Capital Account Liberalization and the IMF

Barry Eichengreen and Michael Mussa

Capital account liberalization may have substantial benefits, but recent experience also underscores its risks. How should liberalization be sequenced and managed to ensure that the benefits dominate?

THE GROWTH of international financial transactions and international capital flows is one of the most far-reaching economic developments of the late twentieth century and one that is likely to extend into the early twenty-first century. Net flows to developing countries tripled, from roughly $50 billion a year in 1987–89 to more than $150 billion in 1995–97, before declining in the wake of the Asian crisis. Gross flows to developing countries and more generally have grown even more dramatically, rising by 1,200 percent between 1984–88 and 1989–94. An increasing number of IMF member countries have removed restrictions on capital account transactions in an effort to take advantage of the opportunities afforded by this remarkable rise in international financial flows.

But these developments, as the official community has acknowledged, raise important questions about the role of the IMF in financial liberalization. In September 1996, the Interim Committee (the committee of finance ministers and central bank governors that reviews IMF activities) requested the IMF Executive Board to analyze trends in international capital markets and examine possible changes to the IMF's Articles of Agreement so that the organization could better address the issues raised by the growth of international capital flows. In April 1997, the Interim Committee agreed that there would be benefits from amending the Articles to enable the IMF to promote the orderly liberalization of capital movements. It reiterated this position in a statement issued at the Annual Meetings of the World Bank and the IMF in Hong Kong SAR the following September.

This idea that the IMF should actively promote the liberalization of capital flows has not gone unchallenged. In the wake of the Asian crisis, which has seen sharp reversals of capital flows for a number of countries, officials and academics alike have questioned how desirable capital account liberalization is and whether it is advisable to vest the IMF with responsibility for promoting the orderly liberalization of capital flows.

Growth of capital flows

Powerful forces have driven the rapid growth of international capital flows. Prominent among these are

• the removal of statutory restrictions on capital account transactions, which is a concomitant of economic liberalization and deregulation in both industrial and developing countries;

• macroeconomic stabilization and policy reform in the developing world, which have created a growing pool of commercial issuers of debt instruments;

• the multilateralization of trade, which has encouraged international financial transactions designed to hedge exposure to currency and commercial risk; and

• the growth of derivative financial instruments—such as swaps, options, and futures—which has permitted international investors to assume some risks while limiting their exposure to others.

"It is important to recognize that financial innovation and liberalization are domestic, as well as international, phenomena."

Above all, technology has played a role. Revolutionary changes in information and communications technologies have transformed the financial services industry worldwide. Computer links enable investors to access information on asset prices at minimal cost on a real-time basis, while increased computer power enables them rapidly to calculate correlations among asset prices and between asset prices and other variables. Improvements in communications technologies enable investors to follow developments affecting foreign countries and companies much more efficiently. At the same time, new technologies make it increasingly difficult for governments to control either inward or outward international capital flows when they wish to do so. All this means that the liberalization of capital markets—and, with it, likely increases in the volume and the volatility of international capital flows—is an ongoing and, to some extent, irreversible process with far-reaching implications for the policies that governments will find it feasible and desirable to follow.

It is important to recognize that financial innovation and liberalization are domestic, as well as international, phenomena. Not only have restrictions on international financial transactions been relaxed, but regulations constraining the operation of domestic financial markets have been removed as countries have moved away from policies of financial repression. Domestic and international financial liberalization have generally gone hand in hand. Both respond to many of the same incentives and pressures.

Costs and benefits

Capital mobility has important benefits. In particular, it creates valuable opportunities for portfolio diversification, risk sharing, and intertemporal trade. By holding claims on—that is, lending to—foreign countries, households and firms can protect themselves against the effects of disturbances that impinge on the home country alone. Companies can protect themselves against cost and productivity shocks in their home countries by investing in branch plants in several countries. Capital mobility can thereby enable investors to achieve higher risk-adjusted rates of return. In turn, higher rates of return can encourage increases in saving and investment that deliver faster rates of growth.

At the same time, however, in a significant number of countries, financial liberalization, both domestic and international, appears to have been associated with costly financial crises. This association may be somewhat deceptive, given that financial crises are complex events with multiple causes and have occurred in less liberalized as well as more liberalized financial systems. Still, there have been enough cases where financial liberalization, including capital account liberalization, has played a significant role in crises to raise serious questions about whether and under what conditions such liberalization—particularly capital account liberalization—will be beneficial rather than harmful.

