Forty Years' Experience with the OECD Code of Liberalisation of Capital Movements

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Publié en français sous le titre :

Code de l'OCDE sur la libération des mouvements de capitaux
QUARANTE ANNÉES D'EXPÉRIENCE

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Foreword

I am very pleased to contribute a short foreword to this OECD report which describes the experience of OECD Members in eliminating exchange and capital controls. It shows how co-operation under the rubric of the OECD Code of Liberalisation of Capital Movements, which was adopted in 1961, has supported this process.

This report is a timely contribution to the international debate on globalisation of financial markets, including the relevance of capital controls in today's economic and financial environment. With virtually all their restrictions on the free flow of capital now abolished, OECD Members do not consider recourse to exchange controls as a viable policy tool. Indeed, in response to severe financial turbulence in emerging markets in the 1990s, Mexico, Korea and the other recent Members opted for accelerating rather than suspending liberalisation.

The report describes the challenges that OECD Members faced as they liberalised capital movements. Among these were ensuring the credibility of their macroeconomic policy, improving financial sector supervision, and building institutions. However, any difficulties were outweighed by the benefits, which included increased integration of enterprises into the world economy; wider investment choice and risk diversification for domestic savers; salutary market signals for economic policy discipline; and enhanced public sector transparency and better governance overall.

The OECD Code of Liberalisation has played a critical role in this process. Adherence to the Code is a central condition for OECD membership. The Code promotes the key principles of progressive liberalisation, non-discrimination among parties and transparency. Based on these principles and the Code's evolving jurisprudence, the OECD has developed standards by which Members can assess their progress. In addition, the peer review process associated with the Code enables governments to learn from each other's experiences and build the capacity to carry out reform.

The Committee on Capital Movements and Invisible Transactions – the OECD body which monitors Members' compliance with the provisions of the Code –

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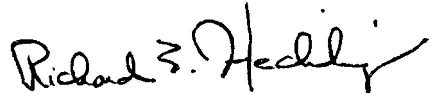
provides international support for national reform efforts. This report is the result of the work of that Committee over many years.

In the future, the OECD will continue its work in this vitally important area and will share its experience with countries throughout the world.



Richard S. Hecklinger
Deputy Secretary-General

Note by the editor

This Study was prepared within the framework of the activities of the Committee on Capital Movements and Invisible Transactions (CMIT), which has approved it for publication.

The Study is based on material assembled by the OECD Secretariat which was reviewed by members in the Committee at its meetings during 2001 and 2002. This material was prepared by Eva Thiel, drawing substantially on earlier Secretariat work undertaken for the Committee. Textual contributions from Members were obtained for the four case studies which are presented in an Annex to the Study.

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Summary and Conclusions

1. The OECD Codes-based approach to liberalisation in an evolving global context

The OECD Capital Movements Code – the only multilateral instrument in existence which promotes capital account liberalisation.

The OECD has been promoting progressive liberalisation of current and capital account operations among its members for forty years. Since its establishment in 1961, its approach to open markets finds its expression in the two OECD Codes of Liberalisation, the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Invisible Operations (which covers cross-border services). Of these two, the Capital Movements Code remains the only multilateral instrument in existence promoting the liberalisation of capital movements.

Capital controls have been abolished in virtually all OECD member countries.

In the OECD area, capital account liberalisation has by now progressed to a point where capital controls have been abolished in virtually all member countries. Requests have been made both from within the OECD and from outside its membership constituency that the Organisation's long-standing experience with capital account liberalisation should be made available to a wider forum, in particular as it has recently been further enriched via the accession of six new members (Mexico, the Czech Republic, Hungary, Poland, Korea and the Slovak Republic) to the Organisation since 1994.

The OECD peer review process enables countries to "benchmark" domestic regulations and measures against those implemented by others.

It was felt that this experience, based on the distinctive peer review approach of the OECD Codes, would be of value to policy-makers in emerging market economies, engaged in the opening of their capital accounts. This is particularly true in today's environment of heightened sensitivity to the risks of opening domestic financial sectors to potentially volatile capital flows. OECD members have confronted such risks and persisted with liberalisation in order to realise the

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fundamental benefits provided by access to greater pools of financial resources as well as of knowledge and technology. The OECD approach does not rely on dogma or political negotiation, nor on detailed prescriptive recommendations for policy implementation. Instead, it involves a process of shared, mutually beneficial learning, where both individual and collective stumbling blocks on the path to open markets are inspected and discussed. It has been found that peer pressure in a multilateral setting can provide strong incentives for authorities to undertake policy adjustment. By "benchmarking" domestic regulations and measures against those implemented by peer participants in this process, countries receive guidance and support in the complex policy area of financial liberalisation.

Regulatory reform of the domestic financial sector and capital account liberalisation are mutually reinforcing processes…

This study describes the OECD role of promoting, consolidating and entrenching liberalisation measures undertaken by its members. While the importance of appropriate macroeconomic policy settings – especially in terms of consistency between these and the chosen exchange rate regime – is underlined, an in-depth analysis of macroeconomic policies in member countries is beyond the scope of the study. The close and complex interlinkage between domestic and external financial liberalisation is brought into focus. The study contends that the two processes of liberalising domestic financial sector activities and relaxing controls on external capital flows largely result from the same incentives and pressures. As manifestations of financial regulatory reform policies adopted by countries seeking the benefits of market-based allocation of financial resources, whether of domestic or foreign origin, they are clearly mutually reinforcing.

… both seeking the benefits of market-based allocation of financial resources.

Nowhere has the revolution in information and communication technologies (which is a main facilitator of globalisation) had such profound effects as on financial sector activities. The results are everywhere visible in vastly intensified financial interchange, making financial liberalisation inevitable for any country aspiring for broad participation in the global economic system.

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Active participation in today's sophisticated international financial markets renders financial liberalisation over time inevitable.

Due to the emergence of the new international financial landscape, the policy context has changed profoundly during the period under review. Advances in communication technology and product innovation as well as the liberalisation process itself have had a significant impact on the manner traditional functions of the financial system are performed, bringing both institutional and regulatory changes in their wake. The combined forces of rapid technological change, a widening range of products and services, conglomeration and mergers, including cross-border, in the financial industry have confronted policy-makers and regulators, both at the national and international level with a different set of challenges. Major changes in the regulatory framework for financial institutions have been undertaken during the past two decades, with increasing emphasis on prudential oversight and growing co-operation amongst national regulators. As more countries reach the level of economic and institutional development where they can fully integrate into highly developed international financial markets, this trend will continue. It is no longer a question of whether to liberalise or not but of deepening understanding of accompanying stresses so that economic and social benefits of financial integration can be maximised.

However, policy-makers must reckon with the fact that financial crises do occur, as the 1990's have dramatically recalled…

Banking and currency crisis situations with significant economic and social costs do arise, not just randomly but due to the accumulation of many different stresses in the financial system and elsewhere in the economy. While it has long been recognised that the macroeconomic policy environment – including the exchange rate regime – is an important factor in achieving an orderly process of liberalisation, the stresses caused by institutional weaknesses or governance failures have recently come into focus. Although currency and banking crises are by no means a new phenomenon, the 1990s have had a considerable share of them. Any lessons to be learned from the collective liberalisation experience of OECD members must thus take into account the tremendous acceleration in capital mobility during the recent decade, which was also marked by the severe currency and banking crises affecting many emerging market economies, including some of the new entrants to the OECD.

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... making crisis prevention and management one of their dominant concerns.

Contagion effects turned the turbulence that began in South East Asia in 1997 into an international financial crisis of rarely seen magnitude in times of peace. Crisis prevention and management have thus become dominant concerns in the international policy debate on capital account liberalisation. The study sets the OECD experience in the context of the changing policy environment, current international debate and initiatives for crisis prevention.

Debating the need for new international financial architecture...

The magnitude and spread of the recent international financial crises have brought renewed interest in the issue of the potential interlinkages between capital account liberalisation and financial instability. The study recalls the views expressed by many experts and market participants in the aftermath of the Asian international crisis, that policy-makers and the international financial community were poorly prepared for dealing with the crisis episodes. Calls for a new "international financial architecture" including reform of the Bretton Woods institutions were heard as well as renewed debate regarding the pros and cons of capital controls.

... growing consensus has developed for relying on standards, guidelines and best practices to ensure orderly and safe capital account liberalisation...

Since then, much work has been devoted to defining and developing universally applicable best practices in key areas of financial and economic policy, as an effective approach to crisis prevention – and general agreement has emerged on the benefits of pursuing the standards-based path. Of course, standards are not a panacea; but they can be a founding stone to improve the system. Crisis prevention can be more effective if it can rely on timely information dissemination, adequate remedial policies, including state of the art prudential supervision, and high quality institutions. This being said, it must be recognised that there are limits and obstacles in this regard. Thus, information-gathering cannot always be ensured within the time-frame required. Despite the sophistication of Early Warning Systems built up by monitoring authorities to signal impending crisis, the alert may only come after the event itself, as information flows in financial markets are instantaneous. Prudential oversight can never be so tight as to totally exclude excessive risk-taking or herding behaviour by financial institutions. More fundamentally, the institutional

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framework can be strengthened, but only slowly, as it takes time for new practices to become "embedded" and fully complied with – a feature that justifies calls for efforts by the policy-making community to sustain the pace of reform over time.

… and exchange controls are no longer a policy option for OECD countries.

The study notes that OECD members no longer consider for themselves recourse to capital controls as a workable tool, as part of broader changes in governance approaches and in a context of highly integrated financial markets. Proposals for better communication with creditors and investors and private sector participation in the resolution of sovereign debt crises are briefly touched upon.

The quality and functioning of institutions is a key factor for successful liberalisation…

Distortions producing excessive balance-sheet mismatches in terms of currency exposure and maturity structure of assets and liabilities in the banking or corporate sectors and weak and ineffective supervision are related to the quality and functioning of institutions in an economy. Well-functioning institutions play a very important role in helping to withstand stresses and external shocks, as is by now generally recognised amongst academics and policymakers participating in the international policy debate. Recent crisis experiences in emerging market economies have brought a better understanding of the importance of well-developed institutional infrastructure in the domestic economy together with sound informational and governance systems for minimising external vulnerabilities.

… which requires further empirical study.

This study argues that it is necessary to look more closely at the institutional infrastructure and the ability of institutions to withstand pressures and shocks. It presents a number of stylised indicators for the majority of current OECD members as well as some non-member emerging market economies. They cover domestic financial development, institutional-governance systems, as well as tentative proxies for the intensity of capital controls at different points in time. They present a fairly mixed story. With some notable exceptions, older OECD members' domestic and international financial deregulation was launched when sound, functioning institutions were in place. The recent members had less of a time-span to reach appropriate

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levels of institutional-governance structures prior to external liberalisation, so they followed an accelerated path with some parallel liberalisation and institution-building. A summary look at major non-member countries in Latin America, Africa and Asia, does not bring out any clearly discernible pattern of sequencing and some reversals of liberalisation measures have occurred.

OECD member experience with progressive external financial liberalisation has been overall positive...

The study also presents detailed reviews of the liberalisation experiences of older OECD members and the still fresh experiences of the six new members in assuming and implementing the liberalisation obligations of the Codes. The study finds that, on balance, the members' experience with progressive external financial liberalisation has been positive. In terms of general economic efficiency effects, cross-border impediments to the efficient allocation of capital have been removed and countries' range for inter-temporal savings decisions has been extended via access to a greater pool of capital. Openness to foreign capital inflows has contributed to enhancing competition and hence improved performance within the domestic financial institutions.

... as banking and corporate sectors have become more competitive and asset portfolios more diversified.

It has also provided an opportunity for domestic corporations, which became free to issue securities abroad, to familiarise themselves with disclosure and other corporate governance standards required by advanced capital markets. For households and business firms, there have been the tangible benefits of being allowed to diversify away from country-specific risks in their asset portfolios. As noted above, in older member countries, crisis experience has been relatively limited as liberalisation was for the most part sequenced with deregulation and reform of domestic financial sectors.

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The task of developing and upgrading the systems of financial regulation and supervision in the six recent members of the OECD formed a crucial part of the liberalisation process. Many of the obstacles that stood in the way of more complete liberalisation from the outset originated both from insufficient development and enforcement of financial regulation and supervision and, to some extent, from the retention of outdated and overly bureaucratic, discretionary procedures. In banking as well as securities markets entities, there were considerable institutional weaknesses and in the government agencies a lack of enforcement capability of regulation already developed to encompass international standards and principles. Amongst the Central and Eastern European new members, pressures and strains in connection with the Asian and Russian financial crises in 1997-98 were felt in particular by the Czech Republic and Poland. Both Korea and Mexico went through full-fledged financial crises shortly upon joining the Organisation.

Financial sector weakness was prominent among those new members where delays in structural reform and institution-building at times exposed serious governance problems.

This experience highlights the need for completeness of economic reforms throughout the economy – half liberalised systems can give rise to severe imbalances, which may be extremely costly to address from an economic, financial and social standpoint. The comprehensiveness and resolve in reform packages is a major factor in establishing credibility during the sensitive period of external liberalisation, as expectations that reform programmes will fail can quickly have a negative impact on investors' assessments of a country's standing.

Completeness and resolve in carrying out economic reforms is of crucial importance…

An important aspect in this context is the maintenance by the governments of consistent messages to all market participants throughout the reform period, regarding the authorities' intentions to adhere to an orderly process of capital account liberalisation, based on pre-announced phases and co-ordinated with other supporting policies Amongst the six new members, Hungary's strategy and signalling of policy intentions stand out as particularly successful.

… to establish and maintain credibility during the liberalisation process.

The study notes that none of the crisis-struck new members took recourse to the Codes' derogation process to suspend liberalisation measures already taken, despite the severity of the crises experienced. Although older OECD members frequently resorted to derogations several decades ago, countries increasingly shun the re-imposition

Sharing the experience of older OECD members, new members shun the reimposition of controls…

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of controls, as evidenced in connection with the ERM-related crises affecting some of the older OECD members.

... during periods of acute financial turbulence.

In addition to its limited effectiveness once a critical mass of liberalisation has been accomplished, an important reason is that such a policy is negatively perceived by international market participants. A country which re-imposes controls on operations previously liberalised will generally not only find future access to international borrowing compromised, but also experience a potentially lasting set-back in terms of the development and standing of its own financial market place and its links with other financial centres.

To complement the accounts of the respective overall experience of older and newer OECD members, individual country case studies are presented in the Annex. These cover the experience with parallel deregulation and reform of the domestic financial sector and external capital account opening in Finland, France and Portugal, respectively, with the intention to highlight differences in approach and the commonality of difficulties encountered. Amongst recent members, a brief review of the currency crisis experienced by the Czech Republic in May 1997 is presented. This case illustrates the crucial importance of fostering state of the art lending and risk management practices in the banking sector as well as ensuring its effective supervision when liberalisation is undertaken.

2. Drawing it all together – Lessons and conclusions

For successful external liberalisation, both the opportunities and the risks of free access to international capital and money markets must be heeded.

Faced with the multiplicity of issues and policy aspects that come to the fore in a discussion of capital account opening, it is essential to keep in mind the fundamental and so far unchallenged benefit of capital account liberalisation: it provides access to international capital markets, enabling a country to finance all manner of socially as well as economically beneficial activities regardless of the constraints imposed by the level of savings that the domestic economy can muster. Hence, the key question is: How is this additional finance being put to use? From the answers to this question, a view can be formed of the vulnerabilities that may be linked to the

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increase in external indebtedness – vulnerabilities in the balance sheets where it ends up, in the degree of transparency and disclosure of these facts, in the risk management and effectiveness of supervision of the financial intermediaries involved, in the legal framework for contract enforcement, registry and enforcement of collateral claims, in insolvency procedures, in the public and private sector governance practices etc.

A* sine qua non *is information dissemination…

This already indicates, as a first lesson, that the provision and dissemination of information is of paramount importance as the capital account opening process is entered into. For capital to be allocated efficiently, for the build-up of vulnerabilities in balance sheets to be anticipated and avoided, for potential weaknesses and distortions in the functioning of prudential supervision as well as governance systems to be dealt with, market participants, monitoring authorities and other policy-makers must have the required information.

… to ensure full disclosure and transparency for risk identification and to build confidence.

This will include data that enable investors to assess the transparency and accountability of publicly released financial statements and audits as well as to assess compliance with standards of regulation and oversight. Information must also be disseminated on a timely and consistent basis regarding macroeconomic fundamentals and policies of the country concerned for the benefit of international markets as an insurance against uninformed herding behaviour. Further targeted information is also required in order for potential and actual vulnerabilities in the system to be identified in time for remedial action.

The heart of any financial system is its institutional-informational infrastructure and its long-term contracting capabilities…

A second lesson, increasingly accepted as an established fact in the international debate on capital account liberalisation, is the crucial importance of institutions – their quality and functioning as well as their ability to withstand shocks and stresses. It has been suggested that the heart of any financial system is its institutional-informational infrastructure and long-term contracting capabilities, without which uncertainty cannot be priced in the form of marketable risk. This concerns in particular the legal and contracting system, but high standards of public and

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private sector governance are also central to the benchmarking of a country's social infrastructure. The role of constitutions, legal systems, property rights and other institutional elements of a higher order, which evolve only slowly over time are also becoming subject to analysis in the context of financial liberalisation.

... even if robust institutions and sound governance cannot exclude vulnerability to crisis, as external shocks and unbalanced macroeconomic policies also play a role.

Further research should investigate the linkage between domestic and external financial liberalisation as well as the role of institutions in the liberalisation context. At the current juncture, it cannot be concluded that economies having appropriate institutional-governance systems and adequately developed financial sectors in place are able to move towards full liberalisation of capital movements with zero risk of a currency crisis. The consistency of fiscal, monetary and exchange rate policies must be taken into account, as well as the strength of any potential external shock. The indicators presented in the study represent an attempt to measure the resilience of institutions and domestic financial sectors to potential stresses as capital account opening proceeds. However, both within and outside the OECD member constituency they produce examples of countries with seemingly sufficient quality of institutions and financial sector development which nevertheless end up in crisis situations when their capital accounts are opened. This does not contradict the importance of well functioning institutional frameworks nor the need for further research into the role and measurement of institutions as suggested above.

Sequencing of liberalisation measures may be a workable policy choice for those countries that lack sufficient supporting institutions and well-supervised domestic banks.

This brings the question whether those countries lacking the required supporting institutional framework and sufficiently advanced domestic financial sectors should postpone liberalisation or opt for a sequenced approach to lifting controls. If an appropriate and workable sequencing of liberalisation of capital movements can be found that fits the circumstances as well as deals with the risks, this may well be a good policy option, although the possibility of circumvention of remaining control barriers is always present once a certain critical mass of liberalisation has been undertaken, as pointed out above. The OECD Codes-based approach favours full freedom of direct investment flows and equity-related portfolio investment as a priority,

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followed by other long-term flows related to operations in debt securities. Most member countries have tended to relax controls on non-trade related financial credits and deposit operations last, as well as maintaining controls on derivative operations by non-bank entities to guard against "speculation".This was also the case of the recent members of the OECD, albeit with some variations. In some, excessive reliance on intermediation of foreign funds by poorly supervised and governed domestic banks, rather than direct foreign borrowing by the corporate sector, led to inadequate risk identification and allocation, and created large balance-sheet vulnerabilities.

Sequencing generally works best in situations of limited financial sophistication.

However, it must be recognised that the strategy of initially welcoming longer-term, equity-related flows and discouraging more volatile flows undertaken for short-term portfolio adjustment purposes works best in situations of relatively low financial sophistication. Already before the proliferation of new instruments and financial engineering techniques in today's markets, it was difficult to distinguish in an economically meaningful way between long-term and short-term capital flows. Short-term credits are often rolled over at repeated intervals and counted upon by borrowing entities in their financial planning, while long-term instruments can be disposed of at short notice in secondary markets. In the case of direct investment, an investor has already for many decades had the possibility of borrowing against his asset and shorting the local currency through a spot and forward transaction. Nowadays, there are multitudes of avenues for altering the effective maturity of an investment, depending on the depth and liquidity of the particular marketplace.

Once a critical level of financial development and liberalisation is reached, evading remaining controls in periods of stress becomes easier.

In periods of stress and generalised loss of confidence by international market participants, the floodgates cannot be kept shut except by draconian measures. Some countries recognise this reality by opting for rapid and full-scale liberalisation of most or all flows, relying essentially on strengthened prudential supervision and improved transparency through adequate availability and dissemination of relevant data, to assess and contain risk relating to short-term capital flows.

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The distortive effects of permanent capital controls are generally recognised...

Thus, the question has frequently been raised whether additional safeguards in the form of controls on short-term flows are needed in anticipation of looming financial problems. This is distinct from advocating controls as permanent features of the policy mix over longer time periods. There is now fairly general recognition of the distortive effects of such controls, in terms of sheltering financial institutions from foreign competition, weakening discipline on policy-makers, vesting unhealthy discretionary power with bureaucrats and inviting rent-seeking behaviour by privileged interest groups.

... while there is some evidence that certain forms of controls can temporarily serve to lengthen maturity structures of inflows.

Amongst temporary controls on short-term flows, those affecting inflows seem to find more forceful advocates. It is argued that they can be justified as part of or supportive of prudential measures and that they have produced the desired results in some circumstances. Controls on outflows are generally agreed to have little if any effect and may even be counterproductive, indicating lack of effective policies or even panic on the part of authorities contending with a crisis situation.

OECD members found capital controls of limited effectiveness already in the 1970s. Today, they are no longer considered as a policy option.

Two facts emerge from the OECD experience that are not always reflected in the international debate: First, the occurrence of crisis is by no means a new phenomenon, confined to emerging market contexts, but has been a feature in the OECD liberalisation process since its inception. Second, OECD members already expressed strong disenchantment with controls imposed to stem short-term flows in the 1970's on account of their decreasing effectiveness. Thus, OECD countries – in Europe and elsewhere – experienced a series of severe currency crises in the past, notably in the 1970s with the collapse of the Bretton Woods system and the first oil shock, in the early 1980s with France and Italy as two examples, in the early 1990's in the Nordic countries and within the European Monetary System. However, this crisis experience tended to be relatively contained as liberalisation was for the most part undertaken in tandem with reform of domestic financial sectors, while sound, functioning institutions were already in place.

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The determination of OECD members to push on with liberalisation despite the possibility of periodic financial instability and disruption shows that the adoption of corrective policy measures which pass the test of free financial markets represented a better policy choice which offered stronger guarantees for economic stability in the future than recourse to capital controls.

The determination of OECD members to push on with liberalisation despite the possibility of episodic financial instability…

Where accompanying economic policies and supporting institutional frameworks are in place, international capital mobility has proved to bring essential macroeconomic benefits and efficiency gains: it offers a better allocation of world savings to productive uses; it ensures liquidity against domestic income fluctuations; it reduces investment risks by allowing portfolio diversification; and it provides signals from international markets that are salutary for the discipline of macroeconomic policies. In recent decades, liberalisation of capital movements has formed an integral part of regulatory reforms aiming to improve corporate and public governance and transparency of rules throughout the economy.

… vouches for the benefits to be derived.

3. Extending and sharing the OECD experience

The study's review of literature indicates that as a policy, capital account liberalisation is not well understood and remains controversial both on the macroeconomic and the microeconomic plans. Different theoretical perspectives have very different implications for the benefits deriving from capital account opening, and empirical analysis has so far not yielded any conclusive results. As regards the analysis of past crises, research has certainly brought out common factors, but evidence is still there that no two crisis situations are ever identical, given specific circumstances and features in the countries concerned.

Policy complexity, and singularity of national circumstances…

This means both that taking a microeconomic approach in attempting to gain further insights into benefits and costs of capital account liberalisation is probably inevitable, and that hard and fast prescriptive rules for sequencing of liberalisation measures are not certain to be of general use.

… makes it difficult to develop prescriptive approaches.

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The OECD experience represents a process of shared, mutually beneficial learning based on the Capital Movements Code's principles…

The distinctive OECD process of peer review in a multilateral setting can provide support for policy-makers engaged in financial liberalisation, by taking into account the specificity of their circumstances while at the same time sharing with them the accumulated experience of peer countries of similar or parallel policy situations. The OECD approach relies on a process of shared, mutually beneficial learning, where countries "benchmark" domestic regulations and policy measures against the standards set by the Codes of Liberalisation and the progress made by peer participants in this process to achieve those standards. In this way countries receive guidance as well as support in resolving the many complex policy issues linked to external financial liberalisation.

… which could be extended to non-members through similarly designed peer-review approaches.

This form of reasoned international co-operation based on the OECD Codes of Liberalisation could be of value to policy-makers in non-member countries, engaged in the opening of their capital accounts. The OECD is committed to share this experience as widely as possible, in partnership with non-members and other international organisations, to address the benefits and challenges of capital movements liberalisation.

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Chapter I

Institutional Framework and Policy Debate

This Chapter gives an overview both of the institutional setting for and the main driving forces behind the liberalisation undertaken by old and new OECD members. Section 1 provides a historical perspective on capital mobility in modern times. Section 2 describes the institutional background for international monetary co-operation emerging in the early post-war period, the reversal of initial liberalisation gains with the collapse of the Bretton Woods system, the renewed impetus for liberalisation in the 1980's and the tremendous acceleration in capital mobility during the past decade, which was marked by severe currency and banking crises in a number of countries. Section 3 sets out the policy responses to this crisis experience on the international stage.

1. A historical perspective on capital mobility

Although the natural starting point for this paper is the year 1961, when the convention establishing the OECD entered into force, a brief look back in time is necessary to acquire a perspective[1] on the issues raised by international mobility of capital and the imposition of exchange controls.

It is often taken as a fact that the high degree of capital mobility that is one manifestation of the current globalisation process represents a new phenomenon in the world economy – a phenomenon that is in part engendered by active integration policies such as those conducted within the framework of the European Union. In fact, there is evidence that capital was highly mobile as far back as the eighteenth century and was moving practically freely in the period between the Franco-Prussian War of 1870 and the First World War.[2]

If we look back as far as the Middle Ages, the movement of production factors was extremely limited. Labour, being bound by law to specific locations because of serfdom could barely move at all, and capital, although free to move in principle, was rendered fairly immobile by fragmented, decentralised monetary systems[3] and limited means of conveyance. As trade volumes increased following the commercial revolution that began in the early 12th century, international transactions involving substantial sums of money became more frequent, spurring a

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move from decentralised silver-based coinage supply to central minting of large denomination gold coinage. Despite the development of banking and the introduction of new monetary instruments in the early modern period, the scale of international capital flows remained fairly small. Incidental, larger movements of capital usually consisted of loans to princes or popes for the purpose of covering military expenditure. More widespread sovereign borrowing did not develop until late in the 18th century, when the spread of constitutional forms of government led to more stable nation states that recognised continuing liabilities to lenders. Nevertheless, flows were still unrestricted, as the imposition of exchange controls was not an option when money supply was exogeneously determined via the price of precious metals in the international market. This made it impossible to conduct an independent monetary policy for any length of time.

From the period 1870-1914, during the gold standard, there is concrete evidence of large-scale organised international financial activity facilitating investment projects in different parts of the world. At that time Europe acted as the "banker to the world", financing large infrastructural projects and also extending direct government loans for general budgetary purposes. Thus, the total stock of European foreign investment arrived at a level exceeding its GDP in the year 1913, while annual flows amounted to more than 5% of GDP. Recipients were other European states (25%), the United States (25%) with the remainder going to other parts of the world.[4]

Institutionally, merchant and investment banks played a key role in facilitating the global flows, earning high fees and commissions in the process of raising funds for ventures in newly developing areas and encouraging governments and railroad companies to issue bonds. The rudimentary state of communication technology did not represent an absolute physical obstacle to quick and sizeable capital movements. It was a matter of days but not of months for major international capital markets to adjust – a delay short enough to undermine the autonomy of monetary policy in a scenario of fixed exchange rates.[5] From today's perspective, it may seem puzzling how the high degree of capital mobility was reconciled with exchange rate stability, in the light of present difficulties for countries to pursue both these goals, given other economic, political and social objectives. It has been argued that subordination of such other objectives to the overriding goal of maintaining gold convertibility was possible in a setting where competing policy targets such as full employment were not clearly formulated, unionisation rates were low and the voting franchise still limited. The pressure to direct monetary policy to other goals was minimal and the high degree of flexibility of wages and prices can also be seen as a contributing factor. No administrative measures such as exchange controls were deemed necessary to achieve exchange-rate objectives because governments also pursued orthodox, non-discretionary fiscal policy.

With the outbreak of the First World War, the movement of production factors became gradually more and more curtailed. Capital was contained within national

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borders by means of a multitude of national regulations. Any international loans extended during this period almost exclusively originated from governmental bilateral assistance agreements of various kinds.

In the inter-war period a version of the gold standard was re-established and in operation during the period 1924-1931 which proved less robust than its predecessor.[6] While high capital mobility was temporarily restored, with the United States entering the scene as a major capital exporter, the reparation burden left by the war weighed heavily on a number of countries, primarily Germany, leading to serious balance-of-payments difficulties. The response of governments in this climate of instability, further heightened by the onset of the Great Depression, was to sever links to the international monetary system. Protectionist tendencies spread across Europe and trade in goods and services decreased significantly. Several countries introduced increasingly restrictive exchange controls and as major capital markets closed down (with the exception of the Swiss bourse which remained open for international issues also throughout the war years), capital movements fell back to about 20% of their pre-war level.

Although the disadvantages of this disintegration process were recognised and some initiatives undertaken to re-link the currencies of certain groups of states, nothing concrete emerged of lasting impact. In reaction to the prevailing monetary disorder – collapse of the gold exchange standard, competitive devaluations, rampant inflation – the *Bank for International Settlements* (BIS) was founded in 1931 to facilitate international payments flows.

In the run-up to World War II, the nationalist tendencies, which eventually culminated in the conflagration of 1939-1945, led to the creation of extensive and permanent exchange control regimes. While Australia, Canada, Finland, New Zealand, Sweden and the United Kingdom established the hard core of their exchange control regimes in preparation for, or during, the war, in a majority of other countries they were put in place during the immediate post-war reconstruction period. In the face of devastation caused by the war and a situation of acute shortages, controls, together with widespread trade restrictions, were used as emergency measures to reconstitute depleted international reserves and allow the imports of much needed equipment and basic goods such as food and energy.

2. Major factors driving exchange control strategies in the post-war period

2.1. *Emergence of a new institutional framework*

The immediate aftermath of the war saw the creation of the *Bretton Woods institutions* with the combined task of ensuring orderly and well-regulated international monetary relations. Initially, this meant fixed exchange rates between currencies, which were to be adjustable in the event of fundamental disequilibrium. Central

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banks would intervene to keep their currencies within 1% of their US dollar parities, while the United States authorities would maintain an official gold parity of USD 35 per ounce.[7] As an integral part of the system, the *International Monetary Fund* (IMF) would administer loan facilities for countries experiencing temporary balance-of-payments difficulties. Governments were expressly permitted to resort to capital controls to deal with problem situations, in particular large speculative capital flows. The IMF Articles of Agreement provided, under Article VIII, for liberalisation of controls on payments and transfers for current international transactions, as an essential condition for an open multilateral trade system. Capital controls, on the other hand, were regarded by the framers of Bretton Woods as a legitimate – and even necessary – instrument of economic policy.[8] Although policy makers were concerned not to interfere with certain operations, such as debt amortisation and commercial credits, considered to be vital for economic growth, extensive capital controls could therefore be maintained. As long as they worked, even if imperfectly, countries could contemplate changes in par values. Moreover, there is evidence that changes in the intensity of the control regime served as a mechanism for correcting balance of payments imbalances.[9] Nevertheless, while the Bretton Woods system was characterised by greater exchange rate flexibility than earlier regimes, adjustments were still relatively infrequent, and gold was not entirely out of the picture as the dollar remained convertible into gold.

The OEEC, *Organisation for European Economic Co-operation*, was created in 1948 to assist initially its Western European members to rebuild their economies and put them on a path of sustained growth. A primary task was to administer the Marshall Aid. To prevent the currency shortages experienced by the former warring European nations from disrupting international trade and payments, the *European Payment Union* was set up under the aegis of OEEC, to clear balances and provide credit facilities, thus initiating the work towards restoring external convertibility of the European currencies. The OEEC focused on trade liberalisation, with the additional ambition to provide for some national policy co-ordination, in the macroeconomic sphere as well as in the industrial and energy policy areas.

Following a number of sectoral European integration initiatives starting in 1952, a fuller economic integration goal was established by France, Germany, the Benelux countries and Italy via the creation in 1958 of the *European Economic Community* (EEC) by the Treaty of Rome. As the attention of policy-makers in Europe was wholly focused on reconstruction and rehabilitation, achieving current account convertibility took precedence over liberalisation of non-trade related capital flows. This goal was reached by 1958, when the European Payments Union could be dismantled. Memories of destabilising speculation in the inter-war period and diverging regimes of exchange control with respect to capital movements kept the number of advocates of full capital account convertibility low. Thus, although the Treaty of Rome is based on the principle of full

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freedom of movements of goods, persons, services and capital, the wording and structure of the Treaty indicates an implicit understanding that freedom of capital movements would be achieved later in the integration process than the other three freedoms.[10]

Once liberalisation of the real sector had been achieved, many advanced economies began to dismantle capital controls in the early 1960s. The impetus for liberalisation was consolidated into an explicit undertaking as the OEEC was reshaped into the OECD (*Organisation for Economic Co-operation and Development*) with an extended membership (to include the United States and Canada) in 1961. The members adopted a legally binding Code of Liberalisation of Capital Movements, which although not committing them to the objective of complete freedom, engaged them in a process of progressive liberalisation, removing restrictions "to the extent necessary for effective economic co-operation". (See Chapter II for a description of the principles, provisions and obligations of the OECD Code of Liberalisation of Capital Movements.)

2.2. *Reversal of the liberalisation process in the 1970s*

The majority of OECD member countries adopted a gradual liberalisation process, and all members have seen fit to impose exchange controls at one time or another since World War II. Only a few countries did not establish a permanent exchange control regime: Canada which has had no exchange controls since the early 1950s, the United States and Switzerland which never had a tradition of controls, and Germany which abolished the bulk of its restrictions as early as 1958. Even so, these three latter countries all used exchange controls periodically in the 1960s and l970s when a reversal of the incipient capital account liberalisation process occurred. (See further Chapter II.2.)

This reversal did not result from the demise of the Bretton Woods system *per se* but from the same factors that brought about its collapse. Under the Bretton Woods system, governments remained dedicated to exchange rate stability as the monetary anchor, attesting to their concern for sound and stable policies. Alternative anchors such as money supply or inflation targeting had not yet entered into the picture. The considerable degree of exchange rate stability of an enduring nature achieved under the system was made possible by rapid economic growth, absence of commodity price shocks and moderate wage pressures. Strong growth and stable prices reduced the need for counter-cyclical monetary and fiscal policy measures which could induce balance-of-payments disequilibria. As long as this situation persisted in the general economic environment, few countries saw serious reasons to question the general belief that state intervention was necessary in many areas (subsidised interest rates, privileged financing channels, industrial policy, price control) to sustain economic growth. A logical complement to this

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entrenched view was that exchange controls were needed to ensure the necessary protection against adverse external shocks and preserve the independence of national policies. Low real interest rates were used to promote domestic economic growth while capital controls were designed to ease possible resulting pressures on the exchange rate and to preserve official reserves.

As some countries began dismantling controls and others found their control systems undermined by increased financial sophistication on the part of firms and institutions, capital mobility increased. The rising United States balance of payments deficit and concerns regarding the inadequacy of international reserves gave rise to doubts regarding the sustainability of fixed exchange rates. Pressures from diverging macroeconomic fundamentals engendered large capital outflows out of the US dollar, at times forcing revaluations of currencies in recipient European countries, (notably Germany). The merits of adopting a floating regime were intensely debated in connection with the recurrent bouts of turbulence in exchange markets resulting from successive waves of speculative flows. The United States took the decision to close the gold window in August 1971 and floated the dollar. The European countries opted to intensify monetary and economic co-operation and to endeavour to preserve exchange rate stability through re-imposition of controls, despite ample evidence of their declining effectiveness. New parities were fixed *vis-à-vis* the US dollar in the Smithsonian agreement at end 1971 and many of the European currencies began to be linked to each other through the "snake" from April 1972, an arrangement which lasted (despite a number of defections by individual members) until the evolution of the E*uropean* M*onetary* S*ystem* (EMS) in 1979.[11] A few countries (Australia, New Zealand and Japan) moved to a managed float but, nevertheless, maintained some form of exchange rate commitment.

In the beginning of 1973, another wave of massive capital flows forced the abandonment of the link *vis-à-vis* the dollar and European countries further tightened capital controls, as the collapse of the Bretton Woods system became a reality.[12] Many of these controls were maintained in a number of countries until well into the 1980s. The two oil shocks in the beginning and at the end of the 1970s, respectively, engendered diverse macroeconomic policy responses by advanced economies, bringing a degree of monetary disorder not conducive to a rapid removal of controls.

2.3. R*enewed liberalisation impetus in the* 1980*s*

From the mid-1970s to the early 1980s, many countries reduced the level of ambition of their exchange control regime to what was considered as strictly necessary to preserve some autonomy of monetary policy. This reflected a beginning shift towards increased reliance on the part of policy makers on the functioning

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of markets. Deregulation and reliance on market-based policy instruments rather than discretionary control measures became a natural consequence of this shift. As this supply-side reform gained strength, it was recognised that capital controls were less and less effective for monetary autonomy. After all, as direct restrictions on capital account operations had been the necessary accompaniment on the external side to such direct monetary policy instruments as credit controls and interest rate ceilings, the move to indirect, market-based instruments to achieve monetary policy objectives meant changing attitudes to both forms of measures. Beyond the disinclination to accept any longer the distorting effects of controls and discretionary authorisation processes, the increased emphasis on price stability as a goal for monetary policy, also reduced the need for maintaining a battery of tools to shield domestic interest rate levels from external influences. The changed role and status of central banks brought by this shift has further contributed to reduce pressures for imposition of capital controls, emanating from particular domestic interest groups. The greater independence from short-term domestic political considerations acquired for central banks pursuing price stability over the medium and long term has enabled them to withstand pressures from any quarters within the domestic economy.

Thus, an acceleration of capital account liberalisation began in the early part of the 1980s, as countries embarked on an outright dismantling of systems of capital controls. This movement was closely interlinked with developments in international financial markets (*the new financial landscape*). Drastic changes were taking place in the financial environment in which countries were now operating, partly engendered by the process of liberalisation and deregulation itself, partly stimulated by developments in technology and communications. Financial markets were becoming more complex and extensive, more interlinked, reacting more swiftly to changed circumstances. Many countries that still maintained controls found these considerably less effective than in the more financially repressed environment of the 1960s and 1970s. Extensive use of innovations such as interest rate options and other derivative products fostered a blurring of different segments and maturities of the financial markets and made traditional transmission mechanisms for monetary policy measures, targeting short-term flows, less reliable. Also, major market participants, such as internationally active banks and institutional investors able to operate on a cross-border basis exerted pressure on their respective authorities for the decontrol they required to avail themselves of the vastly increased range of financial instruments and techniques of risk management.

It was in this general climate that the preparatory work was carried out within the EU for full liberalisation of capital account operations. Only three EU countries, Germany, the United Kingdom and Denmark had fully liberalised all capital transactions by the time the drafting of the 1986 EU D*irective* on capital

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liberalisation was in process, although the Netherlands joined their ranks by the end of 1986. In this Directive, short-term operations were still excluded from the liberalisation obligations. Lack of agreement on a concerted EU move towards full liberalisation was due to diverging opinions on the degree of institutionalised co-ordination of monetary policies required for the co-existence of free capital movements and a stable exchange rate. A fundamental step towards resolving this conflict was taken through the *Basle/Nyborg agreement*, where a common strategy for withstanding speculative exchange rate pressures was adopted. It brought both the higher degree of exchange rate stability and the recognition of the degree of convergence of policies required to progress both on capital account liberalisation and economic and monetary union. When France had joined the ranks of countries favouring complete freedom for capital flows, the 1988 EU *Directive* codifying full liberalisation of capital movements regardless of their specific nature and duration, could be adopted. The 1992 Maastricht Treaty took a further step forward by making the free movement of capital one of the fundamental freedoms of the European Union and prohibiting capital controls not only within the Union but also *vis-à-vis* third countries.

