Chapter 2

International Experience With Capital Account Convertibility

Introduction

Over the past two decades several countries have undertaken measures to open the capital account of their balance of payments as part of a broader process of financial liberalisation and international economic integration. For most industrial countries, the evolution of CAC was relatively slow over the sixties and seventies. The process of liberalisation of the capital account gathered momentum in the eighties and early nineties contemporaneous with the globalisation of financial markets. The move to CAC in the industrial countries was facilitated by the introduction of the Code of Liberalisation of Capital Movements by the OECD and the Second Directive of Liberalisation of Capital Movements by the European Union. As of June 1995 all industrial countries had eliminated exchange controls on both capital inflows and outflows. For developing countries the evolution of CAC has been varied. Prior to the eighties a few of these countries began to liberalise the capital account, drawing strength from a healthy balance of payments position. In recent years, however, a number of developing countries have moved fairly rapidly to institute CAC despite initially weak macro economic conditions. While a majority of developing countries still retain capital controls *de jure, de facto* controls are less prevalent. As at the end of December, 1996 the IMF classified 57 countries as not having restrictions on payments for capital transactions (Annexure III.1). The IMF has conducted a survey of capital controls in 155 developing countries (Annexure III.2).

2.2 The Chapter draws heavily upon an extensive survey of the literature on various issues relating to CAC. The Committee examined theoretical research on conceptual issues in CAC as well as empirical and stylised assessments of country- specific experiences. The Committee also relied on reviews of the evolution of CAC in industrial and developing countries documented by international organisations as also information provided by central banks of countries covered in the Committee's survey. The Committee undertook a detailed study of the experiences of ten countries in instituting CAC. Of these, Argentina, Indonesia, Malaysia and New Zealand are classified by the IMF as not having restrictions on payments for capital transactions. The other six countries chosen by the Committee viz., Chile, Korea, Mexico, Thailand, the Philippines and South Africa have had varied experiences in pacing the liberalisation of capital transactions. The Committee felt that the on-going experience of these ten countries would be of relevance while attempting to chalk out a programme for India. This Chapter encapsulates the lessons emerging from the country experiences with CAC. Beginning, with the approach of international organisations to CAC, the Chapter examines the initial macro economic conditions in the selected countries at the time of the move to CAC. This is followed by an assessment of the preconditions for CAC emerging from the country experiences such as fiscal consolidation, liberalisation and reform of the financial system including the experience of banking crises, inflation control, exchange rate policy, balance of payments and the adequacy of reserves. Issues arising out of the timing and sequencing of CAC in the selected countries are then examined. An evaluation of the developments following liberalisation of the capital account is attempted and in the final section, the lessons emerging from the international experience are drawn.

The Approach of International Organisations to CAC

2.3 A number of international organisations have developed a framework for the liberalisation of capital transactions. While the Organisation for Economic Co-operation and Development (OECD) Codes of Liberalisation of Capital Movements and the European Union (EU) Directives have provided momentum to the process of instituting CAC in industrial countries, the IMF and regional organisations have also addressed CAC in the context of developing countries. A new impetus for liberalising capital accounts is expected to emerge from the World Trade Organisation (WTO) through agreements on trade in financial services and associated capital movements.

IMF

2.4 Until recently the IMF had not considered CAC in a comprehensive way but rather in the context of surveillance, the use of Fund resources and technical assistance. While it has recognised the freedom for countries to impose or maintain capital controls for balance of payments reasons and exchange rate stability, the IMF has welcomed steps to liberalise capital transactions where this was considered to be a crucial element of broader structural reforms. In the recent period, the IMF has taken a keen interest in issues relating to CAC in the context of the progressive integration of the world's capital markets. For industrial countries, the IMF has welcomed initiatives to achieve the OECD and EU Codes. For developing, countries, the IMF has adopted a case by case approach. While it has generally supported a gradual process with concerns expressed about the appropriateness of the large capital inflows which were not in relation to strong fundamentals, it has encouraged an acceleration of this process in some cases. Furthermore, the IMF has underscored the crucial importance of prudential regulations and supervision in the context of strengthening the intermediation by the financial system in the face of freer capital flows. In general, the IMF's treatment of CAC has been selective. It has generally eschewed urging rapid liberalisation but has encouraged some countries to liberalise capital restrictions (Central and Eastern Europe). Furthermore, there has been a general discouragement of the use or reimposition of capital controls, though, unlike under current account convertibility where reimposition of controls is not permitted, the IMF recognises the need for temporary reimposition of capital controls if the emerging situation so warrants.

2.5 While the surveillance mandate given to the IMF under Article IV of the Articles of Agreement enjoins the IMF to take into account the introduction or modification of restrictions/incentives relating to capital flows, it has not explicitly made recommendations or set performance criteria for CAC. Moreover, Article VI of the Articles of Agreements allows members the right to maintain capital controls. In the recent period, the IMF has been considering a proposal to amend the Articles of Agreement to incorporate capital account convertibility as one of the obligations of Fund membership. At the meeting of the Interim Committee of the Board of Governors of the IMF on April 28, 1997 it was agreed that the IMF's Articles should be amended to make the promotion of capital account liberalisation a specific purpose of the IMF and to give the IMF appropriate jurisdiction over capital movements; the scope of such jurisdiction would need to be carefully defined and sufficient flexibility should be allowed through transitional provisions and approval policies. The Interim Committee asked the Executive Board to continue its work in this area, with a view to making specific recommendations on key elements of an amendment by the time of the Committee's next meeting.

OECD

2.6 The OECD has adopted a non-compulsory approach towards capital account liberalisation, based on the uniformity of treatment under different national rules. The Code of Liberalisation of Capital Movements first adopted in December 1961 sets out the general aim that "members shall progressively abolish between one another, ... restrictions on movements of capital to the extent necessary for effective economic cooperation" (Article I a). Liberalisation refers to the abolition of official restrictions on the conclusion or execution of both transactions and transfers. The obligation to liberalise goes beyond restrictions on foreign exchange because the underlyinc, transactions should not be frustrated by legal or administrative regulations.

2.7 The OECD Codes have a legal status and are binding on all members. The Codes have been amended four times. As a result of the revision in 1989, the Codes now apply to all capital movements. They provide for transitional arrangements for retaining controls if a member's economic and financial situation does not justify liberalisation and if there are adverse developments in the balance of payments.

EU Directives

2.8 The EU assigned low priority to the liberalisation of capital movements. Capital controls were to be eliminated only to the extent necessary to ensure proper functioning of the Common Market. As a result, there was no commitment to liberalise capital movements. By the early eighties, only five of the member countries had abolished exchange controls

on capital movements. Over the eighties, emphasis on liberalising capital movements gained momentum in the context of financial integration within the EU. These efforts culminated in the ratification of the Single European Act in 1987. The Act specifically required all restrictions on capital movements be removed and explicitly recognised full liberalisation as a necessary condition for creation of the Common Market.

2.9 Three broad categories of capital movement have been identified : (i) capital operations including commercial credits, direct investments and other capital, (ii) operations in financial market securities and (iii) operations in money market instruments. Capital transactions have been ranked itito four Lists : List A and B contain operations to be unconditionally liberalised , the latter not necessarily at the official exchange rate; List C contains operations to be liberalised conditionally with a possibility of reintroduction of restrictions under certain conditions; List D contains operations in which no undertaking regarding liberalisation was made.

2.10 Liberalisation of capital movements in the EU has proceeded in two stages. In the first stage liberalisation of those capital transactions were undertaken which were most directly necessary for proper functioning of the Common Market. Transitional periods for compliance were allowed to some countries for a variety of reasons including adverse balance of payments positions, high external debt and less developed financial systems. A safeguard clause has been provided that permits reintroduction of controls if capital movements seriously endanger the member's exchange rate and monetary policy. The protective measures can be applied for up to six months.

WTO

2.11 The WTO was established in 1995 to provide a common institutional framework for conduct of trade relations among its members. Although the primary objective of the WTO is to ensure freedom to trade goods and services, the obligations under the General Agreement on Trade and Services proscribe certain restrictions on capital transactions which are associated with specific commitments intended to liberalise trade in services.

Initial Conditions at the Time of Move Towards CAC

2.12 In the assessment of the initial conditions prevalent in various countries on the eve of the move towards CAC, the Committee studied the experience of ten selected countries (hereafter referred to as the selected countries). These country experiences reveal wide variations in the macro economic conditions, the strength of the balance of payments and the progress of overall financial liberalisation and as such, any generalisation is difficult. Nevertheless, for purposes of presentation, the selected countries are grouped into two categories, namely, those which are considered to have instituted CAC by the IMF's classification (Argentina, Indonesia, Malaysia, New Zealand) and those which have made considerable progress in liberalising capital transactions (Chile, Mexico, the Philippines, South Africa, Korea and Thailand). Macro economic indicators for the selected countries for the period 1990-95 are set out in Annexures III.3 and III.4.

2.13 A common feature of the countries drawn from the IMF's classification is that the run up to CAC was set against the backdrop of inward looking economies pursuing import substitution and extensive government intervention.. High levels of tariffs and proliferation of non-tariff barriers provided protection to domestic industry and allowed inefficiencies to take root. Financial repression was widespread. Furthermore, with the exception of Argentina and Malaysia, countries in this group undertook CAC as part of an adjustment to crises in their economies involving reversal of growth, balance of payments difficulties and rise in external indebtedness.

2.14 At one end of the spectrum is Malaysia where strong initial conditions, embodied in high rates of growth, a relatively deep financial structure and a strong fiscal position were reversed in 1985 due to a sharp decline in exports and a collapse in asset prices which adversely affected the portfolios of the financial institutions. In the hostile investment climate which ensued, real GDP declined by 1 per cent, the current account deficit was at 3 per cent of GDP and external debt rose to 65 per cent of GDP. The crisis exposed deep

seated weaknesses in the financial system. A policy package including liberalisation of capital transactions in 1985-86 brought about a recovery in 1987.

