarely specified and no distinction is made between inflows and outflows of capital; it assumes that countries have to liberalise controls on both outflows and inflows simultaneously. A second reservation about the sequencing literature is that it stems from the experience of countries that liberalised at a time when funds were in abundant supply on the international capital markets. The sequencing literature also ignores the political economy of reform. Any move from a restricted to a liberalised financial regime implies a redistribution of income, rents and decision-making powers. Therefore it is likely to meet opposition from the affected groups, such as favoured borrowers under domestic credit rationing, companies entitled to subsidised foreign exchange and banks enjoying a comfortable life as a national monopolist.

This policy brief advocates a positive strategy for capital account liberalisation. The first step is to identify impediments to liberalisation which must first be removed. The next section distinguishes salient characteristics differentiating such impediments in advanced developing countries and OECD countries. This leads to the identification of institutional and policy measures which must precede reform in each group of countries. The final section outlines the appropriate sequencing of capital account liberalisation in the two country groups, giving special emphasis to the interaction between the prerequisite institutional and policy measures, on the one hand, and the sequential opening process on the other.

III. Impediments

1. Loss of macroeconomic autonomy

There are three characteristics typical of developing countries which may pose a particularly important impediment to the dismantling of capital controls on macroeconomic grounds. First, regular tax effort is often weak and replaced by the repression of the domestic financial system. Second, since poor domestic markets necessitate strong reliance on world demand, developing countries rely on capital controls to prevent undesired appreciation in the real exchange rate. Third, the shallowness of domestic securities markets for indirect monetary control and a fragile international credit standing complicate the smooth absorption of shocks. This section discusses each of the three impediments in turn.

First, tax ratios of developing countries tend to be much lower than those of industrial countries — less than half on average. Failure to broaden the tax base is the main cause of weak tax effort in most developing countries. Administrative and technical defects in tax assessment and collection prevent tax revenues from rising, and powerful interest groups often prevent tax legislation reforms aimed at abolishing tax holidays and exemptions. This also explains the widespread objection to multi- or bilateral tax treaties which would prevent the tax-free ownership of foreign assets.

Money creation and domestic financial repression result directly from weak government finances. Base money is an interest-free liability of the public sector which can finance real spending to the extent that the private sector holds domestic currency and the domestic banking system holds reserves with the central bank against its deposit liabilities. Removal of capital account controls reduces the seigniorage base. Interest-free minimum reserve requirements on demand and savings deposits are important in providing the government with direct access to bank credit. As long as the government relies on this source of finance, free entry of banks is resisted. If financial repression does not give the government enough resources at a stable price level, inflation develops and interacts with the reserve requirements to impose an "inflation tax" that gives the government more revenue. High inflation tends to shorten maturities of financial assets, to reduce the information content of relative prices and to stimulate capital flight. Capital controls may serve (for a while) to ameliorate these ills. An additional public finance aim of capital account controls is to accommodate the stock of government debt. Controls serve this purpose by maintaining captive buyers — like pension funds which cannot easily escape controls — at home, forced to buy government debt at below-market interest rates.

Second, capital controls can help the monetary authorities target monetary aggregates and, at the same time, the exchange rate. With increasing openness of the capital account, the effectiveness of monetary policy depends critically on the degree to which a flexible exchange rate is maintained. However, a country such as Korea, whose companies are structured to exploit scale economies on the world market on low profit margins, cannot afford to ignore the exchange rate. Real appreciation induced by capital inflows tends to bite quickly into low margins while the benefits of industrial upgrading are slow to emerge. Sterilised intervention by a central bank to counteract private capital flows and to manage the exchange rate can only be effective when the substitutability between foreign and domestic assets is sufficiently imperfect to replace the dismantled capital controls. In other words, only the existence of an exchange risk premium which causes deviations from uncovered interest parity can be exploited by managed floating to reconcile monetary and exchange rate targets when the capital account is open. Moreover, during the process of financial *opening*, the world's pent-up demand for a country's assets may easily exceed the sterilisation capacity of its central bank.

