III

Capital Account Convertibility

The importance of international capital movements has long been recognized. First, international capital movements provide vital support to the multilateral trading system. This support comes not only in the form of short-term trade finance, but also in the transfer of financial resources from countries with current account surpluses to ones with current account deficits. Second, capital movements play a critical role in economic development. The impact in augmenting domestic savings is most obvious when the capital is transferred in the form of foreign direct investment, although by seeking the highest rates of risk-adjusted return, portfolio investment also has potentially significant benefits for economic growth. The impact of capital movements on monetary and exchange policies is also well recognized.

Global Trends Toward Decontrol of Capital Movements

Capital convertibility in this paper focuses on freedom from restrictions or taxes imposed directly on foreign exchange transactions in a way analogous to Article VIII, but on both inward and outward capital transfers. Under this approach, the following could be considered as exchange restrictions that apply to capital movements and that would give rise to exchange controls on capital account or discriminatory currency practices as related to capital transfers:

- Specific restrictions or requirements for approval to purchase foreign exchange for the purpose of acquiring assets abroad;
- Limits on the amount of foreign exchange that can be transferred for the purposes of investment abroad;
- Requirements, authorizations, or restrictions on the repatriation of capital or foreign exchange holdings; and
- Multiple currency practices that apply to the purchase or surrender of foreign exchange related to capital transfers.

As normally defined, the concept of capital convertibility does not cover prudential requirements or market standards.

Virtually all industrial countries have ended exchange controls on international capital movements, although restrictions remain on the underlying transactions with regard to foreign investments in some sectors and for some types of instruments. The liberalization of foreign exchange markets has gone hand in hand with domestic financial market liberalization, including increasingly indirect instruments of monetary control. By the end of 1994, all industrial country currencies became convertible for capital transfers, as Iceland removed remaining restrictions. It had long been thought that liberalizing capital required a strong external position, and a number of developing countries with structurally strong balance of payments positions had for some decades eliminated exchange controls on capital movements. In recent years, a number of countries with hitherto weak balance of payments have also fully eliminated the controls in the context of comprehensive stabilization and liberalization programs. Nevertheless, the majority of developing countries continue to restrict outflows of capital, usually with the aim of preserving scarce domestic savings by reducing capital flight.

Industrial Countries—Convertibility Nearly Completed

The end of the 1970s marked a turning point in industrial countries' use of exchange controls on capital movements, with the suspension of all exchange controls in 1979 by the United Kingdom and the dismantling of restrictions on capital movements in Japan beginning in 1980.[17] Australia dismantled most controls in 1983 and New Zealand in 1985. In 1986, the Netherlands removed its remaining restrictions, and France, by removing the *devise titre* market for residents' acquisition of securities abroad, achieved, along with Denmark, virtually full liberalization by 1989. Italy eliminated its compulsory deposit requirement, which discouraged various forms of investment abroad by residents; Austria and Ireland removed a substantial number of restrictions; and Sweden and Norway liberalized exchange controls in 1989 and

[17]During the 1980s, only Finland, France, Norway, and Spain felt it necessary to suspend temporarily the freedom of capital movements under the codes of liberalization of capital movements of the Organization for Economic Cooperation and Development (OECD). For a detailed discussion see *Liberalization of Capital Movements and Financial Services* (Paris: OECD, 1990).