2.15 In Argentina, CAC occurred in two phases i.e., in 1976-81 and in 1989-91. The process of CAC was interrupted by the reimposition of capital controls following real exchange rate appreciation, balance of payments deterioration, explosion in the external debt and capital flight. The first phase of CAC was undertaken though the economy was in severe macro economic disequilibrium with acute foreign exchange shortage, negative net foreign exchange reserves and hyper-inflation. The approach to the second phase of CAC starting in 1989 centred on fiscal discipline, inflation control, strengthening of the balance of payments embodied in a surplus in the current account and the build up of reserves; the final move to CAC was rapid with the setting up of the Currency Board and the Law of Convertibility in 1991.

2.16 New Zealand presents another shade of the spectrum where weak initial conditions were sought to be addressed by a rapid move to CAC. Prior to 1984, New Zealand was one of the slowest growing economies in the OECD with real GDP growth averaging less than 3 per cent. The inflation rate rose from 3 per cent in the mid sixties to an average of 14 per cent during 1975-84. Balance of payments difficulties had become chronic and a substantial accumulation of official debt had occurred prior to 1984. The oil shocks together with expansionary financial policies undermined macro economic stability. A combination of unsatisfactory fiscal and monetary management, a pegged exchange rate, persistent expectations of devaluations and frozen interest rates culminated in a severe foreign exchange crisis in 1984. The policy response was rapid and extensive including a large devaluation, removal of interest rate controls, price freeze and a swift process of abolition of exchange control. Policies were designed around an explicit inflation target under a legislated mandate and strong fiscal consolidation.

2.17 Indonesia's approach to CAC was unique in the sense that despite weak initial conditions it established an open capital account in the early seventies; moreover, the capital account was liberalised before the current account. It was not until the late eighties and early nineties that the domestic financial system was deregulated. On the eve of instituting CAC, import substitution and inward orientation had resulted in a continuous deterioration in the performance of the economy. Real GDP growth averaged around 2 per cent. The domestic saving rate had declined throughout and turned negative by 1966-67. Monetary policy played a subservient role in accommodating expanding fiscal deficits. Inflation was well above 100 per cent up to 1968. Simultaneously, the balance of payments deteriorated with the foreign exchange reserves being totally eroded. The stabilisation plan announced in 1966 brought forth immediate results. Thereafter, Indonesia benefited from the oil boom during the seventies, suffered downturn and adjustment during the eighties and entered a period of export led growth since 1989. CAC has acted as a catalyst in accelerating financial and real sector reforms and helped in maintaining confidence among foreign investors. At the same time, it exposed the Indonesian economy to the discipline of external pressures and brought to the fore the vulnerability of the financial sector.

2.18 The group of countries which do not qualify as being convertible on the capital account by the IMF's classification but have nevertheless progressed considerably in the liberalisation of capital transactions reveal heterogeneous initial conditions. There is the experience of Chile and Mexico where capital account liberalisation was undertaken first in the early seventies in an effort to restructure their economies with a distinct tilt towards outward orientation; the reform processes were therefore anchored on a fixed nominal exchange rate. In contrast, Thailand and the Philippines reveal typically Asian approaches to capital account liberalisation marked by efforts to concomitantly strengthen initial conditions.

2.19 Chile's experience with liberalisation of the capital account falls into two phases. Prior to the first phase (1974-8 1), there was a massive intervention of the State in economic activity. As a result, the fiscal deficit exploded and was monetised. By 1973, inflation reached an annual rate of 600 per cent, the public sector deficit was 25 per cent of GDP and international reserves were wiped out with a current account deficit of nearly 3 per cent of GDP. Real GDP had declined by a precipitous 6 percent in 1973. The first phase of relaxation of capital controls formed part of a rapid and drastic *laissez faire* type reform.

Price controls were lifted and subsidies eliminated. Quantitative restrictions on trade were removed and tariffs were cut. The liberalisation of capital controls brought about a surge in capital inflows. While growth resumed with the introduction of reforms, macro economic instability persisted and financial liberalisation proceeded at a fast pace without the provision of proper regulation and control. In 1978, the nominal exchange rate came to be used as an anchor for the price level in the face of runaway inflation. The result was a steep real effective exchange rate appreciation due to surges in private capital flows. The large overvaluation of the Peso led to a loss of credibility in the sustainability of the exchange rate and external debt. As real interest rates rose and a severe international recession set in, foreign capital inflows dried up. Domestic output dropped by nearly 15 per cent and unemployment rose to 20 per cent of the work force in 1981. Capital account liberalisation was reversed as part of the policy response to the debt crisis. Tight fiscal policy, privatisation, increases in tariffs, debt conversion and rebuilding of the financial system around an autonomous central bank formed the other elements of the policy strategy. The overall reform process led to resumption of real growth, decline in inflation, fiscal and external current account surpluses, decline in external debt and a steady increase in international reserves during the nineties.

2.20 Mexico's approach to liberalisation of capital account was in an environment of stable growth. Mexico had a tradition of a relatively open capital account from the mid fifties. Rapid industrialisation had occurred under protection. Sound macro economic policies, particularly prudent fiscal policy yielding low public sector deficits, cautious monetary policy keeping inflation moderate, wage indexation and a fixed exchange rate provided the environment for a strong growth of real GDP. Capital inflows mostly took the form of foreign direct investment, changing in favour of commercial credits in subsequent years. The oil boom of the seventies triggered expansionary fiscal policies which, in the context of a fixed exchange rate, led to the currency being overvalued. With the the current account deficit rising to nearly 8 per cent of GDP in 1976 and a *pari passu* increase in external debt to 50 per cent of GDP, there was sizeable capital flight which aggravated the crisis of 1982. Exchange controls were reimposed in 1982 and quantitative restrictions were applied to imports as part of the measures to counter insolvency. Since May 1989, liberalisation of capital account has been pursued selectively. Although capital inflows resumed, the weakness of the initial conditions, in particular, the overvaluation of the exchange rate remained camouflaged under surpluses in the budget and in the external current account, and these weaknesses were exposed in the crisis of 1994. Subsequently, Mexico has been able to make significant progress in financial sector reforms, fiscal consolidation and inflation control.

2.21 The experiences of Thailand and the Philippines are set in the Asian mould, wherein natural resources and a strategy of import substitution growth resulted in strong initial conditions.

2.22 Thailand's experience with capital account liberalisation began in the nineties from a position of distinct strength. In the late eighties, Thailand emerged as a rapidly industrialising economy with an exceptionally dynamic private sector. Fiscal deficits came down sharply and turned into surpluses. In the second half of the eighties, inflation declined to an average of 3 per cent although there was an upward drift to an average of 5 per cent in the first half of the nineties. Since 1986, the exchange rate was pegged to a basket of currencies of Thailand's major trading partners. A sustained investment boom powered double digit growth which strained against an infrastructure bottleneck. While the overall balance of payments has been in surplus due to strong capital flows, current account deficits have widened to accommodate the growth momentum and capital flows. In fact, the infrastructural constraint, increasing overvaluation due to the fixed exchange rate and the large current account deficit represent the weak elements in Thailand's approach to CAC.

2.23 In the Philippines, a comprehensive economic programme supported by an eighteen month arrangement with the IMF in 1986 resulted in a distinct strengthening of the initial conditions. The entrenchment of the economic recovery during 1987-90 enabled trade reform, deepening of the foreign exchange market and the introduction of the investment code for foreign investors, followed by selective financial sector reform in 1990. On the eve of removal of restrictions on capital transactions in 1992, however, real growth

faltered. The pursuit of'expansionary fiscal policies and accommodative monetary policy was reflected in a deterioration of the balance of payments. Inflation which had declined to below 1 per cent in 1985 soared to nearly 19 per cent in 1991 reflecting macro economic instability.

2.24 In the years following imposition of economic sanctions in 1985, the South African economy went into recession and suffered an acute external financing constraint which compelled it to run current account surpluses of the order of 5 per cent of GDP. This was a period of tight exchange controls for both current and capital transactions. South Africa operated a dual exchange rate system which created distortions and financial crisis and provided incentives for residents to take capital out of the country. On the eve of liberalisation of exchange control in 1994-95, a debt rescheduling agreement was put in place and the exchange rates were unified. The resumption of capital flows, however, brought considerable turmoil to the foreign exchange market, resulting in overvaluation, widening of the current account deficit, inertial inflation and a deterioration in the terms of trade. This led to the postponement of relaxation of restrictions on outflows to March 1997.

2.25 Over the past three decades, Korea has achieved remarkable success in strengthening initial conditions. Real growth has averaged little less than 9 per cent over the nineties with a large reliance on domestic savings rather than external resources. The investment rate has averaged 34 per cent over the last decade. The current account deficit has averaged around 1.5 per cent during the nineties with reserves being steadily built up to over US $ 32 billion by the end of 1995, equivalent of three months of imports. Inflation has trended downwards to around 4.5 per cent in 1995. Monetary policy is conducted within a framework of annual target ranges for the M2 aggregate. Fiscal conservatism helped in keeping government debt at relatively low levels. The exchange rate operates under a managed floating system with variations allowed within a range of the average rate of the previous day; this provided a strong boost to export competitiveness. Korea's approach to CAC has been clearly set out in a preannounced three stage programme encompassing complete liberalisation of capital and foreign exchange markets by 1998-99.

The Preconditions for CAC

2.26 A survey of the selected country experiences shows that while some countries such as Malaysia, Korea and Thailand approached the liberalisation of capital transactions by undertaking reforms to strengthen certain preconditions, others such as New Zealand, Mexico, Argentina, the Philippines and South Africa undertook capital account liberalisation as part of a broader package of reform and preferred to establish the preconditions simultaneously with the opening up of the capital account. For countries such as Chile and Indonesia where capital account liberalisation was initiated much before the institution of other reforms, the relatively open capital account acted as a catalyst for policy action towards entrenching the preconditions.