A further complication for exchange rate management arises when stabilisation does not precede financial opening. Inflation tends to be built into expectations, via implicit (or even explicit) indexation in goods and labour markets. This makes goods prices and labour costs sticky, while financial markets tend to be forward-looking. This asymmetry of response between the labour market and financial markets raises stabilisation costs by producing real exchange rate overshooting. Stabilising the economy while some capital controls (notably on borrowing abroad and portfolio flows) are still in place is the way to avoid burdening exchange-rate sensitive industries because stabilisation then only affects domestic demand. With a clean float of the exchange rate and no capital controls, the effectiveness of monetary policy is enhanced through both domestic demand (tight credit) and foreign demand (strong currency). But the effectiveness of monetary policy comes at an immediate and often persistent cost in terms of external competitiveness. Implying over-investment in non-traded and under-investment in traded goods sectors, as well as missed opportunities for diversifying away from unproductive product ranges, real exchange rate overvaluation exerts a strong negative impact on long-term growth performance.

Third, while OECD countries can spread the costs of external shocks and financial crises through time (witness the recent crisis of US savings and loan institutions), most developing countries do not have this option. They risk losing international creditworthiness, inhibiting consumption smoothing based on foreign borrowing (even Korea was on the brink of losing access to voluntary lending in 1985). And domestic securities markets are too small to absorb shocks through variations in domestic liquidity; liquidity shocks often end up in the central bank as hidden losses. Therefore, full financial opening requires the establishment and deepening of money and securities markets. Otherwise, while using indirect monetary tools for daily operations when everything goes well, the monetary authorities of the typical advanced developing country will tend to resort to direct credit rationing to combat capital flight and recession, implying the need for capital controls.

The failure to establish and deepen domestic money and securities markets is often the simple result of ongoing domestic financial repression. Interest rate deregulation, for example, threatens the soundness and safety of banks which have been saddled with non performing loans through government credit allocation. Interest regulation also inhibits the development of domestic money markets, bond markets, and secondary securities markets — all important ingredients for open market operations. Equally, when much central bank lending consists of the automatic rediscounting of subsidised loans made by the banking system, the discount window can only play a limited role in indirect monetary control. The undercapitalisation of domestic banks often inhibits changes in the required minimum reserve ratio as a monetary policy investment for influencing domestic liquidity.

2. Domestic financial sector constraints

Domestic financial markets in developing countries can be stylised as follows: credit markets are segmented, competition among banks is weak, joint ownership between the corporate sector and financial institutions predominates, asset quality in banks' balance sheets is low, and institutional arrangements for prudential supervision and regulation are inadequate. While some of these features may at times be shared by OECD financial markets, their joint existence in developing countries is likely to increase financial instability, particularly in the presence of macroeconomic disequilibria. Financial opening, unless carefully designed, would be unlikely to generate interest rate convergence towards world levels, to enforce competition within the banking sector and to improve allocational and operational efficiency. Financial stability can be threatened in such a situation through the increased possibility of financial institution failure, inasmuch as the entry of new foreign banks undermines the viability of domestic banks saddled with bad loans and foreign exchange exposure of domestic banks rises.

Even in countries which have deregulated domestic interest rates, credit market segmentation has persisted, discriminating against small and rural financial institutions. Since international capital markets are largely wholesale markets, access to foreign capital is restricted in practice to firms linked to principal banks and to the export sector. With these financial market imperfections, financial opening may result in a distorted relief of liquidity constraints and in misallocated resources. Moreover, the lack of information and difficulties in monitoring small and rural sectors as well as specialised institutions servicing specific sectors impede the interest rate convergence predicted in economic textbooks.

Restrictions on domestic and foreign bank entry, restrictions on foreign ownership of domestic financial institutions and government ownership of domestic banks typically produce an oligopolistic structure of the banking industry in developing countries. If capital account opening excludes the entry of foreign banks, high operating costs and large spreads between lending and borrowing rates are likely to persist until the impact of foreign competition begins to work. This will be felt particularly in high-inflation countries where banks exhibit very high spreads and cost ratios due mainly to the increased paper work caused by inflation and to the expanded branch network used to capture low-cost deposits. Moreover, privileged banks can borrow long-term funds cheaply abroad and relend short-term funds to domestic borrowers excluded from the wholesale world capital market at high interest rates. Again, the presence of cartelised or concentrated banks impedes the reduction in domestic lending costs in spite of financial opening.