2.4. *The 1990s and beyond*

The general shift toward market-oriented economic policies aimed at non-inflationary sustainable growth occurring in the 1980s continued to fuel liberalisation activity in the 1990s, with more countries moving onto the bandwagon of deregulating capital account operations. Not only developed economies removed their capital controls in the 1980s and 1990s but many emerging markets also opened their capital accounts to a considerable extent. Following the hiatus of nearly 40 years experienced since World War II, private portfolio flows to emerging markets had started to resume in the 1970s, soon overtaking the official and FDI flows that had dominated in the interim. In that decade there was a marked rise in the proportion of bank-intermediated funds, in part reflecting the "recycling" of oil revenues via syndicated euro-currency bank lending out of London and other financial centres. The serious debt servicing difficulties experienced in many emerging market countries in the wake of the second oil price shock in 1982 halted the flow of private bank and portfolio capital to most developing countries for the rest of that decade, as their overall macroeconomic performance deteriorated sharply. Net private capital flows to this part of the world soared again to unprecedented levels in the 1990s, remaining high despite the Mexican crisis of 1994-95, helped by a steady rise in net inward FDI. As shown in Table 1, the steady growth in FDI has imparted resilience to total net capital flows into emerging market economies despite the more volatile pattern of portfolio flows and bank lending. The proportion of inflows accounted for by bank loans which had peaked at 70% of total flows in 1989, declined to barely 40% in 1994, as bond and equity issues

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Table 1. **Emerging market economies: net capital flows, 1991-2001**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total											
Private capital flows, net	123.8	119.3	181.9	150.9	212.0	234.2	111.9	65.4	69.4	7.7	31.3
Direct investment, net	31.3	35.5	56.8	80.8	100.1	117.0	142.7	154.7	163.8	153.4	175.5
Portfolio investment, net	36.9	51.1	113.6	113.0	41.2	86.9	46.3	–4.6	33.9	–4.3	–30.2
Other private capital, net	55.6	32.7	11.5	–42.9	70.7	30.3	–77.2	–84.7	–128.2	–141.4	–114.4
Official flows, net	36.5	22.3	20.1	3.5	26.9	–1.5	64.9	60.5	13.7	5.7	37.2
Africa											
Private capital flows, net	8.9	6.9	8.7	13.4	11.9	16.8	8.2	11.9	10.6	3.9	7.9
Direct investment, net	2.0	1.7	1.9	3.2	2.1	3.8	8.0	6.5	8.9	7.3	22.2
Portfolio investment, net	–1.5	–0.6	1.0	3.6	3.1	2.8	7.0	3.7	8.7	–2.4	–8.8
Other private capital, net	8.4	5.8	5.8	6.6	6.8	10.1	–6.8	1.6	–7.0	–1.0	–5.5
Official flows, net	7.8	10.5	7.8	3.3	4.1	–1.9	1.9	3.1	1.9	1.4	1.1
Asia[1]											
Crisis countries[2]											
Private capital flows, net	26.8	26.6	31.9	35.4	56.8	74.3	–5.6	–31.6	–13.9	–15.7	–16.2
Direct investment, net	6.1	6.3	6.7	6.5	10.3	11.7	10.2	11.5	14.6	14.3	8.3
Portfolio investment, net	3.4	5.3	16.5	13.3	18.6	26.9	8.9	–9.0	11.8	7.0	3.2
Other private capital, net	17.3	15.0	8.7	15.6	27.9	35.7	–24.7	–34.1	–40.4	–36.9	–27.7
Official flows, net	4.4	2.0	0.6	0.7	8.8	–4.7	13.7	17.0	–2.2	6.6	0.6
Other Asia											
Private capital flows, net	7.2	–8.7	25.5	34.9	40.7	46.0	19.6	–15.4	15.2	0.2	35.4
Direct investment, net	8.3	8.5	26.3	38.2	44.1	43.9	47.3	48.3	47.3	40.1	45.2
Portfolio investment, net	–2.0	2.6	4.5	7.5	2.1	3.3	–2.1	–9.2	2.4	–2.6	–17.6
Other private capital, net	0.9	–19.7	–5.4	–10.8	–5.4	–1.2	–25.6	–54.4	–34.6	–37.3	7.8
Official flows, net	6.5	8.3	7.9	2.5	–3.3	–7.3	–6.6	3.1	3.8	–2.1	–2.0
Memorandum item: Hong Kong, China											
Net private capital flows				–7.3	–7.2	–9.4	11.7	–8.5	1.0	4.2	–5.1
Middle East and Turkey[3]											
Private capital flows, net	68.6	35.1	33.7	15.7	9.9	7.2	15.1	9.5	0.6	–24.0	–27.1
Direct investment, net	1.2	0.9	3.9	4.8	6.4	4.7	5.2	6.3	5.4	7.3	8.5
Portfolio investment, net	22.3	13.5	21.8	7.6	2.0	1.8	–0.9	–13.2	–3.2	–13.7	–10.2
Other private capital, net	45.1	20.7	8.0	3.4	1.4	0.7	10.8	16.3	–1.7	–17.6	–25.5
Official flows, net	3.9	–1.3	2.3	3.5	4.5	6.6	9.3	2.9	2.4	–0.1	7.1

Table 1. **Emerging market economies: net capital flows, 1991-2001** (*cont.*)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Western Hemisphere											
Private capital flows, net	24.1	55.9	62.6	47.1	44.0	66.4	70.6	71.3	43.2	42.5	27.1
Direct investment, net	11.3	13.9	12.0	22.8	24.2	40.3	56.2	60.6	64.1	61.6	67.2
Portfolio investment, net	14.7	30.3	61.1	65.0	0.8	38.8	25.9	18.7	11.1	4.6	0.9
Other private capital, net	–2.0	11.7	–10.6	–40.7	19.0	–12.7	–11.5	–8.0	–32.0	–23.8	–41.0
Official flows, net	2.7	–1.7	0.6	4.7	18.6	3.4	13.7	16.1	7.4	–0.5	29.1
Countries in transition											
Private capital flows, net	–11.7	3.5	19.6	4.4	48.6	23.5	3.9	19.8	13.9	0.8	4.2
Direct investment, net	2.4	4.2	6.0	5.3	13.1	12.5	15.8	21.4	23.4	22.8	24.0
Portfolio investment, net	–	0.1	8.8	16.1	14.6	13.3	7.5	4.5	3.1	2.8	2.4
Other private capital, net	–14.1	–0.7	4.8	–17.0	20.9	–2.4	–19.4	–6.1	–12.6	–24.8	–22.2
Official flows, net	11.1	4.5	0.9	–11.2	–5.8	2.3	32.9	18.2	0.4	0.4	1.4

1. Includes Korea, Singapore, Taiwan, Province of China but not Hong Kong China.
2. Indonesia, Korea, Malaysia, the Philippines and Thailand.
3. Includes Israel.

Source: IFS, IMF *World Economic Outlook*, various issues.

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again became more important vehicles for raising funds. These developments coincided with the resolution of the Latin American debt crisis through the Brady bond deals and with the effective opening of Asian and Latin American capital markets. Since 1999, however, the drop in both portfolio investment and bank lending has reduced net inflows to emerging markets to a mere trickle in 2000, with indications of a slight pick-up in 2001 and early 2002. Observers discern a pattern of "decoupling" on the part of international investors of the recent debt default in Argentina from the relative merits of investing in other emerging markets. If a sustained decline in contagion[13] is being observed, with more attention paid to the assessment of individual country risk, this could be interpreted as a positive result of the standards and transparency initiatives of the international financial community.

While the adoption of liberal foreign exchange regimes made these capital flows possible, their scale and composition were significantly influenced by ongoing structural changes in international financial markets. The increased share of portfolio flows, including portfolio equity flows, reflects the growing role of institutional investors in international financial markets, as well as the trend towards securitisation. The rising institutionalised saving in OECD economies in line with population ageing has increasingly been directed towards cross-border portfolio investment, in particular via pension funds.[14] Securitisation has been occurring both in the sense of disintermediation, where indirect bank finance is replaced by direct debt and equity instruments and through the creation of actively traded futures and options contracts whereby certain risks are securitised and managed. A further boost to the rapid development of management and trading of risk came through the increased refinement of pricing of options based on the Black-Scholes pricing model of 1973 and later academic work.

When it fosters an appropriate pricing of the risks and returns associated with different investment activities, the increasingly integrated global financial system produces important efficiency gains, through a better allocation of global funds to investment projects. Additionally, cross-border portfolio flows as well as FDI flows can help investors reduce risk by allowing for more diversified portfolios. An additional benefit of particular importance for emerging market economies is that the involvement of foreign financial institutions in domestic financial markets can become a crucial factor in improving financial management, stimulating the adoption of state of the art financial technology and encouraging competition. However, the strong booms in private capital inflows followed by spectacular reversals marking both the Mexican peso crisis in 1994 and the South East Asian crisis in 1997, led to some questioning of the dynamics of the new financial system. Was full participation by emerging market economies really advisable, if it could subject them to such massive pressures and spill-over effects through contagion? Net private capital inflows into the Asian crisis economies (Indonesia, Korea, Malaysia, the Philippines

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and Thailand) rose from USD 35.4 to USD 74.3 billion between 1994 and 1996, and plummeted to – USD 5.6 billion in 1997. At their height these inflows represented some 6-10% or more of GDP in these economies. Similarly, net capital inflows into Mexico reached above 7% of GDP in 1994, dropping drastically following the December crisis of that year. The policy responses to these crises, and the massive retrenchments of capital flows which followed are discussed in the next chapter.

Concluding this brief look at developments in capital mobility during the 1990s, the following observations bear mentioning:

- The financial crises in South East Asia in 1997 and in Russia in 1998 temporarily halted the portfolio flows from mature to emerging capital markets, but a spectacular increase in FDI flows, including from developed to developing countries continued to bring evidence of increased global capital mobility. This development, as a consequence of which FDI came to represent well over 80% gross private inflows in 1999-2000 (up from 50% in 1991-92), was further stimulated by major shifts in the geopolitical balance after the fall of communism.
- More recently, preliminary data indicate a drop in FDI activity in 2001 and 2002.[15] However, many observers have taken direct investment's strong performance over the latest decade as vindication of the argument that FDI flows are inherently more stable than other flows. The relative stability of FDI could reflect the fact that it is driven by "longer-term" considerations than other investment (see OECD (2002)), and that, consisting largely of physical acquisition of plants and equipment, FDI is inherently difficult to reverse at short notice.[16] Data confirm that both in Latin America after the Mexican crisis and Asia after the 1997 crisis, FDI inflows remained substantial, while other flows dropped off drastically.[17]
- The lags in development of domestic financial markets and institutions in the crisis-struck economies stand out as critical factors, not only as concerns the banking sectors where lax lending policies and weak regulation and oversight were contributing to the crisis build-up and subsequent collapse. Weakness of long-term government and private bond markets also appears critical. Their absence limited the scope for sterilised intervention, as well as the potential for allowing domestic economic agents to offset maturity and currency mismatches in their balance sheets. This again underlines the linkage between reform of domestic financial sectors and the process of integration into the international financial system, discussed elsewhere in this study. Policies aiming to maintain a desired minimum level of insulation of domestic financial institutions and markets from foreign competition while still attempting to reap the benefits of international capital mobility seem singularly misguided in this perspective.

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3. Policy responses to 1997-98 international financial crises: the international governance debate

3.1. *Introduction*

In the aftermath of the Asian international crisis, many experts and market participants expressed the opinion that policy-makers and the international financial community were poorly prepared for the crisis episodes of 1994-95 and 1997-98. The criticism was raised that the liberalisation of capital movements in transition countries and other emerging markets should have been more prudently sequenced and better underpinned by other accompanying reforms. There were also initial calls for a new "international financial architecture" including reform of the Bretton Woods institutions as well as renewed debate regarding the need for re-imposition of capital controls. However, through the G-7 summits process during the past few years, in particular via the creation in 1999 of the Financial Stability Forum (FSF),[18] and the G-20 (including large emerging markets)[19] fairly broad international consensus has been generated around a more pragmatic approach to crisis prevention.

This approach follows a standards-based path to define universally applicable best practices in key areas of financial and economic policy. Emerging market countries were encouraged to improve the management and regulation of their financial systems in line with these international best practices put forward via the BIS, IOSCO and other fora, including the OECD.[20] No agreement developed to the effect that capital controls would be desirable to supplement prudential measures except, but there was a consensus that while long-term flows should be encouraged as far as possible, incentives that encourage short-term flows should be avoided. Recommendations were also made to keep short-term foreign borrowing better aligned with free international reserves and to avoid defending a pegged exchange rate during periods of market stress. Better communication with creditors and investors was also called for.[21] Lately, the focus has been on strengthening financial sector institutions and practices through the joint World Bank-IMF Financial Sector Assessment Program mechanism, more transparency of information, *e.g.* through publication of IMF Article IV assessments and an improved debtor-creditor dialogue through the Capital Markets Consultative Group.

3.2. *Implementation of standards*

While standards and codes have shaped the environment for international economic and financial co-operation for several decades, many of the recent initiatives developed by the multilateral bank community together with a number of standard-setting bodies were directly triggered by the generally recognised need to develop

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a supportive environment for financial liberalisation and globalisation. There are now standards, codes and guidelines covering a number of economic and financial areas, including data dissemination; fiscal, monetary and financial policy transparency; payments systems, banking regulation and supervision; securities and insurance supervision and regulation; accounting; insolvency; corporate governance and public debt management. A recent addition are fifteen principles for the regulation of private occupational pension schemes approved by the OECD and endorsed by the International Network of Pension Regulators (INPRS).

Development and further refinement of standards is continuing, but emphasis is shifting towards ensuring implementation. Efforts by national authorities, international financial institutions and standard-setting bodies are now being channelled into assessing the observance and fostering the implementation of the standards. Box 1 sets out a detailed overview of the numerous ongoing efforts by different standard-setting bodies to develop assessment methodologies as well as refinements and additions to existing standards.

At the same time, it has been recognised that the implementation of standards is not sufficient to *ensure* financial stability. The aims spelled out by the FSF Task Force are that the implementation of standards should *promote* sound domestic financial systems as well as international financial stability (see Box 2). While it is beyond doubt that the observance of standards clearly helps to identify gaps in the regulatory and transparency framework as and where they exist, many other factors in the macroeconomic environment clearly will impact on the effectiveness of these standards. Also, the standards are expressed in general terms as broad guidelines so as to elicit wide international recognition. This means that individual country circumstances need to be taken into account at the stage of implementation of general standards.

Empirical comprehensive evidence of the impact of the observance and implementation of standards on financial stability and development is not yet available. In a recent IMF paper (Sundararajan *et al.*, 2001), a framework for such analysis is set out in order to provide some insights on the empirical relation between Basel Core Principles (BCP) assessments and soundness indicators for banks. The authors conclude that the transmission mechanism from standards implementation to overall stability differs according to type of standard. In particular, they note that the distinction between transparency and disclosure standards on the one hand and regulatory and system design standards on the other, is crucial to understanding its nature. In the case of the BCP they find no discernible direct association between the extent of compliance with BCP and overall indicators of credit risk and soundness in banking sectors which appear to be primarily influenced by macroeconomic and macroprudential factors. Compliance could, however, have a sizable indirect influence through its impact on the effect on soundness of macro factors.

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Box 1. **Development and refinement of financial system standards and assessment methodology**

Basel Committee on Banking Supervision (BCBS) – "The Core Principles Methodology" was developed to be used in multiple contexts, including self-assessments, peer or third party reviews, and reviews performed in the context of Fund surveillance, including FSAPs/FSSAs, Fund Technical Assistance programmes and World Bank lending operations. Experience with Basel Core Principles (BCP) assessment by Bank and Fund was discussed by the IMF Executive Board, and the findings communicated to the Basel Committee. The BCBS has developed a guidance document on how to perform a self-assessment, distributed as a BCBS document.

International Association of Insurance Supervisors (IAIS) – The IAIS issued core principles and developed an assessment methodology in 2000. It has been working with multilateral institutions and others to implement the core principles and has also launched a self-assessment exercise.

International Organization of Securities Commissions (IOSCO) – has promoted the implementation of the Objectives and Principles of Securities Regulations through, three self-assessment surveys, a general survey on the level of observance in broad terms and two detailed surveys for securities regulators and issuers respectively. Work is also under way by the Implementation Committee of the IOSCO, in which multilateral institutions participate, to develop detailed assessment methodology.

Committee on Payment and Settlement Systems (CPSS) – Through the recent publication of the "Core Principles for Systemically Important Payment Systems" (CPSIPS) and the joint CPSS/IOSCO "Recommendations for Securities Settlement Systems", the Committee has contributed to the set of standards, codes and best practices that are deemed essential for strengthening the financial architecture worldwide. The IMF and the World Bank participated in the task force that prepared the draft of the CPSIPS, and have begun using the draft core principles in their TA and FSAP activities. The reports of the task force have been issued for public comment.

Organisation for Economic Co-operation and Development (OECD) – The OECD has a long history as a standard-setting body in many areas of relevance for overall financial sector stability. In May 1999 the OECD Ministers adopted the OECD "Principles of Corporate Governance". These non-binding principles are intended to serve as a reference point for countries' efforts to evaluate and improve their own legal, institutional and regulatory framework and are also a benchmark in the FSAP process. Recently, fifteen "Principles for the Regulation of Private Occupational Pension Schemes" were approved by the OECD and endorsed by the International Network of Pension Regulators (INPRS). The OECD "Codes of Liberalisation of Capital Movements and Current Invisible Operations" date back to 1961,

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Box 1. **Development and refinement of financial system standards and assessment methodology** (*cont.*)

although extensions and strengthening have been undertaken since. Implementation and assessment methodology is based on a formal peer review process.

The Joint Forum comprising BCBS, IOSCO and IAIS issued guidelines on supervision of financial conglomerates in February 1999 and a report in 2001 comparing core principles in the areas of banking, securities and insurance supervision with a view to identifying inconsistencies and gaps in coverage of regulatory standards for the financial sector.

The International Monetary Fund has developed, in consultation with national authorities and other standard-setting bodies, standards for data dissemination, fiscal policy transparency, and monetary and financial policy transparency, and guidelines for public debt management. Guidelines for Foreign Exchange Reserve Management have been issued for public comment.

The World Bank has undertaken work on guidelines for insolvency regimes, corporate governance, accounting and auditing, jointly with the Fund and other relevant organisations.

The Financial Stability Forum established a task force on implementation of standards, which reviewed the ongoing work on the standards relevant for financial stability and issued a report in March 2000. A subgroup of this task force is examining the scope for market and official incentives for implementation of standards.

The joint Bank-Fund Financial Sector Assessment Program (FSAP) is the primary mechanism for undertaking assessments related to BCP; the IOSCO, IAIS and CPSS principles; and the Code of Good Practices on Transparency in Monetary and Financial Policies, which serve as inputs into broader assessments of stability and development needs. Some of these standards are also assessed in the context of stand-alone IMFTA programmes. The FSAP provides feedback to standard-setting bodies on assessment methodologies, based on periodic meetings of experts, periodic review of experience and outreach programmes. The Joint Bank-Fund Reports on Observance of Standards and Codes (ROSCs) are summary assessments of members' implementation and observance of internationally recognised standards. ROSCs are prepared in various contexts by the Fund and the Bank and published voluntarily on the Fund or Bank website.

The International Accounting Standards Committee (IASC) has issued some 40 international accounting standards, while the International Federation of Accountants has issued around 30 International Standards on Auditing.

Source: IMF, FSF and OECD.

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Box 2. **Financial Stability Forum – 12 key standards for sound financial systems**

The 12 standard areas highlighted here have been designated by the FSF as key for sound financial systems and deserving of priority implementation depending on country circumstances. While the key standards vary in terms of their degree of international endorsement, they are broadly accepted as representing minimum requirements for good practice. Some of the key standards are relevant for more than one policy area, *e.g.* sections of the Code of Good Practices on Transparency in Monetary and Financial Policies have relevance for aspects of payment and settlement as well as financial regulation and supervision.

Area	Standard	Issuing Body
Macroeconomic Policy and Data Transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard/General Data Dissemination System[1]	IMF
Institutional and Market Infrastructure		
Insolvency[2]		World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)[3]	IASC[4]
Auditing	International Standards on Auditing (ISA)	IFAC[4]
Payment and settlement	Core Principles for Systemically Important Payment Systems/Recommendations for Securities Settlement Systems	CPSS/IOSCO
Market integrity	The Forty Recommendations of the Financial Action Task Force/8 Special Recommendations against Terrorist Financing	FATF
Financial Regulation and Supervision		
Banking supervision	Core Principles for Effective Banking Supervision	BCBS
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Core Principles	IAIS

1. Economies with access to international capital markets are encouraged to subscribe to the more stringent SDDS and all other economies are encouraged to adopt the GDDS.
2. The World Bank is co-ordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate implementation.
3. Relevant IAS are currently being reviewed by the IAIS and IOSCO.
4. The International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC) are distinct from other standard-setting bodies in that they are private sector bodies.

Source: Financial Stability Forum: *www.fsforum.org/Standards/KeyStds.html*

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3.3. *Crisis Resolution*

While the standards-based path for crisis prevention is backed by universal support, there is less consensus on the appropriate framework for resolution of international financial crises as they occur. The IMF's provision of large-scale lending packages, backed by conditionality with respect to the implementation of macroeconomic and structural reform has been the target of criticism on several fronts. Among concerns was the problem of "moral hazards" created by official lending to resolve sovereign debt crises – the reduced incentives of debtors and creditors to act in a financially responsible manner. There has been a succession of proposals searching for the modalities to encourage greater private sector involvement in crisis resolution and avoid excessive reliance on official lending.

Common to the various proposals under discussion from academics, the private sector, national government authorities and international institutions is the discontent with conventional tools for crisis resolution. There is also general agreement that too much uncertainty currently surrounds the sovereign debt restructuring processes and that the difficulties of establishing a collaborative relationship between sovereign debtors and a diffuse and diverse investor base have often proved intractable.

Without entering into the detail of the many proposals put forth,[22] two strands can be distinguished: those that argue for a statutory stay, or standstill, with or without an important role for the IMF in endorsing a standstill request by the debtor country;[23] and those who advocate a contractual approach which would rely on collective action clauses to be inserted in debt contracts between sovereign borrowers and their different categories of creditors

The idea of imposing standstill by statute (through treaty obligation or via amendment of the IMF Articles of Agreement) has given rise to much controversy. Arguments against standstills are that they would: encourage debtors to default as an element of moral hazard; cause investors to "rush for the exit" at the slightest sign of trouble, thus triggering crisis situations; have to be backed up by capital controls in order to be enforceable at the risk of limiting the flow of funds to emerging markets overall. Arguments in favour of standstills are that they would: provide an orderly framework for crisis resolution by co-ordinating and aligning creditor and debtor incentives while safe-guarding the required window for policy adjustment and debt restructuring; enhance the recovery value of debt in case of default; improve risk management of creditors; would likely discourage marginal short-term lending only if the overall volume of funds available were to be somewhat diminished.

The contractual approach builds on the extension of collective action clauses currently in use in international sovereign bond contracts – notably "majority restructuring provisions" and "majority enforcement provisions" – both to allow

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agreement on restructuring among different categories of creditors (to include bank and trade credits in addition to bonds) as well as bind all of them to the renegotiated terms. Arguments against the contractual approach are mainly linked to problems with cost and acceptability factors, especially due to difficulties of establishing inter-creditor equity. Work is currently underway on the detailed drafting of such clauses,[24] on empirical estimation of cost factors and other potential impediments to their use[25] and on modalities for encouraging their acceptance by market participants.[26]

The two approaches need not be seen as mutually exclusive, as some proposals call for a mechanism through which standstill could be combined with co-ordinated private creditor involvement in orderly debt restructuring. A major common concern is to prevent hold-out creditors from disrupting the restructuring process or undermining an agreement reached between a debtor and a majority of its creditors, by demanding repayment through individual action/litigation. To prevent this form of "dissident" creditor action, and achieve the best possible alignment of creditor as well as debtor interests and incentives most proposals now advocate reliance on processes borrowed from basic domestic bankruptcy reorganisation as it exists in individual country legislation.

The implications of the various proposals on crisis resolution mechanisms under discussion for capital movement liberalisation and exchange control, including relationship to existing investment disciplines, have yet to be explored.

3.4. *Controls*

Adjusting policies and implementing standards to strengthen financial sectors and resolve vulnerabilities in corporate sector balance sheets amounts to a comprehensive economic reform programme in the longer-term. The question of whether capital controls would be desirable in the interim to supplement prudential measures has been widely discussed, without any degree of consensus developing. Some agreement exists that while long-term flows should be encouraged as far as possible, incentives should be avoided that encourage short-term flows. Proponents of controls on short-term flows argue that relying only on prudential standards in limiting risks associated with capital flows is not enough, as prudential measures cannot be so strict as to completely rule out excessive risk-taking activity on the part of financial institutions. However, the difficulty in designing and implementing effective controls is also widely acknowledged. Apart from the traditional drawbacks of controls in terms of distortion effects and administrative burden, the fundamental problem remains that once current payments and some capital account operations are liberalised, the possibilities for circumvention of controls are extensive, given the proliferation of financial instruments and techniques in today's markets.

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The most widely discussed form of control on short-term flows is the Tobin-type tax, designed to reign in speculative activity in financial markets and obtain greater independence for monetary policy by segmenting financial operations. Tobin argued that the real sector should be sheltered from the results of speculative activity in international financial markets which is not necessarily related to changes in fundamental economic factors. Thus, through "throwing sand in the wheels" in the form of a tax on foreign exchange operations, speculators would be forced to lengthen their time-horizons.[27]

Although there has been no particular trend increase in foreign exchange volatility in the past two decades, proposals for a Tobin tax – a small tax on large-size currency transactions – have been increasingly promoted by NGOs in particular. The basic argument is that a modest levy – say 0.1% – on the value of a trade will be of little significance to the respective parties to a long-term investment or trade contract, but of much greater importance to short-time operators going in and out of transactions where foreign currency assets are held for very limited time periods. Thus it would deter such speculative operations while not hampering the flow of "regular" *bona fide* operations. Because of the high volume of foreign exchange market transations – exceeding one trillion dollars a day – the revenues are thought by advocates to be substantial and of potential significance as a supplement to official development assistance.

While data support the view that volatility increases at high frequencies (giving rise to the label "noise trading") and that it is hard to explain monthly – let alone daily – movements in exchange rates by movements of what is regarded as "economic fundamentals", it has not been conclusively shown that the volatility observed is excessive.

A recent in depth study by the OED (E*conomic* O*utlook*, June 2002) on the merits of the "Tobin tax" arrives at the following conclusions:

- No firm answer can be given to the question of whether a "Tobin tax" would reduce volatility. A "Tobin tax" penalises high-frequency trading without discriminating between trades which may be de-stabilising and those which help to anchor markets by providing liquidity and information. Indirect evidence from other financial markets where a securities transaction tax has been in place suggests a substantial effect on trading volume but either no effect, or a small one of uncertain direction, on price volatility.

- Potential benefits appear to be small. On the cost side, volatility could rise rather than fall, because of an indirect effect on liquidity, and the "Tobin tax" could hit particularly hard at those trades that enable low-cost hedging to take place. On balance, the downside risks would appear to outweigh the potential benefits.

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- Implementation difficulties could well prove insurmountable. In principle, a "Tobin tax" would have to be implemented on a worldwide basis and possibly also across other financial (and some real) markets. If not, trading would tend to migrate to other, non-taxed jurisdictions, which may well be less regulated than existing venues, or participants could use other financial (or real) vehicles to achieve the same end. The political mechanisms to implement and enforce such a tax are not currently in place.
- If it were possible to implement, the revenue yield from such a tax could be significant, though probably much smaller than suggested by current turnover in exchange markets, in good part because the tax base itself is likely to fall. Even so, earmarking the revenues from such a tax for specific, albeit highly legitimate, expenditures, like official development assistance, would seem to be neither an economically efficient,[28] nor a politically optimal way in which to finance such expenditures at a time when making official aid more effective has become a central issue among governments.

Other forms of taxation have been applied by several countries with the aim of preventing excessive interest sensitive capital inflows and avoid real exchange rate appreciation (Brazil 1993-97, Chile 1991-98, Colombia 1993-98, Malaysia 1994, Thailand 1995-97). Commonly used instruments are unremunerated reserve requirements (URRs), entrance taxes or administrative guidelines. Substantial empirical research into their effectiveness exists, but results are not wholly conclusive.[29] Proponents argue that targeted restrictions of this type have favoured a lengthening of maturity structures of external indebtedness and thus a more growth-friendly composition of capital inflows.

4. Linkages between domestic financial sector development and capital account liberalisation: review of the literature

As discussed in the previous section, the East Asian financial crisis gave rise to considerable debate amongst academics and policy-makers regarding the role of banks and domestic financial liberalisation in contributing to financial crises. Considerable effort has been spent on attempting to answer the question: how do weaknesses in the domestic banking sector, when combined with both domestic and international financial liberalisation, engender currency crisis? While attention in earlier research on currency crises focused more on the issues of incompatibility between fiscal and monetary policy and the fixed exchange rate commitment, (Krugman, 1979), a more recent approach stresses self-fulfilling expectations and herding behaviour on the part of international investors (Calvo, 1995).

Empirical analysis of these and other crises where banking sector fragility played a prominent role (see below), have confirmed a consistent pattern of accumulating short-term external debt, intermediated via the domestic banking

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sector and on-lent to the private corporate sector, with a consequent build-up of maturity and currency mismatches precipitating and aggravating the crises. Hence, a general consensus has since evolved regarding the need for a country embarking on full-scale capital account liberalisation to assure the stability and soundness of institutions in its financial sector, via appropriate regulation and effective supervision. At the same time, focus on this major element of "crisis prevention" has tended to reduce discussion of the interlinkage between the two liberalisation processes to one of a simple "sequencing" precept: Full external financial openness requires a prior strengthening of institutions and governance in the domestic financial sector – to develop sufficient market depth and supervisory structures to withstand stresses brought by extensive and volatile short-term flows. While there is no denying the desirability of such prior conditions, there is a risk of simplification inherent in this "sequencing" approach, as it seems to imply that countries are able to stop and "time" on-going processes in order to adhere to a prescribed ordering of measures.

Clearly, the linkages between the two processes is vastly more complex and dynamic, both seen from the perspective of economic theory and practically, when we take into account the features of contemporary international financial markets. In theory, external liberalisation and a consequent increase in capital mobility will lead to a higher degree of financial market integration and tend to equalise real interest rates. This will improve the global allocation of investible funds and thereby raise the overall level of welfare (in the absence of tax and other distortions). Apart from this potential direct impact, indirect welfare-enhancing effects would flow from the beneficial effects of international financial integration on financial sector development in liberalising economies, due to increased competition and importation of skills. It is hard to visualise the process of capital account opening without a parallel impact on developments in the domestic financial sector and concomitant pressures for deregulation if the sector were still repressed. V*ice versa*, a move away from direct controls on the domestic banking sector to market-based policy measures, even without decontrol on the external side, would in itself bring a degree of *de facto* capital account liberalisation through existing trade linkages and exposure to more advanced financing techniques. Appropriate deregulation in this sense means not only eliminating domestic financial repression, lifting barriers between different segments of the financial industry, but also internationalisation in the sense of cross-border trade in financial services and participation by foreign financial institutions in the domestic financial industry.

Thus, on the one hand the external liberalisation process might entail short-term risk factors for the domestic banking sector (especially if newly deregulated and ineffectively supervised), with serious costs to the economy if these factors were to trigger a full-scale crisis. On the other hand, medium or longer-term positive

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factors are clearly involved as well, which by promoting efficiency and competition in the financial sector could ultimately enhance economic growth performance. A crucial policy question is: How could countries avoid the former risks and still benefit from the latter factors? A policy of only allowing beneficial, "safe" flows of a longer term character, such as FDI, while retaining controls on short term flows does not seem an available option with respect to the financial sector, even if it were so for other sectors. Because of the special role and intermediation functions of the financial sector in an economy, deregulation in combination with significant foreign participation and consequent increased sophistication would immediately accelerate integration with the international market place. Besides, in order to successfully attract foreign investment into the sector, restrictions on short-term flows would have to be seen as minimal – and thus possible to circumvent, since in today's financial market environment, once certain flows are liberalised, controls become ineffective. Even partial external liberalisation, encompassing some capital account operations in addition to current account convertibility, creates opportunities to circumvent remaining controls through these unrestricted channels. As the experience of many countries shows, such opportunities will multiply when domestic institutions gain access to a higher level of skills in financial engineering through developments in product innovation and general progress in technology and communications. This also increases the difficulty in identifying sources and uses of funds in a strict balance-of-payments sense and makes the effective implementation of capital controls less and less possible. In this sense, internationalisation of finance brings a degree of *de facto* external openness which may not necessarily have been formulated as policy intentions on the part of the domestic authorities, nor be evidenced by the presence or absence of capital controls.

Due to the complex and continuing interaction between domestic financial sector development and external liberalisation, there is no unifying theoretical model of the interconnection between the two processes. In addition to the model uncertainty problem, there is a lack of reliable measurement or recording of an empirical nature.

A particular measurement problem, which arises in consequence of the fluidity of financial operations just mentioned (highly developed financial engineering techniques and instantaneous communication) is that the degree of capital account liberalisation as evidenced by the presence or absence of controls cannot be equated with the degree of capital mobility. First, as is well illustrated by the phenomenon of pervasive capital flight in countries such as Russia, where capital account operations are heavily restricted, capital often moves in spite of elaborate control systems. Secondly, without considering the extreme case of outright capital flight, the state of the art in present financial markets inevitably erodes the effectiveness of existing controls even where no illegal evasion intent is present.

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4.1. *The literature*

The following sections present brief reviews of the literature on the relationship between financial sector development and growth and between capital account liberalisation and growth to explore to what extent interlinkages between the two processes have been assessed. We find little explicit recognition of the interaction between domestic financial deregulation and international financial liberalisation in the theoretical growth models, which tend to assess either the impact of financial development on growth in closed economy models or the relationship between capital account openness and growth.[30] This is somewhat surprising in view of the standard policy advice disseminated to emerging market economies from international organisations (including the OECD), emphasising the positive growth effects of opening the domestic financial sector to foreign competition. To the extent that growth models which attempt to explain cross-country differences in economic growth incorporate factors to reflect institutional, legal and regulatory environment, there could of course be an implicit recognition of the interlinkage. Liberalisation and increased foreign entry can speed both the dissemination of information and the regulatory reform necessary for a more efficient financial sector as a whole (introduction of rating agencies, better accounting, more frequent disclosure, improved supervision, fewer bureaucratic obstacles). Hence, these improvements in institutional fabric may be picked up in the growth equations without being ascribed to international financial integration. However, the empirical literature does not explicitly discuss the interaction between the two processes of domestic financial deregulation and external liberalisation, nor does it address explicitly the growth effects of international financial integration other than via substantial capital flows from developed to emerging markets.

Important work on a country-case basis exploring the impact of financial sector development on growth was pioneered by McKinnon (1973), covering selected Latin American and Asian countries in the post-war period. Several other regional studies have followed, with similar findings that better functioning financial systems support faster growth. These do not, however, bring the degree of capital account openness into the context of the analysis. There is, on the other hand, a growing body of literature, which emphasises the direct relationship between the degree of foreign penetration in the financial sector and various measures of efficiency (Claessens and Glaessner, 1998), assessed on a cross-country basis. These studies find that banking sectors in countries allowing foreign bank entry exhibit lower profits and lower costs, but do not explore the growth implications of these efficiency gains. There is also an abundance of country studies and microeconomic research where the beneficial effects of financial integration are recognised. Studies covering banking sectors in OECD new members, in particular Mexico and Korea, in the post-crisis environment give evidence of such benefits via intensified competition. Hungary is often mentioned as a prime example of the benefi-

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cial financial development effects of allowing the participation of strategic foreign investors in financial institutions at an early stage of the liberalisation process (see below). The empirical work on the role of the banking sector in external crises, which is briefly reviewed in the final paragraphs of this section, attempts to identify direct weaknesses in the banks themselves, which in addition to macroeconomic, regulatory and institutional factors can account for the sector being prone to systemic crisis. Although these studies are mainly directed towards developing early warning indicators for impending crisis, they do nevertheless bring both processes of domestic financial sector deregulation and external financial liberalisation into focus.

4.2. *Financial sector development and economic growth*

There is a large body of literature on the relationship between the financial system and economic growth, starting as early as with Bagehot (1873) and Schumpeter (1912) who both underline the critical importance of the banking system in spurring growth. There has not always been agreement on the line of causality, as some authors (notably Joan Robinson 1952) have argued that banks respond passively to economic growth, evolving in response to demand for finance from enterprises. Levine (1997) presents a comprehensive survey as well as empirical work (Levine and Zervos 1998) showing that the level of financial intermediation (via banks as well as stock markets) in an economy is a good predictor of long-run growth rates, capital accumulation and productivity improvements. Although their regression results do not establish a direction of causality, they are consistent with the intuitively obvious understanding that services provided by financial institutions and markets form an integral part of the economic growth process.[31]

Most models of economic growth contain three channels through which financial market developments may affect the rate of economic growth (Andersen, 1993): raising the level of saving and investment relative to GDP; improving the efficiency or marginal productivity of capital; increasing the proportion of saving used for financial investment:

- The first channel,[32] which postulates an increase in saving in reaction to a rise in real interest rates has been difficult to prove empirically, as several countries have experienced a fall in saving following the end of financial repression, as households have been taking on more debt in response to the relaxation of liquidity constraints. The case study of Finland in the Annex constitutes a clear example of this phenomenon.
- The second transmission channel, which relies on a more efficient allocation of capital and a move to positive interest rates, has received stronger empirical support. Nevertheless, for the positive effects to be realised it has been necessary to assume the required skills to be present in the bank-

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ing system in the form of appropriate project screening mechanisms and efficient risk analysis. It also presupposes the existence of appropriate supervision mechanisms.

- Testing the third channel, through evaluations of the savings-investment link has also been complicated empirically, as concerns previously repressed financial systems with both a formal and an informal or "grey" financial sector. Typically, financial liberalisation and positive real deposit rates would provide incentives for households to move their savings/ deposits from the informal to the formal sector. However, it may be that funds available for investment may not actually rise, but perhaps be observed to fall if *e.g.* reserve requirements in the formal sector are high. Depending on the degree of development and efficiency of screening mechanisms in the two sectors, efficiency of allocation of capital could also decline at first, until more skills and different loan approval processes are developed in the formal sector. The situation is further complicated by the fact that transmission mechanisms for monetary policy, which affects savings and investment incentives may become unstable during a move from direct controls to reliance on market-based instruments. As discussed below, financial liberalisation in Latin America in the 1970s took place in conditions of macroeconomic instability and led to accelerating inflation and the use of private saving for financing government deficits rather than real investment.

The banking crises experienced in the Asian countries in 1997 drew attention to the relatively poor state of development of their financial sectors, while the impressive economic growth rates achieved by many of them over past decades are well documented. This has sometimes been interpreted as contradicting the importance of financial sector development for economic growth, although the process of financial deregulation and liberalisation was undertaken by several of these countries with the explicitly formulated goal of promoting real growth through the creation of a competitive financial sector (notably Singapore). Without attempting to summarise the literature on financial markets in Asia before, during and after the 1997 crisis, one important policy lesson can be drawn regarding the role financial market development has played in economic growth in the region. At an early stage of economic development, the existence of well developed and efficient financial markets may be helpful but not indispensable for rapid growth to occur nor for high ratios of saving and investment to be generated. As the economy matures and diversifies, resource allocation becomes too complex a process for limited financial markets to handle. To maximise economic growth, savings need to be intermediated efficiently into productive investment, which requires financial markets with a depth and efficiency that may not be necessary for achieving strong growth at the take-off stage. M*utatis mutandis*, this policy lesson can also

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be applied to situations where previously repressed domestic banking sectors were rapidly deregulated in combination with full capital account opening in economic boom conditions, such as in the Nordic countries in the late 1980s (see Annex, Finland, Financial Liberalisation since 1980).

4.3. *Capital account openness and economic growth*

Estimating the impact of specific variables on economic growth is always difficult because many socio-economic variables are highly correlated. Hence, while there is a presumption that lifting capital account restrictions will increase capital inflows and economic growth, the empirical evidence is difficult to interpret. Indeed, standard growth equations (testing for the influence of capital account liberalisation) typically capture a host of parallel influences among which, as we have pointed out above, domestic financial liberalisation probably plays an important role. Prior trade liberalisation and the quality of institutional infrastructure are presumably also highly correlated with per capita GDP. Even though these problems can be addressed through advanced econometric techniques, empirical results do not permit strong conclusions. Moreover, in addition to the problem of accurately measuring *effective* controls referred to above, several empirical studies rely for measurement on an index derived from the IMF annual publication *Exchange Arrangements and Exchange Restrictions* which only records presence or absence of controls rather than actual degree of restriction. Thus, in his widely-cited study of the correlation of capital-account liberalisation and growth, Rodrik (1998) finds a *negative* correlation between the growth of GDP per capita (controlled for other determinants) and the *share of years when the capital account was free of restriction* as measured by the binomial IMF indicator, for a sample of roughly 100 countries and the period 1975-1989. His findings have been interpreted to indicate that capital account liberalisation has little or no statistical impact on growth, but these claims are unwarranted on statistical grounds.[33] Quinn (1997), developing a more nuanced and informative measure of capital-account liberalisation than available until then, reports a *positive* correlation between the *change in the intensity of capital controls* and growth for 66 countries, using data for the period 1960-1989.

Edwards (2001), in a study based on the Quinn-measure of liberalisation and using Rodrik's growth controls, finds that liberalisation *boosts growth* in the 1980s in the *high-income* countries but *slows it* in *low-income* countries; his finding suggests the necessity of a certain level of local financial and institutional development for capital-account opening to generate net benefits.

Arteta, Eichengreen and Wyplosz (2001) carefully assess existing empirical work on the link between capital account opening and growth, and contribute their own additional tests. They do not find robust evidence of a positive association

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between capital-account liberalisation and growth. The effects vary with time, with how liberalisation is measured and with country-specific prerequisites. Their results cover round 60 countries and the period 1973-92. The authors produce evidence that the positive growth effects of liberalisation are stronger in countries with higher standard indicators of the rule of law (using the law and order index of the I*nternational* C*ountry* R*isk* G*uide*), in countries which have opened up more generally before the capital account was freed (as measured by the S*achs*-W*arner index* for trade openness), and where macroeconomic imbalances (proxied by the *black market foreign exchange premium*) were eliminated beforehand. These results, however, hold essentially for the sub-period 1982-87, when capital flows were curtailed in the wake of the Latin American debt crisis. During the 1970s, when developing countries received ample syndicated bank lending, and during the late 1980s/early 1990s, when portfolio flows to the emerging markets boomed, results could reasonably be expected to differ.