2.27 For all the selected countries, fiscal consolidation and financial sector reforms were assigned priority among the preconditions. While countries in the Asian region (Malaysia, Thailand, Indonesia, Korea and Philippines), New Zealand and South Africa placed emphasis on bringing down inflation to manageable levels either prior to or concomitantly with the opening up, countries in the Latin American region except Mexico undertook strong policy action to reduce inflation only after hyper-inflation emerged. Exchange rate management was in general structured around a stable nominal exchange rate. In countries where the exchange rate was used as an anti-inflationary tool, real appreciation was a significant factor in weakening the preconditions. Even for those countries which did not use the exchange rate as an anchor for inflation but attempted to maintain exchange rate stability through aggressive interventions and sterilisations in the face of capital inflows, incipient overvaluation was unavoidable. While Argentina, Thailand, Mexico and Malaysia allowed current account deficits to widen and accommodate strong capital flows as well as the pressure of domestic demand, other countries undertook policy action to strengthen the balance of payments. Capital flows coming in the wake of opening up were, in general, absorbed into the reserves which, except for South Africa, were built up to exceed the traditional norm of three months of import cover.

Fiscal Consolidation

2.28 Among the countries which undertook CAC early, Indonesia, given its history of large fiscal deficits, moved to fiscal consolidation fairly slowly. Throughout the seventies and eighties the fiscal deficit was expanded, buoyed first by the oil windfall and then by the need to provide fiscal stimulus to an economy in adjustment. It was not until 1989-93 that fiscal prudence in the form of cutting expenditures, widening the tax base, postponement of capital intensive projects and restraint on spending on state-owned enterprises began to yield low and manageable fiscal deficits.

2.29 In contrast, Chile which also began liberalising capital transactions in the early seventies, embarked upon fiscal consolidation almost simultaneously. By 1975, the fiscal deficit was cut to 1 per cent of GDP. Throughout the exchange rate based stabilisation period (1978-8 1) and the debt crisis of 1982 fiscal consolidation was well under way and tight fiscal policy was pursued to revive domestic saving although in the face of a relatively fixed exchange rate, this allowed for overvaluation to build. Since the recession of 1983, the public sector has generated surpluses consistently. Fiscal consolidation has provided the bedrock of the reform process in Chile in 1980 and in the nineties.

2.30 Malaysia represents the example of an economy with entrenched preconditions prior to the opening up of the capital account. Throughout the sixties and seventies a balanced budget and a net creditor position of the government vis-a-vis the central bank marked the conduct of fiscal policy. While expansionary fiscal policy was used to counter the weakening of external demand during the recession of the early eighties and the fiscal deficit rose to 17 per cent of GDP in 1982, this policy stand was soon reversed through expenditure restraint and retrenchment of public investment. The strong fiscal adjustment pursued since the mid-eighties contributed significantly to strengthening the preconditions. With the overall public sector finances turning into surplus in the nineties, prepayment of foreign debt and sterilisation of the monetary effects of capital inflows strengthened the measures of fiscal consolidation.

2.31 In Thailand,- the impulses for growth emanated from a dynamic private sector. Prudent fiscal management resulted in the public sector's fiscal deficit coming down from 4.5 per cent of GDP in the first half of the eighties to 2 per cent by 1986-87 and thereafter there were sustained surpluses. Fiscal adjustment supported the exchange rate policy and contributed to price stability.

2.32 For Argentina as well as Mexico, the failure of the first phase of capital account liberalisation was essentially attributable to the absence of fiscal discipline. In Mexico, the primary fiscal deficit was in excess of 5 per cent of GDP during the second half of the seventies and this was financed by external borrowings. Similarly, in Argentina the harmful effects of financial liberalisation in the first phase were accentuated by large fiscal deficits. The financing of the deficit was a fundamental source of inflationary pressure leading to huge real effective exchange rate appreciation and the abandoning in 1981 of the *tablita* (schedules of future exchange rate changes involving progressively slower depreciation and ending in a fixed exchange rate). In contrast, the second phase of liberalisation in both countries was characterised by a marked fiscal adjustment. In Mexico, the primary balance was transformed into a surplus of more than 7 per cent of GDP during 1988-90. In Argentina, the adoption of a Currency Board in 1991 ensured that the reform process centred on fiscal discipline. The fiscal accounts were kept in approximate balance throughout the first half of the nineties and this enabled the consolidation of public debt.

2.33 The fiscal situation in Korea was sound as a result of a long tradition of fiscal conservatism. Over the years, fiscal expenditure, which is relatively low by international standards, has been kept broadly in line with revenue, resulting in relatively low levels of government debt and high government savings. Taking into account its financial assets, the government has been a net creditor in recent years.

2.34 Against the backdrop of expansionary fiscal deficits, averaging 6 per cent in the early eighties in New Zealand, the reforms of fiscal policy have attracted international attention

on account of the innovative institutional approach, the comprehensiveness and vigour of adjustment and the success in achieving a turnaround from a difficult situation. The promulgation of the Public Finance Act in 1989 and the Fiscal Responsibility Act in 1994 established transparency and accountability, financial delegation and a measure of fiscal performance.

Financial Sector Liberalisation and Reform

2.35 Countries such as Chile, Argentina, Indonesia and Malaysia embarked upon liberalisation of the capital account in the seventies and eighties against the backdrop of financial repression. In Chile, interest rate ceilings were removed and non-banks were provided a relatively open market; however, financial intermediaries remained relatively restricted and were discriminated against in the ability to intermediate in foreign funds. As a result of real interest rates being high and an absence of supervisory competence many banks accumulated bad loans, eventually leading to the crisis of 1982. It was only in the aftermath of the crisis that prudential norms, deposit insurance and recapitalisation of the financial system was undertaken, supported by capital market reforms. Argentina's experience was similar in that financial repression in the form of ceilings on domestic interest rates and quantitative ceilings on external borrowings were removed simultaneously. In the absence of proper supervision and a lack of credibility in the Government's control of inflation, real interest rates rose leading to capital inflows, with real appreciation precipitating capital flight, loan defaults and banking crisis. While in the post 1991 phase, financial reforms have been implemented in consonance with the Currency Board, the vulnerability of the financial system remained a fundamental weakness in Argentina's approach to CAC. Mexico's experience was similar in that the neglect of financial sector reforms in the first phase of capital account liberalisation precipitated the crisis of 1982 . During 1982-88, there occurred financial di s intermediation reflecting the highly regulated financial system. Major financial sector reforms took place late in the process i.e. during 1989-1991, when it became apparent that the efficiency of the financial system lagged in the liberalisation process. Reserve requirements were eliminated in favour of open market operations and controls on interest rates and maturities were eliminated. Development banks and trust funds were restructured as rediscounting institutions to enhance their complementarity with commercial banks.

2.36 In Malaysia the reform process began with a relatively deep financial structure. Nevertheless, opening up of the capital account exposed weaknesses in the financial system, in particular, the health of the banking system and the inadequacy of the regulatory and supervisory framework. Since the late eighties, strengthening of the financial system became the focus of the process of reform. The supervisory role was strengthened, the capital base was increased and management of ailing institutions was reorganised. Simultaneously, interest rates were freed and non-performing assets in the banking system were reduced.

2.37 In Indonesia, the sequencing of financial liberalisation was unorthodox. While the capital account was opened in the early seventies, the financial sector remained repressed and interest rates were freed as late as 1983 and institutional aspects of the financial system were deregulated in 1988.

2.38 In Thailand and the Philippines, financial reforms have been undertaken at a late stage in the process of liberalisation i.e. in the nineties. The Bank of Thailand launched a three year Financial Reform Plan (1990-92) encompassing removal of interest rate ceilings, foreign exchange liberalisation, relaxation in financial institutions' portfolio management to a minimum level necessary to maintain stability and solvency of the financial system, expansion in the scope of the operation of financial institutions to allow greater competition in the supply of financial services, improvement in supervision and monitoring of financial institutions, development of financial instruments and improvement of the payments system to enhance its efficiency.

2.39 In the Philippines, financial reforms were selectively introduced in 1990. The system of taxation of financial transactions was reviewed with the objective of making it more conducive to private sector saving and investment. Priority was given to investment in the

energy sector, agriculture, rural development and social services. The process of reform of the public enterprises sector was carried forward with 130 of the 296 government corporations earmarked for disinvestment and the rest slated for restructuring in the form of mergers, absorption as line agencies or departments, conversion to private non-profit bodies or abolition. By the end of 1991, the government intended to complete the privatisation process. For the corporations that remained in the public sector, the government provided increased flexibility and operational autonomy while maintaining control over their overall financial and economic performance. The reform of the two major government financial institutions - the Philippine National Bank and the Development Bank of the Philippines was largely completed with their balance sheets restructured by transferring most of their non performing assets and related liabilities to the Asset Privatisation Trust and the national government, respectively. In the banking sector, the legal framework for bank supervision was strengthened while arrangements were improved for depositor protection by enlarging the role of the Philippine Deposit Insurance Corporations. To improve competition in the banking sector, the requirement to purchase government securities as a condition to open new branches was lifted, while restrictions on the opening of new branches in rural areas by specified institutions was removed.

2.40 Korea's financial system is layered with different degrees of regulation and control. While the Ministry of Finance and the Central Bank jointly regulate the commercial and specialised banks, financial intermediaries are less strictly regulated. Throughout the seventies, the government used its financial institutions, particularly the commercial and specialised banks, to direct credit at preferential rates to strategic industries such as steel, shipbuilding, machine tools and chemicals. At the beginning of the eighties, financial markets were deregulated to a limited extent and to meet these objectives new financial instruments were permitted. A new policy, announced in December 1988 envisaged a number of measures to deregulate interest rates. Actual deregulation has, however, fallen short of what was provided for in the 1988 plan. The regulation of the domestic financial sector is matched by extensive controls on capital account transactions, based on the Foreign Exchange Control Act of 1961.