The prevalence of joint ownership of financial, industrial and commercial firms in developing countries risks jeopardising the desired results of financial opening. Typically such holding companies or groups are not capable of adjusting quickly to a market-determined cost of credit which financial opening entails. Without prudential regulation and supervision, banks may extend credit to insolvent but related firms in order to protect their own capital. Increased interest rates, which often accompany financial opening, do not reduce demand for credit as expected, but stimulate "distress borrowing", particularly when interlocking ownership relations are prevalent. Interlocking ownership strengthens domestic lobbies against free entry of foreign banks enabling doubtful lending practices to continue.

Interlocking ownership and the resulting credit risk of excessive loan portfolio concentration leading to excessive nonperforming loans in the banking system can only be prevented by independent and tightly enforced prudential regulation and supervision. However, in contrast to the industrial countries, even the advanced developing countries rarely possess the necessary components, such as private credit rating services and uniform accounting standards and practices. The failure of appropriate supervision and regulation will become more serious, since financial opening implies stronger competition and brings financial institutions into areas of new risk, such as interest risk, foreign exchange risk and position risk in securities trading.

A critical impediment to financial opening, in particular to foreign bank entry, is the overhang of nonperforming loans in the domestic banking system. The size of the bad loan problem is easily underestimated. Data on bad debts generally do not include large but doubtful debtors (particularly those with interlocking ownership) for whom the banks are capitalising the arrears into new loans. Questionable accounting and supervisory practices also help to obscure the hidden losses. Inclusion of such nonperforming loans would often increase total bad debts significantly. While domestic interest liberalisation often makes the existence of doubtful loans apparent, it can also contribute to underestimating the extent of the problem. As deposits grow (thanks to higher interest rates), the debt-asset ratio seems stable or even to decline over time. Yet, the banking system may be based on bad debt, with the central bank providing the necessary reserves. Once the monetary authorities maintain a restrictive monetary stance, bankruptcies in the non-bank sector and subsequent financial institution failure will force the government to consolidate the whole banking system. The costs involved in the rescue operation of ailing banks impose a heavy burden on central banks and/or the government budget. The actual cost of the rescue depends — apart from the size of bad loan portfolios to be handled — on the type of rescue scheme and on the timing of intervention. Experience in the Southern Cone of Latin America in the early 1980s suggests that the costs of rescue operations are far from negligible. In Chile, for example, these costs incurred over the period 1982-85 have been estimated at 44 per cent of Chile's 1985 GDP.

IV. Policies towards Capital Account Convertibility

1. Macroeconomic management and market deepening

In the macroeconomic sphere, careful distinction has to be drawn between *opening* of the capital account and *openness*. Opening requires solid fiscal consolidation as a *sine qua non* for durable macroeconomic stability and the establishment of financial markets to provide instruments for cushioning the loss of monetary autonomy implied by opening. Neither area is amenable to a quick fix; both require institution building which takes time and commitment. Openness requires policy instruments to avoid both inflation and overvaluation, notably careful public debt and exchange rate management and new ways of monetary policy implementation, in part to foster interest rate convergence to world levels.

In the short term, government budget control is achieved by cuts in public outlays for consumption and investment, by eliminating subsidies and by privatisating or closing public enterprises running deficits. Long-term government budget control, however, usually needs supply-side tax reform, preferably by broadening the tax base, simplifying tax structures and setting tax rates at competitively low levels. Tax reform also has to compensate for the loss of explicit and implicit taxes on financial intermediation which is inevitable if dismantling outflow controls is not to produce capital flight.

The preparation, drafting and implementation of a tax reform takes time, if it is to be an economic and fiscal success. Tax reforms in developing countries have often failed because the period allowed for preparation and implementation was too short. Indonesia's tax reform, which took effect in 1983, has been a rare exception to widespread tax reform failure, in that a broadened tax base (away from oil) lowered tax rates. The simplified tax system succeeded in raising the tax ratio by several percentage points of GDP. The Indonesian tax reform plan allowed a two-year period for the necessary administrative and technical changes (modernisation of the accounting system, training of tax officials, and changes in administrative structure) before implementation. Since powerful interest groups often prevent legislative reforms aimed at abolishing tax holidays and exemptions, credible commitment to reform on the part of the authorities is absolutely essential. Jail sentences for tax fraud have to become part of the culture, as happened recently in Mexico.