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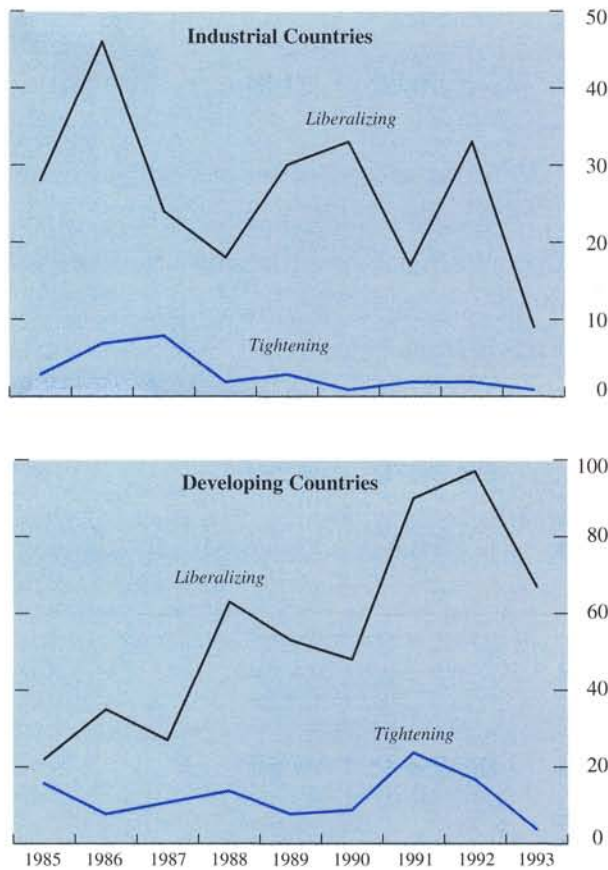
Chart 2. Capital Controls in Industrial and Developing Countries[1]
(Number of measures)



Source: IMF, AREAER (various issues).
[1]These trends do not purport to indicate the economic significance of the measures taken over the period; however, they provide an overall sense of whether member countries are taking more or less restrictive measures.

1990. In March 1990, Belgium and Luxembourg abolished the two-tier exchange rate system that they had operated jointly since 1951. Since 1985, industrial countries have implemented only a few measures tightening controls on capital (Chart 2).

During 1991–94, those industrial countries that continued to maintain exchange controls on capital movements moved to eliminate them. Extensive liberalizations were undertaken by Austria in 1991, by Finland in 1991–92, and by Greece, Iceland, Ireland, Norway, Portugal, Spain, and Sweden in 1992 and 1993. Ireland and Portugal had eliminated all exchange control restrictions by the beginning of 1993. In March 1993, Greece eliminated controls on various capital transactions, leaving only restrictions on loans and deposit accounts of less than one year's maturity; these were in turn abolished in May 1994. Iceland abolished all exchange controls on long-term capital movements at the beginning of 1994 and abolished all such controls on short-term movements by the end of 1994.

Apart from exchange controls, industrial countries have applied extensive controls to underlying capital transactions. The most restricted operation has been the admission of foreign securities on the domestic capital market, often reflecting concerns about the absorptive capacity of the domestic financial markets. Foreign bank credits and loans (both inflows and outflows) unrelated to international trade have also been more heavily restricted than other types of capital movements, possibly because of concerns that such flows were short term. However, commercial credits related to international trade have generally enjoyed a high degree of freedom. While foreign direct investment inflows were generally treated liberally, many countries screened such flows from the point of view of ownership and industrial structure and in some cases limited the areas of economic activity or the flows in the context of bilateral investment treaties. Foreign investments in real estate and the buying and selling of securities tended to be treated more restrictively than foreign direct investment inflows, for reasons that sometimes included concerns for investor protection.

A few industrial countries temporarily intensified restrictions on cross-border capital movements in 1992. In an effort to avert devaluations of their currencies within the exchange rate mechanism (ERM) of the European Monetary System (EMS), Ireland and Portugal temporarily imposed or intensified direct controls over short-term (speculative) capital flows. However, these controls were not generally considered to have been effective in reducing short-term speculative pressures and were rescinded by the end of 1992.

A broader concern is that capital controls are not only ineffective in controlling short-term speculative flows—the main rationale for Article VI in the original drafting of the IMF's Articles of Agreement—but that they may discourage longer-term portfolio and direct investment flows. The impact of capital account liberalization on the capital accounts of nine industrial countries has been reviewed (Australia, Denmark, France, Italy, Netherlands, New Zealand, Norway, Sweden, and United Kingdom). All of these countries recorded larger net foreign direct investment outflows either in the year of the liberalization of capital controls or in subsequent years. In France, Italy, and the Netherlands, the larger foreign direct investment outflows were more than offset by larger portfolio and other capital inflows.

Emerging Convertibility in Developing Countries

As a result of the liberalizations by industrial countries, the issue of capital account convertibility now affects almost exclusively developing countries.