Banking Crises

2.41 The incidence of banking crises in the eighties and nineties in developing countries has been significantly higher and far more severe than in preceding decades. Policy makers in emerging economies have discovered in the nineties that spots of vulnerability in the defence against speculative attacks on the exchange rate were not fiscal deficits but potential quasi-fiscal deficits lodged in banking systems. A factor behind the banking crises is the volatility in international interest rates and real exchange rates induced by private capital flows. Fluctuations in interest rates have affected the cost of borrowings for emerging markets and altered the relative attractiveness of investing in these markets. Real exchange rate volatility has caused currency and maturity mismatches, creating large losses for bank borrowers. In the Mexican crisis of 1994, the gap between Mexico's liquid banking liabilities and the stock of foreign exchange available to meet these liabilities in case of a run widened progressively. On the eve of the crisis, the dollar value of M2 was almost five times higher than the maximum value of international reserves the country had ever recorded. In Chile, the gap was one half of that of Mexico and thus it was much less vulnerable to attack. Furthermore, large capital inflows have led to lending booms and unsound financing during the expansionary phase. Accumulation of bad credit risks and swings in asset prices then cause the bubble to burst and intensify the crisis.

2.42 When domestic interest rates are high, the temptation for the banking system and bank customers to denominate debt in foreign currency is strong. Such strategies can come unstruck when a devaluation occurs. Between December 1993 and December 1994 the foreign currency denominated liabilities of Mexican banks more than doubled; at the same time the credit risk on these loans increased as interest rates rose and as economic activity fell.

2.43 In general, the banking crises are precipitated by inadequate preparation for financial liberalisation as witnessed in Chile, Indonesia and Mexico, with the government taking over the troubled banking system in 1982 in Mexico. Rapid rates of credit expansion

coincided with high interest rates in the wake of financial liberalisation. Lifting restrictions on bank lending and lower reserve requirements permitted banks to accommodate pent up demand for credit in liberalised sectors. Furthermore, new competition and easy access to offshore funds allowed banks to undertake risky activities. In the absence of strong supervisory and regulatory frameworks, therefore, financial liberalisation can trigger banking crises.

2.44 The exchange rate regime can enhance vulnerability to speculative attacks. In Latin America, the adoption of exchange rate based stabilisation plans often led to successes in cutting inflation but were accompanied by significant real exchange rate appreciation. Fixed exchange rates have been found to increase the fragility of the banking system to external shocks through balance of payments deficits, a decline in the money supply and higher domestic interest rates. Sharp appreciations in the real exchange rate have been shown to be a useful leading indicator of banking crises. By contrast, under flexible rates, external shocks are absorbed in a depreciation in the nominal exchange rate and a rise in the domestic price level. This has served to reduce the real value of bank assets and liabilities to a level more consistent with bank solvency. Countries which allowed some nominal exchange rate flexibility showed fewer signs of real exchange rate appreciation and were less vulnerable to Mexico type financial crises (Indonesia, Korea and Malaysia).

2.45 Discipline in monetary and fiscal policies help to contain volatility induced by capital flows and thereby forestall banking crises. A key issue in this regard is whether bank lending booms are discouraged more effectively by high reserve requirements or by binding capital constraints. Criticisms of reserve requirements are that they are costly to banks, they encourage substitution of other forms of liquidity for bank deposits and they put banks at competitive disadvantage *vis-a-vis* the rest of the financial system. The most marked change is found in the increasing strength of non banks, powered mostly by capital markets. In Malaysia, the Philippines and Thailand, market capitalisation in the equity market is already larger than the total domestic currency assets in the banking system. Similarly, in Korea, non bank financial intermediaries have more deposits and assets than the banks which are highly regulated. In most Asian and Latin American countries, however, reserve requirements were found to be important in keeping the size of the money multiplier under control during periods of capital surges (Argentina). On the other hand, binding capital constraints stand a better chance of preventing sharp declines in credit quality in the face of capital flows without penalising well run banks (Malaysia).

2.46 A critical issue is that of prudential regulations and their relationship with the sequencing of financial liberalisation. In the absence of freer entry of privatisation being accompanied by " fit and proper" tests, bad loans may be accumulated and bank insolvency may quickly result (Chile in the seventies). Bank supervision needs to be strengthened before liberalisation. Training of supervisors, better evaluation of risks are important elements of this dispensation. Supervisory shortcomings played an important role in overextension of Mexican banks in the crisis of 1994. The Mexican authorities have recently tightened accounting rules. Chile's banking law has several features conducive to good provisioning practice. Based on a current assessment of the repayment capacity of the borrower, the borrower's past record and the value of collateral, rather than 'past due' payments, banks are required to classify assets in four risk groups. Chile has also moved towards market accounting without accepting the principle as a formal requirement. Government auditors assign each bank a summary credit rating similar to CAMEL (Capital, Assets, Management, Earnings and Liquidity) ratings and publish it in major newspapers while private rating firms offer their appraisal twice a year. Inspectors from the Superintendency of Banks and Financial Institutions visit banks regularly and evaluate the risks of assets with the purpose of quantifying estimated losses and monitoring the impact of any non-provisioned losses on the solvency of banks. This information along with capital convergence ratios and credit risk ratings is published every quarter. A similar example is found in New Zealand where this information must be displayed prominently in every bank branch. Here, these norms were adopted in the wake of capital injection of almost one per cent of GDP in one state owned bank which accounted for one fourth of total banking assets. Argentina has recently required banks to be rated by credit rating agencies with ratings displayed with the interest rates offered for different types of deposits. Almost all developing countries assess the adequacy of the provisioning made by banks. While there is

wide variation across countries, the emerging economies with the highest share of non performing loans (Mexico, Indonesia) tend to display the lowest provisioning coverage with some notable exceptions (Argentina, Malaysia) where coverage in the face of a relatively high incidence of bad loans looks relatively strong (Indicators of the banking industry for various countries are set out in Annexures III.5, III.6 and III.7). A particularly relevant financial aspect of diversification is the role of foreign owned banks. With their access to external resources and concentration on tradeable sector lending foreign banks are able to weather a shock to the local economy better than domestic banks. In Chile and Malaysia, the share of foreign banks is high; in contrast, this share is low in Korea and Mexico.

2.47 In the Argentine banking crisis of the early eighties, the extent of non performing loans and the number of bankrupt firms had a direct impact on the profitability of the financial system. Loan portfolios were deteriorating just as financial institutions were experiencing a steep increase in liabilities, resulting in steep capital losses. Supervisors tended to focus on compliance of rules rather than on qualitative assessment of assets. Information with banks about their clients was limited and this allowed speculative and distress borrowing. Accounting was weak. Nine per cent of loans were non performing in 1980 and 30 per cent in 1985. Interest rate spreads rose sharply and credit and payments systems were disrupted. There was a substantial redistribution of wealth in favour of debtors. Emergency credit to banks rose to 100 percent of their reserve holding. The direct fiscal cost of bank rescue operations was 4 per cent of GDP. The money multiplier rose and became volatile, making monetary control difficult and interest rate controls were reintroduced. The crisis of 1989 had its roots in the large expansion in public spending. Banks lent heavily to the public sector. Public sector banks were weak and inefficient and had very high levels of employment. Monetary expansion was absorbed through remunerated reserve requirements and directed investments which repressed the banking system. In the inter-firm market, participants avoided these regulations and financial institutions tended to dedicate themselves entirely to inter-firm activity. The high level of risk in inter-firm operations led to solvency crises in some institutions when massive withdrawals of inter-firm deposits could not be met by the resources from counterpart loans. These institutions had to use the funds from the formal market to pay off inter-firm deposits and given the central bank's deposit insurance system, central bank aid to troubled institutions led to a large expansion in the monetary base. The realised losses of public sector banks were covered through capitalisation financed by monetary emissions from the central bank. This merely obscured the extent of bank losses. By December 1988, 206 financial institutions were under central bank liquidation. In 1995, reserve requirements were reduced to aid banks and the differential between buying and selling pesos was reduced to minimise transaction costs.

2.48 The banking crisis in Malaysia was brought about by the sharp deflation in the Malaysian economy in 1985-86 underscoring the dangers of overexpansion. Deficiencies in supervision and delay in recognising the magnitude of the portfolio problem of non bank financial intermediaries were chiefly to blame for the crisis. Banks were under family ownership and lacked internal controls. Sporadic bank runs throughout 1986 culminated in the failure of 24 deposit taking cooperatives with the potential danger of systemic failure. The authorities intervened in various banks, finance houses, deposit taking institutions and insurance companies. The response, on two fronts i.e., monetary and regulatory, was sometimes contradictory. Tighter monetary policy raised interest rates but also increased the level of non performing loans. As a consequence, some monetary and prudential deregulation had to be made: liquidity and reserve requirements were reduced during the crisis to aid bank profitability; deposit rates were freed to give banks greater flexibility although controls were reimposed from 1985-87. Minimum capital adequacy requirements were introduced, effectively raising the average capital - asset ratio from 7.4 per cent at the end of 1984 to 8.1 per cent at the end of 1987. Holdings of individuals in the equity of financial institutions were limited to 10 per cent and those of companies or cooperatives, to 20 per cent. Bank credit to single customers was restricted to 30 per cent of shareholders funds and lending to directors and staff were prohibited. The central bank took over ailing financial institutions or injected capital. A secondary mortgage market to aid bank liquidity was established. It also introduced guidelines on suspension of interest on non performing loans, provisioning and standardisation of accounting practices. Off site and on site monitoring, as well as statistical reporting was improved. Legal changes were promulgated

which improved the central bank's ability to intervene in an emergency. Non performing loans were estimated at 32 per cent of total loans in 1988.

2.49 In Chile, rapid expansion and excessive risk taking by domestic and foreign financial institutions in the form of large loans to under capitalised and highly indebted enterprises carried the seeds of the banking crisis of 1981-83. The Chilean crisis showed how long repressed financial markets fail to immediately adapt to liberalisation and cope with financial bubbles. Financial liberalisation occurred in a rapid and extensive manner under little supervisory control and in direct competition with the banking system. A large reliance on external saving served as the unsustainable cause of growth in financial assets. Furthermore, there was high concentration in the banking system and corporate ownership leading to the emergence of unregulated conglomorates which practised oligopoly pricing, extremely high real interest rates and moral hazard arising out of the government assuming private sector debt. The result was bankruptcy, a disruption of the payments system and capital flight with a depletion of international reserves. The initial response was in terms of reimposition of capital controls, devaluation and raising of tariffs. In 1980, a fuller response was in the form of risk classification, provisioning, bank classification under the CAMEL system, diversification of loans, rescheduling, a preferential exchange rate scheme for debt servicing and swap facilities, deposit insurance and recapitalisation. The authorities intervened in 4 banks and 4 non bank financial institutions in 1981. Nine other banks and 2 more non banks were subject to intervention in 1982-83 and many others were assisted. At the end of 1983, 19 per cent of loans were non performina. When the crisis ebbed and a new banking law was enacted in 1986, bank supervision adopted an orthodox stance and stiff requirements for market information were introduced. The law also attempted to eliminate the practice of related lending through a precise definition of the concept of client. A mechanism for bank rescues was set up alongside the tightening of capital adequacy standards and compliance sanctions. Banks were required to dispose of acquired assets quickly or to write them off fully. The scope of state deposit guarantees was scaled down to protect only small depositors.