Tax reform and government budget control do not immediately remove the heritage of past budget deficits, i.e., large stocks of public debt. Dismantling capital controls undermines the government's ability to keep interest rates on its domestic debt low if capital flight is to be avoided. Domestic banks are often very important captive lenders to their government and continued implicit taxation in this discriminatory form weakens their position in the face of new competition from foreign bank entry. Taxing domestic bond returns would help only if the tax did not raise bond yields required from the savers commensurately. With open capital markets, domestic savers would compare after-tax yields at home and abroad, and would simply demand higher gross yields on any domestic government debt they held. Much depends in practice on the extent to which financial opening precludes the option of forcing captive buyers to hold domestic government debt. To the extent that captive buyers are lost, more fiscal discipline will be needed to preserve (or restore) a government's creditworthiness and credibility on open financial markets. Just how much discipline will be required is difficult to say because of changing market perceptions and unstable lending conventions. A more modest approach is to determine the government budget balance needed to stabilise debt ratios and simultaneously to meet other macroeconomic targets. More fiscal discipline is needed to avoid inflation and rising debt ratios when the demand for base money is low, when GDP growth is low relative to real interest rates (when public debt is high relative to GDP) and when real depreciation raises the real value of net foreign debt. Only when real GDP growth exceeds real interest rates and accumulated debt is low relative to seigniorage can the government run a non-interest deficit without raising the debt ratio.

Sound government finances are also a precondition for a more activist fiscal policy for managing domestic demand. As experience in Singapore and Indonesia shows, manipulating the flow of domestic liquidity into the banking system (using government excess savings) partly frees the interest rate from demand management purposes so that it can be used for exchange rate management. This avoids the overcommitment of policy instruments — maintaining exchange rates at competitive levels and using interest rates to manage domestic demand — which cannot be reconciled in the absence of capital controls.

To absorb speculative shocks to domestic liquidity (varying levels of foreign exchange reserves in the monetary base), small open economies typically resort to credit rationing measures, implying the need for controls on short-term capital flows. To obviate the need for these capital controls, domestic money markets have to be established and deepened to equip the monetary authorities with market-based policy instruments. For example, to avoid inflation (through a boost in the reserve component of base money) and unwarranted exchange rate appreciation when a country becomes a popular destination for portfolio inflows, the most important instrument of exchange rate management will be sterilised intervention by the central bank on domestic money markets. A sterilised purchase of foreign currency leaves the money supply unchanged, because the central bank sells domestic assets of equal value to the private sector. As long as domestic securities markets are shallow (as indeed they still are even in advanced developing countries), a direct (contractionary) supply effect is felt much quicker than in OECD countries. The sectoral distribution of the domestic credit squeeze is sharper, working capital costs for unpreferred lenders in the residual curb markets rise faster, the liquidity position of financial markets is quickly affected (especially if instruments used, such as government bonds, carry below-market rates), and the resulting crowding out rapidly depresses the shallow corporate bond market.

The origin of domestic money markets is usually trading in short-term government bonds. Other money market instruments — interbank deposits, bankers' acceptances, certificates of deposits, and corporate bond issues — then develop. The reluctance of finance ministries to pay market rates on their debt is usually the biggest obstacle to the development of a domestic money market. Obviously, heavy reliance of government revenues on concessional borrowing and aid tends to create a shortage of government paper on the domestic market. Lax enforcement of corporate income taxes is another public finance impediment to establishing markets for both private bonds and equities. Evading corporate taxes by showing very low profits is incompatible with creating the investor confidence needed for successful equity and bond issues. Setting up independent credit rating agencies may overcome these obstacles to sound market judgments on private debt issues. Subsidised bank lending is another important obstacle to be removed in order to develop domestic money markets. The time needed to establish and deepen money markets depends crucially on how quickly domestic financial repression is overcome.

2. Bank competition and supervision

Credit market segmentation, lack of competition in the domestic banking sector and insufficient prudential regulation and supervision have complicated financial opening and frustrated intended outcomes. This policy brief identifies three policy areas to help achieve successful liberalisation.