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Countries such as the Middle East oil exporting countries and the offshore financial centers of Hong Kong and Singapore have maintained liberal capital accounts for many years. Indonesia eliminated its capital controls in 1970, and a number of small island economies and those countries that use the U.S. dollar, such as Liberia and Panama, have also maintained liberal exchange controls on capital movements. However, in most developing countries, outward capital movements have remained tightly controlled until relatively recently. Progress toward currency convertibility may have been slower in developing countries because of the more acute shortages of domestic savings and the greater perceived risk of capital flight, particularly in countries with below-market interest rates and generally unsound macro policies. The more recent progress reflected the adoption of more realistic exchange rates by this group of countries since the early 1980s and the development of more market-based instruments of monetary policy. The relationship to the exchange rate is a close one because exchange controls have typically been used in attempts to maintain an exchange rate that was viewed as overvalued by the market.

In countries not considering a general liberalization of capital controls, greater emphasis was given in the aftermath of the debt crisis to liberalizing foreign direct investment inflows.[18] To foster the investment flows, the World Bank's Multilateral Investment Guarantee Agency (MIGA) was formally constituted in April 1988.[19] On a bilateral level, the U.S. Government had announced in late 1981 that it would negotiate bilateral investment treaties (BITs) focused solely on investment. Unlike the previous bilateral treaties, which had established rights and obligations of nationals and companies, the BIT establishes rights and obligations with respect to specific forms of investment.[20]

A common manifestation of exchange controls is the requirement to repatriate foreign exchange earnings. Such requirements were in force at the end of 1993 in 128 IMF member countries, of which 38 have assumed the obligations of Article VIII. In 106 of the 128 countries, the repatriated proceeds, subject to full or partial requirements, had to be surrendered to the central bank or sold to domestic commercial banks within a specified period. However, significant liberalization of surrender requirements occurred during 1990–93. Surrender requirements were either abolished or their ratios reduced significantly in 41 countries, while on only 13 occasions did countries introduce surrender requirements or tighten existing requirements. Several of the countries that introduced surrender requirements during 1990–93 were former republics of the Soviet Union that had acceded to membership in the IMF and introduced their own currencies.

Among the reforming centrally planned economies and some other developing countries, there has been a practice of allowing residents to hold foreign exchange locally and exchange it freely for domestic currency—so-called internal convertibility. For example, Bulgaria, the former Czech and Slovak Federal Republic (nonenterprise holdings), Hungary, Poland, and Romania, as well as most countries of the former Soviet Union followed such policies. By providing residents with the opportunity to hold and invest in foreign currencies through the local banking systems, these policies may have helped to limit capital flight, although they also complicated monetary management. In addition, experiences in other countries with deposit accounts denominated in foreign currency have revealed the exposure risks of the implicit exchange rate guarantees for depositors and banks, and in some cases, for central banks.[21]

More recently, in the wake of the debt crisis and after experiencing substantial capital flight, developing countries appear to have shifted toward liberalization of their capital accounts. Many countries have liberalized exchange controls on capital movements and controls that directly affect the underlying capital transactions and have implemented relatively few tightening measures. The major developments during 1991–93 are as follows:

- Eleven developing countries—Argentina, Costa Rica, El Salvador, The Gambia, Grenada, Honduras, Jamaica, Peru, Philippines, Trinidad and Tobago, and Turkey—extensively liberalized their exchange controls on capital movements, mostly in the context of measures aimed at strengthening a weak external position. As a result of these and earlier changes made in similar circumstances, Argentina, Costa Rica, El Salvador, Grenada, Guyana, Indonesia, Jamaica,

[18]The IMF and the World Bank, mainly through the work of the Development Committee, have emphasized this aspect in recent documents. See *Determinants and Systemic Consequences of International Capital Flows*, IMF Occasional Paper No. 77 (Washington: IMF, 1991); Development Committee, *Development Issues: Presentations to the 46th Meeting of the Development Committee*, Development Committee Series No. 31 (Washington: World Bank, 1993); "Development Committee Communiqué" and "Group of 24 Communiqué," *IMF Survey*, May 17, 1993; and G.P. Pfeffermann and A. Madarassy, *Trends in Private Investment in Developing Countries, 1993: Statistics for 1970–91*, IFC Discussion Paper No. 16 (Washington: World Bank, December 1992).