2.50 In Indonesia, monetary expansion was rapid in the wake of liberalisation in 1988-89. Periodic surges in capital inflows complicated monetary management. High spreads led to disintermediation and growth in non bank financial institutions. Concerns over bank profitability affected authorities' willingness to raise domestic interest rates for monetary control. State banks were poorly managed and subject to political interference. Intragroup lending due to industrial ownership of private banks resulted in large exposures. Non performing loans which were concentrated in state owned banks, were over 25 per cent of total lending in 1993, but declined to 12 per cent in 1995. A large private bank was closed in 1992. The fiscal cost of recapitalisation of state banks and the conversion of the central bank's emergency credit into equity or subordinated debt was 2 per cent of GDP.

2.51 Non performing loans of deposit money banks rose significantly in the first half of the eighties in Korea, exceeding 7 per cent of total assets in 1986. The ratio of non performing loans declined subsequently to 0.9 per cent in 1995.

2.52 In the Philippines, the ratio of bank credit to GDP experienced a sustained increase before the crisis. The world recession hurt bank borrowers. The balance of payments crisis of 1983 spilled over onto the banking sector with the announcement of a moratorium on external debt repayments, provoking panic runs, capital flight and a depreciation in the exchange rate. Real interest rates rose and in the face of the recession there was a credit crunch. Growth suffered an absolute decline before the crisis. During the banking crisis of 1981-87, banks accounting for 1.6 per cent of banking system assets failed. Through the mid eighties, a number of institutions failed or were taken over by the government. Non performing assets of two state-owned institutions were transferred to a government agency. These assets accounted for nearly 30 per cent of total banking assets. Thirteen per cent of GDP was contributed as bank equity. Inflation rose sharply and interest rate controls were reimposed. Emergency credit provisions conflicted with monetary policy and inflation soared. Segregation of commercial and development banks weakened competition as did high concentration at state banks and financial groups. There were weak accounting practices and portfolios were not diversified. Commercial ownership through groups were high, leading to connected lending, interlocking ownership and excessive risks. In 1986, 19

per cent of loans were non performing.

2.53 By 1985, banks in South Africa built up large short-term foreign liabilities owing to high domestic interest rates. When foreign banks reduced their exposure, the exchange rate depreciation and liquidity squeeze on banks resulted in an official moratorium on external repayments.

2.54 During the crisis of 1983-85 in Thailand, credit grew rapidly . Bank spreads fell and there was a sharp decline in loans from finance companies to the private sector. The central bank had to sterilise its liquidity assistance. Nevertheless, monetary policy was eased, banks' reserves grew quickly and interest rates fell. There was, however, a lack of competition and heavy concentration with 3 banks owning 57 per cent of total bank assets. While most interest rates were freed, the exchange rate was fixed in relation to a basket of currencies. Bank ownership was concentrated in a few families, accountability was weak with inadequate controls and management weaknesses were pronounced. Of bank loans, 15 per cent were non performing. There were runs on the financial system and 15 finance companies collapsed. Through 1987, 25 institutions were closed, 9 were merged and 18 supported

2.55 In the wake of the crisis of 1994 in. Mexico, non performing loans which constituted 9 per cent of total loans at the end of 1994 rose to 12 per cent in December 1995. The authorities intervened to support the ailing banks. Several banks were placed under the administration of a deposit insurance agency. At the end of 1995, 19 per cent of the bank loan portfolio was restructured into long term inflation-indexed units. The overall cost of support to the banking system is estimated at 6.5 per cent of GDP. Real interest rates, however, remain high affecting repayment capacity of borrowers. Credit to the private sector declined by about 20 per cent in real terms in 1995.

Inflation Control

2.56 The commitment to hold down inflation has varied. In the hyper-inflationary environment of Latin America, explicit inflation strategies have been weakened by loose macro economic policies although in the recent period the commitment to inflation control has been strongly reinforced through adoption of the Currency Board in Argentina, autonomy to central banks and explicit inflation goals. In the Asian countries, there has all along been a supportive environment of moderate inflation. Nevertheless, tight monetary and fiscal policies have contributed to holding down inflation at low levels. In New Zealand, an explicit inflation mandate has been tied to the autonomy of the central bank.

2.57 In Chile, on the eve of the first phase of capital account liberalisation (1974-81), inflation had reached an annual rate of 600 per cent. Restrictive monetary and fiscal policies impacted upon inflation so that after remaining inertial in the first two years following liberalisation, inflation declined to .37 per cent in 1978. Thereafter, the exchange rate became the primary focus of the anti-inflation programme. A system of pre-announced depreciation of the nominal exchange rate *(tablitas)* was introduced, followed by a fixed nominal exchange rate. Mandatory indexation of wages and the open capital account helped to keep inflation in the range of 20 per cent over the eighties. The second round of capital account liberalisation occurred alongside the establishment of an autonomous central bank in 1989 and tight macro economic policies have ensured a decline in inflation to around 8 per cent in 1995. Since 1990, the central bank has publicly announced an inflation target and has shown a readiness to raise interest rates when domestic spending has accelerated.

2.58 In Argentina, inflation was well above 100 per cent throughout the first phase of capital account liberalisation crossing 3,000 per cent in 1989. The Law of Convertibility which came into existence in 1991 established the Currency Board which, by linking the Peso to the U.S. Dollar, attempted to anchor inflation at the level of inflation in the USA and broke the chain of expectations fuelling hyper-inflation. The results were dramatic with inflation declining to 3 per cent by 1995.

2.59 In the first phase of capital account liberalisation in Mexico, capital inflows and

expansionary domestic policies resulted in inflation rising from 3 per cent to nearly 17 per cent by 1976. Fragile public finances and large nominal devaluations resulted in an acceleration of inflation to over 100 per cent in 1983. In response to the crisis, Mexico tightened fiscal and monetary policies and reimposed exchange controls. Nevertheless, with wage indexation and the external constraint holding down growth, inflation remained inertial hovering around 120 per cent in 1987-88. In the wake of financial sector reforms and tight monetary and fiscal policy, inflationary pressures abated with inflation declining to 7 per cent in 1994, before rising again to 35 per cent in 1995 in the wake of a large devaluation of the Peso at the end of 1994.

2.60 The introduction of capital account convertibility in Indonesia accompanied by the frontal attack on instability resulted in inflation declining to 4 per cent in 1971. Over the seventies, however, expansionary fiscal policies supported by the oil boom resulted in inflation averaging at about 175 per cent. In the adjustment to the downturn in 1983, monetary policy was tightened and as a result consumer inflation declined to below 5 per cent in 1985. Thereafter, monetary policy proactively addressed itself to inflationary pressures, supported by flexibility in the conduct of exchange rate policy embodied in the widening of the intervention band. As a result, inflation has been below 10 per cent throughout the nineties.

2.61 In the Philippines, the commitment to control inflation stemmed from the stabilisation programme of early 1990-91 and supported by an arrangement with the IMF. Inflation, which had risen to 19 per cent in 1991 from a low of less than 1 per cent in 1986, declined to single digit levels in the nineties.

2.62 The institutional framework within which monetary policy operates was fundamentally changed by Reserve Bank of New Zealand Act which came into effect in February 1990. This Act gave the Reserve Bank the primary responsibility for formulating and implementing monetary policy with the sole objective of attaining stability in the general level of prices. The greater operating independence accorded to the Reserve Bank was however, tempered by requirements for much-enhanced accountability and policy transparency of the Bank. This policy objective acquires operational meaning through the Policy Target Agreement (PTA), a document signed by the Governor of the Reserve Bank and the Minister of Finance setting out inflation targets._The current PTA, covering the period 1992-98, specifies that the four quarter change in the consumer price index should be maintained within the tar-et band of 0-2 per cent. The PTA, however, makes allowance for the change in the CPI to move occasionally outside the target range. It gives the Reserve Bank the right to invoke "caveats" in the case of price shocks that are outside the direct influence of monetary policy like changes in indirect taxation or tariffs levied by the government, terms of trade movements, natural disasters and short-term impact of interest rate changes.

2.63 Thailand and Malaysia stand out as examples of countries where capital account liberalisation has occurred in an environment of low inflation. In Thailand, tight fiscal policy and an expansion in the current account deficit preempted demand pressures from impacting on inflation while simultaneously allowing monetary policy to contend with capital inflows. In Malaysia the Central Bank played a crucial role in the fight against inflation. Cautious financial policies and in particular tight monetary policy helped to sterilise the monetary effects of reserve accumulation and allow adherence to inflation targets.

Exchange Rate Policy

2.64 In the conduct of exchange rate policy, two clear strands can be distinguished among the selected countries: the Latin American type where the exchange rate, whether nominal or real, performed as an anchor for the economy and the Asian type where exchange rate policy is fashioned in a manner in which the balance of payments is targeted. While South Africa can be placed close to the Asian type, New Zealand stands separately with its exchange rate geared around a small open economy.

2.65 In Chile with substantial liberalisation of the capital account in the second phase, the fixed

exchange rate system was abandoned in favour of a floating exchange rate system, the emphasis shifting from reducing inflation to promoting exports. The authorities aggressively intervened to counter a real appreciation. Exchange rate policy initiated an era of export led growth and contributed to substantial growth and productivity in the nineties.