Credit market segmentation can be overcome by abolishing restrictions imposed on banks and specialised financial institutions. Institutions should be allowed to extend their business over a wider range of financial activities; for example, industrial sector banks should be allowed to lend to other sectors. Bank management autonomy from government policy guidance can be fostered by making risk-averse management and cultures more profit oriented. Governments should stop restricting the creation of new financial instruments that provide a wider range of financial substitutes better tailored to the needs of clients.

Measures to stimulate competition among existing financial institutions include the abolition of interest ceilings, the abolition of subsidised loans to and credit floors for priority sectors, and the privatisation of government-owned financial institutions. An effective way to intensify competition is to encourage the establishment of direct securities markets. The success of privatisation is tied to the ability of privatised banks to of exercise independent credit judgments. Hence, banks must be able to protect their own capital position against loan losses forced upon them by past and ongoing government credit allocation. This cannot happen before the existing balance sheets are cleaned up by writing off bad loans and by injecting new capital (see next section for details).

New domestic as well as foreign bank entry should be allowed and encouraged, subject to adequate prudential requirements. New entrants should not be allowed to exacerbate the problem of interlocking ownership between financial, industrial and commercial sectors. In developing countries, powerful business interests are often in a position to finance new entrants into the domestic banking system. When domestic competition is a remote option, foreign competition on a level playing field becomes all the more important. A prerequisite for undistorted competition between domestic and foreign banks is to end domestic financial repression. For example, excessive minimum reserve requirements give a competitive edge to foreign banks which can more easily raise funds abroad that are not subject to these reserve requirements. Another obvious disadvantage for domestic banks arises from their obligation to buy government bonds and to make high-risk policy loans at below-market interest rates. Equal treatment also requires that the existing stock of nonperforming loans is largely consolidated before the refreshing winds of foreign competition start to blow. After the banks' balance sheets have been cleaned up, the authorities might consider the merger of some banks with the foreign entrants. This would help domestic banks to obtain an international reputation as well as open opportunities for diversifying into a broader portfolio.

Like macroeconomic stability, prudential regulation and supervision is *a sine qua non* for successful financial opening. Strong regulatory and supervisory policies are important to minimise moral hazard (including corruption, fraud and excessive risk taking) in the banking system, to ensure the viability and health of the banking industry and to make interest rate liberalisation more effective. The ultimate objective of prudential regulation and supervision of the banking sector is to achieve stability (and public confidence in such stability) of the financial system, as well as to manage systemic risk and to protect clients. As risks in the financial system increase as a result of more intensified competition, greater market volatility and uncertainty after deregulation and liberalisation, the authorities must strengthen prudential regulation and supervision practices, notably with respect to capital requirements and the range of banking supervision. In most developing countries financial institutions are significantly undercapitalised and the regulatory framework often lacks meaningful minimum capital adequacy guidelines. To provide a cushion against unexpected losses for the protection of depositors and to maintain general confidence in the banking system, appropriate capital adequacy requirements should be established. When bank accounting and management information systems are sound, it may be appropriate to adopt the risk-based capital adequacy guidelines formulated by the Basle Committee of Bank Supervisors. Concern over the stability of the banking system may induce the government to impose high capital requirements. However, this may deter entry and foster a rather concentrated banking structure.

It is important that prudential regulations embrace the whole spectrum of risks in the banking industry. Frequently, they just cover credit risk. Other risks such as default, liquidity and interest-rate risks should also be supervised and regulated. Effective supervision has to ensure that (i) the supervisors have sufficient autonomy from political interference; (ii) the overall regulatory framework is sound; (iii) the supervisors have adequate resources to hire, train and retain competent personnel as well as to acquire appropriate technology; (iv) the supervisors have sufficient authority to enforce their decisions; and (v) the system of supervision balances off-site supervision and on-site inspection. Among the institutional arrangements needed to achieve these aims are the establishment of "rules of the game" for commercial banks and other financial institutions, the creation of an early warning system and an intensified as well as standardised communications system between the Central Bank and the other financial institutions.