Finding an additional shortcoming in the fact that existing empirical evidence does not distinguish between the structure of capital inflows that the opening of the capital account induced, Reisen and Soto (2001) take a different approach. They analyse what specific types of capital flows affect economic growth in EMEs, rather than explicitly address the extent or intensity of capital controls. Instead of times series analysis, they adopt a panel data approach for 44 EMEs from 1986-97. Their estimates appear relatively robust and suggest that FDI and portfolio equity stimulate long-term growth prospects in EMEs and that equity should be preferred to debt finance.[34]

In summary, while the presumption in economic theory that capital account liberalisation affects growth positively has much intuitive appeal, it seems to be borne out empirically only for higher and middle-income countries – and even here results are still not robust. There is also considerable intuitive appeal in the idea that effects on growth deriving from capital account liberalisation are conditioned by a country's stage of financial and institutional development, presumed to be further advanced in higher-income countries. These results, although inconclusive, open up interesting avenues for future research. One issue to follow up which might have important policy implications concern the differential effects from capital account opening between OECD and middle-income countries on the one hand, and lower income EMEs on the other hand.[35] Should one conclude that higher economic development shifts the balance towards the benefits, away from the costs? Another would be how to assess the indirect beneficial effects on growth from financial integration through the deepening and increased efficiency of domestic financial markets mentioned above. The earlier growth accounting models and the decomposition of growth effects from increased capital mobility focus on those due to additional capital accumulation through access to foreign savings. Since such models do not find that physical or human capital accumula-

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tion exert strong causal influences on long-term growth, it is presumably through the effects on the improved allocation of capital one should look for links to financial integration (which could be proxied by the degree of foreign participation in the banking sector). One could also suggest a similar indirect impact on growth via better resource allocation as a consequence of bond and equity market integration (Fuchs-Schündeln and Funke, 2001).

4.4. *Banking and currency crises*

An extensive literature has emerged in the past decade, particularly since the Asian financial crisis, on the experience of banking crises in different parts of the world and their role in triggering external financial crisis. Empirical modelling of banking and exchange rate crises has been prolific (see Kaminsky, Lizondo and Reinhart (1998) for a comprehensive survey). The direction of causation between banking crises and balance-of-payments crises has not been clearly established, given that both types of crises may have common roots in domestic and external macroeconomic developments (Kaminsky and Reinhart, 1999). The presumption is, however, that banking crises are more likely to occur in banking systems in emerging markets, since these markets are seen as more prone to large and volatile swings in terms of trade that can cause adverse effects on their debt-servicing capability. In addition, their banking sectors are assumed to be characterised by fragile institutions and less well built-out governance-informational and supervisory systems. The present high degree of integration attained in world financial markets, with occasional very large portfolio shifts by increasingly diversified institutional investors, brings additional risks which can take a heavy toll in EME economies. Recent experience of sudden stops or reversals in flows due to contagion and herd behaviour have focused attention on the potential balance sheet vulnerabilities in the banking and corporate sectors of countries embarking on external liberalisation. This is sometimes termed the "double mismatch" problem, where both maturity and currency mismatches arise as borrowers in countries with underdeveloped or non-existent long-term debt markets take on excessive lower-cost short-term foreign debt (usually via the intermediation of domestic banks). Efforts to identify these and other potential vulnerabilities in the interest of crisis prevention have led to the development of early warning models, based on a number of other leading crisis indicators, or even composite measures of vulnerability. Traditionally, such early warning systems have been used extensively by central banks and other supervisory agencies to complement other surveillance processes of financial institutions.[36] The purpose of these new signalling models for impending banking crisis is to trigger countervailing policy adjustment. There are two strands of these models: those that rely on macroeconomic indicators as key explanatory variables of banking crises; and those that assess how bank-

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specific, microeconomic factors may have contributed. In the signalling approach, information on indicators in periods of tranquillity is compared to identified periods of crisis. Formally, and indicator is said to signal an impending crisis if it crosses some given threshold value. This value is chosen so as to strike a balance between false alarms (type II errors) and the risk of missing many crises (type I errors). Common results which have been interpreted as robust are that rapid domestic credit growth, large bank liabilities to reserves and domestic financial deregulation appear to be influential in generating systemic banking crises. With respect to deregulation, this finding would be consistent with the observed behaviour of banks in some countries (*e.g.* Sweden) following the end of financial repression, of taking on higher-risk exposures that are not appropriately priced or result in "too many eggs in one basket".

However, these empirical results also suffer from a number of weaknesses and limitations at least as potential tools for policy makers, relating to choice of sample and indicators. As these are mainly drawn from EMEs the models tend to ignore the existence of risk-absorbing mechanisms in more developed markets, producing prompt corrective action. There is also the difficulty of finding agreement on what constitutes fragility and crisis (see Box 3). Although some common factors emerge from the studies [specifically the importance of macroeconomic conditions in banking crises and shocks to certain asset prices; (Bell and Pain, 2000)] they do not throw much more light on the linkage between capital account liberalisation and crisis. Some of the banking crises investigated (US S&L) were not linked in any obvious way to capital account liberalisation. Rather than being directly attributable to regulatory changes involving capital account opening, many external crises tend to follow macroeconomic disturbances brought about by expansionary and inflationary policies, often financed by external borrowing and draw-down of international reserves. In summary, there is no reason to expect that these indicator models, which are not based on any underlying theory, would have much explanatory power.

Thus the issues are complex and not yet satisfactorily addressed by existing quantitative studies. The review of liberalisation experience of older and more recent OECD members presented in the next two chapters cannot shed more light on the linkage between domestic financial sector development and capital account liberalisation. Previous OECD publications provide comparative data on the timing of particular measures of liberalisation of current and capital account financial operations of individual member countries, but no standardised interpretation or measure of the respective degree of liberalisation has been developed. This study introduces a method for relating information regarding external liberalisation measures to the progress with deregulation of domestic financial sectors, to the extent possible. In the Appendix to Chapter II, indicators of domestic financial development in the majority of OECD member countries, are

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Box 3. **Banking crises: individual bank failure, general fragility and systemic crisis**

One of the criticisms raised against the leading indicator approach to predicting banking problems is that they are not designed to distinguish between general banking fragility and banking crisis and thus lose predictive value. A simple conceptual framework may help to discern the risks and disruptions threatening individual institutions and the banking system as a whole.

Simply put, a bank like any other firm, is likely to face financial difficulties when the value of its assets falls below that of its liabilities, leading to technical insolvency. Both *credit risk* and *market risk* can cause such falls in asset value. Although banks can protect themselves via pricing, screening, diversifying and taking collateral,* total elimination of risk is not possible, partly because of information asymmetries and exogenous shocks, affecting the quality of their loan portfolio or bringing sharp dislocations in asset markets. Because banks' intermediation function often involves lending long at fixed rates and borrowing at the shorter end of the yield curve, they are particularly vulnerable to *interest rate risk* and must anticipate movements in rates. Boom and bust cycles, periods of high inflation or price volatility also present dangers to their financial health.

In addition to credit and market risk, a bank can be exposed to *liquidity risk* involving a run on its deposits, since by the very nature of their activity banks usually hold mainly illiquid assets such as term loans while their liabilities take the form of short-term, unsecured deposits. This is where institutional arrangements such as deposit insurance and emergency liquidity assistance can be helpful, although they also entail some moral hazard risk in producing wrong incentives. If there is a generalised run on banks as in a *systemic crisis*, these arrangements will generally not be sufficient. If many banks in the system are affected by the same shock and have operational similarities, (such as in the banking crises affecting the Nordic countries in the early 1990s) the likelihood of an individual crisis taking on a systemic character is greater. As banks in more developed financial systems tend to consist of many heterogeneous institutions with different characteristics, systemic crises usually involve some *element of contagion*, transmitting financial distress from one institution to another. Such contagion can either be based on information or be independent of economic fundamentals concerning the institutions involved – in worst cases developing into general panic. Contagion may be transmitted via *the interbank market*, through which many banks are linked through direct exposures. T*he payments system* also links banks together and can be a source of systemic risk, if unsustainable losses are suffered by creditor banks following default by a debtor bank. D*erivative market counterparty credit exposures* can also be a source of systemic trouble. In a wider sense, shocks to financial assets markets may affect investors generally, through effects on overall liquidity via margin calls. H*erding behaviour* by investors in such markets aggravates this form of contagion.

* For an exposition of modern banking theory, see Freixas and Rochet (1997).

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Box 3. **Banking Crises: Individual Bank Failure, General Fragility and Systemic Crisis** (*cont.*)

Financial distress symptoms both in individual banks and on a systemic level can thus originate from many causes. The statistical leading indicator models of banking problems generally include bank-specific indicators proxying the different types of risks and moral hazard factors in addition to macroeconomic variables (output, interest rates, private credit growth) and institutional variables (type of payments and settlements system, deposit insurance system, structure of interbank market). However, whether the symptoms studied even if observed in a large number of institutions at one particular point in time could usefully serve as indicator of impending systemic banking crisis is debatable. The models do not capture well the distinction between fragility in the sense of vulnerability to shock (which in itself need not lead to crisis) and crisis actually occurring, partly because of the lack of a generally accepted measure.

presented, (including an assessment of institutional-governance systems in place), together with indicators for the intensity of capital controls at different points in time. These indicators are intended as a preliminary effort to bring out the nexus between the domestic financial sector maturity, the quality of institutional-governance systems and the sequencing of capital account liberalisation.

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Notes

1. For a pioneering effort to quantify the economic performance of nations over the very long term, see Maddison (2001).

2. In addition, integration is not a necessary precondition for (but rather a possible consequence of) capital mobility, except if – following Tinbergen (1954) – defined as the elimination of obstacles for the movement of goods, services and factors of production rather than the creation of equal conditions for integrated parts of the economies concerned. Tinbergen distinguishes between *negative integration*, consisting of negotiated, formal undertakings amongst countries to remove obstacles to trade and capital flows through deregulation, liberalisation etc, and *positive integration*, which requires public institutions in the countries concerned to take action and maintain a political commitment to harmonise, co-ordinate etc. In the absence of such obstacles the only necessary condition for capital mobility is a monetary system which provides for a medium of exchange for the claims on resources represented by the capital flows.

3. Over a hundred different silver currencies existed in Europe before 1500, compared with 38 at the beginning of the 19th century. However, it is interesting to note that as the media of exchange were usually valued on the basis of their precious metal content irrespective of the unit of account or the price level in the country of issue, they were closer substitutes than modern fiat currencies. Foreign coins thus frequently circulated alongside domestic ones [see Eichengreen and Sussman (2000)].

4. In broad terms, there were two distinct groups of capital importing countries. One consisted of countries in North America, Latin America and Australia, receiving capital for development finance primarily from the United Kingdom. Another group was formed by countries in Northern, Central and Eastern Europe, Turkey and Africa, receiving finance primarily from France and Germany, in many cases to cover fiscal deficits.

5. For instance, Zevin (1989) reports findings that the interest rates on short-term deposits of similar characteristics in Amsterdam, Paris and London showed no wider differentials in the 18th century than in the 1970s and 1980s between New York and London.

6. Four major reasons why the revived gold/exchange standard proved less robust are usually cited. 1) The move from a strictly gold based to a gold exchange standard with the consequent increase in central bank liabilities relative to the gold base rendered the system more fragile. It also reduced the degree of discipline of gold movements, since the possibilities for sterilisation were increased. 2) deflationary pressure from the lower real price of gold and a feared gold shortage. 3) uneven distribution of gold reserves among the participating countries, due to the choice of inappropriate parities at the time of restoration; 4) persistent balance of payments problems and consequent chronic shortage of gold reserves experienced by Britain [see Bordo and MacDonald (2001)].

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7. This was the rate that had prevailed since 1934 and in fact only became a binding constraint on the United States in the 1950's. [See Eichengreen and Sussman (2000).]
8. Article VI of the IMF Articles of Agreement states, regarding controls on capital transfers, that "members may exercise such controls as are necessary to regulate international capital movements…". Further, there is a *passus* in the same Article VI stating that the Fund "may request a member to exercise controls [on capital transfers] to prevent [a large and sustained outflow] of the general resources of the Fund". Some controversy has surrounded the interpretation of this latter stipulation, but the Fund has never actually requested a member to impose such restrictions.
9. See Wyplosz (1996).
10. In the provisions of the Treaty of Rome addressing the free movement of persons, services and capital, the Articles 67-73 cover capital movements. Article 67 effectively ranks freedom of capital movements lower than that of goods and services by stating that the obligations to liberalise capital flows was limited "to the extent necessary to ensure the proper functioning of the Common Market". This clearly indicated that the founding members were, at that time, not prepared to surrender economic and monetary competences to a supranational level. See Bakker (1996) for detailed discussions of these points as well as of the adoption of the first two European Directives on capital movements in 1960 and 1962, which both fell far short of any call for full liberalisation.
11. The snake was established in April 1972, as a multilateral European exchange arrangement with bilateral fixed but adjustable fluctuation bands, aiming to stabilise intra-European exchange rates.
12. For a full account of the demise of the Bretton Woods system, see Bordo and Eichengreen (1994).
13. For an overview of the problems linked to financial contagion, see Christiansen (2001) including references therein.
14. See Institutional Investors in the New Financial Landscape, OECD 2000.
15. See OECD, Trend and Recent Development in Foreign Direct Investment, 2002 available at *www.oecd.org/pdf/*M00031000/M00031855*.pdf* – article in the September 2002 issue of OECD I*nternational* I*nvestment* P*erspectives.*
16. It should however, be noted that recorded FDI flows can sometimes be an imperfect indicator. First, the distinction between FDI and portfolio investment in balance of payments data may be slightly arbitrary. FDI is by convention an equity investment above a certain critical percentage (10% being the internationally accepted threshold for definitional purposes), and the transactions above this limit are not necessarily motivated by different sentiments or investment horizons from those that are below. Second, FDI often occurs conjointly with other capital account flows, which may cloud the overall benefits to the host economy. For instance, there are several reasons why direct investors may be disinclined to take open positions in the host country's currency. Investors may eliminate their exposure at the outset, *e.g.* by funding their initial investment from host country banks. Such transactions boost portfolio outflows in unison with FDI. In addition, investors often choose to hedge at the sign of trouble, thus creating an outflow of funds that may eliminate the upward pressure on the currency that emanated from the initial inward FDI.
17. While portfolio flows into Latin America fell from a net inflow of US$65 billion in 1994 to approximately zero in 1995 FDI inflows remained substantial, even increasing from US$22.8 to US$24.2 billion in 1995. Similarly, FDI inflows into the Asia crisis countries

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exhibited only a modest decline of US$1.5 billion in 1997, while there was a turn-around of bank lending of US$73 billion and a drop in portfolio flows of US$18 billion.

18. The *Financial Stability Forum* (FSF) was convened in April 1999 following endorsement by the G7 Ministers and Governors in Bonn on 20 February 1999 of the Tietmeyer report on *International co-operation and Co-ordination in the Area of Financial Market Supervision and Surveillance*. The FSF aims to promote international financial stability through information exchange and international co-operation in financial market supervision and surveillance. The FSF brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF seeks to co-ordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk.

19. The Group of Twenty Finance Ministers and Central Bank Governors held its inaugural meeting in Berlin, December 1999. In addition to the G7 plus Russia, the members are Argentina, Australia, Brazil, China, India, Indonesia, Korea, Mexico, Saudi Arabia, South Africa, and Turkey.

20. See FSF: Issues Paper of the Task Force on Implementation of Standards, page 19.

21. See FSF: Report of the Working Group on Capital Flows.

22. For a comprehensive survey of older as well as more recent proposals, see Rogoff, K. and Zettlemeyer, J.: "Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976 – 2001, IMF Working Paper 02/133.

23. See Krueger, Anne, 2001 "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring" *http://www.imf.org/external/np/speeches/2001/112601.htm* and Krueger, Anne, 2002 "Sovereign Debt Restructuring and Dispute Resolution" Speech at Bretton Woods Committee Annual Meeting Washington DC, June 6, 2002 *www.imf.org/external/np/speeches/2002/060602.htm*

24. See *e.g* "The Design and Effectiveness of Collective Action Clauses" IMF Legal Department *www.imf.org/external/np/psi/2002/eng/060602.pdf*

25. See "The Effects of CACs on Sovereign Bond Spreads", BIS Quarterly Review;Box by Tstsaronis and Becker T, Richards A. and Thaicharoen Y., "Bond restructuring and Moral Hazard: Are Collective Action Clauses Costly?" IMF Working Paper 01/92.

26. See *e.g*. "Collective Action Clauses in Sovereign Bond Contracts – Encouraging Greater Use" IMF Policy Development and Review, International Capital Markets and Legal Departments *www.imf.org/external/np/psi/2002/eng/060602a.pdf*

27. Tobin's original proposal was presented in the wake of the breakdown of the Bretton Woods system. See his Janeway lecture, delivered in 1971 and published in Tobin (1974). See as well Tobin (1978). Others have also proposed such a tax, sometimes, however, at variance with Tobin's original idea. See Dornbusch (1986), Stiglitz(1989) and Summers and Summers(1989).

28. In practice, taxes are being shifted through changes in prices and wages and the ultimate payer of the tax may be a quite different person from the one handing over the tax revenue. In the case of a "Tobin tax", its final incidence is not very clear but it cannot be excluded that some of those paying the tax would be the same developing countries that it was meant to help.

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29. For a review of empirical work on the effectiveness of various forms of capital controls, see Ariyoshi *et al*. (2000). See also FSF: Report of the Working Group on Capital Flows.
30. However, in attempting to explain cross-country and time series variation in financial sector development, Rajan and Zingales (2001) recognise the impact of international financial integration on the domestic financial sector and include the openness to trade as a proxy for capital mobility.
31. Substantial work on the link between financial sector development and growth has also been undertaken within the OECD, see *e.g*. OECD Economics Department Working Papers, 280, 308, 2001.
32. This is the theoretical underpinning for the McKinnon – Shaw school, which developed the notion that direct controls and directed lending programmes imposed on the banking sector retard financial sector development and ultimately reduce economic growth. See McKinnon (1973) and Shaw (1973).
33. Apart from poor data, Rodrik's 1998 paper does not clearly define a null hypothesis or counter factual, *i.e*. what would the economic performance of countries with open capital accounts have been in their absence? Basic statistical theory tells us that the presence (or absence) of a statistically significant regression coefficient cannot prove a hypothesis; statistical tests can only reject the null hypothesis that the co-efficient is significantly different than zero over a chosen confidence range. Rodrik has addressed this issue in a subsequent paper dealing with capital controls in Malaysia by building an IMF programme counter factual; see Kaplan and Rodrik (2001). However, constructing a counter-factual for a hypothetical IMF programme is fraught with difficulty.
34. Reisen and Soto's (2001) estimates correct for standard growth determinants, and attempt to measure the independent growth effects of FDI, portfolio equity investment, bond flows, as well as short-term and long-term lending. Although these estimates appear relatively robust, the explained variance of income growth is under 50%. Such estimates are also sensitive as to how accurately various components of capital flow have been categorised.
35. In general, empirical results are not robust to shifts in country coverage, time period and estimation technique. Quinn *et al*'s 2001 (forthcoming) results appear more robust that Arteta *et al*. 2001 results, in large part because of a longer sample period. However, a particularly interesting feature is growing evidence that social infrastructure and the quality of polity may explain the more favourable impact of financial liberalisation on OECD and middle-income countries compared with low income EMEs (Arteta *et al*. 2001 and Quinn *et al*. 2001).
36. These are usually based on the CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Sensitivity) methodology developed by United States regulators.

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Chapter II

The Role of the OECD in Promoting Liberalisation of Capital Movements

This chapter describes the OECD role of promoting, consolidating and entrenching liberalisation measures undertaken by its members, both old and new.

Introduction

The establishment of the OECD in 1961, with an enlarged membership and expanded mandate compared to its predecessor the OEEC, testified to the need felt by its members for a balanced framework within which they could pursue gradual progress towards capital account liberalisation. As explained in the overview of developments in the regulation of external capital flows in Chapter I.2.1 above, the mood in the early 1960s was not in favour of an immediate and total abolishment of controls on all forms of capital flows. Nevertheless, there was consensus that joint work towards reaping the economic benefits of freer capital movements should be pursued, as clearly set out in the objectives of the OECD Convention.[1]

The commitment to the philosophy of free and open markets finds its expression in the two OECD Codes of Liberalisation : the Code of Liberalisation of Capital Movements which also covers direct investment and establishment, and the OECD Code of Liberalisation of Invisible Operations which covers cross-border services. The modus operandi designed for implementing the Codes' obligations also reflects the members search for a balanced and orderly process where liberalisation could be pursued in a safe manner. It is a dynamic and ongoing process of analysis, consultation and peer pressure, jointly developed by members over the OECD's 40-year history to take into account and respect individual countries' specific needs and preferred pace of liberalisation. In the case of capital movements it safeguards a degree of autonomy for monetary and exchange rate policy by preserving flexibility to restrict capital flows deemed to be of a destabilising nature in situations of economic disturbance.

As stands out clearly from the overview of major forces driving policies regarding capital control given in *Section* 2 above, the quantum shift in major industrial countries' attitude towards liberalisation in recent decades cannot be

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credited to the progressive implementation of the OECD Capital Movements Code alone. While this Code remains as of today the only multilateral instrument under which obligations of liberalising capital movements are agreed and enforced (since 1988 further supported by the EU Directive on capital liberalisation, as the 15 EU members are also members of the OECD), its main function has been to consolidate liberalisation gains made possible by overall policy shifts in member countries. It has served to entrench the capital account opening process as irreversible undertakings by members and to push the process forward on a broad multilateral and non-discriminatory basis. Thus, both Codes can in this sense be viewed as complementing and reinforcing a number of other instruments and processes for the promotion of a liberal international economic environment, managed by the WTO, the IMF as well as via regional and bilateral undertakings.

The Codes are legally binding instruments, which oblige members to maintain – as a minimum – the existing degree of freedom for international capital movements and current invisible operations and to pursue further liberalisation in both areas. There are no sanctions involved in the compliance review process, which relies exclusively on consultation, discussion and examination of measures implemented by the members. Nevertheless, this peer review process has proved to be quite a powerful tool for driving liberalisation forward, even though it does not involve direct negotiations and sanctions. Peer pressure in a multilateral setting, according to the OECD approach, can at times provide strong incentives for authorities to undertake needed policy adjustments. By "benchmarking" regulations and administrative procedures against those adopted and enforced by peer members in the OECD, countries are encouraged to take further liberalisation measures, once a critical mass of liberalisation and deregulation has been reached. This form of guidance for capital account opening, supported by adequate standards of governance and supervision, can assist countries to become better integrated into the global financial system, with the benefits that this entails.

The structure of the Codes of Liberalisation, their guiding principles and implementation process is presented below, while the following two sections trace the experience, respectively, of the older OECD members (founding members and those joining 1964-1973) and of the six new members adhering since 1994 in assuming and implementing the obligations of the Codes. A final section concludes with thoughts regarding future liberalisation work based on the Codes and their application for non-member policy dialogue.

1. The Codes of Liberalisation: structure and implementation

The OECD Codes of Liberalisation are legal instruments which establish rules of conduct for the governments of OECD member countries. Technically, they are Decisions of the OECD Council, which is the supreme organ of the Organisation

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where each country has one vote. Its Decisions, which must be taken unanimously, are legally binding on member governments. They are, however, not a treaty or international agreement in the sense of international law, such as for instance the WTO agreements.

Both Codes consist of a set of Articles, of which Article 1 spells out the central idea: members subscribe to the general aim of eliminating between one another restrictions on capital movements and invisible transactions.[2] The remaining provisions describe the framework under which member countries shall work towards reaching this goal, while annexed *liberalisation lists* specify the operations to which the liberalisation obligations apply. Today, the Capital Movements Code applies to all long- and short-term capital movements between residents of OECD countries. Coverage of cross-border trade in services by the Current Invisibles Code is large, but not quite as comprehensive. Among the major sectors covered are banking and financial services, insurance, professional services, maritime and road transport and travel and tourism. The obligation to liberalise goes beyond the requirement that funds transfers to and from abroad should be free of exchange control restrictions. It also requires that the underlying transactions themselves should not be frustrated by laws, regulations or administrative approval processes.

The main provisions of the Codes can be summarised as:

- the obligation to subscribe to the general undertaking of liberalisation. Specifically, Member countries are committed to allow residents to transact freely with non-residents in any capital and financial services operations abroad. They also are committed to allow non-residents to deal with residents in any such operations when they are permitted between residents of the Member concerned;
- the right to proceed gradually towards liberalisation through a process of lodging and maintaining reservations where full liberalisation is not yet achieved;
- the obligation not to discriminate among OECD Members. The only exception concerns provisions to ensure compatibility with special customs or monetary systems such as the European Union where faster internal liberalisation measures do not have to be extended to all OECD Members automatically;
- exceptions for reasons of public order and security;
- derogations for short-term capital operations and, on a temporary basis, in case of serious balance of payments or financial system difficulties;
- a system of notification, examination and consultation administered by the Committee on Capital Movements and Invisible Transactions (CMIT).[3]

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The first tenet – usually referred to as the *"rollback" principle* – allows member countries to achieve liberalisation gradually through abolishing restrictions over time and according to their individual situation. If and where a member country has decided to maintain restrictions to the free circulation of capital and services, its situation is examined periodically. The other member countries will be informed about the reasons why a restriction is considered necessary and may suggest alternative ways in which the country concerned can address its preoccupations. The Codes' procedures do not provide for coercion or applying of leverage, but build on member countries' commitment to the common goal of liberalisation, within a dynamic process of consultation and co-operation.

Members unable to liberalise immediately are permitted to lodge a *reservation* against specific operations, or items on the Codes' liberalisation lists. If a country has not lodged a reservation to a particular item, the transactions covered by this particular item are expected to be fully liberalised.[4] There are "full" and "limited" reservations. A full reservation means that the transaction to which it refers cannot be undertaken at all. A limited reservation means that the transaction may be permitted, subject to certain restrictions. Members are required to notify all measures which affect any of the transactions covered by the Codes. Reservations are drafted so as to reflect as precisely as possible the restrictions still imposed. This facilitates transparency as well as the review process which aims to turn full into limited reservations, and at further limiting, or deleting altogether limited reservations. Transparency is also enhanced by publishing updated lists defining each country's current commitments on the OECD public website[5] (as well as in regular hard copy publications of the Codes, together with country positions). Any country's individual position at a given moment can thus be understood through reading of the lists of reservations annexed to each Code. Market participants can be confident that no restrictions exist except for those appearing in the reservation lists (this is referred to as the *"top-down" approach* to defining obligations as opposed to the bottom-up approach in the GATS).[6]

OECD member countries have accepted under the Codes that they may not introduce new barriers. Reservations to the obligations of the Code can only be reduced or deleted but not added or extended. This applies across the board and to all transactions under the coverage of the Codes, except for new obligations, for some specific items in the Capital Movements Code,[7] and for a special derogation procedure designed to take account of temporary economic and financial difficulties. Once a restriction has been abolished, it can not be reintroduced. This is usually referred to as *the "standstill" obligation*. In order to achieve standstill as efficiently as possible, governments are expected to word their reservations very precisely so that they reflect only restrictions that actually exist. The regulatory status quo is thus locked in and can only evolve in the direction of further liberalisation, the so-called *"ratchet-effect"*.

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The *obligation of non-discrimination* means that OECD members are expected to grant the benefit of open markets to residents of all other member countries alike, without reciprocity requirements or any other discrimination. Where restrictions have been lifted, this must be applied to everybody in the same way, including members experiencing economic difficulties and unable themselves to liberalise for the time being. The only exception permitted under the Codes to the non-discrimination principle concerns liberalisation measures adopted under a special system of regional integration, such as the European Union, which do not have to be extended to all OECD members automatically.

While the legal commitments under the Codes only apply to the OECD area, member governments have accepted to use their best efforts to extend the benefits of liberalisation to all members of the IMF. Thus, non-member countries can reap the advantages of free market access in OECD countries to the same extent as OECD members can. Indeed, surveys have shown that there is an overwhelming trend among OECD governments to adopt liberalisation measures without discriminating against non-OECD countries.

The re-imposition of controls in cases of acute economic stress is covered by a *derogation procedure*, under which members gain dispensation from their obligations to preserve the freedom of operations on a temporary basis. Resort to derogation must be based on a clearly demonstrated deterioration in the balance-of-payments situation or other serious economic and financial disturbance resulting from liberalisation.

In common with other multilateral agreements affecting the international operations of financial institutions, the Codes recognise the potential stresses and risks for the domestic financial sectors of the liberalising economies brought by capital account opening. The fundamental importance of adequate prudential regulation and supervision as a *sine qua non* for financial sector liberalisation is thus reflected in the Codes, although they do not contain any specific "*prudential carve-out*" chapter or section. There are many references to the need for investor protection and preventing evasion of national regulation in separate remarks or supplementary explanations to the individual sections and items. Limitations on banks' net foreign exchange exposure as well as the mandatory maintenance of certain crucial ratios in their balance sheets are thus not viewed as restrictions, nor are reporting requirements to enable the authorities to for monitoring on an ongoing basis the risks inherent in their assets and liabilities.[8] However, in line with the Codes' principles, it is understood that such regulations should not discriminate against non-resident market participants.

In past examination processes it has sometimes become clear that prudential as well as other regulation has the potential to compromise competition and condone entry barriers, restrictive practices and other anti-competitive mechanisms. The ten-

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dency has nevertheless been to steer away from any in-depth questioning of prudential regulatory arrangements. Only outright bans on different types of transactions or forms of establishment have been viewed as restrictions under the Codes, even where considered by the authorities concerned to be justified on prudential grounds.

Apart from the general guiding principles embodied in the Codes Articles and Liberalisation Lists as described above, there also exists a number of further principles and understandings regarding interpretation and application which have accumulated over time. Some technical and interpretational expertise is contained in formally adopted minutes and reports, but an important part of this "virtual" annex to the Codes in terms of experience and precedents remains in the methods and working processes of the compliance review committee, the CMIT. These have developed over time, sometimes in response to changing circumstances, practices and techniques in financial markets and thus represent a well-tested set of tools. Altogether, the Codes and their implementation structure have for forty years provided a multilateral framework to support, in a co-operative spirit, the individual paths towards liberalisation pursued by OECD countries. They have also created an environment in which member countries with less developed economies, or those going through temporary economic difficulties, have benefited from consultation and frank discussion with their peers. At the same time, the Codes have served as a useful yardstick by which the liberalisation efforts of member countries can be assessed and compared over time.

In summary, the Codes have assisted OECD member countries efficiently over many years in pursuing the aim of getting rid – for good, via the standstill principle – of unnecessary barriers to the free circulation of capital and services, through reasonable and harmonious international co-operation. There are many ways in which the Codes can continue to promote balanced liberalisation not only within OECD, but also in support of work within the WTO and as a complementary forum to the on-going process for discussing standards and best practices relating to international capital movements and financial market integration. Especially in times of doubt about the balance of benefits of globalisation, they provide a stable environment for discussion and exchange of views. The focus of work under the Codes can be adjusted to fit current needs. OECD has a flexible structure which allows it to organise workshops and seminars where the private sector, civil society and academics can participate.

2. Liberalisation experiences in older OECD member countries

2.1. *Overview*

The original twenty members of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United

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Kingdom and the United States. The following countries became members subsequently through accession at the dates indicated: Japan (1964), Finland (1969), Australia (1971), New Zealand (1973). The Commission of the European Communities takes part in the work of the OECD since the founding of the Organisation in 1961.

While a few founding member countries had already liberalised their capital account operations to a large degree (notably the United States, Germany, Switzerland and Canada which never had established extensive control regimes), most members maintained a significant number of restrictions on external capital flows throughout the 1960s. Additionally, some members entered with a special status – under a clause allowing them to derogate from most Codes obligations on account of lagging economic and financial development – and consequently did not assume the full obligations under the Code.[9] This special arrangement was gradually given up as the countries concerned gained in economic development and stability.

In the late 1960s and most of the 1970s few OECD members made progress in liberalising capital movements, as they found themselves wrestling with the consequences of two oil shocks, high inflation, high unemployment and large external imbalances (see *Section* xx). On the contrary, this turbulence led to the imposition of new restrictions by many countries (under the derogation procedure – see Table 3) including by some whose policy towards international capital flows was traditionally liberal. Thus, a number of countries invoked the derogation clauses because of measures designed to prevent capital outflows (the United Kingdom, the United States, Denmark, France, Italy and Sweden). This was followed in 1971-1973 by steps taken by another group of countries (Germany, Switzerland, Austria, Japan, Australia and Finland) to prevent undesired inflows of capital. All in all, during this period, nine countries were led to resort to the Code derogation clauses. The decade ended, however, on a more positive note, as the United Kingdom abolished all capital controls at one stroke in 1979 and Japan prepared new legislation which brought formal controls to an end in that country in 1980, following nearly two decades of deregulation by small steps.

Steps backward were more readily accepted when generalised across countries as was the case in the late 1960s and early 1970s in the context of the strains experienced during the break-up of the Bretton Woods system. Unilateral return to exchange restrictions occurred essentially in countries still retaining extensive controls, such as France in the early 1980s or the Nordic countries in the mid-1980s, or in countries having only recently liberalised, such as Spain during the ERM turmoil of September 1992.[10]

As discussed in Chapter I.2 above, the mood changed significantly in the 1980s and several members moved to substantially relax capital controls, while some even abolished their control regimes altogether. The commitment by

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Table 2. **Operations restricted from the end of World War II to the early 1990s**

	Foreign exchange outflows		Capital inflows (other than direct investment and real estate operations)
	Capital transactions	Travel allowances	
Australia	Until 1983		
Austria	Until late '80s		Early '70s to mid-'80s
Belgium/Luxembourg	Channelled through separate markets from 1955 to 1990		
Canada	Until 1951		
Denmark	LT. securities until l978 ST. financial credits until 1988		LT. securities until 1971 ST. op. until 1988
Finland	Until mid-80s	Until 1985	Securities until 1979 Credits until 1986
France	Until 1986	Until 1958 1968-1970 1983-1984	Credits from 1971 to 1974 Other op. until 1986
Germany	Until 1958	Until mid-'50s	Until 1958; 1972-1975
Greece	LT. op. until 1992 ST. op. until 1994	Until 1992	Credits until 1987 ST. op. until 1994
Iceland	LT. securities until 1993 Other LT. op. until 1990 ST. op. until 1994		Credits until-1992 ST. op. until 1994
Ireland	LT. op. until 1988 ST. op. until end-1992		Until end-1992
Italy	LT. Securities 1973-87 Credits until 1988 ST. op. until 1990	1973-1984	Credits until 1988 ST. op. until 1990
Japan	Until 1980	Until 1964	1970-1973 1977-1978
Netherlands	Credits until 1986 Other op. until 1960		Credits until 1983 Other op. until 1960
New Zealand	Until 1984	Until 1971	Credits until 1984
Norway	Until late 1980s ST. op. until 1990	Until 1984	Credits until early 1980s LT. securities until 1989 ST. op. until 1990
Portugal	LT. Securities and trade credits until late 1980s Other op. until end-1992	Until 1990	LT. securities and trade credits until late 1987 Other op. until end-1992
Spain	ST. credits until 1991 and in October 1992 Other op. until 1989-90	Until 1979	ST. credits until Feb. 1992 Other op. until 1986-87
Sweden	Until 1989	Until the 1950s	Until late 1980s
Switzerland			Securities from 1972 to 1980
Turkey	Until 1989 Trade credits until 1983	Until 1983	Until 1989 Trade credits until 1983
United Kingdom	Until 1979	Until 1977	
United States	1963-1973		

Legend: LT. = long-term
ST. = short-term
op. = operations.

Source: OECD, *Exchange Control Policy*, CCEET (1993).

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Table 3. **Derogation to the OECD Codes of Liberalisation**[1]

	Capital movements		Current invisible operations	
	Invocation of derogation[2]	Cessation of invocation	Invocation of derogation[2]	Cessation of invocation
Australia	09/1972	06/1978	–	–
Austria	11/1972	08/1980	–	–
Belgium	–	–	–	–
Canada	–	–	–	–
Denmark	02/1979	03/1983	05/1969	04/1971
Finland	06/1985	01/1991	–	–
France	–	–	05/1968	09/1968
			11/1968	08/1973
			05/1981	07/1986
			03/1983	01/1986
Germany	06/1972	01/1974	–	–
	02/1973	11/1980		
Greece	09/1967[3]	06/1980	09/1967[3]	09/1977
Iceland	1961[3]	12/1990	1967[3]	12/1990
	01/1993			
Ireland	–	–	–	–
Italy	04/1969	01/1978	05/1974	05/1984
Japan	01/1972	11/1973	–	–
	03/1978	02/1979		
Luxembourg	–	–	–	–
Netherlands	–	–	–	–
New Zealand	–	–	–	–
Norway	11/1984	12/1989	–	–
	08/1986	12/1989		
Portugal	1968[3]	1981	1981[3]	1983
	1977	1981	1977	1981
	1983	1987	1977	1992
	07/1991	11/1992	1983	1987
Spain	1959[3]	1962	1960[3]	1961
	07/1982	06/1985	–	–
Sweden	09/1969	06/1986	09/1969	11/1973
Switzerland	03/1964	10/1966	–	–
	07/1972	02/1974	–	–
	02/1978	01/1979	02/1978	01/1979
Turkey	1962[3]	1985	1962[3]	1985
United Kingdom	05/1966	03/1971	07/1966	01/1970
United States	01/1968	04/1974	–	–

1. Under the OECD Codes of Liberalisation, member countries are not allowed to introduce new restrictions on operations subject to liberalisation obligations (except for the items on the so-called List B of the Code of Capital Movements). However, when a member faces serious economic or financial difficulties, it may enjoy a temporary dispensation from its obligations to preserve the freedom of operations not covered by reservations. Derogations are in principle tolerated for no more than 18 months and are examined by the Organisation to ensure that a liberal regime is restored as soon as possible. A number of countries have also enjoyed in the past a general dispensation from the liberalisation provisions of the Codes when the economic and financial situation justified such a course. This form of dispensation cannot be used again once surrendered.
2. The date of the entry into force, or the maintenance, of the restrictive measures which called for an invocation of the derogation clauses by the country concerned are indicated, and not the date when the council of the OECD formally endorsed the invocation in question.
3. General dispensation from the liberalisation provisions of the Codes.

Source: OECD, *Exchange Control Policy*, CCEET (1993).

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EU members states to achieve complete liberalisation of capital movements by 1990, also inspiring similar moves by the then EFTA members Austria and Sweden in 1989 and Norway and Finland in 1989-90, provided underpinning for the adoption of a major extension of the Codes' obligations. The broadening of obligations – most extensive in the area of short-term capital movements as well as in cross-border financial services – had already been under discussion since 1984 and was adopted by OECD Council decision in May 1989. Previously, most short-term capital flows, except those related to commercial transactions had been excluded. Furthermore, certain measures such as taxes on transactions and payments, dual exchange rate systems and currency deposit regimes had not been considered restrictions under the Code.

By the time this extension of the obligations under the two Codes was formally introduced in the 1992 revised versions of the liberalisation lists, most members had dismantled all controls on capital movements and significantly freed up the cross-border provision of financial services. Greece and Iceland maintained controls somewhat longer, but since the mid-1990s, the only restrictions retained by a limited number of older members concern sectoral limitations on inward direct investment (mainly relating to transportation) and non-resident acquisition of real estate. As to financial services provision, the few remaining restrictions concern insurance, securities underwriting as well as conditions for the establishment of branches and agencies.

2.2. *Diverging speed and patterns of liberalisation*

In the majority of liberalisation experiences since World War II, liberalisation of the real sector was a gradual process. It took more than ten years for continental European countries and Sterling Area countries during the post-war reconstruction period to return to full current-account convertibility. Portugal and Spain achieved Article VIII status of the IMF Articles of Agreement only in the late 1980s, while Turkey and Greece became Article VIII countries in 1990 and 1992, respectively.

As far as capital-account liberalisation is concerned, there is more variability in approach, although a tendency towards acceleration clearly exists. Japan, after its adhesion to the OECD Codes in 1964, took 16 years to liberalise capital movements, little by little. Liberalisation of capital controls in Denmark, begun in the early 1970s, was spread over more than 15 years. Remaining controls were gradually removed from 1977 to 1986 in the Netherlands. Austria tested out the market's reactions to small *de facto* liberalisation steps over a long period in the 1980s, before officially lifting formal controls.

Notable exceptions to this gradual approach to capital control liberalisation exist. Canada took the decision to remove its controls already in September 1950 and they were all dismantled by December 1951. Germany had opened its capital

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account fully at the same time as it introduced full current-account convertibility, in 1958. The United Kingdom opted for a "big bang" approach in 1979, removing all controls in less than 6 months. This one-step removal of all restrictions by the United Kingdom, which in the post-war period had operated a system of extensive capital controls in conjunction with strict domestic financial regulation, acted as a powerful signal to other countries. Both Australia and New Zealand followed suit in the early 1980s. Turkey moved to almost full convertibility for both the current account and the capital account in one step, in 1989 (although some liberalisation measures were already taken in 1984).

Since the mid-1980s, the time taken in what is commonly called the gradualist approach shortened. Finland, Norway and Sweden really started liberalising the hard core of their permanent exchange control regimes in 1986-87, abolishing them in less than 5 years. Sweden liberalised fully via a final important step in 1989 and Norway in 1990, while Finland followed a somewhat more gradual policy (see Annex I for a detailed review of financial liberalisation in Finland).

France's well-documented gradualist approach to decontrol was initiated in 1985, after its system of direct domestic credit control was removed. The momentum of the external liberalisation process, including the abolishment of the "devise-titres" mechanism was kept up for the rest of the decade, despite temporary pressures on the exchange rate in 1987, with the last steps taken in 1989. (see Annex, page 155, for an account of the process of financial liberalisation in France). Italy, which maintained relatively tight exchange controls before the adoption of the EU Directive on capital movements in June 1988, achieved a complete dismantling of controls in less than two years.

The quickening of the pace of liberalisation during the 1980s also resulted in a reduced resort to temporary restrictions requiring invocation of the derogation clause. Only France, Spain, Norway and Finland felt it necessary to suspend temporarily the freedom of capital movements already liberalised, and these measures were all of fairly short duration.