[19]By the end of MIGA's first full financial year of operations, 69 preliminary applications for guarantee covering potential direct investments in 24 member developing countries and a broad range of sectors were registered with MIGA. In 1992–93, MIGA facilitated almost $2 billion in direct investment flows. Given the long-term nature of most direct investment, MIGA typically provides guarantees for 15 years.

[20]The prototype treaty reflects six principles of a liberal investment regime, including free transfers of foreign exchange for all capital and all returns on an investment; full convertibility is to apply to any investments covered by a BIT. As of July 7, 1993, 24 countries had signed BITs with the United States, including 10 countries from Eastern Europe or the former Soviet Union, of which 13 have come into force.

[21]See Section IV.

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Paraguay, Peru, and Trinidad and Tobago now have full currency convertibility.[22]

- Twenty-three developing countries liberalized controls on foreign direct investment inflows, and two developing countries (Jamaica and Korea) also liberalized their controls on foreign direct investment outflows.
- Twelve developing countries relaxed controls on long-term, and three on short-term, portfolio inflows. In most cases, the liberalization granted foreigners freedom to invest in local securities or increased residents' freedom to borrow abroad under exchange control regulations. In addition to the 11 developing countries that significantly liberalized exchange controls, another 5—Brazil, Colombia, Israel, Mali, and Mauritius—eased or eliminated exchange controls on short- and long-term portfolio outflows.
- None of the developing countries reported an intensification of restrictions on portfolio or direct investment outflows, and only three developing countries intensified controls on inflows—Brazil on foreign investments in real estate, Malaysia on residents' foreign borrowing, and Chile on short-term capital inflows.[23]
- Ten developing countries liberalized commercial banks' operations in foreign exchange. Measures included liberalization of banks' operations in foreign currencies (Algeria, Dominican Republic, Jordan, Sri Lanka, Tunisia, and Turkey), forward exchange transactions (India and Korea), and relaxation of surrender requirements (Chile and Jamaica). Six countries—Brazil, The Gambia, Indonesia, Paraguay, Philippines, and Solomon Islands—tightened controls on banks' foreign exchange operations. In all cases, the tightening applied to banks' open foreign currency positions and therefore appears to have been implemented primarily as a prudential measure rather than as an exchange control.
- Twenty-five developing countries liberalized exchange controls on resident domestic operations in foreign currency. One country, Honduras, simplified exchange arrangements that applied to capital transfers.

A preliminary review of developing country experiences with extensive liberalization of their capital accounts suggests a number of common features.

First, in all the cases, the extensive liberalization measures affecting the capital account were undertaken as part of a program of macroeconomic stabilization or structural adjustment. In five of the countries, these programs were supported by an IMF arrangement that included debt reschedulings. In some cases, the capital account liberalizations were part of a broader normalization of external financial relations.

Second, in all but one of the countries, the extensive liberalization of the capital account was in the context of a floating or managed floating exchange rate. The one country that pegged its exchange rate, Argentina, depreciated its exchange rate at the time that it liberalized its capital.

Third, extensive liberalization of the capital account either occurred simultaneously with liberalization of interest rates and movement to indirect instruments of monetary control—in the case of Guyana and Paraguay—or followed a broader liberalization of the domestic financial system, including freeing interest rates, eliminating credit controls, and introducing indirect instruments.[24] However, in no case was currency convertibility introduced without concurrent or earlier moves toward market interest rates.

Fourth, extensive liberalization of current account transactions occurred either before the liberalization of the capital account or at the same time. In the cases of Argentina, Jamaica, and the Philippines, the capital account liberalizations followed a number of years of reforms to eliminate multiple exchange rates and restrictions on current transactions. In Costa Rica, El Salvador, Paraguay, Peru, and Trinidad and Tobago, current and capital account transactions were liberalized virtually simultaneously.

Fifth, in all cases the liberalizations were accompanied by a strengthening of the overall balance of payments. In many, the balance of payments had begun to improve prior to the liberalizations, owing to the impact of stabilization measures and exchange rate adjustment that had preceded capital liberalization. Rather than weakening the macroeconomic adjustment, the elimination of capital controls appears to have helped sustain it. The impact of the liberalization on private capital flows varied from country to country. Total private inflows increased in Argentina, Costa Rica, Guyana, Indonesia, Jamaica, Paraguay, Peru, and Venezuela owing in part to increased domestic interest rates. In those countries where data are available, both foreign direct investment and portfolio inflows recorded improvement. In about half of the cases, the exchange rate appreciated as the net private capital account improved, raising issues for competitiveness of domestic industry and the current account of the balance of payments.