At the theoretical level, the controversy over the benefits of financial liberalization reflects diverging views on whether liberal financial markets bring about an efficient allocation of resources or are so distorted that the benefits they yield to direct participants too often are detrimental to the general welfare. Although a large "efficient markets" literature argues the first hypothesis, others insist that asymmetric information—a situation in which one party to a transaction has less information than the other—pervades financial markets, and that this greatly undermines their efficiency as mechanisms for allocating resources. There is, moreover, good reason to think that asymmetric information is particularly prevalent internationally, because geography and cultural distance complicate the acquisition of information. While the revolution in information and communications technologies—by reducing economic distance—has a profound effect in stimulating international financial transactions, it also leaves international markets—where information asymmetries are attenuated but not eliminated—particularly prone to the sharp investor reactions, unpredictable market movements, and financial crises that can occur when information is incomplete and financial markets behave erratically.

Role of policy

These developments make it critical to accompany financial liberalization with appropriate policies to limit excess volatility and related problems and to contain their potentially damaging effects. As has long been recognized, sound macroeconomic policies are essential for maintaining financial stability. A liberalized financial system is more demanding in this respect than a repressed system in which large financial imbalances may be suppressed for long periods. Recent experience, however, highlights the fact that macroeconomic stability, while necessary, is not sufficient for financial stability, which also requires sound financial sector policies.

The first line of defense against financial risk must be sound risk management by market participants themselves.

Banks and nonbank financial intermediaries must manage their balance-sheet risks prudently. Corporate borrowers must recognize and manage risks appropriately, which requires a strong system of corporate governance. Any tendency to take on excessive risk can be contained through market discipline facilitated by the adoption of best-practice accounting, auditing, and disclosure standards. An appropriate environment can be created by adopting policies that mandate proper accounting, auditing, and reporting rules and by taking care not to form a culture of implicit guarantees, so that lenders will face significant capital losses if they fail to assess credit risk prudently.

When risk-management techniques are not well developed, auditing and accounting practices leave much to be desired, and other distortions interfere with the ability of banks and others to manage risk, prudential regulation has an especially important role. The argument for prudential regulation is reinforced when central banks and governments backstop financial markets and provide a financial safety net that can encourage banks and other market participants to take on excessive risk. A century and more of experience points to the need, in most countries, for central banks to provide lender-of-last-resort services to prevent illiquid financial markets from seizing up in periods of general distress. This backstopping function, though essential, is also a source of moral hazard. The appropriate response for national authorities is rigorous prudential supervision and regulation combined with careful design of the lender-of-last-resort facility to limit the scope and incentives for financial market participants to take on excessive risk. More generally, pursuing policies to develop a financial system that relies less heavily on banks and other intermediaries and involves more direct risk bearing by ultimate investors can help to reduce the risks of costly crises and moral hazard.

Policies toward the capital account

The most serious problems with international capital movements occur when capital flows out of a country suddenly, precipitating a crisis. While sudden capital outflows can affect all forms of capital—debt, portfolio equity, and even direct and real estate investment—the macroeconomic consequences are particularly serious when they involve debt, especially sovereign debt and banking and financial system debt. Recent experience suggests, moreover, that short-term debt can pose special problems for maintaining financial stability.

"The most serious problems with international capital movements occur when capital flows out of a country suddenly, precipitating a crisis."

Like other risks, those posed by holdings of short-term debt are best controlled at the source. The sovereign can and should control its own borrowing. Banks and nonbank borrowers can and should avoid excessive dependence on short-term, foreign-currency-denominated debt. Banks should develop in-house models with which to manage risk, and the national authorities can refer to these when calculating risk weights for capital requirements (as recommended by the 1996 Market Risk Amendment to the Basle Capital Accord). But where risk-management techniques are underdeveloped or significant financial market distortions exist, there is an argument for additional prudential measures to identify and discourage excessive short-term, especially foreign-currency-denominated, borrowing that could jeopardize systemic stability.

Prudential regulations to contain the risks associated with capital flows have been designed and implemented in several ways. Many countries have addressed the risk to the stability of the banking system mainly by limiting banks' open net foreign currency positions (a net open position is the difference between unhedged foreign currency assets and liabilities, typically expressed as a percentage of the bank's capital base), while other countries (such as Chile and Colombia) have sought to discourage excessive foreign exposures of domestic corporations and banks by taxing essentially all short-term capital inflows. Some countries differentiate reserve requirements for banks according to both the residency and currency of denomination of deposits, while others differentiate according to currency of denomination but not residency.

There need not be a conflict between these policies and the objective of capital account liberalization, defined as freedom from prohibitions on transactions in the capital and financial accounts of the balance of payments. Indeed, the analogy with current account convertibility is direct. Article VIII of the IMF's Articles of Agreement, which defines current account convertibility as freedom from restrictions on the making of payments and transfers for current international transactions and makes this an explicit objective of IMF policy, does not proscribe the imposition of such price-based restrictions as import tariffs and taxes on underlying transactions. Correspondingly, capital account convertibility means the removal of foreign exchange and other controls, but not necessarily all tax-like instruments imposed on the underlying transactions, which need not be viewed as incompatible with the desirable goal of capital account liberalization.