Although Ireland, Portugal and Spain took liberalisation steps from 1986, these countries had extensive controls on short-term capital movements until the late 1980s and took measures in 1991 and 1992 to lift remaining restrictions. In the case of both Portugal and Spain, the two years it took them to complete the abolition of controls to comply with the 1992 deadline set by the European Community were filled with turmoil in their foreign exchange markets. Both currencies came under significant speculative pressure in connection with the ERM crisis, forcing realignment of their exchange rates – in the case of Spain, twice, after a period of struggling with different forms of controls on short-term outflows. (Regarding the financial liberalisation experience of Portugal, see Annex, page 166.)

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2.3. *Sequencing by categories of capital account operations*

Amongst members following a gradual approach to lifting exchange controls, the process generally began with less volatile transactions and those more directly necessary to normal business activities. Hence, outward direct investment was usually authorised sooner than portfolio investment abroad, and trade credits were liberalised before financial loans. Equity operations were liberalised before those in debt securities – and when these were liberalised, the OECD countries began with long-term bonds, thus keeping control over money-market instruments for a longer period.

This classical sequencing pattern was only partly adhered to as the liberalisation accelerated in the 1980s. For those opting for a "big bang" approach, following the United Kingdom, any further fine-tuning of liberalisation policy was out of the question. In Turkey, outward direct investment and portfolio investment were liberalised at the same time. Furthermore, as financial-market instruments became more sophisticated and new techniques of financial engineering developed, the arguments for sequencing have tended to lose some of their point. Hence, Sweden liberalised operations in Treasury bills and longer-term government bonds together, in 1989; Italy and Ireland liberalised operations in equities and bonds in tandem rather than in sequence.

Several countries, such as France and Norway, maintained restrictions on lending to non-residents in local currency until the latest stage of liberalisation, for fear of facilitating speculation against the currency. Conditions for issues abroad of domestic securities in domestic currency were also long subject to limitations, until made irrelevant in the EU member countries by advancing monetary integration.

In general, the last operations to be liberalised were those concerning deposit accounts with non-resident institutions abroad; and this mainly for tax control reasons. In France, nonetheless, restrictions on resident accounts abroad were linked to the surrender requirement of foreign exchange revenues imposed on enterprises until 1987 and were not removed until the latter requirement was lifted.

2.4. *Capital controls: Motivations, techniques and supporting institutional framework*

As already mentioned in Chapter I.2 of this study, the motivations for capital controls amongst the older members of the OECD have ranged over the spectrum of monetary and exchange rate policy considerations (preserve a wedge between domestic and international interest rate levels, limit downward – sometimes upward – pressures on the exchange rate), savings and investment considerations (preserve domestic savings for domestic investment purposes, maintain domestic control of key resources and industries) and fiscal policy considerations (preserve domestic tax base and limit evasion). In addition, controls have been kept on due

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to the absence of other mechanisms for reporting and recording capital flows, as well as, in surprisingly many cases, out of sheer administrative inertia. Table 4 gives examples of officially formulated motivations for exchange control from acts and regulations relating to foreign trade and currency exchange. A review of the discussions and motivations put forward in justification of various forms of restrictions in the CMIT committee produces similar evidence. The overwhelming majority of motivations relate in some way or other to the "impossible triangle" dilemma as formulated by Robert Mundell, namely the incompatibility between free capital movements, stability of the exchange rate and autonomy for domestic monetary policy. Thus, capital controls were a dependent variable, which could be manipulated to relieve pressures on the exchange rate when the alternative of adjusting domestic interest rates was deemed undesirable. As also discussed in Chapter I.2 above, the fact that domestic financial deregulation had not been completed in the majority of the older OECD members until well into the 1980s, meant that capital controls were also frequently used to close loopholes under regimes of direct credit control, as being the required complements to direct monetary policy instruments.

Exchange controls were also regularly used to serve a variety of other purposes such as: protecting domestic investors in the face of possibly inadequate

Table 4. **Official objectives of exchange control**

Country	Official objectives
France	To protect the currency, to preserve the autonomy of monetary policy, and to control the participation of foreign capital in sensitive sectors of the economy.
Germany	To counter adverse effects on the purchasing power of the Deutsche mark and to secure equilibrium on the balance of payments.
Ireland	To help safeguard the national external reserves and to regulate the effects of capital movements on the exchange rate of the Irish pound.
The Netherlands	To prevent the capital market from being disrupted, to prevent a large outflow of capital which (threatens to) considerably reduce the gold and foreign exchange holdings, or to prevent a large inflow of capital which (threatens to) seriously thwart financial and economic policies.
United Kingdom	To conserve the United Kingdom's gold and foreign currency resources and to assist the balance of payments.

Source: A.F.P. Bakker "The Liberalisation of Capital Movements in Europe" page 19, quoting the following official sources: France: Galy (1986); Germany: Aussenwirtschaftsgesetz (1961), Article 23.2; Ireland: Memorandum of Irish delegation to OECD (1983); The Netherlands: External Financial Relations Act (1980), based on Articles 4, 7 and 8; United Kingdom: A guide to United Kingdom Exchange Control (1977).

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supervision abroad, preventing evasion of the laws (notably tax fraud, financial malpractice and money laundering) or securing the collection of balance-of-payments statistics. Although ascribing certain tax control, statistical and supervisory functions to the exchange control administration saved budgetary resources, this proved later to cause delays in the abolition of exchange controls in several countries, for the time it took to put in place new reporting systems prior to liberalisation.

The techniques and types of controls which the older OECD members resorted to have been classified into three distinct categories: 1) I*ndividual authorisation requirements*, on the basis of legal or regulatory prohibitions involving direct controls on amounts; 2) *administrative regulations and arrangements* designed to limit the volume of flows by indirect means; 3) *other control measures* designed primarily with other policy objectives in mind, but influencing the incentives for cross-border flows.[11]

In the first category, various ceilings, limits and direct prohibitions have figured, while the second category included many country-specific structures ranging from repatriation and surrender requirements, dual exchange markets and special currency circuits to interest rate limits and other costs imposed on the capital flows. The third category has included investor protection measures of various forms, minimum reserve requirements on external assets and liabilities and limits on domestic credit expansion.

Direct quantitative limits (as in the first category) were the most widespread form of controls across countries on *capital-account operations*. Weaker forms of controls were, however, used in some cases. Common features of administrative controls are that they need underpinning by legislation and implementing regulations and impose administrative obligations on the banking system in order to control flows.

Amongst *current-account operations* controlled well beyond the achievement of full current account convertibility under Article VIII of the IME Agreement in the 1950s was access of residents to foreign exchange for travelling abroad, which continued to be limited on a more or less permanent basis in fourteen OECD countries (Table 2).

Leads-and-lags in trade payments were also tightly regulated in several countries, notably in Japan from 1950 to 1980, and in Italy and in France where domestic enterprises were required up until the late 1980s to surrender their export proceeds.[12]

Certain countries also maintained restrictions on the transfer abroad of interest earnings from bank deposits or other portfolio investments by non-residents, as a means of discouraging speculative capital inflows.

Switzerland (from 1950 to 1954) and the Belgium-Luxembourg Economic Union (from 1955 to 1990) had a *dual foreign exchange market* in which current-account transactions and capital transactions (possibly including access of residents to foreign exchange for travel purposes) were undertaken through separate channels. Such

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systems were also established in France from 1971 to 1974 and in Italy in 1973-74. These two-tier exchange systems did not conflict with the provisions of Article VIII of the IMF Agreement so long as a uniform exchange rate was used for current-account transactions, the definition of which could for the occasion not include travel abroad. Although, at the time introduced by Belgium-Luxembourg, they were seen as partial liberalisation, such systems are now regarded as restrictions under the Capital Movements Code if the exchange-rate differential exceeds 2% continuously for a period of several months. Typically, the motivation behind dual or multiple exchange rate systems have been to insulate current account operations from speculative capital account outflows which could call for undesired interest rate adjustments or lead to reserve losses. They have occasionally been resorted to for accommodation of excessive inflows, which are prevented from exerting upward pressure on the "non-financial" exchange rate. Although regarded as less restrictive in character, as a market-based instrument, this system in practice entailed heavy administrative management and proved of limited effectiveness in cases of crisis unless reinforced by supplementary restrictive measures.[13]

France operated at different intervals between 1955 and 1986 a market, known as "le marché de la devise-titre", where residents holding foreign securities could sell them to other residents, thus leaving more flexibility for portfolio adjustment. (See Annex II). Somewhat similar arrangements existed in Sweden and the United Kingdom, in the form of "investment currency" markets where the purchase of foreign securities could be made only from the sale of existing foreign securities or from foreign-currency borrowing.

Also, penal reserve requirements were imposed on banks in a variety of countries, with varying effects depending on the importance of banking intermediation in their financial system. Germany and France imposed such reserve requirements on banks' external liabilities in the beginning of the 1970s as did Spain towards the end of 1992 in connection with the ERM crisis. Finally, discriminatory taxes were also used in a few cases to restrict capital outflows, of which the interest equalisation tax (IET) on foreign fixed-rate securities purchased by residents imposed by the United States in 1963 remains a well-known example. The measure was part of the "external restraint" programme aiming to discourage outward direct and portfolio investment from the United States and was accompanied by a reserve requirement on Eurodollar borrowing by commercial banks. These arrangements were abolished after the move to floating exchange rates.[14]

2.4.1. *Foreign exchange regulation*

With the exception of the United States, Canada, Germany and Switzerland which never put in place a permanent legal framework for their limited and episodic use of exchange controls, the law in other countries provided that all

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transactions were restricted unless otherwise specified. This type of "*negative*" *exchange regime* approach was taken largely for precautionary reasons, so as to allow governments to take steps backward in case of necessity. The opposite, or "*positive*" *exchange regime* approach, declaring all operations *a priori* free, unless explicitly restricted was adopted only well into the 1980s after members had committed to move towards full liberalisation of the core exchange controls.[15]

Although the legislation was modified in France in November 1968 following the May events, in Portugal after the 1974 Revolution and in Spain with the change in government in 1979, the general legal framework since World War II has been remarkably stable in countries maintaining controls. This was possible because controls could be adapted to new circumstances by way of implementing regulation issued by the central banks and Ministries of Finance.

Current-account transactions and trade credits were generally administered under a general permit procedure, whereas other capital transactions were more often subject to case-by-case authorisation. While law or tradition gave relatively narrow authority to the administration for issuing and interpreting regulations in countries such as Germany, the Netherlands, New Zealand, the United States and most Nordic countries, wide discretion was left to regulators in other countries.

Exchange control instruments have generally been applied on an *erga omnes* basis as concerns capital inflows which are primarily responsive to interest rate differentials and exchange-rate expectations such as short-term portfolio investment and financial credits. Otherwise non-residents could have easily circumvented controls through triangular investment from countries which were not affected by the restrictions. And, to the extent that the "rest of the world" is large relative to the size of individual countries, there is practically no limit to capital inflows through such channels. Belgium and Luxembourg had, however, a common exchange control regime *vis-à-vis* third countries as they formed a monetary union. This was also the case for countries belonging to the Sterling Area in the past.

2.4.2. E*nforcement procedures*

In the majority of countries, commercial banks played a key role in the implementation of controls. Transactions had to be carried out through "authorised' commercial banks and certain other foreign exchange dealers, which were delegated the authority to grant permission for properly documented operations in certain categories or up to specified amounts. Extensive reporting requirements, sometimes on a daily basis as in Belgium and Luxembourg, were imposed on these agents.

Customs officers were heavily involved in the enforcement of exchange controls at the frontier. Customs authorities sometimes had powers exceeding those of the police in some respects, such as the authority to proceed with search

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without warrant in France. There was also close cross-checking of information between the customs administration and commercial banks.

Such controls were more cost-effective when computerised, but there were limits to what could be achieved through electronic data processing because of human errors in entering data. As a result, ex-post surveillance by the government administration was generally exercised through sample techniques and on-the-spot verification of banks' accounts. In Portugal, the administrative apparatus also carried out systematic verification for specific transactions and periods.

On the whole, it appears that procedures to enforce effective controls imposed a significant burden on commercial banks and the government administration. As an order of magnitude, there were 750 staff just at the Bank of England occupied with exchange controls before their abolition in 1979. Relative to the size of the population, there was a similar proportion of agents within the Belgian-Luxembourg Exchange Institute during periods of tensions on the foreign exchange market.

To make the controls credible, extensive sanctions had to be applied in case of non-compliance with regulations, with certain violations being classified as criminal offences. An effective sanction was the withdrawal of the license accorded to authorised banks and foreign-exchange dealers, as licensed banks were concerned to preserve their prerogative to charge generally substantial commissions on foreign exchange operations undertaken on the account of their clients. The risk of losing clients in applying exchange controls too scrupulously was, on the other hand, limited at a time when competitive pressures in the banking sector had not yet become strong.

Severe penalties could also be inflicted on enterprises and persons guilty of evading controls. They ranged from fines equivalent to several times the amount of illegal transfers to one or more years of jail. In some countries, the vehicles of those contravening the regulations could also be confiscated upon crossing frontiers. Such severity may appear, by current standards, somewhat excessive. In practice, it was intended primarily to exert a dissuasive effect and the more extreme sanctions were rarely applied.

More generally, controls clearly represented a handicap for domestic financial intermediaries to compete effectively in global financial markets. Market shares were lost because of bans on cross-border operations. Non-interest bearing deposit requirements and compulsory minimum holdings of domestic government bonds imposed on banks and institutional investors for exchange control purposes also increased costs and reduced their ability to compete. Moreover, the system was often unevenly applied, as in some instances privileged strategic enterprises obtained derogations from existing controls, leading to competitive distortions relative to other enterprises. A general result of discretionary exemptions was the perception that exchange controls served to perpetuate

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discrimination against small, local firms in favour of larger, trade-oriented firms and multinational corporations with easier access to foreign exchange operations, thus encouraging rent-seeking behaviour. On some occasions, these privileged entities even undertook foreign exchange operations on behalf of others, acting as financial intermediaries outside the reach of prudential supervision. In addition, the public could circumvent controls by extensive use of cash instead of cheques or payment cards, thereby delaying the implementation of a modern payments system in some of the less advanced OECD countries. On the whole, there was significant resource diversion due to time-consuming efforts by private enterprises and individuals to circumvent restrictions. In certain countries, notably in southern Europe, incentives to evade exchange controls also fostered an already prosperous underground economy, where compliance with basic rules of a sound and equitable market economy had given way to more corrupt practices.

2.4.3. *Decreased effectiveness of capital controls*

Already in the 1970s, in the light of the rapid development of the eurocurrency markets, OECD countries were aware of the limited effectiveness of their exchange control systems. Attempts by Germany and Switzerland to restrict capital inflows in the 1970s were early recognised to have been largely unsuccessful. When these countries decided in the end to let the exchange rate appreciate, this proved to be a much more rapid and powerful way of stopping excessive capital inflows. It was also clear to the United States administration that there were important limits to what could be achieved through the controls put in place from 1967 to 1973, especially in view of the role of the US dollar as major reserve currency.

A quotation from the report of the horizontal assessment of controls maintained by members on capital account operations undertaken by the CMIT at the end of the 1970s serves as a good summing up of the emerging consensus with respect to effectiveness (OECD 1980):

> "In the main, the more the restrictions may be felt to be needed, say in periods of intense speculative pressure, the greater the incentive to circumvent the controls. A legitimate question is raised as to whether the cost of the insulation or of the time gained for adjustment is worth it when these advantages can be significantly reduced by evasion and, more importantly, by legitimate substitution ('leads and lags' and shifts in non-resident holdings of domestic assets) at the very moment that time or insulation might be useful to undertake longer-term adjustments. Nonetheless, control measures might be imposed simply because they are anticipated by market participants and expected by political interest groups, even when their effects are likely to be limited. The rest of the time, in normal periods, they present administrative

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and economic costs with the only benefit being largely protection from minor international fluctuations which all but the smallest countries with the most underdeveloped (*sic*) capital markets could normally absorb without controls with little cost."

The limited effectiveness of controls was also one a key reason advanced by member countries who abolished their exchange control regimes in the course of the 1980s. Three lessons can be drawn from the practical experience of the OECD countries with the implementation of controls over the past four decades:

- It proved especially difficult to keep controls effective when market participants' incentives to circumvent restrictions were strong. In retrospect, this may seem somewhat disappointing, since controls were intended to be especially useful during periods of currency unrest.
- To make controls durably effective, it was necessary to minimise loopholes in regulations. Loopholes proved, however, difficult to close unless the authorities were willing to interfere with normal trade payments and legitimate exchange-risk management by business firms.
- Erosion of controls accelerated whenever kept in place for an extended period as market participants gained experience on how to circumvent them, with the effect of multiplying and enlarging the loopholes.

This experience was confirmed also on the occasion of major turmoil in foreign exchange markets affecting a number of member countries in the 1980s and the early 1990's. In France, the extreme tightening of exchange controls did not prevent three devaluations largely undertaken under the pressure of speculation, by more than 25% in total between 1981 and 1983, in about 18 months, although the restrictions probably affected the timing of currency realignments. Italy faced similar currency unrest during the same period. The decision to dismantle all capital controls in Australia in December 1983 and in New Zealand in December 1984 was preceded in each case by episodes of massive capital flight that controls were unable to arrest. During the ERM turbulence in 1991-92, there was still a broad consensus among OECD countries that the adoption of corrective policy measures which pass the test of free financial markets represented a long-run investment which offered a better guarantee for economic stability in the future than a return to controls. It should be noted that the three ERM countries (Ireland, Portugal and Spain)[16] which tightened existing foreign exchange regulations or re-introduced certain restrictions during Autumn 1992 finally removed all remaining controls by the end of 1992, in conformity with their initially announced schedule (see Annex III for a detailed account of Portugal's experience during this period). Only in Greece and Iceland where financial markets were significantly less developed were controls seen to perform well enough, at least in the very short term, to be worth retaining somewhat longer.[17]

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2.4.4. *Placebo effects and signalling*

As mentioned in the extract from the 1980 CMIT report reproduced above, there was a certain element of placebo effect in the imposition of controls on short-term flows in periods of high volatility and pressure in currency markets. Through such signals, policy-makers could demonstrate to the general public and special interest groups that they were "doing something" to arrest the speculative flows, even if it was realised that the controls imposed represented, at best, a temporary stop-gap measure.

However, this could mean missing more fundamental and important signals coming from the market, especially if controls were vigorously enforced. Implicit behind the new, market-based approach to monetary policy was a recognition that financial markets do not deviate from "fundamentals" of the economy for long periods of time. Monetary authorities increasingly realised that capital controls could mask timely and useful signals by the market that corrective policy measures were called for.[18] By the same token, it was increasingly recognised by several governments that they did not necessarily possess better information on where the equilibrium exchange rate should be. In particular, in countries vulnerable to large terms-of-trade shocks such as Australia and New Zealand, it proved difficult to distinguish capital flows reflecting changes in fundamentals from purely speculative or cyclical capital movements.

In the context of moving to a market-based paradigm for monetary policy, one key concern of the monetary authorities was to establish credibility-enhancing mechanisms. The abolition of controls has been seen as one of the means of signalling to the market participants the firm commitment of authorities to stick to pre-announced adjustment programmes. Indeed, with more open money and capital markets, most visible deviations from initially stated monetary policy objectives are more rapidly and more severely sanctioned.

2.5. *Conclusion*

The OECD 40-year history shows that the membership experience with progressive external financial liberalisation has been overall positive. In terms of general economic efficiency effects, cross-border impediments to the efficient allocation of capital have been removed and countries' range for inter-temporal savings decisions has been extended via access to a greater pool of capital. Openness to foreign capital inflows has contributed to enhancing competition and hence improved performance within the domestic financial institutions. It has also provided an opportunity for domestic corporations, which became free to issue securities abroad, to familiarise themselves with disclosure and other corporate governance standards required by advanced capital markets. For households and business firms, there have been the tangible benefits of being allowed to diversify

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away from country-specific risks in their asset portfolios. On balance, crisis experience has been limited as liberalisation was for the most part sequenced with deregulation and reform of domestic financial sectors. Critically, domestic and international financial deregulation was launched when sound, functioning institutions were in place. The recent members, whose experience is covered in the next section, had less of a time-span to reach appropriate levels of institutional-governance structures, but within this smaller sample of OECD member countries, there have been notable differences in approach, pointing both to the importance of initial policy setting as well as clear and consistent messages to market participants regarding the authorities evolving policy intentions.

3. The liberalisation experience of recent OECD members: a question of governance

3.1. *Six new members adhere to the Capital Movements Code* 1994-2000

The OECD membership constituency remained unchanged for twenty years, following the accession of New Zealand in 1973. During the period 1994-2000 six new members acceded to the OECD. Mexico was the first to join (May 1994), with the Czech Republic (December 1995) and Hungary (May 1996) following suit in quick succession. Poland (November 1996) and Korea (December 1996) were ready to accede almost simultaneously, while Slovakia concluded its accession process in the first half of 2000 and became a member in December 2000.

From the beginning, the Codes of liberalisation played an important role for the new members joining the OECD. For the new Central and Eastern European (CEE) members, still in their early stage of transition to market-based economic systems, they formed a central part of their overall process of economic and financial opening. For Korea and for Mexico, accepting the Codes obligations meant adhering to a set of permanent liberalisation standards confirming their commitment to an open markets policy on a non-discriminatory basis. For all of them, the Codes have served as a tool to measure readiness to share their peers' philosophy of international economic relations.

Following a brief overview of the international financial policy context during the 1990s below, this section sets out the liberalisation approach of the six new members under the OECD Codes. In accordance with the structure of the Committee review process, the account is organised by major categories of capital account operations. The focus is on the policy concerns expressed and the motivations given for maintaining controls in certain cases, with an attempt to distil the essence of the discussion during the examinations.

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3.2. Policy context

The accession to the OECD of the six new members took place during a period which was marked by a fundamental shift towards a liberal economic system in the 1980s and into the 1990s, as the former socialist economies of Central and Eastern Europe, Russia and the remainder of the former Soviet Union began their transition from command to market-based rule. This process was also under way in China, Vietnam and other Asian economies, where central planning and other forms of discretionary state intervention were being abandoned in favour of market-based principles of economic management. That this general shift implied significant macroeconomic and structural policy challenges, was clearly demonstrated by the severe financial crises which affected Mexico in 1994-95 and South Korea in 1997. Important indirect effects of the 1997 Asian financial crisis spread to the new CEE members, reinforced by contagion from the Russian financial crisis of August 1998. These developments focused world attention on the issue of how to achieve "desirable" capital account liberalisation without destabilising effects on the domestic financial sectors of the liberalising countries.

The fact that Mexico and Korea experienced deep and costly financial crises following their accession to the OECD led to some questioning of the liberalisation impetus embodied in the accession process. Questions were raised whether adherence to the OECD Codes of Liberalisation had contributed to a premature opening up of their economies to destabilising short-term flows. In many instances, such questioning of the OECD role in the liberalisation process arose from a lack of understanding both of the process which guides new OECD members in assuming the liberalisation obligations under the Codes and the policy background which shaped the approach of the six new members to liberalisation. While each application for membership in the OECD is judged on its own merits, all candidate countries are expected to meet, *inter alia*, the following standards based on the guiding principles of the Code of Capital Movements:[19]

- no restrictions on payments and transfers in connection with permitted international transactions;
- an open and transparent regime for foreign direct investment;
- liberalisation of other long-term capital transactions; and
- an indication of a timetable for future further liberalisation.

While these standards charted a prudent path towards the eventual goal of full capital account openness, they could not in themselves represent a guarantee that external pressures and vulnerabilities will not occur.

The specific economic policy context and degree of institutional development of the CEE members as well as of Mexico and Korea were of paramount importance to their respective liberalisation experience. Because of the fundamental system-

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shift of their economies from central planning to market-based economic management, the approach by the four CEE countries to capital account liberalisation differs fundamentally from that taken by the advanced economies during the 1980s and prior to the collapse of the Bretton Woods system in the early 1970s. As a consequence of this system shift, market-oriented monetary and exchange rate policies were adopted and important sectors of the economy deregulated over a much shorter time span than in the advanced economies in Europe and elsewhere. While capital account liberalisation in the latter tended overall to be a protracted process, accompanied or preceded by gradual development of market-based, indirect monetary policy instruments and progressive deregulation of financial sectors, the Central and Eastern European economies compressed this process into a much swifter transition, synchronised on many, even if not all, fronts. Compared with the extensive foreign exchange regulations and capital controls in place in the beginning of the 1990's,[20] the four CEE countries have in ten years managed to achieve high – and for two of them, full – liberalisation.

This is not to say that capital account liberalisation was undertaken in one "big bang" exercise, but to emphasise that there was less time for experimenting and allowing policies to evolve slowly, in tandem, while still providing room for manoeuvring and allowing deregulation to proceed at varying speeds as between sectors. That stresses and imbalances arose within such a large undertaking of institution-building and policy development is hardly surprising. At the same time, the experience of the older OECD members shows that there is no assurance that a more protracted reform process will enable a country to steer clear of crisis occurrences.

In summary, allowing for the very different initial conditions prevailing in Mexico and Korea, all six new members were facing pressures arising from the need to build or adjust institutional and regulatory structures to the increased degree of integration with the global economy made possible by accession to the OECD. It is also true that for all of the six, the OECD accession had a very significant impact on the degree and form of capital liberalisation undertaken. Without the impetus provided by the need to adopt a position *vis-à-vis* the Codes of Liberalisation, involving detailed discussions and justification of the various exceptions and dispensations they proposed to the obligations under the Codes, there would probably have been less overall dismantling of exchange controls. However, this momentum was not gained in a context heedless of the stresses that capital account opening brought. The main principles and ideas embodied in the structure of the Codes, aiming for an orderly, securely anchored process of liberalisation played an important role in shaping the approach taken. Although differences in specific domestic policy concerns were reflected in differences amongst the individual new members as to exact timing and sequencing of the lifting of restrictions, such decisions were also to some extent guided by the structure and tenets of the Codes obligations.

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A review of the discussions held during the accession examinations of the six recent members produces numerous references to the need for institution-building and for addressing financial sector fragility through improved regulation and oversight. In fact, these discussions probably brought added impetus for reform to promote financial robustness and improve management practices so as to withstand shocks not only in the financial, but also in the corporate sector. Domestic political constraints as well as inertia in the legislative process prevented the new entrants from introducing the full range of improvements to corporate and public governance practices and to the predictability and transparency of rules and regulations recommended by the OECD Committees in charge of the accession examinations. However, it is significant that liberalisation of remaining capital controls proceeded largely according to the agreed time schedule both in Mexico and Korea following the crisis experience, allowing for certain delays connected to the extent of the overall administrative burden of pursuing financial sector reform in the wake of the crisis. None of the new members sought recourse to new control measures under the derogation procedure and several explicitly stated in post-accession examinations that reverting to controls to address crisis symptoms was never considered a viable option.[21]

It should also be remembered that the four Central and Eastern European new members had a special policy agenda in that they were looking towards EU accession and eventual monetary union. They had all signed separate association agreements with the EU before joining the OECD, imposing time limits for certain liberalisation measures, and the prospective date of entry to the Union naturally set a future cut-off point for all restrictions on capital movements. To the extent that this prospect influenced their monetary and exchange-rate policies as well as the development of their financial frameworks, it could reasonably be expected to have reinforced their commitment to the OECD process.

3.3. *Liberalising* FDI *inflows: industrial policy and foreign ownership*

In the more protracted liberalisation processes of the advanced economies of Europe and elsewhere, controls on long-term capital flows in the form of direct and portfolio investment motivated by industrial policy concerns sought to curtail outflows as well as inflows for two principal reasons. Restrictions on outflows were based on the developmental objective of keeping scarce capital resources from flowing to better investment opportunities abroad, while restrictions on inflows were maintained in order to discourage or prohibit foreign ownership in different sectors of domestic industry. In some of the six recent members of the OECD discussed in this article, it is mainly the latter form of policy concern that has prevailed, with resort to outright exclusion from certain strategic sectors of industry; maximum shares of overall foreign ownership in the sector concerned or joint-venture requirements with domestic investors. In a few cases, non-transparent privatisation

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procedures as well as cumbersome administrative authorisation processes and operational requirements have also been applied with the aim of limiting foreign participation in certain sectors. As to *outward* FDI, none of the six new members except Korea imposed any restrictions and none of the countries imposed any controls on the liquidation of permitted direct investments and acquisitions of real estate, nor any limitations on repatriation of proceeds from such liquidation, including capital gains. In Korea, outward direct investment had been progressively liberalised since 1992, but there remained some limitations at accession which relied on discretionary screening and validation procedures setting in above certain specified amounts. Requirements for finance from own resources were also initially maintained.

a) T*he* CEE *new members*

The absence of any general screening mechanism whether for new "greenfield" investments or for take-over of, or participation in, existing enterprises established in the domestic economy was specifically noted in the case of the Czech Republic, Hungary and Poland, while in the case of Slovakia a number of features limiting the access of foreign investors, especially in relation to the privatisation process, were noted in the first examination in 1996. Generally, the four CEE members entered the OECD with very few sectoral restrictions to inward FDI, adopting more whole-heartedly than Korea and, to a lesser extent also Mexico, the policy of encouraging foreign direct investment inflows across the board in order to stimulate domestic industrial development and enhance access to new technology and management techniques (although in the case of Slovakia, only after the political changes in 1999). With the exception of air and water transport – in a few cases also telecommunications – there were no significant concerns raised regarding protection of the competitive position of domestic producers.[22] On the whole, these four countries have achieved a level of openness to FDI comparable, and sometimes exceeding, that of older members of the OECD.

The attitude adopted towards foreign ownership of land and certain other natural resources constituted a special case, due in particular to the political complications of restitution rights to assets confiscated during the communist regimes and geo-political considerations dating from the World War II. Thus, all four countries were reluctant to liberalise fully the acquisition of land by foreign investors and lodged reservations accordingly under the Codes of Liberalisation, although the purchase of real estate necessary for business establishment was generally freed. Remaining restrictions are expected to be progressively lifted in the context of the EU accession, leaving certain categories of land and real estate subject to a transitional period. High political sensitivity to non-resident ownership of land other than directly related to the establishment of production facilities is not unique to the CEE members. It has also found an expression in similar restrictions

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by established OECD members such as *e.g.* the Nordic countries and Switzerland, in relation to secondary residences in particular.

Poland and Hungary both restricted the form of establishment of foreign investors via branches, requiring full incorporation, but these restrictions were lifted within a period of three years after accession. Resulting from shared legislation in the past, the Czech and Slovak Republics also imposed restrictions on foreign direct investment in the energy sector, as well as on foreign participation in lotteries and casino operations (the latter have been addressed by amendments to respective laws).

Given the important role of the state as owner of productive assets in all of the CEE countries, the Committees took pains to examine the strategies and procedures for on-going privatisation processes, and in particular that foreign investors were given equal access with domestic investors in all phases of the process. This included ensuring national treatment for transactions in the shares of privatised enterprises and insisting on full transparency with respect to specific qualifying conditions imposed on investors in certain sectors. Thus, *e.g.*, the Czech Republic restricted access to the local telephone network and services to entities with minimum participation by Czech natural or legal persons. The Committees also recommended (in the case of Hungary and Poland) that the number of strategic enterprises designated to remain under state control be limited as far as possible in the new privatisation legislation being drafted. During the first examination of Slovakia, the Committees expressed concerns regarding delays in the privatisation process as well as evident lack of transparency, predictability and consistency in the implementation of privatisation rules.

b) *Korea*

At the time of accession, Korea maintained significant restrictions on inward FDI, with certain sectors of industry fully closed to incoming greenfield investment, and others subject to partial closure, sometimes in combination with so-called joint venture obligations. A large number of firms were designated as defence-related companies where inward foreign investment was subject to prior approval. There were also limitations on aggregate foreign investor ownership in state-owned enterprises put up for sale in successive privatisation programmes. Moreover, the administrative procedures and approval processes confronting foreign investors were lengthy and cumbersome. By 1998, improvements in all these aspects had been introduced, with successive reduction in the number of reservations concerning inward FDI, but the Committees still found reason to encourage greater resort to non-discriminatory means for meeting the concerns underlying the sectoral restrictions in the post-accession report of 2000.

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Although the sectoral restrictions were very substantially diminished in scope in the period 1998-2000, as Korea shifted to a "negative list approach" as recommended by the Committees, its regulatory regime for incoming greenfield direct investment still excludes certain sectors fully or partially from foreign investment. Moreover, the liberalisation process applied favours a stepwise relaxation of the ceilings imposed in the various restricted sectors, rather than an outright abolition of the ceiling itself. A similar regulatory approach to the direct participation of foreign investors in the industrial and services sector was also evident in the process of privatisation. Although foreign investors were in principle allowed access to this process without discrimination, limitations on aggregate foreign ownership were (and still are) maintained for a number of the SOEs concerned in their individual articles of association. Thus, while the Committees welcomed the considerable progress made with the privatisation programme, they found it necessary to add an encouragement to the Korean authorities to ensure that foreign investors were given access equal to domestic investors to the capital and management of companies being privatised on the basis of transparent rules and procedures.

The Korean authorities have ascribed the perceived need to maintain their very cautious approach to incoming foreign direct investment as well as the provision of cross-border services in certain sectors to security considerations arising from their particular geo-political situation since the end of the Korean war.

c) Mexico

The Mexican approach to inward FDI was already conditioned by its engagements *vis-à-vis* NAFTA at the time of accession to the OECD. Thus, the decision to abandon its previous extensive regulation of foreign participation in domestic business and service sectors was taken already in the beginning of the 1990s. Although Mexico had traditionally relied on extensive regulation of foreign direct investment, with screening mechanism in place for greenfield investment, outright prohibition in the financial sector and significant restrictions in the energy, mining and transport sectors, substantial liberalisation on an *erga omnes* basis was introduced at the end of 1993, to accommodate the undertakings under NAFTA as well as to meet OECD entry requirements. Membership in other regional organisations provides a potential source of discrimination arising from regionally backed protectionist policy considerations, with exclusion of third countries or strict reciprocity requirements as a result. However, both in the case of NAFTA for Mexico and Association Agreements with the EU for the CEE new members, the introduction of *erga omnes* principles of extension of liberalisation measures to all OECD members has been a positive force in advancing liberalisation.

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Mexico lifted asset thresholds for screening requirements of incoming investment successively during the period 1997-2000 in line with the NAFTA schedule. In the financial sector, financial institutions from NAFTA countries were allowed to establish or acquire existing institutions in Mexico subject to market share restrictions applying during a transitional period from 1994-1999. Mexico committed to extend this treatment to institutions from non-NAFTA OECD members and other countries with whom Mexico enters into international agreements (see further below).

3.4. Foreign participation in the financial sector: developmental benefits versus domestic control

With the exception of the Czech Republic, the CEE members extended very few restrictions on non-resident acquisitions and establishment in the financial sector at the time of accession. The Czech Republic (as well as the Slovak Republic, although before its accession in 2000) maintained a special approval requirement covering foreign equity participation in Czech banks, which was lifted only in 1998 following a thorough revision of the Banking Law. Limitations on foreign ownership stakes in the Prague Stock Exchange were also maintained until 1998. This was also the case in Slovakia, regarding the Bratislava Stock Exchange, due to the common legislation applying before the separation of the two countries.[23] The extensive state ownership of financial institutions persisting in both Republics and the slow pace of privatisation in this sector as well as the lack of transparency regarding cross-ownership of interests in the banking and the corporate sector were subjects of repeated discussion in accession and post-accession examinations. Concern was expressed not only regarding the substantial overhang of bad loans resulting from the large state involvement and related moral hazard issues but also about the interconnections between banks and corporations and the attendant forms of "crony capitalism". The latter also had significant adverse effects on the development of the securities markets in the two countries, as the absence of sanctions on non-transparent and even fraudulent securities operations caused a general loss of confidence on the part of investors in the stock market as an institution.[24]

The Committees recommended that privatisation plans for the major state-owned banks be accelerated and carried out on the basis of transparent rules and procedures. Although the Czech banking sector is by now largely privatised with substantial foreign participation,[25] the process was lengthy and complicated by repeated state bailouts of distressed banks.

By the time of the second examination of Slovakia in 2000, the conditions in its banking sector had deteriorated into a crisis situation, requiring urgent action by the government to recapitalise the state-owned institutions in preparation for

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imminent privatisation. Hence, no significant restrictions on foreign participation in the financial sector were maintained, as policy direction had shifted towards encouraging foreign acquisitions of Slovak banks and other financial institutions. Nevertheless, in view of the fragility in the financial sector the Committees encouraged the Slovak authorities to vigorously pursue structural reforms, including completion of the rehabilitation and privatisation process under way for the three major banks.

With respect to the *Hungarian* financial sector, the Committees welcomed the successful privatisation and large participation by foreign financial institutions, which had resulted from Hungary's consistent policy of selling controlling shares in state-owned banks to foreign strategic investors at a rapid pace. This raised the skill content in the sector and introduced the application of more sophisticated credit evaluation and risk management techniques at an early stage. Earlier problems of insolvency in Hungarian banking sector had been addressed already prior to is accession to the OECD and a bank consolidation programme initiated in 1994 paved the way for privatisation of the major banks, completed by the end of 1996. At the present time, the Hungarian banking sector ranks among the healthiest in Central and Eastern Europe, with foreign participation exceeding 60% of the capital of the sector[26] and the share of non-performing loans standing at low levels and capital adequacy ratios well above levels required by international standards.

Poland's comprehensive measures for dealing with bad debt problems in financial institutions were undertaken prior to OECD accession, based on a Financial Enterprises and Bank Restructuring Act of 1993. This consisted of a bank-led enterprise restructuring programme based on a variety of instruments, including debt-equity swaps through which banks acquired ownership stakes in their financially impaired clients. The programme provided ample room for foreign participation and significant foreign strategic investment was attracted to the sector in the second half of the 1990s. Overall, privatisation had proceeded rapidly, banking supervision had been well developed and foreign participation in the sector was already substantial upon accession. Thus the Committees raised no special concerns regarding risk management and solidity. The only restriction requiring a reservation was an incorporation requirement for foreign financial institutions, lifted on 1 January 1998, one year ahead of the accession commitment, which was welcomed by the Committees.

On the eve of the financial crisis, which hit *Korea* in the autumn of 1997, the Korean financial sector exhibited many characteristics of developed markets with relatively sophisticated instruments and techniques, while at the same time important structural weaknesses were evident. These weaknesses or vulnerabilities were in part due to the complex regulatory regimes in place for rigidly segmented sub-sectors of the financial system. The pressure from foreign

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competition was not strong enough to bring about a dismantling of these rigidities, as significant restrictions were maintained on foreign participation in the banking and securities markets. The structural weakness of the sector was also due to the excessive government interference in the allocation of banks' loans, via programmes of directed lending that had been operated for many years.

At the time of Korea's accession, the establishment of foreign bank subsidiaries was not legally forbidden, but in practice no licences were given. The Korean authorities considered that the rapid liberalisation and deregulation of their financial system had aggravated the risk of systemic instability and they had therefore opted not to grant new banking licences, neither to domestic, nor to foreign banks. Acquisition of individual shareholding in Korean banks was subject to ceilings, stipulated in the Banking Act, which applied equally to foreign and domestic investors (and hence required no reservation). Single investors could own up to 4% of the shares in nation-wide banks, 8% of those in commercial banks converted from investment and finance companies and 15% of those in local banks. The objective of these ceilings was to prevent concentration of economic power in banking. In this case, reverse discrimination applied, as foreign banks were permitted to acquire shares in Korean banks, whereas domestic banks were not allowed to expand through acquisitions.

Korea maintained significant restrictions on the establishment of non-bank financial institutions and insurance firms, in many cases limiting foreign participation to a maximum of 50% of the share capital (securities brokerage and dealing companies, credit information companies, investment trust companies), in other cases excluding foreign investors altogether.

The Committees expressed concern regarding the deterioration in banks' capital base due to compulsory lending requirements and questioned the argument that foreign banks would need to be restricted from establishing subsidiaries on account of the risk of overbanking. Firm recommendations were made that the number and scope of restrictions on foreign participation in the financial sector be reduced, underlining that this should form part of a comprehensive reform package to sustain economic development. The Committees also stressed the need for the Korean authorities to design and implement prudential rules for financial institutions on an objective and non-discriminatory basis.

The reform measures undertaken in the aftermath of the 1997 financial crisis brought a relaxation or elimination of many of the restrictions on the participation of foreign institutions in the Korean financial markets. As a result, a substantial number of reservations lodged at the time of accession were withdrawn after the post-accession examination as foreign establishment and participation in the financial sector was for all practical purposes freed from restrictions. In grappling with the consequences of the crisis, involving the closure, restructuring

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and rehabilitation of a large number of financial institutions, the Korean authorities proceeded to review and thoroughly reform the regulatory and supervisory systems covering the operations of these institutions. Borrowing by Korean banks in international markets at low interest rates for on-lending in the domestic market at higher rates (so-called "carry trade") had led to unsustainable domestic credit risk exposure as demand from lower quality borrowers with inadequate foreign exchange earning capacity was increasingly accommodated. The consequent mismatches in banks' currency and maturity structures of assets and liabilities were not adequately monitored and controlled at the time, either by the banks themselves or the supervisory authorities. Thus, in the post-accession review, the Committees welcomed the reforms to the system of prudential regulation and oversight, including the installation of an "early warning system" regarding foreign currency exposure of the banking sector, as excessive exposure of banks to currency and credit risk had been a major factor behind the Korean financial crisis.