2.66 Argentina followed an exchange rate policy of *tablitas* in the eighties. Daily rates of depreciation were below the existing difference between domestic and foreign inflation. As the rate of depreciation of the exchange rate declined with the implementation of tablitas, the spread between domestic interest rates (adjusted for the pre announced rate of depreciation of the exchange rate) and external interest rates widened, which provided domestic residents with an incentive to borrow external funds to finance domestic expenditures. The resulting inflows of foreign capital were accompanied by relatively slower fall in the inflation rate and there was real exchange rate appreciation. The Law of Convertibility adopted in 1991 introduced a Currency Board which set a fixed exchange rate guaranteeing one to one convertibility of the Peso into U.S. Dollars. The decision to link the Peso to the U.S. Dollar was written into the Constitution and strict rules were established concerning the creation of money. The adoption of the Currency Board enhanced the credibility of the new exchange rate system.

2.67 Mexico's exchange rate policy was the key factor precipitating the crisis of December 1994. In the wake of the stabilisation programme of 1987, exchange rate policy went through three distinct phases. First, following an initial devaluation of almost 40 per cent a fixed exchange rate *vis-a vis* the U.S. dollar was established to serve as a nominal anchor for an exchange rate based stabilisation programme. From January 1989, limited flexibility was adopted through a preannounced crawling peg with slower depreciations in each succeeding year and from November 1991, a crawling exchange rate band was adopted with the ceiling expanding by 0.0004 per day. The crawling band ushered in little variability until the end of 1993. Fiscal correction, a decline in inflation and continuing capital flows were conducive to the authorities' strong desire to continue reliance on a nominal exchange rate anchor. Persistent inflation differentials, a widening current deficit, the resulting accumulation of external debt and uncertainties in the form of a large increase in short-term interest rates in the U.S., political instability all contributed to an erosion in the credibility in an overvalued exchange rate with which the authorities persevered. The exchange rate began to fluctuate more widely within the broad band. During 1994, the loss of confidence was evident in capital flight which, in the face of the commitment to the fixed exchange rate, led to a massive loss of reserves. Ultimately, in December 1994, with a depletion of reserves of US $ 22.5 billion over the year the exchange rate was no longer defensible. The exchange rate band was widened by 15 per cent which only served to precipitate the crisis. Selling pressure on the Peso rose sharply and when the authorities exhausted reserves in trying to hold on to the new floor, the Peso was allowed to float. The float, however, did not immediately reverse expectations and it was not until February 1995 that the vicious circle was broken with the Standby arrangement with the IMF. In March 1995, an adjustment program was launched with a relatively free float with no intervention in the foreign exchange market as an integral element. The external value of the Peso is now determined in the inter bank market by the forces of demand and supply.

2.68 In the case of Indonesia, in 1978 the link with the dollar was severed with the central bank setting the middle rate by using the basket of currencies of Indonesia's major trading partners. A one per cent band was set on either side with the central bank clearing the market at the intervention rate. Recently, the intervention band has been widened to 4 per cent on either side.

2.69 In the case of Malaysia, intervention through the U.S. dollar kept the ringgit relatively strong *vis-a-vis* the U.S. dollar prior to 1984. The ringgit was subsequently allowed to move freely against the U.S. and Singapore dollars. This led to a sharp depreciation of the ringgit which contributed to gains in international competitiveness. The capital flows have been dominated by foreign direct investment mostly flowing into the tradeable sector. By aggressive sterilised interventions in the foreign exchange market, the authorities have been able to prevent any marked real appreciation except for a brief episode in 1994.

2.70 Since 1984, the Thai baht has fluctuated in a very narrow range against an undisclosed

basket of currencies. The exchange rate is fixed on a daily basis by the Bank of Thailand through the Exchange Equalisation Fund (EEF). The EEF determines the mid-rate for the US dollar exchange rate and at this rate the central bank stands ready to buy or sell foreign exchange from and to commercial banks.

2.71 In the Philippines, in 1984 the exchange rate was allowed to float. The foreign exchange surrender requirement was terminated and allocations of foreign exchange by the central bank were abolished. No margins are maintained in respect of exchange transactions and the exchanae rate is determined on the basis of demand and supply in the exchange market. The authorities intervene when necessary to maintain orderly conditions in the exchange market. Sizeable nominal depreciations in 1990, 1991 and 1993 have been followed by modest appreciations since 1994

2.72 In Korea, under the market average exchange rate system introduced in 1990, the Won/US dollar exchange rate in the inter-bank market floats within a range centred around the previous day's weighted average spot rate. The daily exchange rate fluctuation band was widened on five occasions, most recently in December 1995, when it was increased to +/- 2 1/4 per cent. On a day-to-day basis, the Won has tended to vary marginally within the band. Foreign exchange banks are permitted to enter into forward exchange contracts with their customers provided that there is a bonafide underlying commercial transaction .

2.73 Consequent upon the imposition of economic sanctions on South Africa in January 1985, exchange control were imposed on capital transfers by non residents. A financial Rand i.e., dual exchange rate system was reintroduced. Inflows and outflows on the capital account were effectively regulated by the financial Rand. The financial Rand mechanism was meant to insulate the official forex reserves from non resident capital withdrawals. In March 1995 the financial Rand was abolished and a unified exchange rate system came into existence.

2.74 In New Zealand the move to capital account convertibility in 1984 was preceded by a devaluation of 20 per cent and a floating of the New Zealand dollar. As a result, the Reserve Bank effectively withdrew from the foreign exchange market, apart from discretionary trading associated with meeting the government's foreign exchange requirements on current account and minor transaction for market testing. It was felt that the float would ensure that the exchange rate does not again depart from its equilibrium level for long periods. This would enable maintenance of overall external balance in the medium term. It was also expected to improve resource allocation since the market value of the exchange rate and not the administratively determined value, is now used in private sector decision making. Again, changes in international competitiveness and in terms of trade could be signaled more rapidly to domestic producers and exporters' profitability should not be adversely affected by an inappropriate rate. Furthermore, it was felt that the float will also give a greater independence to monetary policy by the linking of monetary, fiscal and exchange rate policies, together with other policies for structural change. In addition to the resource allocation and monetary policy effects, it was felt that a floating exchange rate would allow greater control over the Government's external debt and would remove the possibility of speculators securing large windfall gains. In the latter half of the eighties, capital inflows caused the currency to appreciate in real effective terms. While the real appreciation moderated in the early nineties, upward pressures have reemerged since 1994.

Balance of Payments

2.75 In general, the selected countries have approached capital account liberalisation by using resultant capital inflows to strengthen the balance of payments the exceptions being Thailand and Mexico.

2.76 In Chile, after a period of unsustainable current account deficits and an explosive increase in external debt up to the early eighties, the authorities took steps to hold the current account deficit within sustainable limits. The current account deficit narrowed steadily from 1985 onwards, turning into a small surplu,,s of 0.2 per cent of GDP in 1995. Capital inflows were absorbed into the reserves in the second phase of liberalization and at the end of 1995, the reserves stood cover for 11 months of imports.

2.77 In Argentina, in the period 1992-95, the surge in capital inflows was accommodated by an expansion in the current account deficit to aroun'd 3 per cent of GDP. Inspite of the expansion in the current account deficit the large capital inflows allowed for a rebuilding of the losses of reserves which had occurred until 1989. Since 1990 there was a steady accretion to the reserves which stood cover for 9.5 months of imports by the end of 1995.

2.78 In Mexico, the reforms launched in the wake of the debt crisis of 1982 turned the current account deficit into a surplus. Thereafter, however, the current account deficit reappeared and began to widen reaching an unprecedented level of 8 per cent of GDP in 1994. The behaviour of foreign exchange reserves have been erratic with periods of build up followed by large drawdowns. At the end of 1995 the reserves stood cover for 4.3 months of imports.

2.79 The weakness in Indonesia's balance of payments at the time of the institution of capital account convertibility was strengthened during the seventies by the oil boom. Despite the widening of the current account deficit to a little below 3 per cent of GDP during the period, international reserves were built up almost continuously. The high order of deficits witnessed in the first half of the eighties moderated in the second half as a result of prudent macro economic policie's and the restoration of export competitiveness. Over the eighties, the stock of external debt rose more than three fold to US $ 67 billion in 1990 and further to US $ 100 billion in 1996. The current account deficit widened again in the nineties under the pressure of domestic demand to around 3 per cent of GDP. The import cover of reserves has hovered around 4 to 5 months.

2.80 In Malaysia, in the early eighties, expansionary fiscal policies led to a large widening of the current account deficit to a peak of 12 per cent of GDP in 1984. Thereafter, although the current account deficits declined turning into surplus of 8 per cent of GDP in 1987, external debt rose to around 60 per cent of GDP. The reserves declined up to 1984 after which they began rising steadily. In the nineties, there has been a widening of the current account deficit which reached 8.3 per cent of GDP in 1995. Capital flows have been strong; however, the expanding current account deficit absorbed the capital flows necessitating a drawdown of reserves which at the end of 1995 were equivalent to less than 4 months of imports.

2.81 In Thailand, strong real growth has spilled over onto large current account deficits which in turn enabled capital inflows to meet the needs of growth. Over the eighties, weak external demand, reliance on imported petroleum, the fixed exchange rate and rising inflation were reflected in large current account deficits. Adjustment measures restored export competitiveness while imports declined. In 1985, the current account deficit turned into a surplus of one per cent of GDP. Thereafter, the current account deficits have been widening, exceeding 8 per cent of GDP in 1995. This has resulted in the external debt rising to 50 per cent of GDP. Since 1987 there has been a steady accretion to the reserves which presently equals a little over six months of imports.

2.82 Korea has adopted a cautious approach to the balance of payments. Large current account deficits in the early eighties turned into surpluses in the late eighties on the strength of export growth. In the nineties, current account deficits have reappeared but they have been contained at below 2 per cent of GDP. Net capital flows have been used to build up the reserves which stood at US $ 32.6 billion or three months of imports at the end of 1995.