Exchange rate flexibility can also help to discourage excessive reliance on short-term foreign borrowing. There have recently been a number of episodes in which an exchange rate peg has been seen by both lenders and borrowers as a link in a chain of implicit guarantees. In these circumstances, the high nominal interest rates characteristic of emerging markets can lead to very large short-term capital inflows. The exchange risk associated with greater nominal exchange rate flexibility can play a useful, if limited, role in moderating the volume of these short-term flows. It can encourage banks and firms to hedge their short-term foreign exposures, which insulates them from the destabilizing effects of unexpectedly large exchange rate movements. Greater exchange rate flexibility is no panacea, however; if introduced suddenly, without advance planning, and in a setting where banks and corporations have heavy debts denominated in foreign currency, its effects can be destabilizing. But if the authorities take advantage of a period of capital inflows to introduce greater flexibility, so that the exchange rate begins its more flexible life by strengthening, the beneficial effects are likely to dominate.

Sequencing

The most important point to recognize in the sequencing of capital market liberalization is the danger of precipitously removing restrictions on capital account transactions before major problems in the domestic financial system have been addressed. Among the problems under this heading are

- inadequate accounting, auditing, and disclosure practices in the financial and corporate sectors that weaken market discipline;
- implicit government guarantees that encourage excessive, unsustainable capital inflows; and
- inadequate prudential supervision and regulation of domestic financial institutions and markets, which open the way for corruption, connected lending, and gambling for redemption (namely, the pursuit of high-return but low-probability investments by institutions with low or negative net worth).

Countries in which these problems are severe but that suddenly and fully open the capital account run the risk of incurring a serious crisis. This implies that countries should liberalize the capital account gradually, at the same time as they make progress in eliminating these distortions.

In addition, liberalization that is limited to inflows to and through the banking system can pose considerable risks, even for a well-prepared and well-regulated system, if these flows are substantial. Liberalization of capital inflows should thus proceed on as broad a front as possible, beginning with direct investment inflows in order to avoid overloading channels more vulnerable to sudden reversals.

While foreign direct investment sometimes raises concerns about foreign ownership and control, there is considerable evidence that economic benefits, including the transfer of technology and efficient business practices, are associated with such investment. Volatility in flows of direct investment does not appear to generate the same acute problems of financial crises as do sharp reversals of debt flows. For this reason, liberalization of inward direct investment should generally be an attractive component of a broader program of liberalization. Such liberalization need not occur all at once; for countries that face the prospect of large surges of inward investment, a gradual approach may be advisable. It generally makes little difference if foreign investment is limited in some selected sectors of the economy. The financial sector, however, is an important exception. Opening domestic financial markets to participation by foreign (or multinational) financial institutions is an integral element of full capital market liberalization. There can be important benefits, especially for smaller countries, from the diversification of risks that is made possible when banks can operate across national boundaries.

Barry Eichengreen is John L. Simpson Professor of Economics and Political Science at the University of California, Berkeley. He was Senior Policy Advisor in the IMF's Research Department when the study on which this article is based was prepared.

Michael Mussa is Chief Economist and Economic Counsellor of the IMF and Director of its Research Department.

Conclusion

Capital account liberalization and financial liberalization more generally are inevitable for countries that wish to take advantage of the substantial benefits from participating in the open world economic system in today's age of modern information and communications technologies. As recent events have again demonstrated, however, financial liberalization also has its dangers. As liberalized systems afford opportunities for individuals, enterprises, and financial institutions to undertake greater and sometimes imprudent risks, they create the potential for systemic disturbances. There is no way to completely suppress these dangers other than through draconian financial repression, which is more damaging. But they can be limited considerably: sound macroeconomic policies to contain aggregate financial imbalances and to ameliorate the effects of financial disturbances can be combined with sound prudential policies designed to ensure proper private incentives for risk management, especially in the financial sector.

With these safeguards, orderly and properly sequenced capital account liberalization and the broader financial liberalization of which it is part are not only inevitable but clearly beneficial. F&D

This article summarizes the conclusions of a study prepared by an IMF staff team led by Messrs. Eichengreen and Mussa and comprising Giovanni Dell'Arricia, Enrica Detragiache, Gian Maria Milesi-Ferretti, and Andrew Tweedie. That longer study is published as IMF Occasional Paper 172, Capital Account Liberalization: Theoretical and Practical Aspects *(Washington, 1998).*