Rules governing the ownership of banks were eased, with both foreign and domestic interests permitted to acquire strategic stakes in Korean financial institutions, as the existing ceilings could now be exceeded on the basis of approval from, or prior notice to, the Financial Supervisory Commission. Foreign acquisitions of up to 100% was permitted from April 1998, although subject to additional review by the Financial Supervisory Commission in line with the increase in stakes beyond certain predetermined thresholds. Similar rules were imposed on domestic investors and parallel rules on ownership in securities companies were introduced in March 1998. Increased foreign participation and the resulting increase in competition were now seen as key to raising managerial skills in Korean institutions while building capital in the system. Foreign banks and securities companies were authorised to establish subsidiaries in April 1998. Laws were also enacted to strengthen the powers of boards of directors of banks and to enhance transparency in dealings with shareholders. Foreigners were permitted to become directors of bank boards as of May 1998. The government also announced a policy of ending direct interference in bank management. The Securities and Exchange Act was amended to facilitate hostile take-overs in the financial sector.[27]

Upon accession to the OECD, M*exico* undertook to extend to OECD member countries the NAFTA's measures which fully liberalised the direct establishment of, and direct investment in, securities specialists, investment companies, managing companies of investment companies, bonding firms, general deposit warehouses and foreign exchange firms. Second, concerning liberalisation measures affecting banks, securities dealers, insurance companies and other financial institutions subject to market share limitations under NAFTA, Mexico also agreed to consider extending the benefits of NAFTA to all OECD members, no later than the beginning of 1998. It was thus envisaged that from that date OECD members other than the two

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NAFTA members Canada and the United States would be able to enter the Mexican financial sector directly as well as indirectly via their off-shoots in North America. However, the enabling legislation for the direct establishment of *de novo* subsidiaries by non-NAFTA-based financial institutions was in place only in 2001.

The financial crisis that engulfed the Mexican economy some six months after its accession to the OECD led to a sharp deterioration in the quality of loan portfolio of Mexican banks, forcing the Government to implement a comprehensive financial sector support package. The recapitalisation needs of the sector led to an acceleration of the staged opening up to participation by NAFTA-based financial institutions foreseen in the NAFTA Treaty. By the end of 1997 more than two thirds of total banking sector assets were held by institutions with substantial foreign participation, having risen from near zero five years earlier. The Committees welcomed this development in the 1997 post-accession review, having recommended in 1994 that foreign equity participation in Mexican banks and other domestic-controlled financial institutions be increased in the interest of modernisation and enhanced efficiency of these institutions.

3.5. *Liberalisation of other capital account operations:*[28] *monetary and exchange rate policies, investor protection and excess volatility*

All six new members maintained restrictions on certain securities markets operations as well as on a number of operations in short-term debt, derivative instruments and deposit accounts at the time of their accession, both in order to influence the speed of convergence of domestic interest rate levels with those prevailing in international markets and to shield the domestic economy from the impact of short-term flows on the exchange rate. Investor protection concerns were also voiced in the accession reviews, as several new members considered that domestic investors lacked the sophistication required for operating in international markets.

In considering the pattern of liberalisation of portfolio flows, in particular those viewed as of a more volatile and sensitive nature, it is useful to briefly review the monetary and exchange rate policy settings of the six new members. To varying degrees, the monetary authorities in all six new entrants faced the same central challenge of completing and consolidating disinflation and securing financial stability during an ongoing process of major structural change in the real economy. They all had to contend with underdevelopment of financial markets and open or latent vulnerabilities in financial institutions which both limit the range of available policy choices to preserve monetary stability and make monetary transmission mechanisms less predictable. By committing to progressive liberalisation of capital movements through joining the OECD, the option of trying to preserve full autonomy of monetary and exchange rate policies via

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extensive capital controls was no longer available, even though the Codes provide flexibility through List B operations[29] and allow temporary derogation for controls aiming to diminish excessive exchange rate volatility and rapid depletion of foreign exchange reserves in situations of acute stress. Nor was it the objective of any of the new entrants to the OECD to fully insulate domestic money and capital markets from international developments by resorting to capital controls, as many older OECD member countries sought to do under the Bretton Woods system. After all, one of their motivations for joining the OECD was precisely to integrate further with international capital markets. In addition, they had already initiated a move towards deregulated markets and the use of market-oriented monetary policy instruments, which to a considerable extent precluded the resort to the type of control mechanisms used under earlier fixed exchange rate regimes with different monetary policy targeting and institutional settings for central banks. Nevertheless, having decided to liberalise they had both to choose the most appropriate monetary and exchange policy regimes – and specific anchors – that would help to sustain growth and reduce financial instability in this setting of increased capital mobility. All expressed concerns during the accession process for being exposed to excessive volatility of flows, especially in combination with speculative attacks. Concerns as to whether certain categories of short-term flows should remain restricted and what safeguards, if any, needed to be kept during the liberalisation process were repeatedly voiced and also reflected in the drafting of new foreign exchange legislation (notably by the Czech Republic, Poland and Korea).

Table 5 sets out the exchange rate and monetary policy regimes in force in the six accession countries from 1994-2001, as background to the discussion of the capital account opening process, together with summary indications of restrictions imposed.

The table shows that pegs were considered useful in the early stages of disinflation by the CEE new entrants, but were successively abandoned as exchange rate flexibility was found preferable in dealing with increased capital mobility and the need to minimise financial vulnerability. Inflation concerns also prompted the abandonment of the exchange peg, as the flexibility in wages and prices which prevailed earlier in the transition process could no longer be relied upon for adjustment. Hungary has retained its crawling peg but moved to a wider band in May 2001, reflecting a need for more manoeuvrability in the face of sizeable capital inflows. Free floating regimes also replaced earlier exchange rate targeting efforts in Korea[30] and Mexico. Thus, floating exchange rate regimes are by now maintained by all of the new members except Hungary and monetary policy strategies are directed towards controlling inflation. Some degree of exchange rate volatility is regarded as acceptable, as the corporate sector generally is able to hedge against exchange risk.

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Table 5. **Exchange rate and monetary policy regimes and capital account operations (other than FDI) restricted**[1]

Country	Exchange regime	Official intervention	Monetary policy goal	Restricted at time of accession	Restricted as of 1 Jan. 2002
Czech Republic	Pegged to a basket of currencies since 1990, simplified to 35% USD, 65% DM since May 1993. Fluctuation band 1992-97 with ±0.5 band until February 1992,then (±7.5%). Managed float since May 1997	Occasional intervention to smooth large swings in rate	Exchange rate peg served as anchor until end 1997, since 1998 pre-announced inflation targets	Outflows through issue by non-residents on domestic market Outward financial credits (other than banks) Outflows via residents' purchase of financial derivatives and operations with deposit accounts	No restrictions
Hungary	Central parity crawling peg with fluctuation band of ±2.25%. Band widened to ±15% in May 2001	Interventions at edges of band	Announced declining target for headline inflation	Outflows through issue by non-residents and purchase abroad by residents (removed for high-grade issuers, non-OTC from 1997). All operations with money market securities and financial derivatives (except banks) Financial credits(except banks)	No restrictions
Korea	Daily fluctuation bands until 1997, then free float	Some intervention by Bank of Korea	Monetary aggregates	Inflows through issue abroad by residents, purchase by non-residents in Korea Inward and outward financial credits(except banks) and certain categories of inward commercial credits Operations in financial derivatives Operation of deposit accounts	Outflows through issue by non-residents of money market securities in Korea and via residents' purchase of won-denominated short-term securities abroad Inward (screening) and outward (limits) short-term financial credits Certain limits on operations of deposit accounts

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Table 5. **Exchange rate and monetary policy regimes and capital account operations (other than FDI) restricted**[1] *(cont.)*

Country	Exchange regime	Official intervention	Monetary policy goal	Restricted at time of accession	Restricted as of 1 Jan. 2002
Mexico	1989: Crawling pegged exchange rate based on a pre-announced rate of devaluation after a short period of completely fixed rate. From 1991 creation of a widening fluctuation band 1995 onwards: floating exchange rate	Until 1995: sterilised intervention to prevent capital inflows from fuelling base money growth and inflation From 1995: Interventions only under exceptional circumstances	Until 1995: Base money as a nominal anchor From 1996: gradual transition towards an inflation targeting scheme	Inflows through issue by residents abroad (only peso) and purchase on domestic market by non-residents (only peso)	Same as on accession
				Outflows through issue by non-residents on domestic market	Same as on accession but only relates to debt securities
				Outflows through purchase by domestic securities firms of foreign securities	Same as on accession
				All short-term operations in domestic currency by non-residents or in foreign markets by residents, financing operations in foreign currency from abroad by resident banks (but applied in a liberal manner)	Operations of deposit accounts in foreign currency subject to minor restrictions
Poland	Fluctuating band mechanism around crawling peg, abandoned for a free float in April 2000	No intervention since April 2000	Exchange rate anchor since 1991, via pegged band mechanism until 2000. Monetary aggregates targeted until 1998, since then announced headline inflation targets	Inflows through issue by residents abroad, lt and sht (except banks) Outflows through issue by non-residents on Polish market, lt and sht, and through purchase of money market instruments and financial derivatives (except banks) Inward and outward short-term financial credits (except banks) Operations in deposit accounts (except banks) Repatriation requirement	Inflows through issue abroad of short-term debt instruments and financial derivatives (except banks)[2] Inward and outward short-term financial credits (except banks)[2] Operations in deposit accounts (except banks)[2]

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Table 5. **Exchange rate and monetary policy regimes and capital account operations (other than FDI) restricted**[1] (*cont.*)

Country	Exchange regime	Official intervention	Monetary policy goal	Restricted at time of accession	Restricted as of 1 Jan. 2002
Slovakia[3]	Peg to USD/DM basket 1993-1998. Since then free float	Occasional intervention, at times with sterilisation to restrain appreciation of exchange rate	Exchange rate peg until 1998, then inflation benchmarks for core and headline inflation	Inflows via issue by residents abroad (only mMunicipal debt and maturities below 1 year)	Inflows via issue by residents abroad have been liberalised
				Outflows via issue by non-residents on domestic market (restricted to high-grade issuers) and via purchase abroad by residents of money market instruments and financial derivatives	Outflows via issue by non-residents on domestic market have been liberalised Outflows via purchase abroad by residents of money market instruments have been liberalised Operations in financial derivatives are still restricted
				Inward and outward financial credits (except banks)	No restriction
				Operation of deposit accounts	Same as upon accession
				Repatriation requirement	Same as upon accession

1. The restrictions are presented in short form and should not be interpreted as a comprehensive description of the operations covered by restrictive measures imposed. For an exact rendering, consult OECD members' reservations lists as set out in Annex B to the Capital Movements Code: *www.oecd.org/daf/investment/instruments*
2. The entry into force of a new foreign exchange law from 1 October 2002 has since freed all capital flows between residents in Poland and residents in member countries of the European Union and the OECD.
3. When joining the OECD in 2000, Slovakia committed to remove remaining capital controls as from 1 January 2003.

Source: OECD.

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The table also gives a summary overview of the restrictions in place on major categories of portfolio flows. The CEE new members did not maintain restrictions on *long-term portfolio inflows* at the time of accession, other than those arising out of regulations on inward direct investment. In the Czech Republic portfolio inflows were free except for a provision in the Debt Securities Act requiring prior approval for residents to issue securities on foreign markets, which was eliminated by amendment of the relevant law entering into force from 1 January 2001.[31] In Hungary, Poland and Slovakia, inward portfolio investment was also liberalised at the time of accession, while in Mexico only the purchase by foreign residents of peso-denominated securities was restricted. Korea maintained until 1998 an array of detailed restrictions and ceilings on non-resident purchases of both won-denominated and foreign-currency denominated securities. O*utward flows* through purchase abroad by residents were only restricted by Hungary (although this restriction was relaxed already from 1997 onwards) and by Mexico, with respect to peso denominations and portfolio investment abroad by securities firms. However, several of the new members still restrict the purchase and trading of OTC securities, allowing only securities listed on a regulated stock exchange, in the interest of investor protection. Outflows through issuance on domestic markets by foreign entities were initially restricted by all the new entrants except Slovakia, which, as a latecomer in 2000 had already liberalised this item. The other CEE countries successively lifted or narrowed their restrictions on this form of capital outflows, as did Korea and Mexico.

As a result of this progressive liberalisation, no reservations of any significant scope apply at the present time to long-term portfolio flows in any of the new members. They can thus be considered as fully liberalised, with the exception of certain limitations on the portfolio allocation by institutional investors, which have recently been included in the liberalisation obligations under the Codes.

Considering operations with *short-term money market securities and financial derivatives*, all the new members countries applied some controls at the time of accession, generally restricting such operations to authorised banks and foreign exchange dealers. In K*orea*, in- and outflows related to such short-term instruments were strictly confined to authorised foreign exchange banks, which had full freedom to undertake these operations already before Korea's accession in 1996. Korea also imposed restrictions on a range of inward and outward financial and commercial credits considered potentially volatile. In M*exico*, operations in peso-denominated instruments were not liberalised for any market participants, including authorised banks, although some of the restrictions on operations by banks took the form of recommendations rather than outright controls. During the post-accession reviews, several of the new members reported progressive relaxation of controls on this type of operations, allowing the corresponding reservations to be considerably narrowed.

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Short-term financial credits were restricted by Mexico, as far as inflows are concerned, and the other new members upon accession, as were *operations in deposit accounts*. While financial credits are now generally liberalised, several of the new members have retained reservations with respect to the opening of deposit accounts by residents with non-resident banks in domestic and foreign currency, which is considered a possible channel for volatile short-term flows. Similarly, all of the new members (except Mexico) imposed *repatriation* – and in some cases, *surrender* – *requirements* on foreign currency earnings, which necessitated reservations under the Capital Movements Code. The Czech Republic imposed a repatriation requirement since accession, which was eventually abolished with effect from 1 January 2002. Slovakia had a surrender requirement, which was lifted in 1998, two years prior to accession.

Monetary and exchange rate policy considerations expressed by individual members and respective approaches to regulation of short-term capital flows are summarised below:

The Czech Republic, burdened by a large current account deficit and subject to growing international investor concern over lags in structural reform and non-transparent practices in the stock market, found its exchange rate peg increasingly difficult to defend and finally abandoned it in favour of a managed float in May 1997.[32] This policy change, including the adoption of an inflation-targeting framework as well as resolute and concerted effort to enhance structural reform in many sectors, enabled the authorities by the end of 1997 to proceed with further liberalisation of capital movements. The time schedule indicated at accession of lifting all capital controls within a period of 3-5 years was largely adhered to. It is worth noting that in abolishing restrictions on short-term financial credits and certain other operations as of 1 January 1999, the Czech authorities declared that as liberalisation of various categories of capital flows had by now reached a critical mass level, the distinction between commercial and financial loans as well as between short and long-term flows was no longer operational. The remaining restrictions regarding the repatriation requirement on foreign currency earnings were eliminated through the entry into force of a revised Foreign Exchange Law on 1 January 2002. At the present time, the Czech Republic, together with Hungary, has advanced furthest among the new entrants with capital account liberalisation.

Slovakia likewise suffered certain turmoil in the foreign exchange market in connection with the 1997 international financial crisis and took the decision in 1998 to abandon the fixed exchange regime which had served as anchor for monetary policy since 1993, (with a central rate that had been unchanged since its initial fixing).

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Following the move to a floating rate, there has been little volatility evidenced in the koruna and the National Bank has gained substantial credibility for its transparent and stable conduct of monetary policy aiming to keep inflation in a target zone. There is an intention to shift to an exchange rate target for the koruna against the euro in the medium term. Upon entry to the OECD in 2000 only a few restrictions on short-term capital flows were imposed. The Slovak authorities have indicated their intention to maintain these controls until 2003, as a safeguard against potential pressures. When these are relaxed, Slovakia will have attained the same degree of liberalisation as the Czech Republic and Hungary.

H*ungary* introduced an economic stabilisation package in 1995, before its entry to the OECD, which included abandonment of a previous exchange rate regime of discretionary devaluations (and eroding credibility) in favour of a tightly managed crawling peg. During the 1995-96 accession examination the Hungarian authorities stated that, if the macroeconomic situation continued to improve according to the government's expectations, the abolition of all remaining capital controls could be completed within a period of three to four years, beginning with remaining restrictions on portfolio investment in foreign capital market securities by residents. The liberalisation of long-term outward financial credits would follow. The final steps would provide freedom for residents to operate deposit accounts abroad and for residents and non-residents to undertake operations in any securities and other financial instruments. Meeting this timetable was not a legally binding commitment, but it was given a special force through its inclusion in the Hungarian Government's Accession Declaration. The timetable was largely adhered to as the final phase of abolition of exchange controls was completed on 16 June 2001.

In its report to Council recording Hungary's decision to abolish remaining controls, the Committees expressed their appreciation for the consistency and coherence applied by the Hungarian authorities in their approach to liberalisation. By clearly signalling their policy intentions and backing up the gradual lifting of controls with other, supporting policy measures, they acquired substantial credibility with market participants and amongst peers. However, this does not mean that Hungary remained immune to tensions between internal and external objectives of monetary policy. In a report to the Committees, the Hungarian authorities stated that the existence of specific restrictions on short-term capital inflows played a positive role in coping with the risk of financial turmoil in Hungary during the financial crises of 1997-98. A limited number of restrictions involving operations assessed as carrying substantial risk for the conduct of monetary and exchange rate policies was thus kept for the latest stage. Also, the Hungarian authorities emphasised that the phasing-out of this group of restrictions had been conditional upon further improvement in international investors' assessment of Hungary's economic situation.

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The country experienced strong capital inflows in 2000, with banks borrowing abroad to take advantage of the high interest rate differential, forcing the central bank to cut interest rates aggressively to stem inflows. Commercial banks were obliged to observe a limit on open foreign exchange positions of 30% of capital, but some ways to evade this restriction were found.[33] A temporary tax was imposed via reduced reserve remuneration on balances above the 30% limit but abolished in May 2001, after the authorities widened the exchange rate band to ±15%, while for the time being retaining a crawl of the central rate against the euro.

In *Poland*, the effects of the 1997 emerging market financial crisis were less severe than in the Czech Republic, despite a sizeable current account deficit. While stock and bond market suffered somewhat, there was no real confidence crisis and in the end Poland's macroeconomic fundamentals were strong enough for capital inflows to pick up again after a few months. Under Poland's crawling band system, exchange rate pressures and official intervention had mostly been one-sided, with the central bank trying to contain the appreciation of the currency. In 2000, a floating exchange rate policy was introduced as the National Bank abandoned the fluctuation band mechanism and stated that it would normally refrain from interventions in the exchange markets. Since then volatility has increased somewhat and the exchange rate has appreciated slightly in real terms. As to monetary policy, the initial experience with inflation targeting has produced somewhat disappointing results, with considerable overshooting of targets. The contagion effects from the Russia crisis in 1998 led the authorities to switch from a restrictive to an accommodating stance, after which interest rates were sharply raised again. Real interest rates rose steadily to levels of around 10%, causing capital inflows to pick up even further from 1998 onwards. Thus, the Polish authorities postponed the lifting of the remaining restrictions on short-term flows (scheduled for end-1999). In their view, allowing the short-selling of zlotys could make the currency even more vulnerable to sudden swings or drastic reversals in capital flows. The Foreign Exchange Law that entered into force in January 1999 maintains the restrictions on capital inflows and outflows involving instruments with maturities of less than one year and on operations with financial derivatives. It also introduced two safeguard clauses under which the government would be entitled to re-establish restrictions: in the form of non-interest bearing deposit requirements on capital flows other than FDI if the implementation of the main lines of the monetary policy is threatened; or, alternatively on all foreign exchange operations, including repatriation of profits by non-residents, in the event that the stability and integrity of the financial system are at "extraordinary risk". These restrictions can be established for periods of no more than 6 months.

The introduction of these safeguards provoked some discussion in the Committees as, especially the first one, may appear to go beyond the safeguards provided for by the derogation clauses of Article 7 of the Code and the protection of its List B

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system for short-term capital account operations. The Polish authorities are aware that they are allowed to activate these safeguards only in accordance with Poland's rights and obligations under the Code and other international agreements, including Article VIII obligations in the IMF on current account convertibility.

The Committees expressed concern regarding Poland's inability to resolve inconsistencies between its accession commitments and the present structure of foreign exchange restrictions. Some doubts were raised in the discussions whether the actual or potential flows targeted by the prolonged restrictions would represent a significant added source of vulnerability. It was pointed out that these operations are already fully liberalised with respect to transactions in Polish government securities and other transactions in short-term instruments where the counterparty is a Polish bank. This already provided ample room for investors to create any desired maturity profile on their portfolios, and further speculative pressure could easily be built up by large-scale investors via liquid international derivative markets for the zloty. In summary, the Committees felt that consistent strategies regarding foreign exchange regulation, signalled to the market and buttressed by overall macroeconomic and financial supporting policies, would seem of less short-term character and build more credibility.[34]

Following the outbreak of the financial crisis in 1997, *Korea* abandoned its previous daily fluctuating bands and moved to a free float of the won. As stability was regained in international markets, the won appreciated steadily during 1998 and into 1999, to the point where the authorities encouraged state-owned enterprises to repay their foreign currency debt to ease the upward pressure. Monetary policy is conducted with the primary objective of price stability, although exchange rate developments are still closely followed by the Bank of Korea. Monetary aggregates are the intermediate target in achieving the price stability objective, with reserve money as an operational target.

The limitations imposed on inward portfolio investment in Korean debt and equity instruments were abolished in the wake of the 1997 crisis, as were the screening restrictions imposed on Korean residents' issue of securities abroad. In earlier examinations, the Committees had expressed concern regarding these type of restrictions which included detailed provisions as to which categories of borrowers would qualify for raising funds from abroad as well as to permissible use of proceeds, giving large scope to discretionary influence and moral hazard risks. The Committees were of the opinion that such screening of qualifying borrowers by the authorities can easily lead to situations where domestic borrowers would consider themselves protected by the government from the risk of bankruptcy and foreign creditors would perceive domestic debts to be backed by some forms of government guarantee. It was further pointed out in the examinations that these practices favoured indirect foreign currency borrowing by Korean firms via the intermediation of Korean banks (who faced no restrictions), thus

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limiting the exposure of domestic firms to the disclosure requirements and other disciplines exercised by international securities markets.

On 2 September 1998, the Korean National Assembly passed a new Foreign Exchange Transactions Act, which entered into force on 1 April 1999. An expressed ambition of the Korean authorities in introducing this Act has been to establish a simple and transparent legal framework in the place of existing complex and cumbersome laws and regulations governing foreign exchange transactions. At the same time, far-reaching liberalisation in line with OECD principles was intended. The first stage of liberalisation under this Act was completed by April 1999 and the second stage was enforced by year-end 2000. As the implementing regulations for the new Act were being developed over a considerable period of time, some uncertainty as to their exact implications remained during 1999. At their meeting in November 1999, the Committees stressed the need for expeditious translation and dissemination of such regulations in the interest of transparency needed for investors and other financial market participants.

The new law abolished a set of restrictions on trade-related short-term flows, in particular the minimum one-year maturity on commercial loans contracted abroad by Korean residents, and the similar maturity restriction on financial credits contracted abroad by non-banks. At the same time, new limitations were introduced regarding which non-bank borrowers would qualify for raising such short-term foreign currency loans. The Committees expressed concern that this qualifying or screening process would comprise elements of discretionary rather than rules-based tests.

New restrictions were also introduced with a view to preventing speculative movements of won currency funds, as stated by the Korean authorities. These concerned investment abroad by Korean residents in won-denominated short-term securities and the issue in Korea by non-residents of money market securities in domestic currency As both operations concerned are contained on List B of the Capital Movements Code, where new reservations can be reintroduced, there was no break of the stand-still principle. It was felt that the situation in the international and domestic money and foreign exchange markets would not yet allow complete liberalisation.

The new Act also contains safeguard clauses under which the government would be entitled to re-establish extensive temporary restrictions. The Korean authorities are aware that they are bound to activate these safeguards only in accordance with Korea's rights and obligations under the Codes.

Mexico has traditionally maintained free convertibility of its currency, complying with the obligations under Article VIII of the IMF Articles of Agreement as early as 1946, fifteen years before most OECD countries. Convertibility restrictions were only actively resorted to for a short period of time during the second half of 1982,

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in the wake of the external debt crisis. A two-tier market for foreign exchange was in place from 1982 to 1991, with the objective of raising the cost of acquiring pesos for speculative demand, while accommodating normal trade-related peso demand at more favourable exchange rates.

Notwithstanding its traditionally liberal attitude to cross-border capital flows, Mexico still restricted operations abroad in domestic securities and deposits denominated in the domestic currency at the time of accession to the OECD in 1994, with the stated reason to prevent the development of peso positions by foreign financial institutions. The main objective was to avoid the development of an offshore peso market which could render domestic monetary policy measures less effective. These restrictions, dating from 1985, on the ability of Mexican banks to create liabilities to non-resident banks in domestic currency were partially dismantled in 1996 as the Mexican authorities were only aiming to maintain an influence on the development of the off-shore trading volumes of the peso. Certain money market instruments denominated in pesos could be freely acquired by non-residents, and non-resident financial institutions could open peso accounts in Mexico as long as the funds deposited derived from an equivalent sale of foreign currency. With the gradual development of international futures market for pesos, both at the Chicago Mercantile Exchange and elsewhere, the Bank of Mexico has widened the scope for non-resident banks to operate domestic peso accounts with Mexican financial institutions.

There were also restrictions on the purchase abroad of foreign-currency denominated securities by Mexican securities firms and other institutional investors on their own account and on account of clients. The objective here was to prevent excessive risk taking by such firms, but also with the concern not to facilitate outward portfolio investment at a time when scarce investment resources were required for the emerging domestic capital market.

The collapse of the peso in December 1994 and the subsequent period of intense currency turmoil presented very serious challenges for the monetary authorities, as it was followed by a prolonged period of acute financial distress in the economy. In examination reviews following the crisis, the Mexican authorities stated that the reintroduction of capital controls would not have prevented financial market instability, especially in view of the fact that such controls would have had to apply to capital outflows, which are operations notoriously difficult to restrict as already experienced during the 1982 debt crisis. They also considered that recourse to capital controls would have caused long-lasting economic distortions and had serious negative impact on investor confidence.[35]

After the crisis, monetary policy focused on the growth of monetary aggregates and limits to credit growth, and the inflationary effects of the sharp exchange rate depreciation that followed the 1994-95 events were largely brought under

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control. The main objective of monetary policy has since been to bring inflation down on a gradual and sustainable basis. The central bank's expressed medium-term objective is to bring down inflation to the rate prevailing in Mexico's trading partners by the end of 2003, while it is currently in the process of moving to an explicit inflation-targeting regime such as operated in other OECD member countries. The central bank does not provide indications or signals regarding the desired level of the exchange rate, but it intervenes in currency markets to smooth volatility. Moreover, the bank has followed a strategy of gradually accumulating foreign exchange reserves, which has implied sizeable purchases of foreign currency in the past few years.

3.6. *Conclusions and lessons*

The recent OECD experience shows that orderly liberalisation is possible and can provide important benefits if the right policy and governance settings are in place. It confirms the crucial role played by transparency and market-friendly authorisation/reporting systems and other regulatory practices. Clearly, financial regulation and supervision are key factors in the process of establishing the conditions that will allow a full dismantling of restrictions to the free flow of funds on an international scale. It also highlights the important role played by international financial market developments and integration in driving liberalisation of cross-border movements of capital and financial services and the continued interaction between these forces.

An important lesson from the incidence of financial and corporate sector strains connected with the adjustment to a liberated system concerns the need for international financial market confidence in the regulatory and supervisory framework of a counter-party economy. Unless its system of financial regulation and supervision and administrative practices is seen by international market participants as conforming to international standards, most forms of capital inflows are potentially volatile, with anticipation of signs of financial sector fragility heightened by recent crisis experience. This means not only that high standards of transparency, regulation and oversight should be instituted in a virtual sense but that they should be perceived as properly "embedded" in practices and attitudes in the domestic economy, actually seen to be put into operation and, especially, vigorously enforced. Experience shows that funds will flow into a less well-regulated system to take advantage of high real interest rates, to lock in a fixed rate of return by various means, but will tend to remain "footloose" as long as there is little trust in the institutions and practices characterising the local market place.

It is evident from the review of liberalisation experience that the task of developing and upgrading the systems of financial regulation and supervision in the six recent members of the OECD formed a crucial part of the liberalisation pro-

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cess. Many of the obstacles that stood in the way of more complete liberalisation from the outset originated both from insufficient development and enforcement of financial regulation and supervision and, to some extent, from the retention of outdated and overly bureaucratic, discretionary procedures. In banking as well as securities markets entities, there were considerable institutional weaknesses and in the government agencies a lack of enforcement capability of regulation already developed to encompass international standards and principles.

Another lesson, deriving from the experience with international financial crises and also supported by evidence from the accession process of the recent OECD members, is that the regulation and supervision of financial markets need to be complemented by the provision of adequate financial disclosure as well as high-quality standards of governance in the corporate sector. These are necessary to strengthen the transparency and accountability furnished through financial accounts and audits. The point has been made that lack of transparency and insufficient information regarding domestic corporate and financial sector entities make a country more vulnerable to the obvious signs of irrational behaviour so often affecting emerging financial markets. If there is not enough high quality data to provide a reliable picture of situations nor to make informed guesses, it is in the end not economic fundamentals but changing perceptions based on a mixture of news, rumours and sentiments which drive capital flows in and out of the markets in question.

It is clear that the construction of the various elements ensuring good regulation, disclosure and governance takes time. This is especially the case in emerging markets where financial infrastructure and regulation may have to be built on relatively sparse foundations. Thus, the search for a satisfactory path towards full liberalisation has come to the forefront in order to allow sufficient time for crucial institution-building before opening markets fully. As discussed briefly in the beginning of this article, questions have been raised whether an appropriate and workable sequencing of liberalisation of capital movements can be recommended. On the whole, the experience acquired with the Codes and OECD member liberalisation favours full freedom of direct investment flows and equity-related portfolio investment as a priority, followed by other long-term flows related to operations in debt securities. Most countries have tended to relax controls on non-trade related financial credits and deposit operations last, also maintaining controls on derivative operations by non-bank entities to guard against "speculation". This was also the case, as illustrated above, of the six recent members of the OECD, albeit with some variations. In some, excessive reliance on intermediation of foreign funds by poorly supervised and governed domestic banks, rather than direct foreign borrowing by the corporate sector, led to inadequate risk identification and allocation, and created large balance-sheet vulnerabilities.

However, it must be recognised that the strategy of initially welcoming longer-term, equity-related flows and discouraging, or at least avoiding bias in favour of,

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more volatile flows undertaken for short-term portfolio adjustment purposes works best in periods of relative stability in international financial markets. In the case of a generalised loss of confidence in a particular country's creditworthiness and policy settings by international market participants, the floodgates cannot be kept shut except by draconian measures. Some countries recognise this reality by opting for rapid and full-scale liberalisation of most or all flows, relying essentially on prudential supervision and improved transparency, and the associated adequate availability and dissemination of relevant data, to assess and limit risk relating to private capital flows.

The issue should rather be phrased in relation to the perceived need for controls and the degree to which they can be expected to have the effect sought. Experience in Latin America and Asia has shown that controls on certain inflows can temporarily achieve the desired effects, but usually need to be adjusted and extended as market participants find ways to circumvent them. The costs of maintaining controls is a factor speaking strongly against a rigid interpretation of a sequencing approach, which may not be warranted by economic circumstances. If controls are extensive – which they usually end up being to maintain effectiveness – there is the risk that they may interfere with desirable capital and current transactions as well as those targeted as undesirable. Considerable administrative resources are usually expended on implementation and monitoring compliance. More importantly from a policy standpoint, controls may be kept in place as a substitute for tackling structural reform or adjusting other policies in a more optimal direction, thus entailing significant costs for the economy.

None of the six new members resorted to derogation procedures during the bouts of serious financial turbulence in the recent past, thereby concurring with the by now accepted wisdom that reimposition of controls is negatively perceived by international market participants. A country which re-introduces controls on operations previously liberalised other than *in extremis* will not only find future access to international borrowing compromised, but also experience a potentially lasting set-back in terms of the development and standing of its own financial market place and its links with other financial centres.

A final lesson that should be drawn from the liberalisation process reviewed above is the need for completeness of economic reforms throughout the economy – half liberalised systems can give rise to severe imbalances, which may be extremely costly to address from an economic, financial and social standpoint. The comprehensiveness and resolve in reform packages is a major factor in establishing credibility during the sensitive period of external liberalisation, as expectations that reform programmes will fail can quickly have a negative impact on investors' assessments of a country's standing.

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Box 4. **Korea's five-year membership of the OECD: example of a shared learning process**

In December 2001, Korea celebrated its 5-year anniversary of joining the OECD, upon which occasion former Korean ambassador to the OECD, Dr. Soogil Young presented a keynote speech, addressing four frequently asked questions regarding Korea's experience in the OECD as follows:

- Wasn't Korea's accession in 1996 premature in terms of its level of development?
- Was the accession not a major contributor to the severe financial crisis, which struck Korea within a year of its accession to the OECD?
- Do the other members of the OECD view Korea as a marginal member?
- Is the Korean government making good enough use of the OECD?

Since the second of these questions deals explicitly with the possible linkage of capital account liberalisation with the subsequent crisis experience, an abridged extract from Dr. Soogil Young's speech answering this question is reproduced here. The objective of presenting the extract is to illustrate the sharing of policy experience during the accession process and lessons gained on the Korean side. Lessons were also learned on the side of the OECD, and specifically by the CMIT Committee, from the Korean banking and currency crisis. Prior to this crisis, the Committee had tended to consider inter-bank operations used to raise funds in international markets for on-lending to domestic corporate clients (such as extensively engaged in by Korean banks) as belonging to the realm of internal banking regulations and supervisory arrangements, better addressed by other competent agencies. As the Korean experience showed, these fund-raising operations by Korean banks, which were already liberalised before Korea joined the OECD, were a major cause of the financial crisis, via the resulting currency and maturity mismatches. Yet, they had not been the focus of the accession discussions, as neither the conditions on which Korean banks on-lent their funds to domestic clients nor the risk-management criteria applied were documented by Korea in the context of establishing its position under the OECD Codes. In subsequent reviews with other prospective members, the Committee has naturally insisted on looking specifically into such financial sector vulnerability aspects linked to risk management procedures, prudential regulations and supervisory efficiency in applicant countries.

Extract from keynote speech by Dr. Soogil Young at the 2nd Korea-OECD Conference on Korea's Five Years in the OECD: Finding a New Path, held at Hotel Shilla, Seoul, on December 13-14, 2001:

"Some seem to equate the accession to the OECD with the opening of domestic markets. It would be wrong to do so. It is true that a criterion for admission into the OECD is a commitment to the principle of open domestic markets. But, as a matter of principle, the focus of the OECD's peer pressure process is not on securing the openness of the domestic markets of the member countries per se but on the creation of domestic economic and social conditions which would be conducive to the opening of the domestic markets.

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Box 4. **Korea's five-year membership of the OECD: example of a shared learning process** (*cont.*)

By the same token, the opening of the markets at home was not the principal feature of Korea's accession procedure of the OECD. The fact of the matter is that an applicant country for accession to the OECD has to undergo a country examination process which covers all major fields of economic policy, and during this process, the existing member countries present requests to the applicant country for commitments for certain policy modifications, including those for certain market-opening measures. Many of such requests are accepted, but not necessarily all.

As an applicant country, Korea underwent such an examination process, which covered capital movement, international investment, international trade, banking, insurance policies, labour relations, climate change, environment, and maritime transportation. In this process, the Korean government was presented with many requests, as well as recommendations, for commitment to policy changes.

The key issue raised by the question of whether Korea's accession to the OECD contributed to the financial crisis is the specific content of the government's concession on the movement of financial capital. What is true is that the Korean government had taken measures to liberalise the movement of short-term financial capital by the time of its accession to the OECD. It is also true that there was a major flight of such capital out of the country in 1997, causing the Korean financial crisis. The issue is whether those measures on the movement of short-term financial capital were a result of the OECD member governments' request made during the accession process.

There was an internal examination of facts over this issue within the OECD Secretariat in 1998. The finding, which is not inconsistent with the findings from Korea's National Assembly hearings on the financial crisis, is as follows:

OECD member countries asked Korea to: 1) accelerate and broaden the scope of Korea's original liberalisation plans for foreign direct investment, including take-overs; 2) permit establishment of subsidiaries by foreign banks and securities firms and further foreign participation in Korean financial institutions; 3) liberalise further other long-term capital flows (*i.e.*, foreign purchases of Korean listed shares and corporate debt securities of one year or more, their issue on foreign markets, long-term financial credits); 4) liberalise *bona fide* inward credits linked to foreign trade.

In the end, Korea agreed to take certain measures in response, but resisted any significant liberalising steps regarding inward trade credits and inflows of long-term financial capital. Those steps were taken only after the occurrence of the financial crisis under the IMF's prodding.

With respect to capital outflows, by the time accession negotiations started, the basic freedoms were by and large already in place.

The OECD request represented an encouragement for Korea to shift further away from the old, increasingly inefficient credit allocation system based on banking intermediation and government intrusion to direct corporate finance.

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Box 4. **Korea's five-year membership of the OECD: example of a shared learning process** (*cont.*)

More to the point of the present issue, however, the OECD did not request Korea to liberalise foreign investment in money market securities and other short-term instruments, including derivatives, and short-term financial credits from abroad. The OECD did not request a liberalisation of non-resident investment in real estate, which was fully restricted in Korea at the time.

Nor did the OECD request Korea to allow the transfer of foreign funds to Korean banks. This was permitted long before Korea's accession negotiations started. And as a matter of fact, at the time of Korea's accession, the OECD drew the attention of the Korean authorities to the need to modernise the banking system and, in particular, to upgrade the prudential supervisory framework. Those efforts, however, could not be launched until after the IMF intervened in response to the financial crisis.

The conclusion is very clear: Korea's financial crisis happened because of problems at home and its occurrence had *nothing* to do with the accession to the OECD."

In this context, an important factor is the maintenance by the governments of consistent messages to all market participants throughout the reform period, regarding the authorities' intentions to adhere to an orderly process of capital account liberalisation, based on pre-announced phases and co-ordinated with other supporting policies. Hungary's strategy and signalling of policy intentions stand out as particularly successful in this regard. To assemble the necessary political coalitions and administrative capacity to make such comprehensive reform possible is the challenge facing governments wishing to reap the full benefits of capital movements liberalisation.

Appendix. Stylised indicators of domestic financial development and international financial liberalisation in the OECD constituency 1958-1999

1. Introduction

To follow up on the discussion in Chapter I.4 above regarding the interlinkages between domestic financial liberalisation and development and the external capital account liberalisation, a series of stylised indicators for OECD members as well as a sample of non-member developing countries is presented below. These indicators have been developed by Chan Lee (2001) and by Chan Lee and Ahn (2001), drawing

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on a number of key studies attempting to gauge the quality of institutions and financial systems(see authors for detailed references). The authors contribute original measurements of controls on international financial operations based on a coding system where quantitative restrictions and administrative rules are classified as being more restrictive – of greater intensity – than taxation or market-based control measures. Although these indicators are not perfect and cannot substitute for close scrutiny of how authorisation policies are applied in practice, they represent an improvement over measures used in the majority of existing studies based on IMF's listing of the presence or absence of restrictions. The indicators thus permit a juxtaposition of estimates of the degree of financial sector deregulation and development with estimates of the intensity of restrictions on current and capital account operations at different points in time to assess what sequencing was followed and whether liberalisation of domestic financial sectors tends to occur more in tandem with external financial liberalisation in the more sophisticated financial environment of today. In response to the greater attention on the quality and role of institutions since the 1997 Asian crisis, an additional indicator based on an assessment of 27 microeconomic and institutional factors has been included, although to some extent correlated with the measures of financial liberalisation and depth. This allows a "benchmarking" of a country's social infrastructure to provide an additional assessment of systemic risk in the face of rapid credit expansion following liberalisation of the domestic financial sector.

2. Indicators of domestic and international controls

2.1. *Measurement of domestic financial liberalisation*

This section describes indicators for the degree of domestic financial liberalisation (DFL) in 33-EMEs and 28 OECD countries, as well as for exchange restrictions on current account transactions and capital account controls for from 1958 to 1999. DFL is usually gauged by the timing and degree of interest rate decontrol, together with some measure of financial depth. These indicators are not controversial, although the latter can be misleading in the absence of reliable information on the quality of institutions and prudential supervision. Domestic financial decontrol has typically occurred after trade liberalisation,[36] but before the opening of the capital account, but there are no hard and fast rules.

2.2. *Measures of Financial sector development*

Real interest rate patterns

The timing and degree of interest rate liberalisation and quantitative measures of financial depth are standard criteria of financial liberalisation (Gelbard

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and Leite 1995, Levine and Zeros 1998). The first criterion is based on the timing and sustainability of real interest rates. Suppressed financial systems are strongly characterised by negative real interest rates (especially deposit rates which are more likely to be administered). Following domestic financial decontrol, real interest rates (especially lending rates) inevitably turn positive – often substantially so – as non-price rationing mechanisms are eliminated. Moreover, real rates in a domestically liberalised system will typically be higher than in an internationally liberalised system (Pill and Pradhan 1995).

In summary, the index of effective domestic financial liberalisation shown is a combination of two measures:

- the number of positive annual real interest rate observations[37] relative to the total sample from 1980-2000;
- the proportion of real rates falling in the range of 0 to 7%.[38]

These indicators are squared to obtain an overall score of effective DFL (see Table 6).

The degree of monetisation

A commonly used parallel criterion of financial sector development or financial depth is some measure of broad money supply to GDP. Of available measures the ratio of private credit to GDP is by far the most appropriate, as it strips out the influence of government transactions on the monetary base. The correlation coefficient between the degree of effective interest rate liberalisation and financial depth is quite high and appears to be a relatively representative indicator at early and intermediate stages of financial development. However, it is not failsafe. After a certain threshold, this ratio will typically decline. This is not a sign of financial regression, but rather of growing sophistication reflecting the development of other financial instruments (money market instruments, long-term bonds and equity markets). Moreover, there are danger in using this indicator in a growth equation, as one will typically find that greater monetisation is good for growth (Levine and Zeros 1998, is typical of these first generation models). This may, indeed be generally true – but as illustrated in the 1997-98 Asian financial crisis, rapid credit growth after domestic and international financial deregulation, in the absence of adequate prudential supervision and sound institutions and well-capitalised banks produces extreme vulnerabilities.