2.83 In the Philippines, the current account deficits have ranged between 2 to 6 per cent in the nineties, enabling the absorption of capital flows which have averaged around 6 per cent of GDP. The capital flows have allowed the import cover of reserves to be preserved at around four months of imports.

2.84 Prior to 1984, serious and persistent current account deficits characterised the New Zealand economy reflecting internal imbalances. After the implementation of reforms in 1984 there has been a conscious attempt to reduce current account deficits to sustainable levels. Capital flows have been relatively modest with net outflows in the early nineties. As a result, the reserves have covered a little less than four months of imports during the

nineties.

Timing and Sequencing of CAC in Selected Countries

2.85 Among the selected countries, Chile, Malaysia, Thailand, Korea and Mexico approached the liberalisation of capital transactions in a gradual, phased approach, along with broader financial sector reforms, and macro economic policies were oriented to establishing the preconditions for attaining CAC. In Mexico, however, financial sector reform occurred late in the process. Indonesia represents an unusual example of establishing capital account convertibility early before the financial sector reform and the current account liberalisation occurred at a late stage in the process.

2.86 In countries such as New Zealand, the Philippines, Argentina and South Africa, the process of liberalising the capital account was relatively rapid and the removal of capital controls provided the momentum for the entrenchment of preconditions such as fiscal consolidation, financial sector reform and the pursuit of inflation control. While Argentina, South Africa and New Zealand established current account convertibility well before opening up the capital account, the Philippines accepted the obligations of Article VIII of the IMF's Articles of Agreement only in 1995. The South African experience has been marred by exchange market turmoil so that while measures to liberalise inflows have been put through, the elimination of controls on residents' outflows has had to be postponed.

2.87 While episodes of financial crash in the Southern Cone in the early eighties and fears of instability in the financial sector led to a gradual approach, the experience of the nineties indicates that some countries have been able to achieve a rapid opening of the capital account without damage to the financial system. What appears important is the timing of the capital account opening relative to pre-requisite institutional and policy measures.

2.88 As regards sequencing of measures of capital account liberalisation, the preferred approach across countries has been to relax restrictions on inflows by non-residents and related outflows before removing restrictions on capital outflows by residents. Argentina and New Zealand moved to CAC in a rapid manner and over a short period of time, similar to the approach of several developing countries in the nineties.

2.89 In Chile, by 1980, the capital account was completely open to nonresidents. Commercial banks, however, continued to be prevented from taking net positions in foreign exchange. By 1981, limits on investments by banks in equity abroad were raised and they were allowed to open branches abroad. Banks were allowed to take positions in the foreign exchange market with the maximum exposure limited to their capital and reserves. In response to the crisis, during the period 1982 to 1989 there was a reimposition of capital controls. Since 1990, the opening of the capital account has once again progressed gradually with liberalisation somewhat faster on outflows than on inflows. Residents were allowed to make investments abroad. Commercial banks were allowed to invest abroad up to 25 per cent of their foreign exchange deposits. Capital repatriations were liberalised in 1992. Domestic commercial banks were authorised to grant trade credits to other Latin American countries and the proportion of export proceeds exempted from surrender requirements was raised. Furthermore, measures were adopted to moderate capital inflows by the imposition of a stamp tax, non-remunerative reserve requirements and size restrictions and rating requirements for Global Depository Receipts issued by residents.

2.90 In Argentina, a significant degree of capital account liberalisation was undertaken in the late seventies but there was substantial back tracking in the early eighties. Argentina once again initiated a liberalisation of capital transactions in 1989 and completed a rapid transition to full convertibility in 1991 with the introduction of a Currency Board (Annexure III.8).

2.91 Mexico had the tradition of a relatively open capital account for residents co-existing with quantitative restrictions on imports. Following the crisis of 1982 there was a reintroduction of capital controls. Subsequently, there was a very gradual process of liberalisation of the capital account. Several exchange controls were relaxed and restrictions on foreign direct investment were eased in 1989. Some controls on short-term capital flows were retained.

With the exception of financial institutions located in the areas bordering the United States, bank deposits denominated in foreign currencies were not allowed in the domestic financial sector. At present outward direct investment, acquisition of real estate abroad by residents and issue of foreign currency denominated securities by residents are freely allowed.

2.92 In Indonesia, while the trade regime was marked by strong protection, by 1979 there were no limitations on inward remittances of capital. Both residents and non residents could hold foreign currency deposits with banks and a 15 per cent reserve requirement was applicable to such foreign currency liabilities with no such requirement for borrowings of non bank financial institutions and private companies. Entry barriers to the banking system were removed to allow greater participation for foreign banks and off-shore banking restrictions were removed. The ceiling on foreign borrowings by banks was removed and replaced by net open position ceilings linked to capital. The amount of short-term borrowings overseas by banks was restricted to 30 per cent of capital. In 1994, restrictions on foreign investment in the form of domestic partner requirement, minimum size requirement etc., were removed.

2.93 Malaysia's approach to capital account liberalisation has been gradual. In the seventies, foreign investment, both inward and outward were allowed under an approval procedure. Certain capital controls were relaxed in 1983 and commercial banks could approve payments to non residents without limits. In 1987, foreign currency loans from non residents up to certain limits were freed from authorisation and residents were no longer required to obtain prior approval to invest abroad subject to certain conditions on their domestic loan liabilities. Furthermore, residents could freely make remittance to non-residents against the purchase of shares listed in the stock exchanges as well as against immovable property located in Malaysia. In response to strong capital inflows and exchange market turmoil, controls on inflows were imposed in January -February 1994. They comprised (i) a ceiling on foreign liabilities of banking institutions other than those related to trade and investment; (ii) a prohibition on residents against selling short-term monetary instruments to non residents; (iii) an obligation for commercial banks to deposit with the central bank the ringgit funds of foreign banking institutions (vostro accounts of non resident banking institutions) in non-interest bearing accounts; (iv) a prohibition against all non-trade related swap transactions and outright transfers on the bid side with non residents; (v) a prohibition on sale of short-term private debt to foreigners; and (vi) imposition of maintenance charges on non-interest bearing foreign deposits. When the exchange rate stabilised, these controls were removed gradually and completely lifted by August 1994.

2.94 In Thailand, the liberalisation of capital transactions began with foreign investments and off-shore loans. In 1991, capital transactions like repatriation of investment funds and repayment of loans were liberalised and could be effected without limit. Resident investors were allowed to freely transfer up to US $ 5 million abroad for direct investment. Direct investment abroad below US $ 5 million do not require prior authorisation. Remittances to Thai emigrants with permanent residence permits abroad are allowed up to US $ 1 million per person from the emigrants' personal assets. Remittance of funds abroad between relatives were also allowed up to US $ 100,000 per person per year.

2.95 In the Philippines, the sequence of liberalisation began in 1984 with the termination of the foreign exchange surrender requirements. Limits on banks' holdings of foreign exchange were abolished in August 1985. In June 1991, a major step was taken to encourage foreign investment, with the passage of the new Foreign Investment Act. Under this Act, foreign nationals were allowed full ownership of export and domestic market enterprises except for those on three negative lists such as foreign investments in defence-related activities and in those detrimental to public morals and health.

2.96 In the Philippines, inflows are free except in banking and specific sectors defined in the Foreign Investment Act of 1991. Outward investment is subject to prior approval by the Central Bank only if it exceeds US $ 6 million per investor per year and is funded by purchases of foreign exchange from the banking system (this limit set at US $ 1 million in 1992, was raised subsequently to US $ 3 million and further to US $ 6 million in November 1994). In February 1995, the minimum allowable oversold foreign exchange

position of commercial banks was raised from 5 to 10 per cent of unimpaired capital, while the maximum overbought position was reduced from 25 to 20 per cent.

2.97 In New Zealand, relaxation of capital controls were rapid and extensive. In October 1984, limits on foreign exchange dealers' holdings of spot foreign currency balances and limits on private overseas borrowings were relaxed. Overseas owned companies operating in New Zealand were allowed unrestricted access to capital market. Domestic financial institutions were allowed to borrow more freely overseas to fund their day-to-day operations. In December 1994, all exchange control regulations were effectively removed. In August 1995, the Overseas Investment Amendment Act was enacted to streamline the processing of applications for FDIs by bringing all controls under one regime. Under the Act, only light screening of proposals is required. Non residents are freely permitted to acquire land.

2.98 In South Africa, the unification of dual exchange rates was supported by the announcement of measures of capital account liberalisation, which virtually ended capital controls on non residents. Contrary to the Plan, the relaxations could not be carried further following a run on the Rand. South Africa postponed the elimination of controls on residents' capital outflows. Subsequently, the following exchange control relaxations were announced in March 1997. (i) South African corporates are allowed to transfer up to R 30 million from South Africa to finance approved investments and South African corporates with projects abroad are permitted to borrow abroad. (ii) South African corporates are permitted to invest a percentage of their assets abroad for portfolio investments. (iii) Qualifying South African institutional investors were permitted to invest offshore up to 3 per cent of their inflow of funds in the previous calendar year. Similarly, in 1997 offshore investment of up to 3 per cent of the net inflow of funds for the calendar year 1996 would be permitted, subject to an overall limit of 10 per cent of total assets. Additionally, subject to the overall limit of 10 per cent of total assets, an extra 2 per cent of the net inflow of funds for the calendar year 1996 could be invested in securities on stock exchanges in certain countries in southern Africa. (iv) From July 1, 1997 registered tax payers in South Africa would be permitted to invest a limited amount of capital abroad. Such persons may alternatively hold foreign currency balances with banks in South Africa within a defined limit. (v) US $/Rand futures are being introduced in the South African Futures Exchange. Participation would initially be restricted to non residents and authorised dealers in foreign exchange. Residents would be allowed access only through authorised dealers. (vi) Documentation requirements for forex transactions are being significantly curtailed for transactions of R 40,000 or less as against R 2,000 earlier. This is expected to reduce some 60 per cent of the workload associated with implementation of exchange control requirement.

2.99 As part of a gradual and cautious approach towards capital account convertibility, Korea has drawn up, in June 1993, a detailed blue print encompassing capital transactions and financial markets involving three distinct stages (Annexure III.9).