[22]A number of other countries have free or liberal capital systems, mainly those with structurally strong balance of payments positions. Venezuela has very recently reintroduced limitations on convertibility, and Mauritius has reportedly introduced capital convertibility.

[23]While there is some evidence that capital inflows in Chile slackened temporarily following the introduction of the controls, evasion of the controls also began quickly; see S. Schadler, M. Carkovic, A. Bennet, and R. Kahn, *Recent Experiences with Surges in Capital Inflows*, IMF Occasional Paper No. 108 (Washington: IMF, 1993).

[24]Interest rates in Indonesia and Venezuela were subject to regulation at the time of the full exchange system liberalization although interest rates had already been adjusted to market-determined levels.

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Evolution of the IMF's Policies on Capital Account Convertibility: A Brief History

The main arguments for controlling capital movements have included (1) that capital controls can improve welfare by increasing the volume of domestic investment and local tax revenue; (2) that the liberalization of the capital account should be sequenced relatively late in the reform process to allow for the elimination of distortions in the goods markets and the development of the necessary supporting institutional arrangements, including indirect monetary controls; (3) that additional freedom would be provided to domestic interest rate and exchange rate policy through capital controls; and (4) that controls on capital movements can help protect a country's reserves and improve its balance of payments. There have been a number of counterarguments, the most important of which is that the flows may tend to be destabilizing rather than stabilizing. The empirical outcome suggests that industrial countries have judged the macroeconomic efficiency costs of the controls to exceed the benefits, while in developing countries the main experience has been the problem of enforcing the controls, although recent liberalizations by these countries have also questioned the optimality of the controls.[25] Under the Bretton Woods system, controls were seen to make it more difficult for market participants to test the authorities' resolve to defend an exchange rate parity. However, the advent of floating exchange rates and the rapid integration of capital markets have shifted the balance of costs and benefits away from the controls.

The IMF's Articles of Agreement do not extend the institution's jurisdiction to exchange transactions and transfers related to the large body of international capital movements, and, as a result, members have been free to restrict capital transfers.[26] Rules and procedures governing capital movements have been established in other forums, including by the OECD,[27] and regional economic and monetary arrangements (such as the European Union (EU).[28] However, the obligations established in these forums apply to only part of the IMF's membership, mainly industrial countries.

Article VI, Section 3 of the IMF's Articles of Agreement provides that "members may exercise such controls as necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions. . . ." Article VI, Section 1 provides that the IMF may request a country that is using its general resources to impose controls to prevent these resources from being used to meet large or sustained outflows of capital.

The approach to convertibility in the IMF's Articles—that capital movements could legitimately be restricted, whereas current international payments should be free—can be traced to the Keynes and White plans for the creation of the IMF. In Keynes's view, in the context of the system of fixed but adjustable exchange rates that was envisaged, countries had to be able to protect themselves against short-term, speculative capital flight and transitory foreign inflows that reflected, in part, concerns about monetary independence.[29] However, the intention was not to interfere with legitimate long-term international investment. Although there is no distinction in the Articles of Agreement between short-term, speculative capital flows and productive investment flows, the language in Article I, by seeking to eliminate foreign

[25]P. Quirk, "Capital Account Convertibility: A New Model for Developing Countries," in *Frameworks for Monetary Stability*, ed. by T. Baliño and C. Cottarelli (Washington: IMF, 1994); D.J. Mathieson and L. Rojas-Suárez, *Liberalization of the Capital Account: Experiences and Issues*, IMF Occasional Paper No. 103 (Washington: IMF, 1993); N.U. Haque and P. Montiel, "Capital Mobility in Developing Countries—Some Empirical Tests," IMF Working Paper No. 90/117 (Washington: IMF, 1990); H. Faruqee, "Dynamic Capital Mobility in Pacific Basin Developing Countries: Estimates and Policy Implications," *Staff Papers*, International Monetary Fund, Vol. 39 (September 1992); J.E. Greene and P. Isard, *Currency Convertibility and the Transformation of Centrally Planned Economies*, IMF Occasional Paper No. 81 (Washington: IMF, 1991); M. Dooley, "Country-Specific Risk Premiums, Capital Flight and Net Investment Income Payments in Selective Developing Countries" (unpublished; Washington: IMF, 1986); M. Deppler and M. Williamson, "Capital Flight: Concepts, Measurement, and Issues," *Staff Studies for the World Economic Outlook* (Washington: IMF, 1987), pp. 39–58.