Informational Quality of Financial Systems (IQFS)

The unanticipated severity of the 1997-98 Asian financial crisis has prompted much greater attention to the “quality” of social capital and the role institutions. Institutional economics suggest that the heart of any financial system is its

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Table 6. **Domestic financial liberalisation: selected economies**

	Dating		Functional effectiveness %	Private credit to GDP (%)			Private bonds % GDP 1997	IQFS 1998	Domestic Financial Liberalisation (DFL) relative to Capital Account (KA) opening
	Start	End		1960	1988	1997			
Australia	1981	1984	65.4	28	76	77	16.8	7.5	DFL complete > KA opened from late 80s
Austria	1985	1987	80.0	33	68	90	33.3	5.5	DFL complete > KA opened slowly from late 80s
Belgium-Luxembourg	1981	1984	75.0	8	23	29	53.1	5.4	DFL complete > KA opened from late 80s
Canada	1980	1983	90.6	32.4	67.9	86.4	11.5	7.7	DFL complete < KA historically been open
Czech Republic*	1994	1999	29.0			60	4.8	4.0	DFL well advanced = KA fully open from 2001
Denmark	1980	1985	71.9	43	83	80	105.9	7.2	DFL complete > KA opened from late 80s
Finland	1983	1985	74.3	43	46	55	26.7	6.7	DFL complete > KA opened from late 80s
France	1982	1985	84.3	41.5	83.1	79.8	36.6	6.5	DFL complete > KA opened from late 80s
Germany	1980	1982	73.4	39.1	76.9	110.7	47.5	6.5	DFL complete < KA historically been open
Greece	1980	1997	35.6	23	35	34	0.1	3.8	DFL complete > KA opened from late 80s
Hungary*	1992	–	52.9					3.7	DFL well advanced = KA fully open 2001
Iceland									
Ireland	1983	1985	56.5	32	50	50	0.1	6.2	DFL complete > KA opened from late 80s
Italy	1983	1986	69.1	–	61.6	50.4	33.3	5.2	DFL complete > KA opened from late 80s
Japan	1982	1984	88.9	57.7	124.9	203.8	33.3	6.7	DFL complete > KA opened slowly from late 80s
Korea	1982-83	1993	67.5	38	75	16	34.1	5.4	DFL well advanced = KA open since 2000
Mexico	1989	–	27.6	19	9		1.5	3.1	DFL partial = KA nearly complete
Netherlands	1980	1982	88.9	39	128	177	15	6.7	DFL complete > KA opened from late 80s
New Zealand	1983	1990	86.1	25	38	95	0	6.1	DFL complete > KA opened from late 80s
Norway	1982	1989	78.9	61	106	85	0	6.1	DFL complete > KA opened from late 80s
Poland*	1995	–	24.9			60	0	3.4	DFL well advanced = KA opening nearly complete
Portugal	1985	1994	69.4	45	51		19.6	4.9	DFL complete > KA opened from early 1990's
Slovak Republic	1994	–				17			DFL partial = KA nearly complete
Spain	1983	1991	74.7	40	69	76	7.8	6.0	DFL complete > KA opened from late 80s
Sweden	1981	1986	76.0	53.6	83.9	57.4	57.4	7.0	DFL complete > KA opened from late 80s
Switzerland	1982	1982		118	185	167	55.5	8.1	DFL complete < KA historically been open
Turkey	1999	–			16	18	0.4	1.8	DFL partial < KA opened from late 1980's
UK	1981	1983	90.4	16.1	25.0	120.0	22.6	9.5	DFL complete > KA opened from late 80s
USA	1974-79	1980-81	88.3	77.7	135.9	188.9	62.6	9.1	DFL complete < KA historically been open
OECD-core (22) members	1980-81	1983-84	75.5	40.8	83.5	94.2	–	–	DFL complete early 1980s > KA opening completed early 90s

Notes and sources: Starting date of domestic liberalisation from published sources or the start of 5 consecutive years of positive real lending rates. End-period, sustained positive real deposit and lending interest rates. Data from IFS CD Rom 2001. Functional effectiveness: is the proportion of annual positive real lending and deposit interest rates from 1980-2000 multiplied by the proportion of positive observations falling in the range 0 to 7%. Private credit to GDP and private bonds to GDP ratios from World Bank Beck *et al.* 1999. IQFS reading from Chan-Lee and Ahn 2001.

* Preliminary calculations not suitable for cross country comparisons.

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institutional-informational infrastructure and long-term contracting capabilities. These factors determine a system's capacity to transform heterogeneous information into sufficiently homogenous units that allows uncertainty to be priced as diversified marketable risk. Chan-Lee and Ahn 2001 have assessed 27-microeconomic and institutional indicators to proxy IQFS for 34 EMEs and 21 OECD countries for 1995-98 (with preliminary estimates for 1985). Although these indicators of IQFS are highly correlated with measures of financial liberalisation and financial depth, they have the advantage of avoiding the fatal pitfall of "more is better" in EMEs with poor financial transparency and regulatory systems. Moreover, they provide a means of "benchmarking" a country's social infrastructure – that allows an assessment of systemic risk in the face of rapid credit expansion following financial deregulation. To make this approach more manageable, as updating of this complete set of indicators is very laborious, a subset of core indicators (rule of law, creditors' rights, accountancy standards, shareholders' rights foreign bank presence and proportion of state-owned banks) can be selected for purposes of specific analysis.

2.3. *Measuring the intensity of exchange restrictions and capital account controls*

Measuring capital account openness (KAO) is far more complex than DFL, because of the number and complexity of controls, ranging from outright bans, ceilings, quotas, licenses, screening reviews and explicit taxes to multiple exchange rates. Moreover, when there is a combination of some of these forms of controls, judgement is needed as to which are the more restrictive. The ideal approach would be to calculate "implicit taxes" for each type of control imposed but this would prove too resource intensive. Hence the challenge is to find a somewhat less labour-intensive system which would reflect the varying intensity of the controls without becoming totally mired in specific details.

The widely cited IMF summary indicator of capital account restrictions is a simple arithmetic count of how many capital account restrictions are in place, relative to the total number possible (over time)see Johnston (1999a and especially 1999b) and (Rossi (1999).[39] This index has limited information value and is flawed, as no distinction is made for the *intensity* of controls. Countries with different regimes or implementing steady liberalisation over time can still receive identical scores.

A theoretically more appealing technique has been developed by Quinn (1997) drawing on Arrow's (1973) seminal insights into the efficiency costs of controls. Quinn derives a tractable coding system, whereby quantitative restrictions and administrative rules are treated as being more restrictive (from standard microeconomic theory) than is taxation (*e.g.* multiple exchange rates), and allows one to proxy the intensity of current and capital account restrictions by broad

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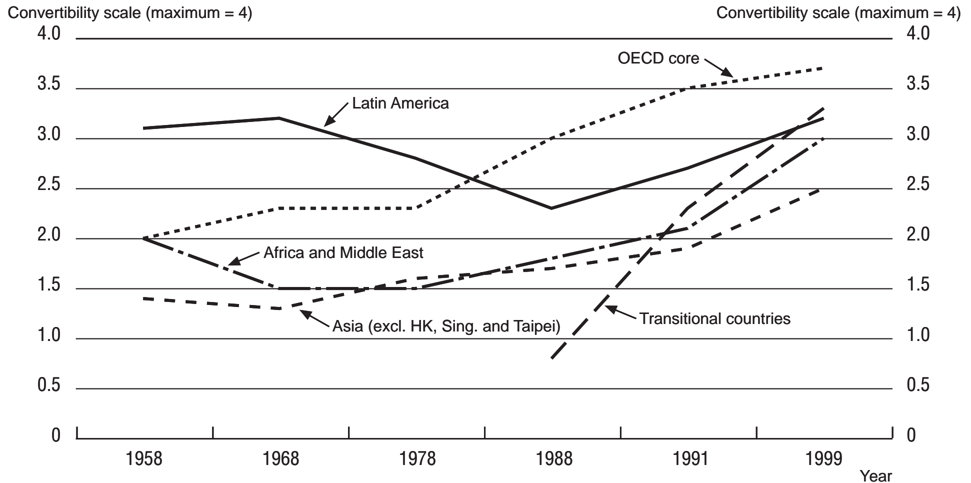
categories over time. Exports, imports, invisible payments and receipts and capital payments and receipts are all scaled on a zero to two basis (with 0.5 intervals), so that the current account is scaled from zero to eight and the capital account from zero to four. A detailed discussion of methodology is presented in Quinn 1997.

This approach has greater information value than a simple binary system, but does not capture changes *within* categories. Hence, the unremunerated reserve requirements (URRs) on short-term capital inflows into Chile are scored as being less restrictive than an outright ban, a quota system or administrative approval procedures. This coding system does not distinguish between the fine-tuning of URRs rates over time;[40] but may provide a useful cross-check on the speed and degree of KAO relative to salient measures of DFL, social infra-structure and macroeconomic disequilibria.

3. Empirical data for OECD members and selected non-members

The synoptic table below presents stylised indicators of domestic and international financial liberalisation at points in time ranging from 1958 to 1999. These are preliminary impressions and remain to be vetted by in-depth case studies,

Figure 1. **Capital account convertibility for selected country groups**



Source: OECD.

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which will help flesh out key characteristics of systems. Even so, a number of features can be underscored as regards the OECD countries:

The OECD countries are not a totally homogenous group with respect to domestic financial liberalisation (DFL) and capital account opening. Canada, Switzerland, the US and Germany have traditionally had open capital accounts throughout the post-war period, which means that DFL lagged capital account opening in their case. Thus the overwhelming statistical impression that the OECD countries followed "classical" sequencing patterns reflects the experience of the other 18 OECD countries in the sample. As regards dating, real side reform was basically achieved by 1961 with the general adoption of Article VIII status; DFL by the early 1980s and capital account opening by the early1990s.

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Notes

1. Article 2(d) of OECD Convention of December 1960 enjoins members to "pursue their efforts to reduce or abolish obstacles to the exchange of goods and services and current payments and to *maintain and extend the liberalisation of capital movements*".
2. "Invisible" is the general term applied to all exchanges in which no merchandise is involved. Within this group there are current and capital operations, and most of these consist of a transaction between two parties and a related funds transfer. The OECD has not attempted to give theoretical definitions of current and capital operations but distinguishes them by reference to lists.
3. The "CMIT", is the structure where member countries meet to discuss application and implementation of the Codes. All OECD countries are entitled to nominate an expert as a member of the Committee. The European Commission is represented. Other representatives, including from non-member countries, may be invited; the IMF and EFTA are also observers.
4. The Codes are instruments of international law which produce rights and obligations for governments. Legally, individual citizens or enterprises of member countries cannot directly invoke rights resulting from the Codes to invest abroad, move funds or provide cross-border services; they need to go through their national governments for a case under the Codes to be eventually raised before the CMIT. However, the Codes demand that member countries implement their obligations through adopting or maintaining the necessary measures at the domestic level.
5. *www.oecd.org/daf/investment/instruments*
6. The GATS and the Codes both promote the same goal: encouraging liberalisation. The GATS favours a "bottom-up" approach to defining countries' individual commitments, meaning that countries may select within the general coverage of the GATS those sectors where they wish to make commitments. Another distinction is that GATS seeks to achieve its goals through rounds of negotiation as opposed to unilateral liberalisation and peer persuasion as in the OECD. GATS negotiation of commitments means that progress towards liberalisation is achieved through mutual concessions, sometimes across different services sectors.
7. The Code contains a so-called "List B" of operations with respect to which a member country can re-introduce restrictions, and lodge reservations accordingly, at any time. List B currently covers only short-term financial operations and non-resident acquisitions of real estate. The faculty for member countries to reintroduce reservations under List B has proved to be in practice an effective way to facilitate liberalisation in sensitive areas and to avoid "precautionary" reservations (*i.e.* maintained for the sole reason of leaving open the opportunity to re-impose restrictions without breaching the standstill provisions of the Code).

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8. The clearest statement of the legitimacy of prudential regulation is perhaps to be found under paragraph 7 to Annex II to Annex A setting out the conditions for establishment and operations of branches, agencies etc. of non-resident investors in the banking and financial services sector. Paragraph 7 states that "Domestic laws, regulations and administrative practices needed to assure the soundness of the financial system or to protect depositors, savers and other claimants shall not prevent the establishment of branches or agencies of non-resident enterprises on terms and conditions equivalent to those applying to domestic enterprises operating in the field of banking or financial services", which also gives us a clear formulation of the equivalent treatment principle. An explanatory note further enumerates which specific prudential regulatory measures are referred to in this particular case. Another specific mention of prudential measures occurs in Section IX, Financial Credits and Loans, where explanatory note 8 states "members may regulate the net external position of domestic financial institutions dealing in foreign exchange." In addition, Article 5 on "controls and formalities" allows members to impose measures to *verify* the authenticity of the operation concerned, such as anti-money laundering measures, or to prevent evasion of laws and regulations, such as tax control measures for instance. These controls and formalities must be kept as simple as possible. Pursuant to Article 5, members are thus permitted to require certain operations to be effected through an authorised intermediary, such as a resident broker, acting on the account of its client, provided that this requirement is not used as a disguised means of restricting the making of the operation concerned. Capital transfers and payments may also be required to be executed through the banking system.
9. Thus Spain (61-62), Greece (1977) Turkey (1986) in regard to both Codes and Iceland (1964) with regard to the Current Invisibles Code. All members now adhere fully to both Codes.
10. Reversibility is likely to be technically more difficult in case of attack against the currency in countries where full liberalisation has already been achieved for some time. First, the administrative machinery that the operation of exchange controls necessitates generally no longer exists. Second, non-residents have been allowed to accumulate local-currency denominated assets which may represent substantial amounts.
11. The OECD Codes have from the outset had the objective of freeing not only payments flows but also the underlying transactions. This was not the case with respect to the initial EEC provisions regarding liberalisation of capital movements, which were strictly confined to direct exchange control measures.
12. These provisions are not considered as restrictions under Article VIII of the IMF Agreement, although they are now so regarded under the OECD Code of Liberalisation of Capital Movements.
13. For a detailed assessment of the Belgian experience with its long-standing dual exchange market, see Daco (1992).
14. For a discussion of the US regulations, see Cairncross in Swoboda (1976).
15. Transactions were declared all free unless otherwise specified in 1961 in Germany, in 1977 in the Netherlands, 1979 in the United Kingdom, 1980 in Japan, 1988 in Denmark and Italy, 1989 in France and Turkey, 1990 in Austria and Norway, 1991 in Portugal and 1992 in Spain.
16. From the late 1980s until the early 1990's, Spain experienced large portfolio investment inflows attracted by high interest rates due to the combination of persistent, large fiscal deficits and tight monetary policy aimed at fighting inflation. These inflows were by

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and large triggered by expectations that the peseta would be maintained close to the upper limit of its 6 per cent fluctuation band within the ERM, rather than be realigned. When uncertainties arose during Summer 1992 over the prospect for European Monetary Union and the Spanish government's ability to stick to its convergence objectives, the peseta came under heavy pressure and was subsequently devalued within the ERM, by 5 per cent in September and by a further 6 per cent in November. Following the first devaluation, limited exchange controls were re-imposed to defend the new parity. As the overall EMS turmoil appeared more serious and lasted longer than initially expected, the Spanish authorities recognised that controls could not help significantly and that deeper correcting policy measures were called for. Controls were partly lifted on 5 October and finally abandoned in connection with the second devaluation. Partly, difficulties stemmed from the fact that progress in inflation convergence with the core ERM countries was insufficient to sustain a parity unchanged since Spain entered the ERM in June 1989. Although the Portuguese escudo joined the ERM later, in April 1992, Portugal faced a somewhat similar experience, with unsustainable inflationary capital inflows from 1989 to mid-1992 followed by a downward realignment of the exchange rate in November 1992, despite a temporary tightening of existing exchange controls two months before, and in May 1993. These realignments were also largely induced by the Spanish devaluations (*cf.* Annex: Portugal).

17. Until the end of the 1980s, Greece maintained "financial repression" to finance its budget deficit and direct credits towards targeted industries. This contributed to delaying financial modernisation and thereby facilitated the implementation of exchange controls. Offshore/on-shore interest-rate differentials suggest that controls were binding in particular during the periods of national elections. Even so, financial underdevelopment did not prevent several major balance-of-payments crises in Greece in the 1980s. The unofficial parallel foreign exchange market, to which both companies and individuals had easy access, was functioning relatively smoothly during the 1980s, with a low premium except during very short periods of time. More recently, during the European currency turmoil of Autumn 1992, despite a tightening of existing regulations, the Bank of Greece had to intervene massively to defend the Drachma and the inter-bank money market rates rose by 10 percentage points.
18. Along a similar line of argument, in countries wishing to introduce a pegged exchange-rate policy, greater freedom for capital transactions could enable the authorities to obtain some indication of an equilibrium level that market participants regard as sustainable, at which to establish the peg. This was one of the reasons for liberalisation plans in the early 1990s in Iceland.
19. See further Poret and Ley (1997).
20. Poret (1992).
21. C*f.* Annex: Czech Republic.
22. These sectors are also commonly protected by older OECD members.
23. An amendment to the securities legislation in Slovakia eliminated this restriction in November 2000.
24. C*f.* Annex: Czech Republic.
25. C*f.* Annex: Czech Republic.
26. The foreign-owned share of registered capital in the Hungarian banking sector end 20001 stood at 78.4 per cent, of which 61.7 per cent owned directly by foreign credit institutions.

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27. Previously, a regulation under the Securities and Exchange Act stated that any investor wishing to purchase 25 per cent or more of a publicly-traded company's shares was required to make a "tender offer bid" (TOB) to purchase more than 50 per cent of such company's shares. However, this regulation was abolished as of February 1998. Under the current General Banking Act, hostile take-overs of banks are allowed, provided the FSC's approval is given for the acquisition of shares in excess of the general limit.
28. Debt and equity securities, money-market instruments, financial derivatives, financial credits and operations in deposit accounts.
29. The Code contains a so-called "List B" of operations with respect to which a member country can re-introduce restrictions, and lodge reservations accordingly, at any time. List B currently covers only short-term financial operations and non-resident acquisitions of real estate. The faculty for member countries to reintroduce reservations under List B has proved to be in practice an effective way to facilitate liberalisation in sensitive areas and to avoid "precautionary" reservations (*i.e.* maintained for the sole reason of leaving open the opportunity to re-impose restrictions without breaching the standstill provisions of the Code).
30. Prior to December 1997, the exchange rate was "allowed" to fluctuate in a band of ±2.25 per day but in practice, the system functioned as a fixed but adjustable peg, in view of intervention and capital market regulation (OECD Economic Survey of Korea 1998).
31. The Czech Republic maintained a safeguard clause in their 1995 Foreign Exchange Act which provided for the imposition of a deposit requirement on all inward capital flows in case of acute pressures on the exchange rate. This initially required a number of reservations, which were lifted in 1998 as Czech authorities undertook only to activate the provision in the Foreign Exchange Law in accordance with the disciplines of the temporary derogation clauses in the Codes for serious balance of payments difficulties and other economic and financial disturbance.
32. C*f.* Annex: Czech Republic.
33. Some commercial banks were able to maintain higher on-balance sheet open positions by structuring corresponding off-balance sheet covering positions via their in-house brokerage firms.
34. The entry into force of a new foreign exchange law from 1 October 2002 freeing all capital flows between residents in Poland and in member countries of the European Union and the OECD has since removed the Committee's concerns regarding these former restrictions.
35. The authorities indicated that the new Central Bank law had removed the possibility for imposing exchange control measures, so that the only option would be thorough new legislation enacted by Congress. However, had there been a real political will to reintroduce controls, action could probably have been taken by special presidential emergency decrees or similar extraordinary means.
36. The acceptance of current account convertibility (or Article VIII status) is used here as a simple gauge of the absence of major real-side microeconomic imbalances and hence of effective trade liberalisation.
37. These are *ex post* annual real interest rates and refer to relevant deposit, lending and money market rates, deflated by the annual change in the consumer price index, published in the IMF's IFS CD Rom 2000.

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38. The BIS in a similar estimate of EMEs vulnerability applied a 4 per cent cut-off (see Hawkins and Klau 2000). However, this appears to be an excessively threshold when allowance is made for transitory shocks and the normal impact of excess demand on real rates.
39. For example, the IMF's summary of the 1978 import licensing and exchange control system in Turkey contains two pages of descriptions of quotas, licensing, duty rebates, related export subsidies, advance deposit schemes, etc. These also varied by type of import and sector leading of myriad of possible combinations. These are simply shown as a "1" indicating "the presence of restrictions" in line E-2 of the summary table, the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions.
40. As noted above, attempts at measuring the effects of URRs in Chile encountered a number of difficulties, notably isolating the substitution effects between taxed and non-taxed components of capital inflows and related financial engineering. The implicit tax rate varied daily, as interest rate spreads over foreign interest rates were used to calculate opportunity costs. Despite intensive research, there is scant evidence that the URRs were successful in their main purpose, *i.e.* to deter excessive capital inflow and an appreciation of the real exchange rate. However, there is evidence that the URRs were not totally evaded, and did help to change the composition of net inflows and to lengthen maturity structures, see Valdés-Prieto and Soto 1998.

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Annex

Case Studies of Financial Liberalisation in Four OECD Countries

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Czech Republic

The Czech crisis of May 1997: was capital account liberalisation part of the problem or the solution?[1]

The Czech Republic presents an interesting and instructive case to analyse in terms of its capital account liberalisation experience, as this relatively swift process was accompanied and marked by a number of phenomena and developments complicating or even jeopardising its chances of success: a pronounced swing in the economic cycle accompanied by sharp reversals in capital flows 1993-98, a brief period of acute currency crisis in May1997, forcing a switch to a floating exchange rate regime, subsequent balance-of-payments adjustment both on current and financial accounts, accompanied by a drawn out banking sector crisis due to inherent structural weaknesses as aggravated by the deteriorating economic circumstances. Active policy debate was engendered concerning the role played by external financial liberalisation in these developments. Questions were raised whether the chosen strategy of early and comprehensive capital account liberalisation had been misguided or whether inappropriate macroeconomic policies, or other (structural, legal, institutional etc.) characteristics of the Czech economy could be regarded as the cause of the difficulties experienced.

Although what is often termed as the Czech "crisis" of May 1997 never represented a banking cum currency crisis of the nature experienced by Korea or Mexico along with other emerging markets, it highlights and underscores the importance of several conclusions presented in this study. Many of the factors and policy considerations that emerge from a closer look at the developments preceding, during and after this "crisis" constitute excellent support and illustration for the general reasoning and recommendations set forth. To avoid repetition of historical detail and analysis already in the main text, a format with three sets of bullet points is chosen in the interest of conciseness. The first set presents facts and circumstances relevant to the build-up of the currency turbulence, which pushed the country into a political crisis and economic recession. The second set aims to evaluate the policy responses elicited while the third, concluding set highlights cumulative consequences of earlier options selected for the general transition road map.

1. Factors of importance to the build-up of the currency turmoil

- ***Early commitment to comprehensive liberalisation of capital movements reinforced by spontaneous deepening of liberalisation via market activity/sophistication***

Although many capital account operations were restricted in the early 1990"s until a new Foreign Exchange Act was introduced in October 1995, the general legislative environment and everyday practice were rapidly gearing the Czech economy to a higher mobility of capital flows. Indeed, in this respect the Czech currency assumed a unique position among other currencies of the reforming Central European economies.[2] Thus, to a large extent, the 1995 Foreign Exchange Act merely codified the existing liberal environment, where the banking

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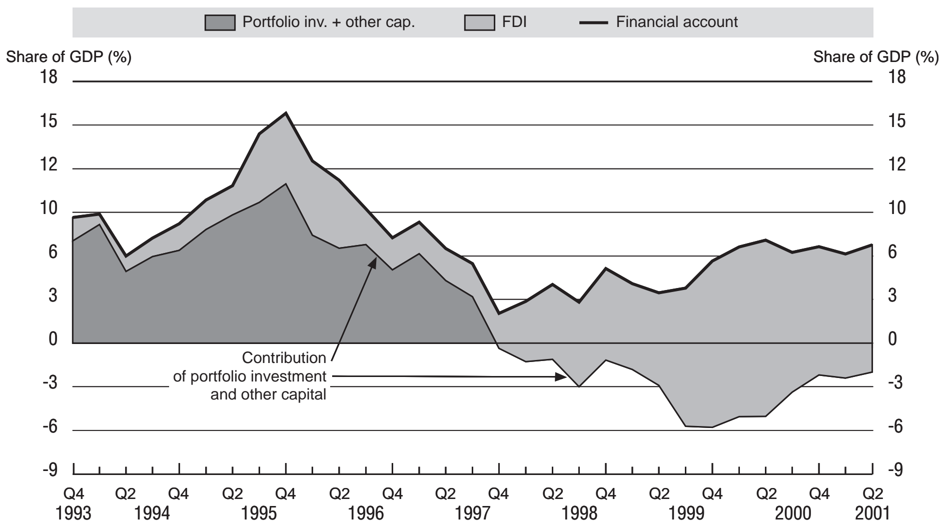
sector and other so called foreign exchange agencies (licensed securities brokers, in particular) continued to be a source of erosion of remaining regulations.

The attractiveness of the koruna based on the high degree of convertibility achieved and a relatively advanced infrastructure of trading was reflected in a high turnover of the foreign exchange market.[3] The existing minimum of restrictions allowed classic short selling and much of trading had already for some time been transferred offshore (London, in particular). Another important factor in providing greater *de facto* freedom was the reluctance on the part of regulatory bodies to intervene in entrepreneurial activities of economic agents, which they saw as going contrary to their image of the new Czech identity as a transition economy with an ambitious reform programme oriented to extensive liberalisation.

- ***The exchange rate peg and the nature and composition of capital inflows***

From 1992 to early-1996 a fixed exchange rate with a very narrow fluctuation band was maintained. This period was marked by massive inflows of foreign credit and portfolio investments into Czech banks and companies. Capital inflows accelerated from 1993 to 1995, when a peak of about 15% of GDP was reached. Portfolio investment and "other capital" dominated in these flows (even though the FDI inflow increased in 1995, due to the privatisation of telecommunications (see Figure 1). The foreign capital was attracted by the combination of a high and growing interest differential[4] with an improving rating of the Czech Republic, the privatisation process, development of the Czech capital market and a strong external borrowing demand from the Czech corporate sector.

Figure 1. **Financial account of the balance of payments**
4 quarters moving averages



Source: Czech National Bank.

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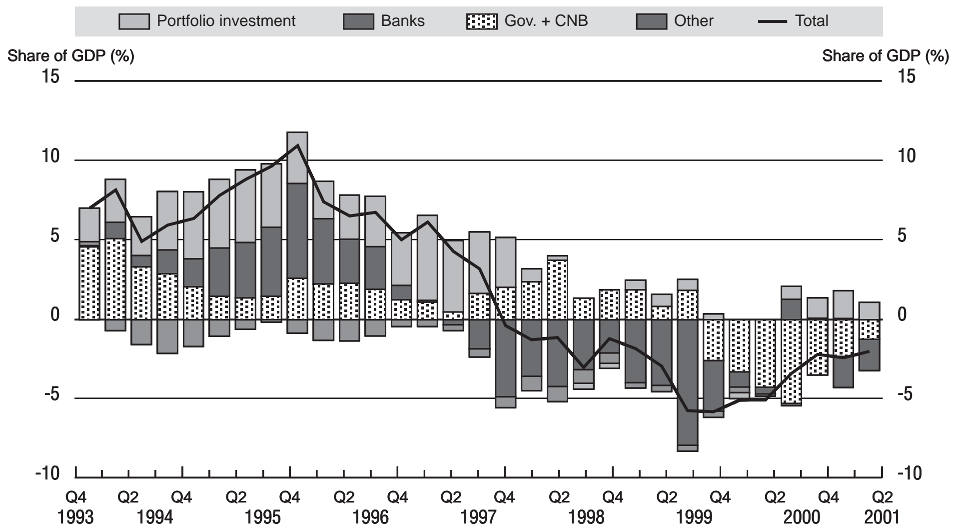
The implied surplus of the balance-of-payments had to be compensated by automatic foreign exchange interventions of the Czech National Bank (CNB). Even though the CNB tried to sterilise these interventions, its sterilisation operations were becoming increasingly inefficient and costly. As a result, the money supply growth exceeded the CNB's targets substantially in all years between 1993 and 1995

Figure 2 breaks down the short-term capital flows into net portfolio investment and net foreign credit taken up by banks, the public sector (*i.e.* the government plus CNB) and the private non-bank sector (denoted by "other" here). As we can see, the fast inflow of short-term capital in 1993-96 was composed of portfolio investment, and foreign borrowing by Czech banks and non-bank public. However, the relative importance of portfolio investment was gradually declining from about 5% of GDP to about 2% of GDP. The foreign borrowing of non-bank private sector was relatively stable from 1993 till the end of 1997: it averaged at 3.5% of GDP with fluctuations of about 1 percentage point (for the four-quarter moving average). Clearly the highest volatility has been recorded in foreign borrowing by Czech banks, which peaked at 6% of GDP at the end of 1995, but fell back to zero by the end of 1996 (or early-1997). Since then, there has been a strong net outflow of bank funds (accompanied by a very slow growth of net foreign credit attracted by the non-bank public).

In 1996, the capital inflow slowed down, partly due to the widening of the fluctuation band of the Czech crown, and partly as a result of weakening investor confidence in the Czech economy associated with the growing current account deficit and evidence of decelerating

Figure 2. **Structure of short-term capital flows: net portfolio and other investment**
4 quarters moving averages



Source: Czech National Bank.

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structural reform. Combined with the mounting current account deficit, this led to a modest balance of payments deficit in 1996. The capital inflow slowed down further in 1997, *i.e.* the year of currency turmoil, and the balance of payments' deficit increased to more than 3% of GDP that year. It is worth noting, however, that even in the period of 1996-97, capital inflows still remained positive on a four-quarter moving basis, *i.e.* although there was a sharp reversal of short term capital flows in the second quarter of 1997, there was not a longer-lasting net outflow of capital.[5]

- ***Financial sector structure and the role of the banks***

The Czech financial sector is bank dominated and highly concentrated, with a relatively underdeveloped role of insurance companies, investment funds and pension funds by international comparison. Compared to other transition countries the sector is relatively large, with total financial sector assets corresponding to 169% of GDP, with 143% attributable to deposit banks. The heavy burden of non-performing credits characteristic of the Czech banking sector is due both to inherited bad assets and an accumulation of bad loans, particularly by the large, essentially state-owned or state-controlled commercial banks during the 1993-97 credit boom. The ratio of classified loans to total bank credit increased by more than 5 percentage points in 1999 and exceeded 32%, as the actual extent of bad asset problems started to be more openly revealed, partly due to stricter loan classification regulations of the CNB. The ultimate public cost of the government's clean up is usually estimated between 15 and 20% of yearly GDP. The restructuring and privatisation process started towards the end of the decade and had by end 2001 brought the foreign ownership share of total banking sector assets up to 94%.[6]

Given the importance of the banks in financial intermediation,[7] the question was naturally raised to what degree the banks' problems were affected by the volatility in capital flows. What appears to stand out in the Czech case, as opposed to other emerging market currency and banking crises, is that the major banking sector problems followed the currency turmoil with a lag of about one or two years.

The inflow of foreign short-term capital through the banking sector, which took place in 1994-96, resulted in the Czech banks accumulating a negative net position towards non-residents of about CZK 100 billion. However, the strong stimulus for banks to borrow abroad to profit from the interest differential did not produce the sort of currency cum maturity mismatch seen in other emerging market financial crises, since standard regulations for covering foreign exchange risk were observed and low cost hedging facilities were available in the highly developed market place in the Czech Republic. In particular, the banks lent on a part of their foreign borrowing to the domestic companies as foreign currency loans, which means that they opened their foreign exchange balance-sheet position much less than their total position towards non-residents. This position moved roughly between CZK – 10 and – 40 billion during 1996, and was fully hedged by off-balance-sheet operations, with the result that the banks' total open foreign exchange position remained close to zero, and was in fact slightly positive in May 1997. Therefore, while the easy credit policies followed by the large state-owned banks and complicated cross-ownership patterns between banks and their debtors can be considered a contributing factors to the onset of currency crisis, the banks' immediate financial stability was not directly endangered by the currency turmoil in 1997 (in fact, some banks even made short-term profits). There were no liquidity runs on individual banks at the time, which vouches for the important role played by the prudential management of foreign exchange risk in the banking sector.

This does not mean that Czech banks were immune to the consequences of the currency turmoil as there were of course indirect effects. By passing their foreign exchange borrowing

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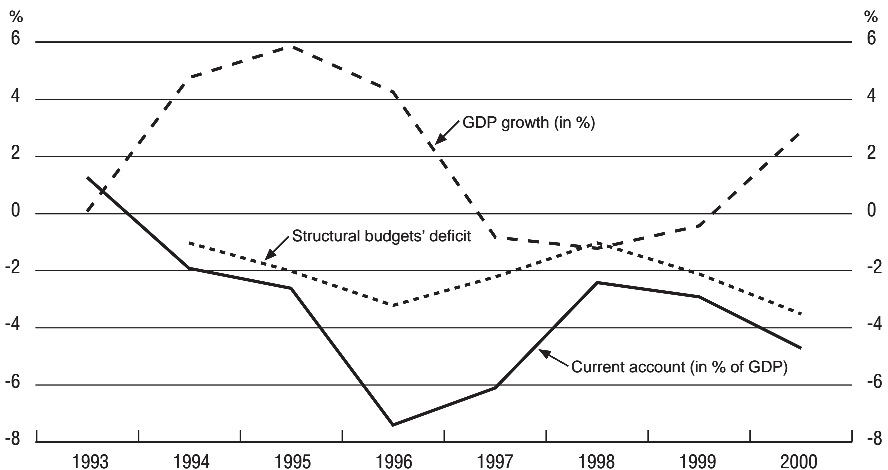
on to the (often non-hedged) domestic enterprises, the banks in many cases just transformed the foreign exchange risk into a credit risk. The negative consequences of the currency turmoil and subsequent stabilisation policy measures were clearly visible in the performance of domestic firms and thus *post facto* exacerbated the already excessive credit risks that the Czech banks had taken on during the credit boom. The impact of the currency turmoil on Czech banks was thus not of an immediate nature, but a lagged one, working through the credit-risk channel.

2. Policy responses and the pace of structural reform – evaluation

- ***Overburdened monetary policy, overshooting and lack of co-ordination with fiscal policy***

As can be seen in Figure 3, after the temporary stagnation in 1993, associated with the split-up of the Czechoslovak federation, the Czech Republic started to grow at an accelerating speed in 1994-96. This period was also characterised by excessive wage growth, quickly appreciating real exchange rate due to the inflation differential, and massive inflows of foreign debt finance as discussed above. Even though the Czech National Bank tried to sterilise the impact of these inflows, the money supply growth consistently exceeded its targets. Although the public sector budgets appeared relatively restrictive on paper, the structural budget balance in fact deteriorated by about 2.5% of GDP in 1994-96, taking into account privatisation revenues and the fast GDP growth. These factors contributed to a fast expansion of domestic demand (7.5-8.5% in 1994-96) and an economic overheating reflected mainly in a growing current account imbalance, which exceeded 8% of GDP in early 1997.

Figure 3. **GDP growth, current account balance and public budgets**



Source: CNB, Czech Statistical Office; Bezděk, Matalík (2000).

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To regain control over the domestic demand in the absence of fiscal restrictive measures, the CNB widened the exchange rate's fluctuation band in February 1996 to 7.5%, and introduced a set of restrictive monetary policy measures in the second half of 1996. These restrictions included, among other things, raising the minimum reserve requirements by 3 percentage points and increasing all the CNB's major interest rates by about 1 percentage point.[8] However, these measures proved to be insufficient or even counterproductive in the short run as they contributed to the CZK's appreciation, leading to a further deterioration of the current account.

The widening of CZK's fluctuation band triggered a one-off outflow of short-term capital, which, together with the restrictive monetary measures led to a reduction in money supply growth to about zero in real terms by the end of 1996.

An economic recession followed the currency turmoil. The depth and persistence of this recession gave rise to considerable debate over whether monetary policy tightening had been excessive or should have been relaxed earlier. A consensus assessment appears to be that the painfulness of the stabilisation period was due to the substantial overheating of the economy that took place in 1994-96, partly engendered by pro-cyclical fiscal policy in the run-up to general elections (1996 was an election year), including quasi fiscal stimulus via agressive lending by state-controlled banks and by a sub-optimal mix of policies that was subsequently used to stabilise it. The monetary authority thus chose this option even though it was evident that a more optimal policy mix would have required a greater involvement of fiscal and income policies to restrain demand and combat excessive wage growth.

The fiscal policy was tightened only in 1997 (shortly before and then again after the currency turmoil), and further in 1998, when the Czech economy had already entered an economic recession.

- **A *move from exchange-rate targeting to inflation targeting enforced by the crisis***

As the currency turmoil ensued in May 1997, the CNB tried to defend the currency band for about two weeks through foreign exchange interventions and a sharp hike in nominal and interest rates but eventually it was forced to float the koruna. Nominal and real interest rates remained at a relatively high level also after the exchange rate was floated (until the second half of 1998).

Since 1998, the Czech National Bank has introduced inflation targeting as its monetary policy strategy. The CNB undershot its targets in all three years since the adoption of inflation targeting, even though in 2000 by a relatively small margin only (see *e.g.* Tůma, 2000b; ČNB, 2001). Partly, this was due to external price shocks (low food prices in 1999 and oil prices in 1998 and early 1999), but the economic recession and a strong exchange rate rebound during 1998 also contributed. The ex-post consensus seems to be that the CNB should have lowered the interest rates faster in 1998, responding more readily to the fiscal tightening and the appreciating exchange rate (see *e.g.* Čihák, Holub, 2000).[9] Such a move might have made the recession shorter and the undershooting of inflation targets smaller.

- **P*ost-crisis stabilisation achieved***

After a period of economic recession and sharply rising unemployment in 1997-99, a turn-around since mid-1999 has now allowed the Czech GDP to marginally exceed its peak of mid-1996, as well as its starting level at the beginning of economic transition. The business cycle experienced was sharp, with rebound growth at a low trend of about 2.5% a year, which is substantially below potential based on the empirical cross-country studies of economic growth.[10]

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The current account deficit declined to 2-4% of GDP in 1998-1999. The rapid disinflation brought net inflation (*i.e.* inflation net of changes in administered prices and indirect taxes) to the edge of deflation in 1999. In 2000-2001, the economic recovery has been accompanied by a turn-around both in inflation and current account deficit, with assistance from the external oil-price shock and (in the case of inflation) a food price hike in 2001.

3. Conclusions: governance problems and institutional weaknesses

- ***The speed of capital account opening enabled the integration with international financial markets to proceed at a rapid pace, but was not the "cause" of the 1997 currency turbulence with ensuing recession nor of the costly recapitalisation and restructuring of the banking sector undertaken in the period 1999-2001.***

The reluctance of the Czech authorities to reintroduce short-term controls during the currency turmoil and the lack of success with the non-binding measures imposed on banks as inflows accelerated testifies not only to their commitment to liberalisation but also to the fact that once integration with international markets and trading systems has been achieved, it is extremely hard to pull back. The robustness of the domestic infrastructure for currency and interest rate trading was demonstrated by the fact that the interbank market continued to function throughout the crisis weeks, with no significant tiering or closures of participating institutions.

- ***Excessive optimism in the 1995-96 boom conditions caused the alarming growth of the current account deficit to be insufficiently heeded***

The prevailing view amongst experts and policy-makers was that it was "natural" for the economy to be importing capital at its current stage of development. As in Mexico, a credit boom funded by capital inflows developed, but any doubts raised regarding the sustainability of the current account deficit due to mounting evidence of supply side constraint were slow to result in policy action to correct the external imbalance.

- ***Better institutional arrangements for co-ordinating monetary and fiscal policies would probably have lessened the risk for overshooting of policy measures to stabilise the economy***

The occasional high-level consultations regarding policy measures which took place between the CNB and the Ministry of Finance were not a substitute for continuous, working-level dialogue and information exchanges required for effective co-ordination. Such institutional arrangements obviously form part of the overall framework for public sector governance which can only be built up gradually. At the same time, it remains true that for an exchange-rate-based stabilisation to remain a reasonable idea for the first stage of economic transition in the place of a domestic nominal anchor, it needs to be strongly supported by fiscal policy. Halfway measures and indecision regarding the respective roles and courses charted for monetary and fiscal policies risk sending the wrong signals to market participants. . As the Czech experience also shows, the policy choice of whether to completely accept a loss of monetary policy autonomy or to give up the exchange rate anchor should preferably be resolved before the markets themselves enforce it.

- ***Government intervention in the banking sector lending policies led to sub-optimal allocation of credit, and a conversion of bank exposure to currency risk into credit risk***

Although part of their bad loans were inherited from the communist past, the major banks with substantial state ownership were encouraged to actively participate in the lending boom of 1993-1997, accumulating further bad assets in the absence of adequate risk assessment techniques and sound governance.

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- ***Reluctance on the part of policy-makers to allow earlier participation by foreign strategic investors in the large state-owned banks blocked one avenue for dealing with governance problems and misallocation of funds in the banking sector***

Until the extent of the non-performing asset problem in the banking sector became clearly apparent in 1999, there was insufficient political support for early privatisation and strong resistance in some quarters for selling major stakes in the banking sector to foreign interests.