Improved prudential regulations can also help avoid the problem of nonperforming loans, the emergence of interlocking lending among related banks and firms as well as the concentration of loans to specific sectors and firms. In countries with such problems, full interest-rate liberalisation should not occur prior to their solution. Successful financial reform also depends on the healthy profitability of the private sector. If the macroeconomic environment is unstable and bank supervision is ineffective, interest-rate liberalisation should proceed gradually to avoid possible disruption to long-standing financial contracts that may otherwise be caused by a sudden removal of interest-rate regulations. Given the economies of scale in finance and the temptation to form economic groups based on banks, banking regulations must be devised to limit bank-ownership links, to assure a wide distribution of ownership and control of banks, and to limit loans to any single economic group or sector, especially if it is related to the bank itself.

Prudent regulation is also essential for the development of a healthy capital market. An adequate regulatory environment for securities markets should include systems of corporate disclosure, external auditing and the establishment of credit ratings. Furthermore, regulations on insider trading, price manipulations and other unfair transactions should already be effective before the opening of capital markets.

An adequate information system is an important, but frequently neglected, ingredient for financial system efficiency. Lack of complete and accurate information, the absence of adequate accounting standards and reluctance to make balance sheets and profit-and-loss accounts available to creditors probably constitute the most severe obstacles to financial development in many advanced developing countries. They require institutional reforms that include a strong supporting infrastructure to provide an adequate flow of information, credit appraisal and rating, and legal and accounting systems. Accounting and auditing are fundamental tools not only for managerial decision making but also for lender evaluation of credit risk. Information and disclosure requirements are particularly important for effective securities markets. Publicly available sources of accurate, reliable and honest information is still scarce in most developing countries.

Deregulation, technological advances, financial innovation and the globalisation of financial markets imply stronger competition and expose financial institutions to new areas of risk, including foreign exchange risk and position risk in securities trading. In economies with a long history of financial repression, the participating actors, be they banks or managers, borrowers, lenders or public servants, are not trained to deal with these risks. Financial opening has therefore to be accompanied by a further strengthening of bank supervision and surveillance of the financial system. At the same time banks' capacities to assess new types of risks associated with international financial markets have to be strengthened. While the supervising body should be concerned with the integrity of the financial system as a whole, the banks should receive special attention because they are the major depository of savings and have a central role in the payments and settlements systems.

3. Solving the bad-loan problem

The overhang of nonperforming loans in the domestic banking system represents a stumbling block to financial opening, in particular for free entry of foreign banks. In view of the limited number of successful restructuring experiments and because cross-country evidence on cost-effective ways to handle the problem is precarious, not many generalisations on the optimal approach to the bad loan problem can be made. However, some basic principles can be advanced.

The first step for a government committed to solving the bad-loan problem is to determine the precise extent of the damage sustained. The lack of data on nonperforming loans (reflecting the inadequacy of financial statements and accounting methods), the failure of the banks and authorities to recognise the size of the problem and to address it at an early stage exacerbates the cost of rescue schemes. Auditors, who must be independent from the parties (the current bank management, the nonperforming borrowers, the authorities involved in credit allocation) involved in the problem should identify and assess the magnitude of the problem as well as prepare rescue schemes.

In the second step, a choice has to be made whether to liquidate or to recapitalise the ailing financial institution. The decision depends on a country's legislative framework, the size and structure of the national banking system, the amount of loss not backed by the ailing bank's equity and by the weakness (or strength) of government finances. Recapitalisation can take various forms. One solution adopted by Chile in the 1980s is for the government to buy up the nonperforming loans by swapping them for government bonds. Another mechanism is to inject of new capital, either by existing or new shareholders or by the public authorities. A third solution is to merge the ailing domestic banks with healthy domestic or foreign corporations. Two recent examples of dealing with the bad loan problem are worth closer scrutiny.

Chile recapitalised its banking system by removing bad loans from the banks' portfolios and then providing a government-backed mechanism for injecting new capital. First, the government identified the damage by means of a special portfolio audit and then purchased the banks' bad loans with long-term government bonds carrying a yield above the banks' cost of funds. With the gradual elimination of problem loans and the positive net income flow from the government bonds, the banks' capital grew over time. Chile's approach placed a considerable burden on the government budget which had to absorb losses on the bad loans and transfer new resources to the banks through interest payments on the government bonds.