[26]See M. Guitián, "Capital Account Liberalization: Bringing Policy in Line with Reality," in *Capital Controls, Exchange Rates, and Monetary Policy in the World Economy*, ed. by S. Edwards (Cambridge, Mass.: Cambridge University Press, forthcoming, 1995).

[27]Following a 1989 amendment, the OECD codes generally apply to all underlying capital transactions. Prior to that amendment, most short-term capital movements, except for commercial credits and loans, were excluded from the codes. The codes were broadened to cover practically all types of capital movements, but they do not extend the obligations of members to all types of exchange transactions related to capital movements. For example, taxes on transfers, multiple currency practices applicable to capital transactions, and advance deposit requirements are not covered by the codes. The OECD membership includes all countries classified by the IMF as industrial countries as well as Turkey.

[28]Proposals to liberalize capital movements within the EU were first expressed in a 1983 initiative on financial integration. This was followed by a 1987 directive liberalizing certain long-term capital transactions and security market transactions between members. The list covered long-term credits relating to commercial transactions and the acquisition in the capital market of one member state of securities issued by a company in another member state. Shortly thereafter, the EU considered the elimination of all remaining capital controls as part of a plan to establish a European financial common market by 1992 in the context of a single market in which goods, services, capital, and individuals move freely. The conditions for such a market included not only elimination of capital controls, but also harmonization of bank supervision rules and taxes on capital yields.

[29]J.M. Keynes, "Proposals for an International Clearing Union," British Government White Paper Cmd. 6437, April 1943. For a discussion of this paper, see J.K. Horsefield (ed.), *The International Monetary Fund, 1945–1965: Twenty Years of Internation Monetary Cooperation, Vol. 3, Documents* (Washington: IMF, 1969).

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exchange restrictions that hamper the growth of world trade, may have been intended to suggest that the restrictions to be eliminated were not only those that applied directly to payments in respect of current international transactions, but also those that inhibited the flow of productive capital.[30]

White's plan[31] viewed exchange controls as an undesirable form of interference with trade and capital flows but noted that at times it may be in the best interests of a country to impose restrictions on movements of capital and goods. "The task . . . is not to prohibit instruments of control but to develop those measures of control . . . as will be most effective in obtaining the objectives of world-wide sustained prosperity." The background to these views was elaborated in the U.S. Treasury's commentary.[32]

[30]J. Gold, *International Capital Movements Under the Law of the International Monetary Fund*, IMF Pamphlet Series No. 21 (Washington: IMF, 1977).

[31]H.D. White, "Preliminary Draft Proposal for a United Nations Stabilization Fund and a Bank for Reconstruction and Development of the United and Associated Nations" (Mimeo; April 1942). For a discussion of this paper, see J.K. Horsefield (ed.), *International Monetary Fund, 1945–1965*.

[32]United States, Department of the Treasury, *The Bretton Woods Proposals: Questions and Answers on the Fund and the Bank*" (Washington: U.S. Treasury, 1944).

Gold notes that, although Article VI, Section 3 permitting members to exercise control over capital movements was not modified at the time of the second amendment of the Articles of Agreement, it has to be read in conjunction with the amendment to Article IV, Section 1, particularly Section (iii), calling for members to avoid manipulating exchange rates. The IMF's policies with regard to surveillance over exchange rates were amended consistent with the revisions to the Articles of Agreement on members' exchange rate policies. The policies established included the principle of looking into capital movements in the exercise of surveillance over exchange rates.[33]

[33]"The Fund shall consider the following developments as among those which might include the need for discussion with a member:

(iii) (*b*) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and

(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements."

Selected Decisions (Washington: IMF, 1993).

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