- ***The 1997 crisis and ensuing recession was aggravated by the unfinished transition agenda regarding governance practices in banks and enterprises, creditor discipline and effective securities market supervision***

The shortcomings with respect to creditor rights and the legal framework for debt resolution have repeatedly been singled out as an area where more work remains to be done. Also, even though the excesses of tunnelling mechanisms to strip assets to the detriment of minority shareholders are a thing of the past, securities market regulation and oversight is often mentioned as an area where further progress would be desirable. The first big frauds that took place in the sector of barely regulated investment funds left a lasting unease amongst the general public as well as foreign investors of deeply non-transparent and unethical practices plaguing the domestic capital market. Public opinion was also critical of a number of failed privatisation projects and the diluted and non-transparent ownership structure which resulted from the voucher privatisation, bringing only a minimal contribution to the equity capital strengthening of the corporate sector.

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Notes

1. This material draws substantially on papers by Oldrich Dedek, (Dedek 2000), Tomas Holub and Zdenek Tuma (Holub and Tuma, 2002), both of the Czech National Bank, as well as OECD Economic Surveys of the Czech Republic for the relevant years. It has also benefited from the assistance of Petr Prochazka and Jana Krelinova of the CNB and Pavel Klima, Permanent Mission of the Czech Republic at the OECD and several colleagues from the Czech Ministry of Finance.
2. The Czech banknotes were regularly purchased and sold by many Austrian and German banks, the so called Viennese unofficial (called also parallel) exchange rate even became an important feedback information on the credibility of monetary policy of the Czech National Bank.
3. According to Citibank estimates the total daily turnover with currencies of transition economies amounted in April 1997 to USD 8.1 billion Of this the Czech koruna accounted for USD 5.5 billion which represents almost 70% of the total sum.
4. In assessing the importance of the interest rate differential, Holub (1997a), for example, concluded for the period of 1993-96 that an increase in the interest rate differential by 1 percentage point led to an increase in the short-term capital inflows in the subsequent quarter by CZK 5 – 7 billion (roughly 1.5 – 2.0% of quarterly GDP at that time) and by about twice as much in the long-run. Short-term capital flows moved together with the interest rate differential until the end of 1995. In the period between the widening of exchange rate's fluctuation band in the first quarter of 1996 and the stabilisation of the situation after turbulence in 1997, the positive correlation broke down, and in fact became negative, indicating that expectations regarding the exchange rate probably became the major force driving the short-term capital flows after the peg was abandoned. Since 1998, the interest rate differential again seems to have become a factor in the sense that an outflow of short-term capital occurred when the interest rate differential was sharply reduced (almost to zero in late-2000). The short-run correlation turns out quite weak, which suggests that other factors – such as exchange rate expectations and/or FDI flows – dominate in the short run.
5. Since 1999, the Czech Republic has reached another peak in foreign capital inflows, but the structure of these flows has changed dramatically compared to the earlier peak. In particular, there has been a massive FDI inflow that has put the Czech Republic at a lead among all CEE transition economies in terms of per capita FDIs. The investments into manufacturing, and above all greenfield investments, have increased substantially in volume (even though their share on total FDI reaches just about one third), partly thanks to the FDI incentive scheme that was introduced in 1998.
6. The sale of the 60 percent public sector stake in Komercni banka to Societé Générale in mid-2001 provided a grand finale to the rapid introduction of strategic foreign investors into the sector.

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7. Bank credits to the domestic private sector reach about 55% of GDP, compared for example to about 20% of GDP in Hungary and Poland.
8. The CNB resorted to some administrative measures, making the short-term capital inflows more difficult. For example, a spread of 0.25% was introduced between the central bank's purchases and sales in the foreign exchange fixing, and limits on commercial banks' open short-term positions towards non-residents were introduced (short-term assets were not allowed to exceed short-term liabilities by more than 30%, but CZK 500 mil. at most). These administrative controls were introduced at the same time as the financial account liberalisation was being implemented, but proved to have little effect.
9. See also IMF: "Czech Republic: Staff Report for the 2000 Article IV Consultation," August 2000. However, as the IMF pointed out too, fears prevailed in 1998 that the emerging market crises might undermine stability of the CZK and lead to quick reversals in capital flows. These concerns may serve as an ex-ante explanation of why the interest rate cuts were slower in 1998 than is now perhaps viewed as optimal.
10. For example, Fisher, *et al.* (1998) calculated the expected potential GDP growth rate of the Czech economy at 4.2-4.6%.

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Finland

Financial liberalisation since 1980[1]

1. Introduction

In this paper we present an overall description of the liberalisation of the domestic credit market and foreign exchange transactions in Finland since 1980. The paper includes the description of the structural change in financial markets, the principles, timing and sequence of liberalisation, the macroeconomic conditions and legislation. However, we focus especially on the experiences of the deregulation process and the lessons to be learned.

Before the liberalisation Finnish financial markets were bank-dominated, underdeveloped and lending was characterised by credit rationing. Finland became gradually convinced about the advantages of liberalisation and in the 1980s the central bank began to actively dismantle exchange control. Pressure for regulatory changes was also growing as enterprises and banks found ways to avoid existing constraints. The Finnish deregulation process was made in a gradual way and practically the whole decade of 1980s was a period of step by step regulatory changes. Most important decisions were taken in 1986 and 1987 and the process was carried to its end in 1991.

The paper underlines the need for wide policy discussion before the liberalisation process. The principles, timing, sequence, rules, supervision, legislation and overall policy-mix should be made clear first and then the deregulation can be introduced successfully. The process should be carried in connection with other relevant reforms. Especially, great emphasis should be pointed to financial market supervision, risk management, corporate governance and other policy actions, which will dampen the expansionary effects of liberalisation. Also the banking crisis management should be thought out, if risks in some day actually materialise.

The paper proceeds as follows. First we give a picture of the state of Finnish financial markets in the 1980s. In Section 3 we outline the principles, sequence and timing of the liberalisation. Then the macroeconomic conditions and especially aggregate bank lending are being discussed. Section 5 presents the state of supervision and banking legislation at the time. In the final section we construct a list of the Finnish experiences and policy recommendations.

2. Finnish financial markets

Up to the 1980s, the Finnish financial markets were very narrow and dominated by a small number of large banks.[2] Deposit banks were central to the financial system, the market was protected and highly regulated. From the domestic perspective, the initial situation was characterised by 1) direct controls on average lending rates[3] and on tax-free rates on household deposits, 2) the absence of well-developed money and securities market and 3) a well-developed banking sector. From the international point of view, regulations included restrictions on international capital flows.[4]

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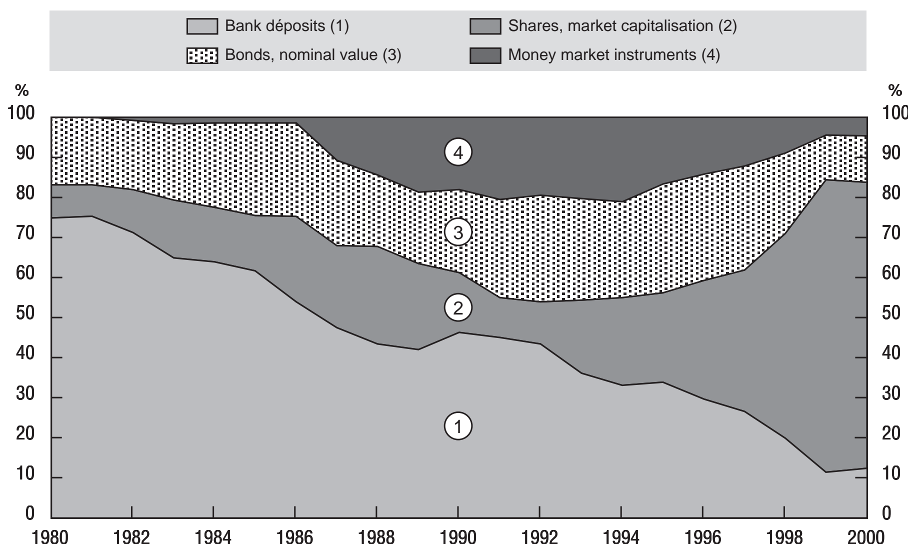
Preferred low lending rates and binding capital controls resulted in credit rationing. Access to credit was normally, especially for households, conditional upon prior savings and, for both households and enterprises, the use of other banking services. As a consequence of that, customers were more concerned about the relations to their banks than profitable deposit contracts. Credit rationing also tended to discriminate small as well as newly established firms. A predominant share of the savings flow was channelled from surplus to deficit units by financial intermediaries, while equity and bond market played a relatively minor role.[5]

Figure 1. **Percentage breakdown of financial assets**



Source: Bank of Finland, Statistics Finland, Helsinki Stock Exchange, State Treasury.

Up to the mid-1980s there was no direct price competition in the banking sector due to regulation. Competition took a more indirect form of attracting low-cost deposits by building large branch networks and investing heavily in banking technologies. Capital imports were tightly controlled by the central bank, and cross-border lending was subject to quantitative restrictions. Foreign banks operated only as niche players in the Finnish markets – mainly only in the currency and money markets.[6] For example in the year 1985 all foreign-owned banks contributed slightly less than 0.6% of the total lending of the commercial banks to the private sector.[7]

In that time deposit rates were set at a uniform level by mutual agreement among deposit taking institutions in a cartel like arrangement – interest on household deposits was tax-exempt as long as all banks offered the same set of interest rates on the various classes of household deposits.[8] The results of this lack of domestic competition was that Finland, in

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Table 1. **Banking capacity in the Nordic countries**

	Per 10 000 inhabitants, end of 1991			
	Branches	Staff	ATM	EFTPOS
Finland	6.2 (8.2)[1]	93.6 (104.4)[2]	5.8	67.0
Sweden	3.7 (5.9)[1]	55.0 (83.1)[3]	2.5	9.7
Norway	3.9	59.2	4.1	37.4
Denmark	5.0	99.5	2.1	37.8

1. Including post offices.
2. Including post office personnel in customer service (5 420).
3. Including post office personnel in customer service (18 415), personnel of the postal giro system (3 840) and personnel in the housing finance institutions.

Source: Nyberg and Vihriälä, 1994, 9.

the beginning of the 1990s, had more banking personnel and branches per capita than the neighbouring Nordic countries (Table 1). It also had one of the densest and most advanced ATM networks and point of sale terminals in the world.[9]

Until the latter half of the 1980s, a major shortcoming of the financial system was the absence of an efficient money market. In addition the Finnish bond market was virtually non-existent until the early 1980s. This was largely due to the bank-dominated financial system and tight regulation of the financial markets. The most popular instruments at first were widely issued tax-exempt bonds of the central government and mortgage bank as well as corporate bonds, often privately placed with banks. No real secondary market developed for these instruments. A market for commercial paper was launched in 1986, growing vigorously in the late 1980s and reaching a peak in 1990 – 1991.[10]

For a long time exchange control was mainly based on a licensing procedure for long-term foreign capital operations. On the other hand, short-term operations based on commercial transactions were primarily approved when organised through authorised banks.[11] Until the late 1970s the major part of the foreign capital inflow was based on one-off licences linked to specific transactions.[12]

Towards the end of 1980s capital imports and the pricing of bank lending had been largely liberalised. With the development of a money market in the 1980s banks became less dependent on deposits as a source of funding. With the liberalisation of foreign borrowing in conjunction with the policy of fixed exchange rate banks increased their funding from abroad. Lending also expanded, with companies investing heavily in new capacity and facilities.

Households' interest payments were tax deductible[13] at a high marginal tax rate. This privilege included also interest payment on consumption loans. Thus it can be said that especially the interest rate system and tax deduction system had particularly national features.

3. The liberalisation process

3.1. *Principles of the liberalisation process*

As described in the previous section, up to early 1980s the Finnish financial markets were tightly regulated and highly protected. Pressures for liberalisation and a more receptive attitude on the part of policy-makers began to develop in the 1970s. After Finland became a mem-

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ber of OECD in 1969 it accepted the obligations of the OECD's Code of Liberalisation of Capital Movements, although Finland initially lodged a substantial number of reservations.

Finland like other countries gradually became convinced about the advantages of liberalisation and the regulation was beginning to be seen as having more negative than positive effects on the economy. It was increasingly realised that the old system would not survive in the more interdependent markets where financial technology was changing rapidly.[14] Pressure for regulatory changes was also growing as enterprises and banks found ways to avoid existing constraints.

In the 1980s the central bank began to actively dismantle exchange control. With the expansion of international trade and capital movements, the major goal of regulating capital movements became to safeguard the economy from external disturbances and to ensure independence in monetary policy. The general trend was to relax exchange control in small steps.[15] An exception to this progressively more liberal attitude towards long-term capital account transactions was the measures taken in June 1985, when the central bank banned the sale of markka-denominated bonds to abroad.[16, 17] The reintroduction of these restrictions required derogation from Finland's obligations under the OECD code. The Committee concluded that Finland was justified in invoking the derogation clause of Article 7b.

In the mid-1980s there were some discussions on whether the deregulation should be handled as a gradual or a "big bang" exercise like that undertaken in the United Kingdom. This debate never really ended in intellectual consensus; rather, pragmatism won the day-to-day battles.[18]

On the whole, there was not much intellectual discussion regarding the impact of the liberalisation, the risks connected to the process, the optimal overall policy-mix, etc. Deregulation operations were seen more or less as a technical exercise. The sequence and timing of the taken measures, were also to a limited extend designed to support the monetary policy.

The liberalisation was introduced in a gradual way and practically the whole decade of 1980s was a period of sequencing regulatory changes. As a consequence of this taken step by step-policy, the process in Finland was somewhat slower and took place later than in many other OECD-countries.[19]

3.2. *Sequence of liberalisation*

Bank funding

The deregulation of Finnish financial markets started really in 1980 when the banks were allowed to borrow freely in foreign money markets to cover the commercial forward currency positions. There were limitations on banks' open foreign exchange positions, while they were allowed to borrow and lend abroad to cover the exchange risk resulting from their forward positions. The Bank of Finland turned over the operation of the forward exchange market in convertible currencies to the commercial banks,[20] because it was thought that the banks could operate the market more efficiently.[21] This strengthened banks' links to foreign short-term markets. Freer access to the forward market made it also easier for companies to exploit international interest rate differentials.

From 1979, foreign banks were allowed to establish subsidiaries in Finland. This opening measure was taken in order to increase competition in the emerging money market and in international financial services. The first foreign banks[22] entered into the market in 1982.[23]

Especially from the beginning of 1980s the unregulated market, grey market,[24] started to develop and grow alongside with the regulated one.[25] There are many reasons behind this

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development. Rising international trade and increased contacts with foreign capital and money markets led to greater capital mobility and heightened borrowers' sensitivity to international interest rate differentials. Over time, non-preferred borrowers became increasingly aware of opportunities to balance the limitations on their access to domestic bank credit, either due to rationing or the interest ceilings shutting them out of the market. After the grey market had developed there was good potential to gain arbitrage profits from the spread between unregulated and regulated market.[26]

Companies also realised that they could bypass banks as intermediaries and thus save money. Large corporations set up an informal short-term money market by themselves, where they could lend and borrow money with better terms of trade. Banks responded by extending funding in the form of unregulated bond purchases instead of loans, partly funded through forward transactions with exporters. Since leasing and factoring were both new forms of financing and unregulated, some banks created finance companies specialising in such activities.[27]

The Bank of Finland did not try by accommodating liberalisation measures to check the grey market administratively, instead it tried to incorporate the market into the system. In May 1983 the central bank started to encourage banks to move their grey market operations into their balance sheets. This was made by allowing banks to pass a part of the cost of their unregulated funding onto their lending rates.[28]

In 1986 the development of domestic money market were aided first by a downgrading of the role of the call money market. The introduction of a spread between the deposit and the credit rates in the call money market created a vacuum in which the money market could develop.[29] This provided room for profitable transactions in the inter-bank market. In December a system of three month fixed rate credits were introduced by the central bank as a transitional arrangement. The amounts and the interest rates on term credits were set daily in an auction system. As a consequence of these actions banks responded by shifting almost entirely from call money credits into term credits.

In late 1986 and in early 1987 the central bank worked together with the commercial banks to develop the domestic CD[30] market.[31] This allowed banks to offer competitive interest rates on CDs and to trade them at low cost. In February 1987 the Bank of Finland started to issue its own CDs and a little later it began to buy and sell CDs to influence money market conditions. A true money market was established by exempting bank CDs from the cash reserve requirement and agreeing on a code of conduct to be applied in money market operations.[32]

Lending rates

Banks' lending rates were controlled much longer and more tightly than lending decisions. However, by the early 1980s the lending rate regulation was beginning to lose its effectiveness, as banks started to offer cocktail loans made up of a mixture of regulated and unregulated loans. Interest rate deregulation on the lending rate side got under way in 1983. Until May 1983 the average bank lending rates were subject to low and binding ceilings. In 1983 restrictions were relaxed by allowing banks to pass on part of the cost of their unregulated funds.[33]

Historically, the interest rate levels on long-term loans were tied to the Bank of Finland's base rate, which was under the power of Parliamentary Supervisory Council.[34] Because of low interest rates were long a political priority, the rate tended to be sticky, lagging real and financial developments within the system.[35] The real interest rate was negative especially in the 1970s, but also in the early 1980s (Figure 2).

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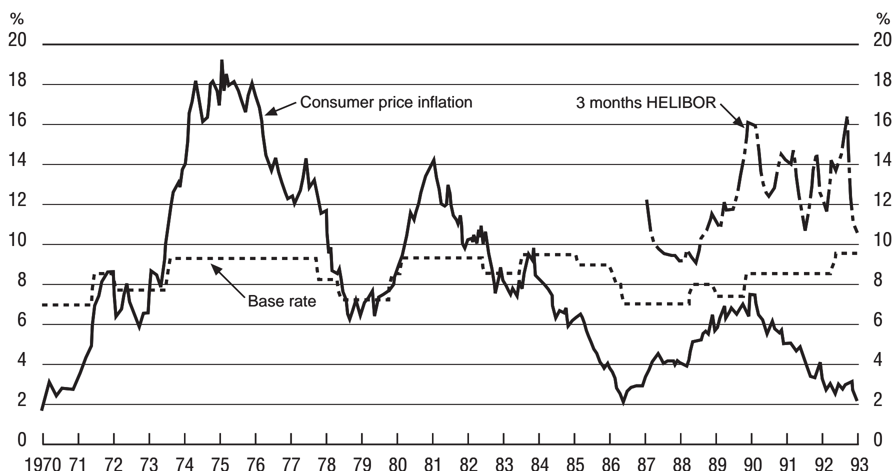
Figure 2. **Inflation, base rate and market-based short-term interest rate**



Source: Bank of Finland, Statistics Finland and Reuters.

The central bank took first step toward the use of other reference rates in December 1985, when it allowed banks to link loans up to one year to the call money rate. Further step in that process was taken in 1986 when banks were permitted to link loans up to five years to a reference rate, which reflected the cost of short-term funding in the unregulated market. However, loans maturing more than five years and housing loans were still linked to the base rate. In May 1987, new market related interest rates called HELIBOR[36] were introduced. After the introduction banks were allowed to link all other loans except housing ones to these newly created short-term rates. Helibor rates became quickly the primary reference rates on new loans, especially commercial ones. In January 1988 banks were also allowed to link housing loans to long-term market reference rates. For this purpose the central bank began to publish three and five years market rates based on the offered rates in the secondary market for taxable, fixed rate bonds.[37]

Other major steps

In 1982 banks got restricted rights to take a part in syndicated loan arrangements abroad. In 1984 these restrictions were loosened and Finnish banks were also allowed to establish branches abroad.[38] It should be pointed out that even if foreign banks were allowed to establish subsidiaries in Finland, they were not able to open branches until the year 1991.

In March 1985 authorised banks were given the right to enter into currency option contracts in a limited way. In 1986 manufacturing and shipping companies were granted the right to borrow long-term[39] credit from abroad without any quantitative restrictions for their own operations.[40] In the following year this right was extended to all non-financial companies.

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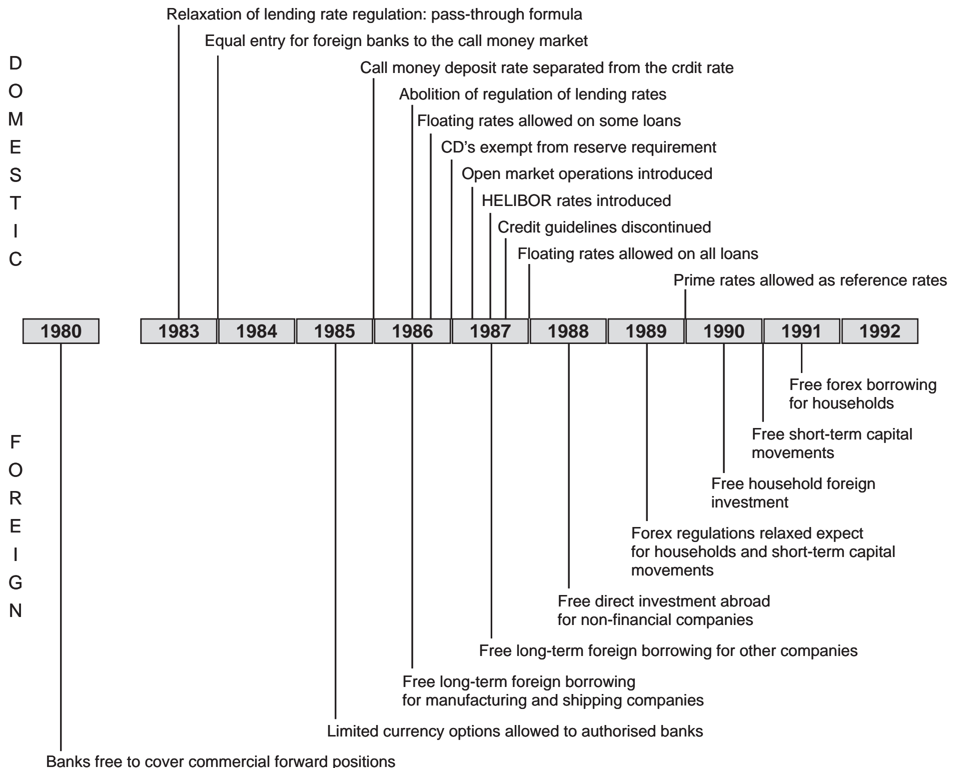
In 1988 direct investments abroad for non-financial companies were exempted from authorisation[41] and in July 1989 it was extended to cover also the financial sector. In September 1989 Forex regulations were relaxed excluding households and short-term capital movements. Since 1990 households were allowed to invest freely abroad and the sale of markka-denominated bonds to non-residents was allowed.[42] Also in the same year all restrictions concerning non-resident accounts were removed. Beginning of 1991 restrictions on the purchase and sale of money market instruments were abolished. Since October 1991 Finnish individuals and companies have been allowed to raise loans abroad freely.[43]

Figure 3 illustrates that deregulation of Finnish financial market was a long process with most important decisions taken in 1986 and 1987. The last of the foreign exchange controls were rescinded in 1991, after a decade-long process.

Figure 3. **The main steps in the process of Finnish domestic and external financial liberalisation**



Source: Nyberg and Vihriälä,1994, 11.

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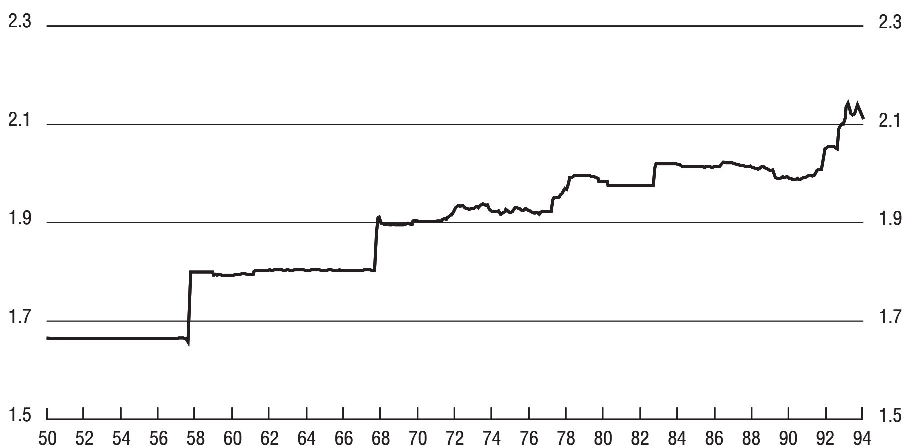
Figure 4. **The nominal markka exchange rate**[1]



1. Logarithmic values of the trade-weighted currency index,1982 = 100. When line goes upwards, currency depreciates and *vice versa*.

Source: The Bank of Finland.

3.3. *Monetary and exchange rate policy considerations*

Historically, inflation in Finland had almost continually exceeded that of its trading partners and Finland had to devalue markka at roughly ten years intervals, by 10 – 30%.[44] In the 1980s the widely agreed policy aim in Finland was to get out of this inflation/devaluation cycle. This meant in practise that the mission was to keep the external value of markka stable against the trading partners' currencies (so called "hard currency" – policy).[45]

The sequence and timing of the external deregulation indicate that the Bank of Finland tried to take into account the monetary policy stance considered appropriate at the time. When high or rising interest rates were desired, capital exports were liberalised. When the central bank preferred lower interest rates or bouts of devaluation speculation drained away foreign exchange reserves, capital imports were freed. Of course, from the monetary policy point of view deregulation was only a one-shot instrument – each measure could be used only once and thus they were weak instruments in longer run. Obviously, for example when capital imports were liberalised, they permanently allowed greater inflows of capital and lower interest rates than previously. What reduced problems at one time was, therefore, destined to make them worse when economic circumstances reversed them, needing stronger monetary measures.[46]

Of course many other reasons than those of monetary policy were always factored in. This was especially true when it became clear that existing regulations were being circumvented or when they clearly discriminated between different enterprises. In such cases additional liberalisation was introduced to avoid clear inconsistencies.[47]

In 1984 and the three first quarters of 1985 there was a period of strong capital inflow in Finland. At the time domestic banks' foreign lending and portfolio investment alternatives

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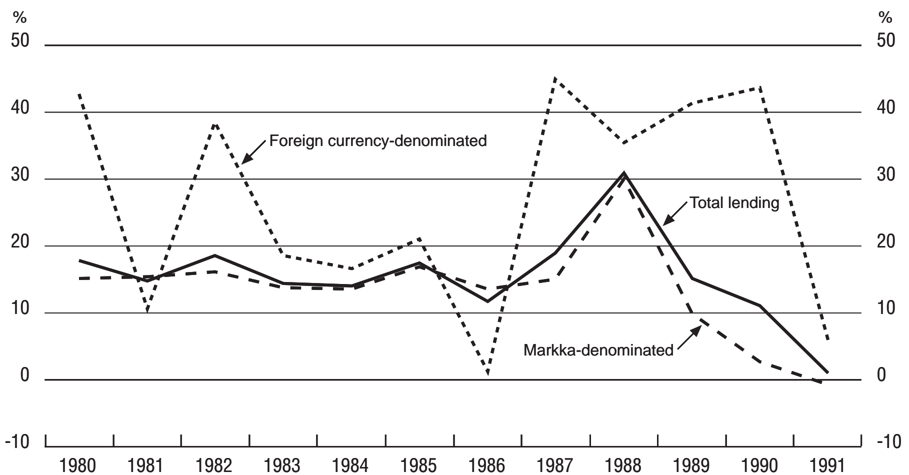
were widened and they were allowed to open branches abroad. In the same time, the sale of markka-dominated bonds abroad was banned and rules on the sale of forward cover on commercial transactions were tightened. In mid 1986 Finland faced a strong capital outflow[48] and as a response to that, regulations on the use of foreign credit to finance domestic exporters' long-term receivables were eased and restrictions on long-term foreign borrowing by shipping and manufacturing companies were also eased.[49]

4. Macroeconomic conditions

During the era of regulation, the export sector had been favoured in the allocation of credit. After the financial market liberalisation also the domestic sector's possibilities to get external finance were expanded. Companies and individuals started to use these new resources and they expanded remarkably their debts. The central bank's commitment to the hard currency policy provided an added incentive to borrow in foreign currency. Especially in the late 1980s companies invested heavily in new capacity of retail trade, hotels and restaurants. Dwellings remained the main objective of household investment.[50] This developed a huge credit boom into the economy, whose effects on demand and prices were not commonly understood as temporary features. On the contrary, massive investment plans were built on overly optimistic future expectations.[51] The lending of households and companies peaked in 1988, when bank annual lending grew over 30%. Another reason behind the soaring lending may have been banks heavy competition over customers.[52]

Afterwards one could say that the rise in asset prices was a bubble, which was fuelled by speculations and an increased use of leverage. Unfortunately Finland is an example of hard real landing after an asset price boom. Asset prices started to decline at the beginning

Figure 5. **Banks' lending to private sector, annual percentage changes**



Source: Bank of Finland.

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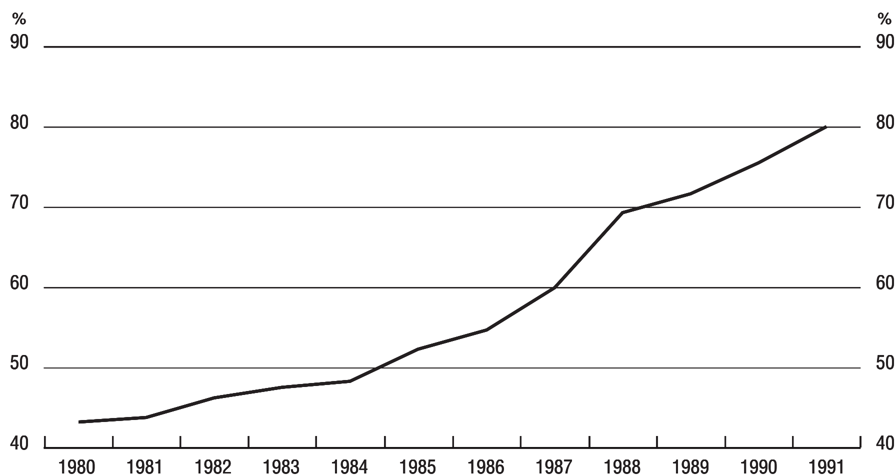
Figure 6. **Banks' private sector lending in relation to GDP**



Source: Bank of Finland and Statistics Finland.

of 1989 following the tightening of monetary conditions observed in most Western countries.[53] The asset price plunge left many indebted households and firms in a bad financial situation with insufficient collateral. This collapse in asset prices was combined with high initial levels of debt and with higher than expected interest rates.

Credit expansion was strongest in the savings bank sector.[54] Skopbank, the central bank of the whole savings bank sector, even disregarded the instruction given by the Bank of Finland to restrain the growth of private sector lending. On the contrary, it promoted local savings banks to increase their lending to the private sector.[55] Savings banks could not augment their capital structure via equity issue, being constituted as foundation-like entities. There is evidence that the aggregate credit supply of the savings banks would have been substantially less if their capital had been high enough to eliminate moral hazard incentives.[56] These excessive risks taken by savings banks may also have been affected by deficiencies in owners' oversight, since in the savings banks' organisational form, there are no owners *per se*.[57] A system of shared responsibility for group solvency meant that a number of deeply insolvent local banks in effect bankrupted the whole group.

The 1980s was a period of strong growth in Finland. The GDP grew steadily and unemployment fell to record lows below 4%. The boom ended with a crash of exceptional severity in the beginning of the 1990s. The Finnish depression of the 1990s was exceptionally deep in comparison with other European countries.[58] During the depression, GDP shrank by over 10% and the unemployment rate rose almost as high as 20%. These first years of the 1990s were characterised by falling output, high interest rates (both nominal and real) and collapsing asset prices.

The resulting decline in incomes further increased the problems of those entities with relatively high debt service obligations. As the adjustment of domestic demand to increased

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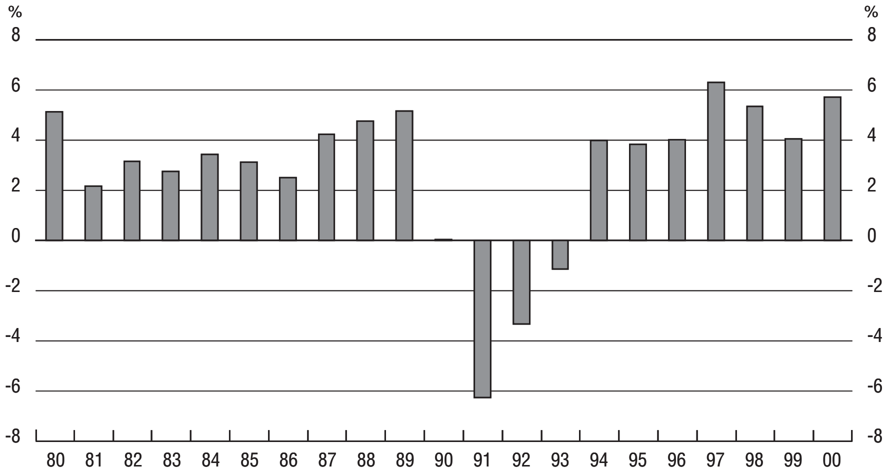
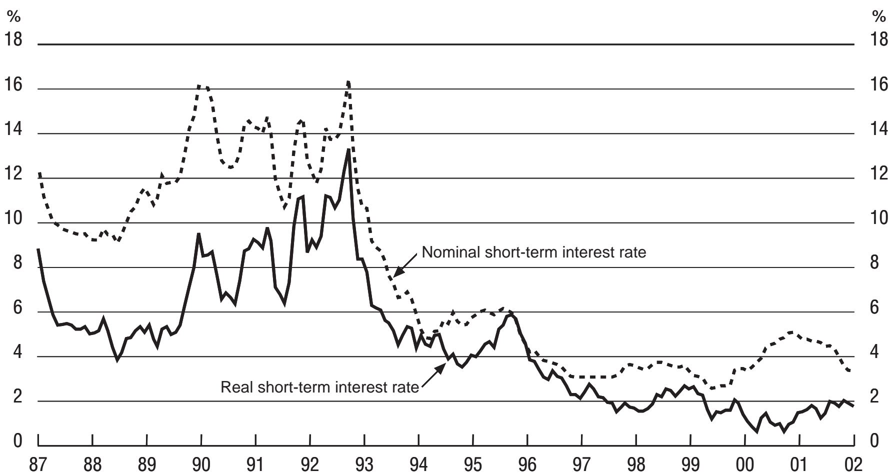
Figure 7. **The annual change in GDP**



Source: Statistics Finland.

Figure 8. **Nominal and real short-term interest rates in Finland**



Source: Reuters and Statistics Finland. The used deflator is consumer price indexed.

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indebtedness continued with full force, the GDP declined by over 6% in 1991. At the same time Finland experienced a heavy capital outflow and as a consequence of that, the markka had to be devaluated by 12.3% *vis-à-vis* the ecu in November 1991.[59] However, the pressure against the currency did not cease and in September 1992 Finland was forced to move to a floating exchange rate system. Taking into account both the devaluation in 1991 and the period of floating in 1992, the markka depreciated by almost 40% against the Deutschmark.[60] Large amounts of debt capital was raised in foreign currencies, so the depreciation of the external value of markka increased the financial burden.[61] Because of many of these companies operated only in the domestic market, the exchange rate change did not have any compensating effects on revenues. In 1993, GDP decline started to decelerate, but 1994 was the first calendar year with positive growth figures.

The financial distress started to multiply when banks' customers could not keep up their debt repayments. Simultaneously, the banking sector's situation deteriorated. This was mainly due to an excessive exposure to interest-rate risk and to credit-risk.[62] Afterwards it is quite easy to say that banks, especially the savings banks, should have assessed their customers' credit-risk more correctly.[63] Also the base rate did not rise as much and as quickly as the market determined rates and this materialised the banks' interest rate risk.[64] Some banks had considerable difficulties to meet the capital adequacy requirements, even though the requirements were not exceptionally demanding at the time.[65]

Banking sector problems were followed by a currency crisis that further weakened the already fragile banking system. Failures in the risk taking were one of the reasons, which deepened the recession in the beginning of the 1990s. The banking sector insolvency aggravated to the point where substantial government support to the sector became necessary. When guarantees are included, the government had to inject over FIM 97 billion (EUR 16.3 billion) into the banking system during the 1990s. The savings banks turned out to be the worst affected banks and over 90% of the sum was directed to this sector. It has been estimated that the after the guarantees are expired and all the reimbursements are taken into account, the banking crisis costs will total around FIM 33 billion[66] (EUR 5.6 bn.).[67] In relation to GDP in 1990, these costs represented respectively 18.6 or 6.4%.

It is clear that on the aggregate, Finnish banks took far too heavy risks and as a consequence saw non-performing loans increase substantially in the beginning of the 1990s. However, it should be pointed out that not all of the loans were *ex ante* bad business, since one part of the loans became impaired due to the unpredictably deep macroeconomic crisis. In this bank-centred system even large companies relied on banks as the main source of external capital.[68] This also explains the deepness and seriousness of the Finnish banking crisis.

5. Supervision

In the 1980s the responsibilities of the Banking Supervision Office[69] were substantially enlarged by new legislation and after that the responsibilities covered almost all of the financial institutions. Only the insurance companies were an exception; they were under the oversight of the Ministry of Social Affairs and Health. The Bank of Finland also had some supervisory functions based on the Foreign Exchange Act and its role as a lender to the banks. The Act assigns the Bank of Finland to supervise the currency risks of financial institutions.[70]

The overall atmosphere in the society did not encourage to put more power to supervision, even if the responsibilities were much larger than before. The common attitude was that market participants are able to handle the risks inherent in their business by themselves. In the 1980s there were also some shortcomings in the banking legislation. For example, the legislation did not allow the exercise of supervision on a consolidated basis. Some

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of the banks took advantage of this and shifted risks beyond the supervision. Also the possibilities to regulate banks' associated companies were limited. There are also signs that accounting standards and financial statements did not properly reflect banks' and other companies' financial condition.

It has been pointed out that the Banking Supervision Office focused very much on the legal aspects of the supervisory functions, but relatively little effort were put to the quantitative risk analysis or in-depth risk appraisal of individual institutions. In the newly liberalised markets banks had many more ways to operate than before and also opportunities to increase their risk positions. It can be said that the main supervisory authority did not make clear warning signals or restrain the growing risks. Similarly, the Bank of Finland failed to perceive early enough the full consequence of the credit boom.[71] However, one can reasonably doubt whether increased powers by themselves would have improved the situation at the time, as supervisory practices, skills and even the philosophy itself take time to develop.

For the reasons mentioned above, the financial market supervision and banking legislation was not tight and extensive enough in the 1980s. Also banks failed to upgrade their management information systems for controlling business risks adequately. Comprehensive supervision must be based both on internal and external control.

6. Experiences with liberalisation

Liberalisation process should be started with a deep discussion about the principles, timing, sequence, rules, supervision, legislation, overall policy-mix and so on. In the case of Finland it could be said that there was no wide policy discussion. The regulation changes were seen mainly as technical issues – with the result that no clear overall picture of regulatory changes and their impacts emerged. It is evident that deregulation is a process which is almost impossible to stop after it has been started. After a beginning, it comes increasingly easy and profitable to legally circumvent existing regulations.

In Finland forward exchange market was eased in 1980, whereas long-term capital movements were longer tightly controlled. If the autonomy in monetary policy was the motivation of exchange controls, it would have been more appropriate to control short-term capital flows rather than long-term ones, because short-term flows are more interest-sensitive.[72]

Before liberalising financial markets it is relevant that financial market supervision, risk management and corporate governance are organised in an appropriate way. Also the banking crisis management should be thought out, if risks in some day actually materialise. In Finland proper actions to tighten the banking supervision were not carried in connection with the process of financial market liberalisation. There were also shortcomings in banking legislation,[73] for example the capital adequacy standards did not meet international standards in the 1980s. This had very negative effects when deregulation got under way: banks could operate with too low levels of capital and the true risk levels were underestimated.[74] An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

The liberalisation of the domestic credit market and foreign exchange transactions was not accompanied by other reforms that would have significantly dampened the expansionary effects of liberalisation. The incentives to borrow remained unchanged, economic policy in general did not adequately restrain domestic demand or price and income expectations.[75] From the companies point of view equity capital was heavily taxed relative to debt and thus debt continued to be the cheapest form of external finance. Until the beginning of 1990s households' interest payments were tax deductible at a high marginal tax rate – including interest payment on consumption loans. This connected with high inflation history[76] encour-

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aged the willingness to incur debt and save less. Also the tax exemption of interest earnings on low yielding bank deposits constituted a subsidy to banks, which boosted banks' lending capacity. If the privilege had been taken off already in the 1980s, the whole competition in the banking sector could have been based in more reasonable basis.

From the cyclical point of view the timing of deregulation was not very well chosen. The most important decision to deregulate was taken at the midpoint of a period of long and exceptionally rapid growth. Capital inflows were deregulated just before the economy overheated.[77, 78]

After the liberalisation the range of financial assets and market participants has increased significantly. So that Finnish financial markets are no longer bank-centred or underdeveloped. Corporate access to external finance is now much greater than in the 1980s, and healthy competition in bank lending has tightened margins, which has been beneficial to consumers. The overall financial market deepening has also increased the stability of the system.