Developments Following Liberalisation of Capital Accounts

2.100 The initial impact of the relaxation of capital controls has, in general, been reflected in the balance of payments. While the elimination of controls on inflows has expectedly resulted in large positive entries in the capital account of the balance of payments, the elimination of controls on outflows supported by appropriate financial policies, far from putting a pressure on the balance of payments has generated confidence and drawn a further surge in capital inflows. Apart from initial attempts of capital account liberalisation in Chile, Argentina and Mexico which were against the backdrop of inconsistent macro economic policies and weak financial systems, all.. the selected countries which took steps towards CAC recorded overall improvement in the balance of payments. Argentina reversed a long period of overall deficits to record large overall surpluses in 1992 and 1993. It was only in the fall out of the Mexican crisis that overall deficits reemerged in the Argentine balance of payments in 1994 and 1995. For Mexico, the impact of capital account liberalisation was equally dramatic. Overall deficits recorded since 1982 were reversed into large surpluses immediately after capital account liberalisation in 1989, and resurfaced only in the face of the crisis of 1994. In Indonesia, the experience has been uneven; however, since 1989 strong capital flows have ensured consistent surpluses in the overall balance of payments. A similar experience is recorded for the Philippines since 1991. Malaysia has had a history

of buoyant capital inflows which turned into surges since 1989. The overall balance moved into surplus reaching a peak of US $ 11.3 billion in 1993 before turning into a deficit in the following year, reflecting controls on capital inflows imposed in the wake of exchange market turmoil. Thailand has recorded overall surpluses since 1984 and since 1988 these surpluses were large. For Korea, large surpluses in the overall balance of payments have been recorded over the eighties especially in the latter half. Since 1992, capital inflows have resulted in massive overall surpluses which peaked at US $ 7.7 billion in 1995. New Zealand stands out as an exceptional case where overall deficits have been consistently recorded in the balance of payments except in 1995. In South Africa, a brief period of overall surpluses was reversed in 1993 when South Africa returned to the international economic mainstream. In the following years there was a resumption of strong capital inflows which generated large surpluses in the overall balance of payments. In early 1996, inability to cope with capital inflows ultimately turned into a confidence problem leading to run on the Rand.

2.101 The response to capital inflows in the wake of capital liberalisation can be broadly divided into two categories. Countries like Malaysia, Mexico, the Philippines, Thailand and South Africa expanded current account deficits to absorb the inflows. Of these countries, Malaysia, the Philippines and Thailand used the resulting inflow of external resources to supplement domestic resources and raise gross investment rates. Gross investment rates tended to decline in Mexico -and South Africa which was indicative of the use of external resources to boost consumption. In Mexico and the Philippines, rising current account deficits became unsustainable and had to be corrected in 1995. Among the second group of countries, current account deficits either declined (Chile, Korea) or were run at historical levels (Argentina, Indonesia, New Zealand). Argentina underwent a correction in the current account deficit in 1995. The current account deficits were expanded in Indonesia and New Zealand in 1995. For the second group of countries, however, gross investment rates trended upwards or were maintained, reflecting the relatively large reliance on domestic resources in preference to external resources.

2.102 Countries which did not expand current account deficits in relation to capital flows recorded accretions to international reserves (Argentina, Chile, Indonesia, Korea and New Zealand). While Argentina and Chile increased the import cover of reserves, Indonesia, Korea and New Zealand maintained the import cover of reserves at historical levels, reflecting the progressive liberalisation of the access to imports, spurred by capital account liberalisation. Countries such as Malaysia, Mexico, the Philippines, Thailand and South Africa which had expanded current account deficits to contend with the capital flows also experienced build up in reserves which was clearly indicative of the large volume of capital flows drawn by liberalisation programmes. Mexico and Malaysia reduced the import cover of reserves to accommodate import liberalisation while Thailand and South Africa increased the import cover of reserves. In the Philippines, the reserves/import ratio was maintained at historical levels .

2.103 Countries which did not expand current account deficits to absorb capital flows (Argentina, Chile, Indonesia, Korea) instead brought about a reduction in debt and in debt servicing. For countries which expanded current account deficits, Mexico and Thailand recorded accretions to debt and an uptrend in debt service ratios. In Malaysia and South Africa, debt service ratios were held stable.

2.104 While the selected countries experienced real appreciation in the wake of capital account liberalisation, nominal depreciation was in most cases insufficient to correct for overvaluation of the currencies. In Chile, Korea, Malaysia, the Philippines, Thailand and South Africa nominal exchange rates, in fact, appreciated. In Indonesia and New Zealand steady nominal depreciations were recorded. Substantial nominal exchange rate corrections took place in the case of Mexico.

2.105 As regards growth performance, all selected countries with the exception of Mexico witnessed either acceleration in real growth rates or maintained high growth profiles. Argentina, Chile and South Africa succeeded in reversing earlier periods of declines in real growth.

2.106 All the selected countries recorded perceptible reduction in inflation, the strongest corrections being recorded in Argentina, Chile, Mexico, the Philippines and South Africa. By 1995, with the exception of Mexico which faced the pass through of a large nominal devaluation in 1994, all the selected countries had moved to single digit inflation rates.

Lessons from the International Experience with CAC

2.107 Profiles of the countries which were considered in the Report reveal a wide variety of experiences with the evolution of capital account liberalisation. Country experiences differ depending on the state of macro economic conditions prior to undertaking liberalisation, the pace and success in establishing the preconditions (such as fiscal consolidation, inflation control, financial sector reforms, exchange rate policy, balance of payments and adequacy of reserves) and the timing and the sequencing of measures of capital liberalisation. These factors have interacted in determining successes and failures, the realisation of gains of an open capital account and the episodes of back tracking embodied in the reimposition of controls. Each experience in many ways has been unique and specific to the country situation. Under these conditions, generalisations are difficult and run the risk of glossing over important facets of each evolutionary experience. Nevertheless, these experiences offer an opportunity to assess whether or not particular approaches or aspects thereof are suitable for adoption in the Indian context. In this sense, lessons can be drawn regarding the appositeness of the move to CAC on the basis of the prevailing macro economic situation, the state of the preconditions and the prospects of entrenching them as the process of CAC gathers momentum and the stage of progress of the overall reform process. In particular, a careful assessment of the international experience with CAC provides some useful insights into the sequencing of specific measures of relaxation of capital controls.

2.108 Drawing from the lessons of international experience, the Committee noted that in general, countries which initiated the move to CAC on the basis of strong fundamentals were able to modulate the pace of instituting CAC without undertaking large and dramatic shifts in the stance of macro economic policies. Furthermore, these countries were less vulnerable to backtracking and the reimposition of controls in the face of exogenous shocks. In fact, the pursuit of reforms in other areas by these countries instilled confidence in the process of opening up of the capital account. Countries with weak initial conditions adopted drastic macro economic policies to facilitate the move to CAC. Some of these countries had to face interruptions and reintroduction of capital controls in the evolution of CAC. Nevertheless, rapid moves to CAC did not inevitably lead to failure if prerequisites in terms of institutional arrangements and policy measures were assiduously pursued.

2.109 While most countries considered a strong balance of payments position as a necessary precondition for the move to CAC, in the view of the Committee this was not by itself sufficient and the introduction of CAC sparked off capital flows which strengthened initially weak balance of payments. While some countries responded to capital flows by expanding current account deficits, this led to an accretion in indebtedness and preemption of current receipts by debt servicing. Countries universally built up reserves. Based on country experience, therefore, the Committee felt that an adequate level of reserves emerged as a precondition although in view of problems of monetary and exchange rate management, several countries such as Indonesia, Korea, New Zealand and the Philippines took into consideration the cost of holding reserves

2.110 In the Committee's view, strengthening of the financial systems emerged as a high priority precondition across countries. The review of the banking crises in the countries studied showed that a major factor behind banking crises in these economies was the volatility in interest rates and real exchange rates induced by surges in capital flows. Furthermore, capital flows encouraged lending booms, unsound financing and credit risks which precipitated the crises. Fixed exchange rates led to banks' borrowers maintaining large unhedged foreign liabilities which came unstuck when the exchange rate came under pressure thus exposing the borrowers and eventually the banking system to severe shocks. Appropriate monetary and fiscal policies help to contain volatility induced by capital flows and thereby forestall banking crises. Strengthening of prudential regulation and bank supervision is necessary before liberalising the capital account.. "Fit and proper" tests

should accompany freer entry and exit and privatisation, failing which bad debts can accumulate. Good accounting, provisioning and disclosure practices are a *sine qua non* of a strong banking system.

2.111 The Committee recognised from the survey of international experience that fiscal consolidation emerged as another important precondition for CAC among all countries. In South Africa and the Philippines, the move to CAC was rendered fragile and the fisc operated as a drag on the process of liberalisation. In New Zealand, fiscal consolidation went hand in hand with a mandate for transparency and accountability. This, in the Committee's view was important as it intended to ensure that fiscal laxity did not occur in the guise of quasi-fiscal operations. The Committee noted that an inevitable consequence of capital account liberalisation was a tendency for a real appreciation of the exchange rate generally brought about by surges in capital flows. Despite restructuring of exchange rate regimes to endow them with flexibility to cope with capital flows, most countries could not undertake sufficient nominal exchange rate corrections in the face of overvaluation. While countries in the Asian region attempted to persevere with an undervalued exchange rate supporting a current account objective, intervention along with sterilisation failed to prevent real appreciation in the face of capital inflows. Consequently, intervention bands had to be widened from time to time.

2.112 As regards sequencing, with the exception of Indonesia and Argentina, current account liberalisation and financial sector reform preceded the opening of the capital account. In the specifics of capital account liberalisation, the Committee recognised that restrictions on inflows and related outflows by non residents were removed first, followed by the relaxation of restrictions on outflows by residents. Among residents, corporates and non banks usually received preferential treatment followed by banks and finally by individuals. Most countries preferred to liberalise long term flows before short term flows. Finally, an important lesson from the international experience, in the view of the Committee, is that most countries maintained some controls on capital flows during the period of transition to CAC.