An alternative approach was chosen by Malaysia's authorities. Shareholders of ailing banks were required to inject as much capital as possible through a rights issue. The privately injected capital was supplemented by the Central Bank to meet the minimum adequacy requirements. The shares subscribed by the Central Bank were held under a buy-back scheme whereby those shareholders having participated in the rescue operation were allowed to buy back the unsubscribed shares at par plus holding costs. Malaysia's approach meant less government involvement than Chile's and more immediate restructuring of ailing banks (or liquidation if not enough private subscribers could be found).

Financial opening (rather than delay of reform which would preserve financial repression) provides other avenues for solving the nonperforming loan problem in the domestic banking system. Newly entering foreign banks are potential candidates for mergers with and recapitalisation of ailing domestic banks. The participation of foreign banks in the consolidation of the domestic banking system can be made part of the entry conditions. There are essentially two options available. The first is the direct merger of the foreign bank with the ailing domestic bank as a precondition for entry. The second option for foreign banks unwilling to participate directly in a rescue operation would be an auction procedure for a limited number of new bank licences. Those with the highest bid would be awarded the licence and the auction proceeds could be earmarked for the rehabilitation of the domestic banking system.

4. Phasing out capital controls

The variety of capital flows on which controls are often imposed equips the policy maker with an instrument which is often neglected in economic advice. He can sequence the process of capital account liberalisation itself. To develop a watertight blueprint that provides a guarantee against financial crises would be pretentious. Open financial systems always face the risk of crisis, but crisis has often been a forceful catalyst for reform. As this policy brief hopes to have made abundantly clear, however, pitfalls with financial opening and openness can and should be avoided by establishing durable macroeconomic stability and tightly enforced prudential regulation and bank supervision.

The instruments available to the policy maker are the various controls which are imposed on different capital flows. Flows must be identified as outflows or inflows, short-term or long-term, bank or non-bank flows. Major capital flows to be distinguished are borrowing and lending, buying and selling of securities, and foreign direct investment. Flows should also be distinguished by whether they are for real investment, financial investment or consumption. Foreign direct investment and trade-related finance, for example, are absolutely necessary for development at the earliest stage. Moreover, they are unlikely to cause trouble for macroeconomic management and financial sector stability. They are early candidates for liberalisation, while other capital flows confront the authorities with more complicated issues.

In view of the considerable time needed to establish sound government finances, to lay the ground (and the reputation) for durable macroeconomic stability as well as to implement institutions for prudential regulation and bank supervision, these steps should be undertaken without delay and should precede the dismantling of further capital controls. Fiscal consolidation is a necessary prerequisite for domestic financial liberalisation because regular tax revenues obviate the need for government to rely on the implicit taxation of the domestic financial intermediation. The solution of bad loan problems also requires strong government finances.

Even a tight fiscal and monetary stance will not immediately reduce inflation and inflationary expectations. Using the exchange rate regime (a nominal peg, an active crawl, or a pure float) would help speed up the disinflationary process with open capital markets, but the costs of misallocation involved by real overvaluation of the currency would seem too high to make this route advisable. Moreover, only when disinflation has succeeded in reducing nominal interest rates and raising real interest rates can the problems of domestic interest rate deregulation (which are apt to complicate the process of removing capital controls) be avoided. This is part of a strategy of domestic financial liberalisation which aims at avoiding sustained interest differentials with world financial centres.

Domestic interest rate deregulation removes both the main incentive for capital flight and the most important obstacle to the development of domestic money markets. Having succeeded in deepening financial markets offering undistorted assets for financial investment, controls on capital outflows can now be dismantled. Deregulating interest rates, reducing minimum reserve requirements and solving the bad loan problem pave the way for the free entry of foreign banks (which can simultaneously help solve the bad loan problem). When and if adequate prudential regulation is in place, the free entry of foreign banks is a realistic strategy for promoting competition in the banking sector.

At this stage of the liberalisation process, the major elements should be in place for dismantling controls on short-term capital inflows. With increased bank competition due to free bank entry, with credit market integration from competition, with banks exercising independent credit judgments after the solution of the bad loan problem, with prudential regulation preventing distress borrowing and with lowered interest rates resulting from stabilisation, the integration of short-term capital markets should now produce interest rates convergence to world levels. Deepened money markets now allow the authorities to absorb shocks to domestic liquidity in a smoother and less contractive way than before. This is the time to dismantle controls on short-term borrowing for banks and non-banks and to allow non-residents to operate freely in the domestic securities markets.

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