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Notes

1. This paper has been prepared by Perttu Tuomi of the Finnish Ministry of Finance, on secondment to the OECD Secretariat during January 2002.
2. However, there were also around 250 local savings banks and over 360 local co-operative banks.
3. Although banks had some freedom to price loans individually over the spread around the average (Swoboda, 1986, 15).
4. Bordes *et al.*, 1993, 19.
5. Swoboda, 1986, 13.
6. Nyberg and Vihriälä, 1994, 8.
7. Suomen rahoitusmarkkinat, 1986, 39.
8. Swoboda, 1986, 2-13.
9. Nyberg and Vihriälä, 1994, 8.
10. Financial Markets in Finland, 1996, 20-23.
11. Suomen rahoitusmarkkinat, 1986, 59.
12. Johansson and Solttila, 1989, 314.
13. Within certain limits.
14. Swoboda, 1986, 17.
15. Lehto-Sinisalo, 1992, 19.
16. The reason behind the measure was the heavily increased sale to abroad and the underdevelopment of domestic financial markets (Johansson and Solttila, 1989, 314). Finnish authorities also pointed out that the substantial rise in the sale of Finnish securities to non-residents threatened to undermine the anti-inflation policy (because of the expansive effect on the money supply). Corporate bonds and debentures could be issued at unregulated interest rates, which were running at relatively high levels (13-14% in 1984). The sales to abroad totalled FIM 188 million in 1983, FIM 1 098 million in 1984 and in 1985 (Jan.-June) FIM 4 549 million. For example Norway had taken same kind of a measure in November 1984.
17. Lehto-Sinisalo, 1992, 19.
18. Nyberg, 1992a, 3.
19. Raha, inflaatio ja talouspolitiikka, 1988, 228.
20. After that the central bank intervened through the commercial banks.
21. Abrams, 1988, 5.
22. In 1982, subsidiaries of Citibank, Chase Manhattan Bank and Banque de l'Indochine et de Suez were established. The next ones to enter into the market were Samuel Montagu in 1985 and Svenska Handelsbanken in 1990.

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23. Pankkitoiminan rakennemuutos Suomessa, 1994, 60.
24. An example of financial market innovation to bypass regulation is so called "fenno" market (1984-1985). Forex regulations did not specifically prescribe any connection between uses and sources of foreign currency in banks' balance sheets. At the times of strict monetary policy and large interest rate differentials between domestic and foreign rates, banks felt free to lend foreign currency on their balance sheets onward to the domestic market even though direct foreign borrowing was forbidden. The resulting "fenno" credits were given to companies expressively denied access to foreign credits and were explicitly denominated in a foreign currency. They were financed through domestic currency deposits instead of through foreign borrowing and carried exorbitant interest rates. The authorities squashed the market by declaring funding through domestic currency deposits to be same as funding through foreigners' currency deposits. (Nyberg, 1992b, 6-7. See also Suomen rahoitusmarkkinoiden kehitys 1980-luvulla, 1990, 19-20.)
25. By 1983, one fourth of all loans and one fifth of deposits were unregulated and these numbers were rising (Abrams, 1988, 17).
26. Abrams, 1988, 4.
27. Nyberg, 1992b, 6.
28. Abrams, 1988, 7.
29. In January 1986, the differential was set to 0.7 percentage points and was gradually increased to 3.5 percentage points in April 1987.
30. Certificates of deposits.
31. At the time Ministry of Finance relaxed its restrictions on CD issues. Originally, the restrictions were designed to prevent banks from issuing promissory notes comparable to banknotes (Lahdenperä, 1995, 4).
32. Bank CDs have accounted for a dominant share of money market assets, a feature which distinguished the Finnish money market from those of many other countries. It was just in 1990s when the stock of Treasury bills started to grow.
33. Abrams, 1988, 5-10.
34. The Parliamentary Supervisory Council had the power to fix the interest rates controlled by the Bank of Finland and to propose changes in the fluctuation range of the currency index.
35. Abrams, 1988, 11.
36. Helsinki Inter-Bank Offered Rate. 1, 2, 3, 6 and 12 months HELIBOR rates were calculated daily on based on the average bid offers for each category of CDs.
37. Abrams, 1988, 11.
38. Johannsson and Solttila, 1989, 314-316.
39. Maturing at least five years.
40. However the terms of conditions had to be submitted for the prior approval of the Bank of Finland.
41. Excluding countries, with which Finland maintained bilateral payment agreements.
42. These actions also eased the companies' risk management (Suomen rahoitusmarkkinat 1990. 1991, 17).
43. Lehto-Sinisalo, 1992, 48-80.
44. Korhonen, 2001, 9.
45. For example Kiander, 2001, 13-14.
46. Nyberg, 1992a, 4.

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47. Nyberg, 1992a, 4-5.
48. Year 1986 was the first time when the "hard currency" policy was attacked by devaluation speculations. The central bank responded by raising the call rate up to 40%.
49. Abrams, 1988, 14.
50. Vihriälä, 1997, 34.
51. Valtioneuvoston tiedonanto eduskunnalle pankkituesta, 1993, 6.
52. Suomen rahoitusmarkkinat 1996, 1996, 27.
53. Bordes *et al.*, 1993, 13.
54. Vihriälä, 1997, 34.
55. Valtioneuvoston tiedonanto eduskunnalle pankkituesta, 1993, 14.
56. Vihriälä, 1997, 5.
57. Halme, 199, 526.
58. Kalela *et al.*, 2001, 27.
59. Markka was linked to the ecu in June 199,1 following similar decisions by Sweden and Norway in the preceding months.
60. Kiander, 2001, 27-29.
61. The rigid exchange rate system may have also lowered perceptions of currency risk.
62. Bordes *et al.*, 1993, 13.
63. Valtioneuvoston tiedonanto eduskunnalle pankkituesta, 1993, 9.
64. Aaltonen *et al.*, 1994, 80.
65. The capital requirement was 4% of bank liabilities for commercial banks and 2% for savings and co-operative banks. The new regulations were introduced in the 1990s. (Vihriälä, 1997, 32).
66. This is the net sum without taking account the cost of capital raised and interest inflows. If these items were included, the cost would be FIM 16.8 billion higher.
67. Valtioneuvoston selonteko eduskunnalle pankkituesta 16.11.1999., 22-23.
68. Vihriälä, 1997, 31.
69. In 1993 the responsibilities of the Banking Supervision Office were transferred to the Financial Supervision Authority (FSA) and at the same time more resources were allocated to the supervision. The FSA operates in connection with the Bank of Finland but is an independent decision-making body. The Banking Supervision Office had been under oversight of the Ministry of Finance.
70. Nyberg and Vihriälä, 1994, 26.
71. Nyberg and Vihriälä, 1994, 26.
72. Swoboda, 1986, 27.
73. Major changes to the banking legislation were made in the 1990s.
74. Halme, 1999, 512.
75. Nyberg and Vihriälä, 1994, 11.
76. For example from beginning of 1975 to end of 1984 the average consumer price inflation was over 10%.
77. It should be remembered, however, that forecasts indicated moderating rather than accelerating demand at the time.
78. Nyberg, 1992a, 9.

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France[1]

1. Introduction: Capital and exchange control from World War II to the 1980s

In the immediate post-war period, France maintained a system of relatively strict controls on foreign currency operations, to contend with severe foreign exchange shortages and persistent downward pressure on the franc. After the general return to current account convertibility by Western European countries in 1958, France's restrictions were focused exclusively on capital account operations. While France subscribed to the advantages of liberalisation, capital controls were generally maintained or reimposed with a view to prevent adverse balance-of-payments dynamics which would induce a major worsening of the macroeconomic fundamentals. Following monetary reform and the introduction of the new franc on 1 January 1960, capital controls were gradually relaxed, in line with a strengthening of the balance of payments and rising foreign exchange reserves. An important step in this process was the abolishment in 1962 of the "*devises-titres*" market, through which residents wishing to purchase foreign securities had to acquire the necessary foreign exchange from resident sellers of foreign securities at a market-clearing rate. A law from 31st December 1966 abolished all remaining foreign exchange controls. These measures, which were undertaken in parallel with the introduction of market-based mechanisms in the domestic financial sector, were also motivated by the aim of enhancing the international role of the franc and creating the conditions for Paris to become an international financial centre. While the reform work in the financial sector was carried on, (the so-called Debré reforms, see Box 1), the political disruption and exchange rate turbulence brought by the May 1968 events caused the French authorities to re-establish capital controls in November 1968. In 1969, the devises-titres market was resurrected and later transformed into a more comprehensive dual exchange rate market, which separated the rates applicable to commercial transactions from those at which purely financial transactions were conducted. By the beginning of the 1970's most of the earlier liberalisation had been reversed.

Controls designed to limit excessive inflows were maintained to discourage an appreciation of the French franc in connection with the US dollar crisis in the early 1970's while controls on outflows were tightened in connection with the 1973 first oil crisis, in the expectation of a sharp deterioration in the balance of payments. Generally, the controls aimed to provide more room for an accommodating monetary policy. On the whole, controls on outflows were considered more effective than controls on inflows, as the large administrative control apparatus operating through a strictly regulated and compliant banking system allowed few loopholes, as long as the French franc was not extensively circulating offshore.

In 1979, France joined the EMS, while maintaining its extensive control system. Renewed expansionary policies followed the second oil crisis, and a change in government in 1981 was accompanied by nationalisation of major banks and a general increase of government intervention in the economy. This policy shift caused renewed pressures on the exchange rate, which continued as the growing commercial and current account deficits, and

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Box 1. **The main steps of financial deregulation in France (1948-1997)**

While, from 1945 to 1965, the government maintained an extensive role in the financing of the economy (via administered yields on savings, grants to public financial institutions and selective credit distribution), regulation to gradually increase the role of the market within the financial system was introduced from mid-1960 to 1983. Laws from 1966 and 1967 enlarged the autonomy of banks, allowing them to extend long term credits funded by short-term resources. Barriers to the opening of branches were lifted, giving banks the opportunity to build deposit-collecting networks. A framework for the creation of financial groups* was installed; ensuring cheap and abundant resources for commercial banks through the principle of non-remunerated deposits. Refinancing markets were widened through the creation of the mortgage market. From the first oil shock up to the beginning of the 80's, commercial banks' refinancing possibilities were enhanced through the opportunity to discount medium term credits at the central bank. French banks were gradually allowed to increase their reliance on external markets. In 1980, more than nine tenth of the cash in circulation was invested in commercial banks, confirming the hegemony of the universal bank.

1945-1965: The "Treasury network" (circuit du Trésor)

- Banking system organised under the direct control of the government (nationalisation of 1945).
- Administrative control of savings and credits.
- System of credit quota.
- The financing of the economy was in the hands of the Treasury, itself financed by the central bank through cash advances and commercial banks (through Treasury bonds which they had to subscribe to according to precise rules); banking credit was limited by the existence of discount ceilings.

1966-1983: The supremacy of the universal bank

- Birth of the universal bank throughthe laws of 1966 and 1967 and free creation of branches.
- Creation of capital markets (opening of the money market, creation of the mortgage market, establishment of the "C*ommission des opérations de* Bourse") to ensure the necessary financial resources for banks and the economy and to reform of the compulsory reserve system.
- Permanent quota on credit (1968-1969, 1972-1986) in a system dominated by financial intermediaries.

* The "Banque nationale de Paris (BNP)" was thus created from a merger of the former "Comptoirs nationaux d'escompte de Paris" and "Banque nationale pour le commerce et l'industrie".

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Box 1. **The main steps of financial deregulation in France (1948-1997)** (*cont.*)

- Diversification of deposits to channel savings to banks (creation of housing-savings in 1966 and in 1969).

1983-1997: Liberalisation and the construction of Europe

Liberalisation

- Widening and deregulation of capital markets organised by the government (1982-1985).
- Regulatory harmonisation of credit institutions and banking deregulation (banking law of 1984).
- Removal of credit control(“*encadrement du crédit*”) in favour of a system guided by the leading interest rate of the *Banque de France*;
- Privatisation from 1986 on, in two waves: 1986-1988 and 1993-1995.
- Implementation of a system of prudential control, in part within the framework of the central banks’ co-ordination process (Basel Committee, 1988).

European co-ordination regarding banks

- Gradual phasing out of the compulsory reserves of banks (1991).
- Liberalisation of operations within the European framework (1988-1993).
- Harmonisation of prudential dispositions (1989-1996).
- Enforcement of the directive on investment services in 1996 (transposition in France by the means of the law of modernisation of financial activities).

a rising differential in nominal interest rates with Germany offered speculative opportunities against the French franc (see Figures 1-3). Thus, in 1983, after repeated attacks on the exchange rate and three devaluations of the French franc in 18 months, the authorities decided to counter speculation by further tightening of exchange controls. Measures were introduced to prevent evasion via the use of leads and lags in current account transactions and to prohibit all forward exchange transactions by importers and exporters. In 1983, severe curtailment of foreign travel allowances was also imposed.

At the very beginning of the eighties, the costs of capital controls had become a considerable burden, both in economic and political terms.

From an economic point of view, the capital control regulation entailed significant management costs both for public administration and for the private sector. The smaller the exporting companies, the higher the burden was, especially as large, strategically important firms were frequently exempt from the controls in place. Beyond these additional costs which prevented small- and medium-sized companies to develop exports, tight capital con-

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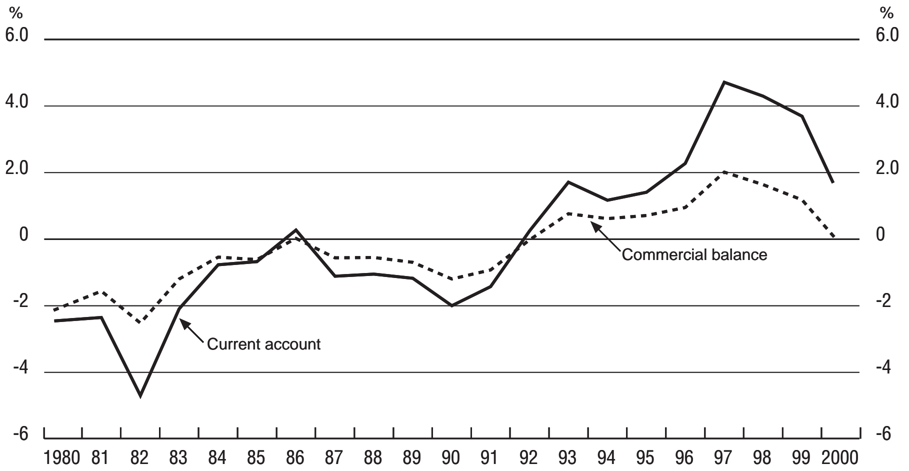
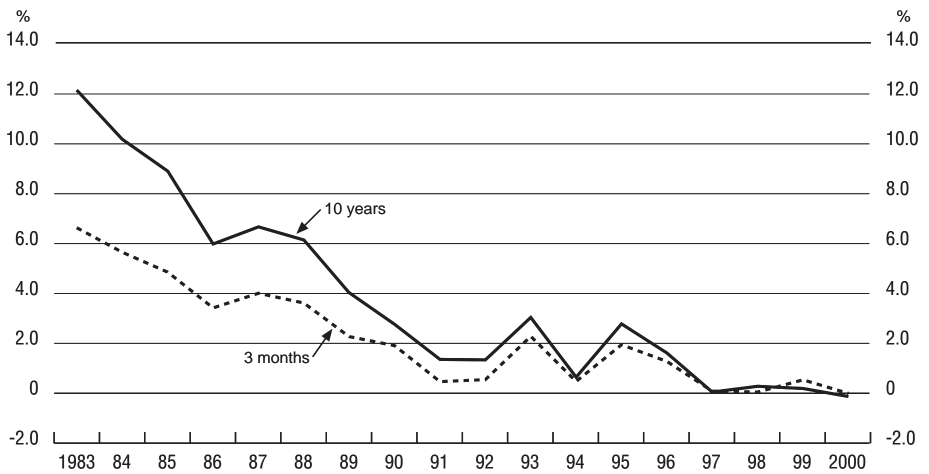
Figure 1. **Commercial balance and current account (% of GDP)**



Source: OECD.

Figure 2. **Interest rate differential France-Germany**



Source: OECD.

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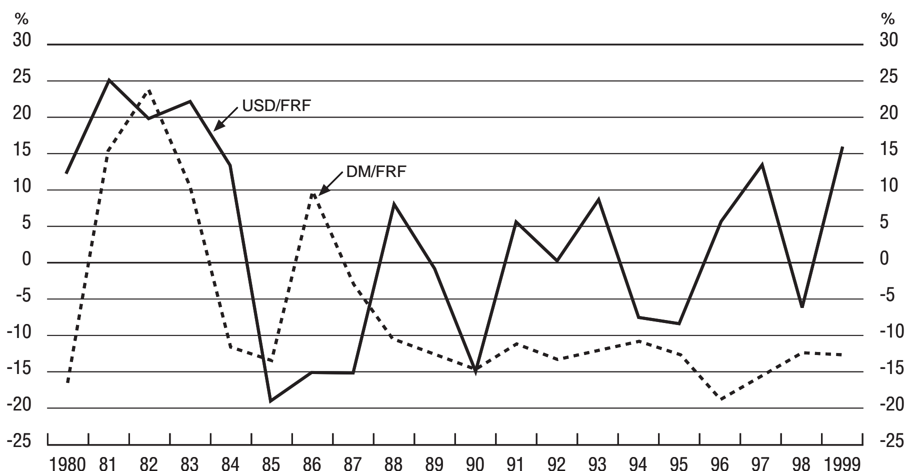
Figure 3. **Movements in exchange rates DM/FRF and USD/FRF**



Source: OECD.

trols were significantly detrimental to internationalisation of French companies. Not only did they limit export growth but they also hampered the take-over of foreign companies.

From a financial point of view, capital controls clearly threatened the role of Paris as a major financial marketplace. In discouraging non-residents from investing in domestic securities, they limited incentives to modernise the functioning of the market at a time where national saving significantly dropped due to a rapid rise in the public deficit.

2. A strategic reorientation leading to renewed external financial liberalisation

A reorientation of France's economic strategy in 1983 led to significant changes in policy implementation both as concerns the pace of financial sector deregulation and reform and the dismantling of the exchange control system.

The liberalisation process which started in 1983, presents two main caracteristics: *i*) a brisk pace of measures, *ii*) a determined and consistent government commitment, in turn influenced by the ongoing construction of Europe and the international trend towards deregulation. The financial liberalisation in France was implemented through several packages of measures:

- deregulation and opening-up of capital markets;
- unification of legislative framework of credit institutions via the banking law of 1984;
- modernisation of the management of the general government debt by creation of Treasury bonds;
- suppression of banking credit control ("*encadrement du crédit*") (in 1987);
- reduction of government intervention in financing (with subsidised loans – "*prêts bonifiés*"– sharply decreasing between 1985 and 1992);

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- beginning of a privatisation program of the largest industrial and banking groups from 1987.

The liberalisation of capital controls was not an easy task. Nevertheless, their phasing out was carefully designed and implemented within the space of only a few years. In order to ensure price and domestic currency stability during the process, the pace of capital control liberalisation had to remain in line with the pace of improvement in macroeconomic fundamentals. In most cases, it meant that, unlike the one-shot removal by France of the foreign exchange control measures undertaken in 1967, liberalisation had to be gradual. But, given the degree of financial sophistication already attained by the market, a gradual approach was difficult to implement For that reason, sequencing and macroeconomic consistency were two key issues in capital control liberalisation.

The removal of foreign exchange controls was precisely sequenced. The first two periods of the process each implied an important leap forward. From 1984 to 1986, the stress was put on the most immediate priority, namely the liberalisation of trade-related operations. From 1986 onward, liberalisation efforts concerned chiefly the financial system. The last step, from 1987 to 1990, was dedicated to the phasing out of remaining foreign exchange controls and the liberalisation of foreign direct investment inflows.

3. The liberalisation of trade-related foreign exchange operations and the evolution towards a market-financed economy (1984-1986)

In 1983, most operations involving financial transactions with non-residents were controlled. Whereas capital account restrictions applying to the financial sector mainly concerned state-owned-banks which operated in a system of very tight credit control, foreign exchange controls were affecting most companies involved in international trade and were especially detrimental to the smallest ones, for whom the administrative work-load and attendant costs were particularly burdensome.

The liberalisation process began with the phasing out of the restrictions measures applicable to French individuals, which were obviously the most sensitive politically, in so far as they were considered to interfere with privacy and individual freedom. As of mid-1983, discretionary private transfers were allowed below a certain ceiling that was gradually increased up to 1986. At the end of 1983, the famous *carnet de change* (foreign exchange voucher) limiting the amount of foreign currency French tourists could acquire was removed. The year after, the free use of credit cards abroad was re-established.

At the same time, decisive measures were taken towards restoring fundamental macroeconomic balance, including price stability. As of 1982 and 1983, wages were progressively de-indexed. This important reform paved the way for a better control of inflationary expectations leading to a sharp and sustained decrease in the inflation rate. Meanwhile, restructuring of French companies was speeded up. The capital base of the largest companies was improved through nationalisations followed by government-led restructuring of the main industrial sectors. The profitability of the French corporate sector improved markedly, reducing their dependency on bank lending.

As of 1985, the launching of the Single Market process[2] provided a further incentive to remove barriers hampering trade. In 1985, currency hedging for ECU-denominated imports was allowed. The same year, restrictions on export credits were lifted. In mid-1986, a decisive step was taken: currency hedging was totally liberalised and some flexibility was introduced in foreign currency cash management. In late 1986, the administrative control of trade transactions was definitely removed.

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The liberalisation of capital transactions presupposed a prior change in the system of financing of the French economy. Financial deregulation took place in France within a couple of years, from 1984 to 1986. During this short period of time, the French economy moved from a situation characterised by a wide range of administrated rates, a relative scarcity of financial instruments and credit regulation known as "*encadrement du crédit*" to a market-based economy. These substantial changes impacted both on the conduct and the efficiency of monetary policy.

The new Banking Act of January 1984 can probably be considered as a cornerstone for these changes. This Act, replacing the 1941 and 1945 legislation, removed remaining divisions between investment and commercial banks. It also introduced a new and uniform set of prudential rules for all financial institutions.

The beginning of the deregulation process, *per se*, may be tracked back to November 1984. At this time the end of the "*encadrement du crédit*" was announced for January 1 1985. This credit rationing system was introduced by French monetary authorities in 1972. It may be compared to similar credit controls systems in many industrial countries (excepting Germany and the United States), such as the "window guidance" in Japan or the pre-1971 credit ceilings and the "corset" in the UK. In such a system, the quantitative control of bank lending was intended to enable the monetary authorities to control monetary aggregates, since, at least in France, capital mobility was limited by restrictions on foreign exchange transactions. In practise however, the conduct of monetary policy turned out to be more complex than expected: the "*encadrement*" was subject to many exemptions for a wide range of subsidised credits, regarding low-cost housing, exports, agriculture or investments. It also added many distortions leading to artificial pressures on interest rates and generating high administrative costs. As a consequence of the demise of direct credit control, the French monetary authorities began to rely exclusively on interest rates and legal reserve requirements for monetary management.

The monetary authorities also reformed the money market, dividing it into two distinct segments. The first one, the "interbank market", was only open to financial institutions and was the segment on which the French central bank operated. The other segment, the "new money market", was open gradually to all economic agents and focused on debt instruments of all maturities from overnight up to seven years. Moreover, banks were allowed to issue certificates of deposit whilst firms were permitted to float commercial paper. At the same time, the purchase of Treasury bills was opened to every one.

The crowning change occurred in late 1986 with the reform of the B*anque de* F*rance*"s money market intervention techniques and the end of the "fixing": the "fixing" meant that every morning, the French central bank announced the price at which it would deal during the day, thereby setting a standard for all transactions. As this practise ended the 1st December 1986, prices started to vary continuously, and different prices started being quoted simultaneously. In line with the reform on money markets, from 1986 onwards, the Banque de France started to intervene more frequently on the market, either through outright transactions or through very-short-term repurchase and withdrawal transactions for fine tuning purposes, without any formal announcement.

Because of all these changes, the French economy, which was exceptionally reliant on banking for finance, as illustrated by the concept of "*économie d'endettement*", became more and more dependent on self-finance and capital markets.

Although it is difficult to assess accurately the impact of all these changes on the transmission mechanism of monetary policy, some econometric research[3] evidenced an improved efficiency: comparing two period, 1987-91 and 1992-96.showing that the response of money market rates and bank lending rates had become both more rapid and larger in the second

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time period than in the late eighties. The same conclusion can be drawn as regards the impact of interest rate changes on the exchange rate since the interest rate rise required to alleviate exchange rate pressure became progressively less important.

The interconnection between foreign exchange controls and structural reforms is quite apparent during this period. France never considered capital controls as a substitute to monetary policy but the restoration of structural conditions conducive to price stability was clearly a prerequisite to relaxing foreign exchange control. In fact, foreign exchange liberalisation measures entailed significant costs for France's currency balance that would have been incompatible with a continuous strain on foreign exchange reserves. Macroeconomic improvements and the positive effect on confidence in France's economic policy, along with the credibility effect resulting from the EMS membership relieved the pressure on the franc and made it possible to go ahead with foreign exchange liberalisation.

4. The liberalisation of most capital account transactions (1986-1987)

Up to the mid-1980's, the financial sector in France remained controlled by the State through a wide range of tools: compulsory reserves of commercial banks held in the central bank's direct credit control, shareholding control by the State of the largest banks and subsidised loans to the industrial and agricultural sectors.

The reform of the banking sector was accelerated by the desire to boost the competitiveness of Paris as a financial marketplace and also, the need for the State to address rapidly increasing borrowing requirements through attracting non-resident savings. These factors lead to a deep reform of the French debt market. A structured monetary market was created with three kind of issuers: the state (with T-bills called B*ons à* T*aux annuel*, BTAN in short and B*ons à taux fixes*, or BTF), the banks (with deposit certificates) and the private companies (with commercial paper called *billets de trésorerie*). The long-term debt segment was also restructured. The sovereign debt market was organised around regular issuance of bonds (*obligations assimilables du* T*résor*), all being fungible in a small number of main lines. For market making, a system very close to that of the primary dealers was adopted with the selection among both French banks and subsidiaries of foreign ones of Spécialistes en valeur du Trésor. Meanwhile, the stock market has been dramatically modernised through dematerialized shares and electronic trading. In February 1986, a Futures market on bonds, the "marché à terme d'instruments financiers (MATIF)" (later denominated "*marché à terme international de* F*rance*") was created. Commissions and fees for financial markets were completely deregulated as well.

These significant changes made it possible to remove progressively some important restrictions on cross-border financial operations. The legal framework applicable to currency – denominated loans abroad was relaxed in 1986. The year after, the raising of franc-denominated loans abroad was allowed.[4] In mid 1986, the "*devise-titre*" mechanism was suppressed, liberalising the purchase by French residents of securities listed on foreign equity markets. French banks were also allowed as from 1986 to lend francs to non-residents.

At the same time, the framework of outward foreign direct investment began to be loosened significantly. Concerning private persons, the acquisition of real estate abroad by French residents was fully liberalised.[5] Concerning corporations, investments abroad were progressively de-controlled from the end of 1985 to April 1986. At that time, only investments in holding corporations were still subject to prior authorisation by the Treasury.[6]

The deregulation of inward foreign direct investment also made significant progress during this period. As of March 1986, the remaining ten million FRF ceiling, above which addi-

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tional acquisitions of French companies by non-residents were subject to administrative authorisation, was removed.

5. Towards total abolition of capital controls (1988-1990)

The remaining restrictions on capital flows were removed between 1988 and 1990. In June, the legal framework applying to exporting companies was simplified. In early 1989, franc-denominated loans to non-residents were allowed again. As of the first June, the control of the aggregate foreign exchange position of commercial banks was abolished and replaced by prudential regulation (see Box 2). At the end of the year, residents were allowed to freely open and keep currency-denominated accounts in France and currency- and franc-denominated accounts abroad as well as to hold monetary gold abroad.

All remaining administrative restrictions regarding foreign direct investment in France were also phased out during this period. In September 1998, the establishment of non-resident owned companies in France was fully liberalised and the creation of new companies by non-residents became entirely free.

In 1990, the legal framework concerning investment by EU-companies in France was considerably simplified.

This liberalisation process did not mean a decline in terms of statistical accuracy of the French balance of payments nor a weakening of the fight against financial crime and money

Box 2. **Prudential regulation in France (1990-2000)**

During the 1990's, the liberalisation of international capital flows was accompanied by a progressive implementation of a prudential framework derived directly from decisions taken at the international level (Basel committee) and at the European level. This framework rests on two complementary principles: *liberalisation* (mentioned in the banking law) and *harmonisation of regulations*. In the first instance, prudential rules are attached to classic banking risks, with norms elaborated for counter-party risks and exchange rate risks inherent in banks' assets and liabilities. Norms based on assets and liabilities of banks' balance sheet have also been set for the limitation of liquidity risks. After the liberalisation of capital movements, the rapid development of market activities of banks and important banking crises, have raised greater concerns about market risks, leading to a double European initiative: *i*) the creation of investment companies by the directive on investment services in order to define and delimit the non banking financial organisations not subject to specific financial regulations and *ii*) to equalise competitive conditions with banks. Finally, due to the growing activity of banks and investment companies, it has become necessary to fix rules limiting the risks taken by these firms, therefore the directive on capital adequacy was promulgated. In comparative terms, the French framework of prudential rules is quite strict as, French financial institutions have to respect specific rules in addition to the European framework.

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laundering. Banks are subject to a monthly compulsory declaration to *the* B*anque de* F*rance*.[7] Specific legal provisions were designed for preventing money laundering. Cash transfers are limited to 50 000 FRF (8 000 EUR). According to an "early advice" system, banks have to alert an administrative unit dedicated to financial crime fighting each time account movements give rise to suspicions of money-laundering activities.

Parallel to the completion of the system of prudential regulation during the 1990's, *the* B*anque de* F*rance* was granted full independence through new statutes voted in 1993.

6. Conclusion: lessons from the French experience

Overall, the French experience in capital control liberalisation can be considered as an indisputable success. First, the process was quickly achieved. From 1984 to 1988, France switched from a high level of protection to a nearly totally deregulated environment. In no more than five years, all controls pertaining to trade balance and current account were phased out.

This process was not detrimental to macroeconomic fundamentals. On the contrary, it was accompanied by a restoration of economic stability. The trade balance improved significantly. The French franc stabilised. In early January 1987, a limited readjustment took place (devaluation of 3 % of the franc *vis-à-vis* the Deutsche mark) for the last time.

The best proof of this consolidation was the good resilience of the Franc to the deep currency crises at the beginning of the 1990's years. Unlike some other European currencies, the franc was never forced out from the EMS, even if its defence against recurrent testing by the markets of the authorities' resolve necessitated repeated use of joint foreign exchange interventions. In fact, the French way of liberalising enabled France to enter EMU as it was created in January 1999 with a conversion rate which kept intact the 1987 value of the franc.

The reasons for this success are diverse and are partly interconnected with non-economic or external factors (*e.g.* political commitment, economic recovery from 1986 onwards etc) but three characteristics of the French approach decisively contributed to success: the liberalisation policy implemented between 1983 and 1990 was *pragmatic*, *integrated* and *flexible*.

- P*ragmatic approach*

Ideology never played any significant role in the liberalisation process, nor had it conditioned the imposition of capital controls. From the beginning, the priority was not to speed up the process at any price but to ensure progressive liberalisation without turning back which would have entailed heavy credibility costs. For that reason, a step by step approach triumphed instead of a more radical one ("big bang"). Great attention was paid to sequencing, to ensure satisfactory results.

- I*ntegrated design*

The process was not exclusively focused on the removing of the capital controls. The architects of the process shared the conviction that each step in capital control liberalisation should proceed hand in hand with macroeconomic stabilisation and structural reforms because these two last points were crucial to strengthen the economy and then ensure the sustainability of the reforms.

- F*lexible implementation*

Flexibility in design made it possible to speed up the process of liberalisation as and when the economic situation allowed. As a result, the whole liberalisation process was completed in 1990 six months ahead of schedule.

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Notes

1. This case study is based on a document jointly prepared by the Ministère des Finances et de l'Industrie and the Banque de France.
2. The European Commission published a white book on the achievement of the inner market which decided France and Germany at the Milano Council, on 28th-29th June 1985, to call for a inter-government conference embracing both this theme and institutional matters.
3. *Cf.* Christian PFISTER and Thierry GRUNSPAN (1999): "Some implications of bank restructuring for French monetary policy", BIS conference papers, Vol. 7, The monetary and regulatory implications of changes in the banking industry, March.
4. With an initial 50 millions FRF ceiling which was abolished as of first June 1988.
5. It was previously subject to an authorisation proceeding managed by the Banque de France.
6. Excepting investment flows towards the South African Republic which remained prohibited for political reasons.
7. However, companies whom international trade in goods exceeds one billion FRF (EUR 15.25 million) directly declare their flows to the Banque de France.

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Portugal[1]

1. Introduction

Portugal's successful experience with international economic co-operation, beginning with its entry as an original member in 1961 to the Organisation for European Economic Cooperation, the European Payments Union and the consequent acceptance of the obligations of the OECD Codes of Liberalisation of Capital Movements and Invisible Operations has been largely ignored. On the other hand, acknowledgment of the success of the accession to the European Community in 1986 and to the euro area in 1998 is widespread.

This view of Portugal as a "good student" of European integration is reflected in the 1999 OECD *Economic Survey* and in academic publications (*e.g.* Brito, 2002 and Royo, 2002). After acknowledging that financial performance indicators had converged or even surpassed OECD averages, the *Survey* explains the success by "a reform process, which, pushed to a large extent by European Community membership, involved a careful and gradual sequencing of steps, accompanied by prudent macroeconomic management (p. 63)". As the experience with the OECD Codes of Liberalisation shows, this is also an example of the role "peer pressure" plays on national policy making.[2]

During the 1960s, first due to membership in the European Free Trade Association, then to the association with the European Community, the Portuguese economy became open to international trade in goods, services and labour. Signing on to the OECD liberalisation codes also helped attract foreign investment, even though the political regime remained as suspicious of financial freedom as it was of political freedom. Accordingly, commercial banks – most of which were part of industrial-financial conglomerates – were closely regulated by the government.

Shortly after the first oil shock, though, economy and society were subject to a series of shocks of a magnitude that must have seemed unusual in the OECD. Some of these shocks were macroeconomic in nature, leading to inflation and balance of payments problems, but the root causes involved an attempted change in the economic system based on private enterprise. From 1975 to 1996, in fact, the bulk of Portugal's banking sector went from private to state ownership and then back again. The privatisation of the banking sector (affecting about two-thirds of financial activity, by deposits or loans) was part of the general liberalisation of the economy and the financial system that took place after 1987.

For about a decade after the nationalisation of all domestic banks in 1975, financial markets in Portugal were very narrow, with credit ceilings and exchange controls. There were virtually no financial institutions other than state-owned banks and most of these were saddled with large volumes of non-performing loans, overstaffing, and unmet pension fund liabilities. Meanwhile, the central bank took over the role of supervising banking activity.

As economic liberalisation policies were pursued, significant real and nominal convergence was achieved. State-owned banks were privatised and new institutions permitted to

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operate, exchange controls were dismantled, and the Treasury returned to international markets for funding. The *escudo* joined the Exchange Rate Mechanism (ERM) of the European Monetary System as a precursor to being a founding member of the Euro. Legislation was passed in agreement with the single market in financial services and the central bank was made independent of the government in the conduct of monetary policy.

As a consequence of the liberalisation process, by 1996 financial markets had broadened and deepened significantly. Corporate access to international financial markets increased markedly, intermediation margins were significantly reduced and consumers began to benefit from financial services of a variety and price comparable to those in other developed financial markets, even well before the introduction of the single currency.

Following a short description of the economic antecedents to the liberalisation process (section 2), section 3 describes the convergence strategy, which had a structural aspect (the privatisation of state-owned banks, reviewed in section 4) as well as the implementation of appropriate monetary and exchange rate policies, the subject of section 5. Section 6 discusses the link between financial liberalisation and convergence, highlighting the need for sustained effort at completing the programme of reforms throughout the economy. Section 7 presents some conclusions.

2. Background – revolution, nationalisations and liberalisation

In 1974, a revolution led by the military restored political freedom but attempted to introduce a new economic order influenced by philosophies of state centralism. The military proceeded to nationalise most of the largest firms, including privately owned banks. After the initial excesses, the democratic process gradually steered a more moderate course, particularly after 1985. New, private, banks were authorised and, in 1989, the requisite two-thirds Parliamentary majority was obtained to change the national Constitution so as to permit the State to relinquish majority ownership in "strategic" sectors, including banking. Over the next 8 years, the previously private banks were privatised again and, towards the end of the process, even a previously state-owned bank was privatised.

Before the revolution, the Portuguese government owned just a handful of firms, including a major bank, CGD (Caixa Geral de Depósitos), created in 1876 and with an enterprise status since 1969. In the aftermath of the April 1974 revolution, all banking institutions owned by Portuguese nationals were nationalised in March 1975. The new Constitution finalised in 1976 declared the nationalisations "irreversible" and included banking and insurance as activities reserved for the public sector. Gradually, however, the revolutionary extremism began to fade and in 1983 private sector activity was again permitted in banking. Further changes in 1987-88 permitted the sale of minority portions of public enterprises and in 1989 full-scale privatisations became legally possible and the privatisation process got under way. By 1996 all of the public sector banks were privatised, except for the CGD group (CGD and BNU – Banco Nacional Ultramarino), which remains state-owned.

Before the financial liberalisation process got under way, the Portuguese banking market was described as one of the most regulated Western markets. All banks but three small foreign-owned institutions were owned by the Government, which accounted for more than 95% of the market with just 11 individual institutions. Banks were subject to quantitative credit ceilings, as well as minimum and maximum rates.

The abatement of revolutionary fervour in the economy was significantly assisted by the recognition in the late 1970's that Portugal's membership of the European Community could be an important factor in accelerating the country's economic development and in consoli-

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dating its democracy. Portugal's accession coincided with the momentum to build the single market, and 1986 saw the introduction of a program of rapid economic and financial liberalisation, culminating in capital account convertibility of the escudo and a Banking Law (Decree Law No. 298/92 of 31 December), which introduced the single market in financial services.

Quoting again from the 1999 *Survey* (p.95): "The collective experience of OECD countries has shown that deregulation has led to increased competition in the financial services industry. Competition, in turn has helped raise efficiency of financial intermediation by spurring reductions in both financial margins and operating costs. Furthermore, removal of regulatory restrictions has given financial firms more freedom to adopt the most efficient practices available and to develop new products and services. This has also been the case in Portugal, where reforms have had significant effects on the efficiency of financial intermediation, the deepening and the internationalisation of markets, the structure of the financial sector and the soundness and profitability of the system. Moreover, by enhancing the conduct of monetary policy, they have contributed to improved macroeconomic performance and to a successful transition to EMU."

"In spite of its positive effects on the efficiency of financial intermediation, financial market liberalisation has led to significant micro and macroeconomic problems in some OECD countries. A prominent feature of the post-liberalisation period has been the emergence of a number of cases of failure of institutions in the financial sector; with significant costs to the economy as a whole and to the public treasury in particular. In most cases, this derived from the failure of macroeconomic policy to counteract the explosive expansion of credit and of supervision authorities to prevent the increase in risk-taking by banks. The boom-bust cycle associated with the deterioration of credit quality and bank failures that followed financial market liberalisation in many OECD countries did not occur in Portugal."

3. Sustained regime change towards convergence

Portugal's financial liberalisation process was part of a strategy of convergence towards Community standards, in effect a sustained regime change. At the core of the regime change was a sequence of adjustment programmes, beginning with a "programme to Correct External Imbalances and Unemployment", approved in March 1987. It was reasonably successful in ensuring real convergence, the elimination of the balance of payments deficits and sustained employment creation.

In July 1989, the government revised the programme, basing fiscal adjustment on the newly reformed tax system. The adjustment strategy was gradual and the public sector remained essentially frozen until 1990. A policy of expected depreciation through a pre-announced crawling peg had been in place since 1977 and, in a weaker form, since EC accession. Were the *escudo* to stabilise, a greater degree of monetary and fiscal restraint would be required than what was envisaged. The solution adopted was an exchange arrangement of shadowing the ERM. The change was anticipated as part of the "National Adjustment Framework for the Transition to Economic and Monetary Union (EMU)", approved in June 1990.

The commitment to EMU featured prominently in the Convergence Programme for 1992-95, submitted in November 1991 to the European Commission and then approved by the ECOFIN Council. Fiscal, structural and incomes policies were set in a macroeconomic framework consistent with a single European currency to which the *escudo* would be credibly pegged. While the domestic repercussions of the 1991-92 international recession meant that the budget deficit reduction envisaged in the Convergence Programme did not materialise, the pegging of the *escudo* permitted the acceleration of the financial liberalisation process. It

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also contributed strongly to meeting the nominal convergence objective and ensured that the *escudo* became a founding member of the Euro.

In terms of outcomes, the convergence strategy was largely successful. From the early 1990s, when the inflation rates in Portugal were above 10, a dramatic process of deceleration of inflation was already under way, having come down from 25-30 % 4-5 years earlier. By 1997 catching up with Europe had already taken place in terms of price differentials. In terms of real convergence, that is real GDP growth differentials between Portugal and the EU, again the story is one of convergence or general catching up of between 0.5 and 1.5 percentage points on average per annum except for 1993 and 1994, which were years immediately after the international recession. After those two years real convergence resumed.

4. The bank privatisation process

4.1. *Preliminary issues: de novo private banks alongside state-owned banks*

At an initial stage, new private banks were allowed to enter the market in 1984, competing with the state-owned banks, the latter dominating the market. In this phase, while the bulk of market conditions was still tightly regulated (interest rates,[3] administrative restrictions to branching, credit ceilings, capital controls), new budgetary and public sector financing rules left interest rates on Government debt to be determined by market forces. In this context, the burden banks suffered on their large public debt portfolios issued at below-market rates throughout most of the 1980's began to fade away. In addition, credit limits ended in 1991, at a significantly later stage of the liberalisation process. This fact, limiting strongly the competitive forces, allowed, on one hand, the recovery of state-owned banks profitability, and on the other hand, the growth and the accumulation of experience by the new private banks, before full and effective liberalisation of competitive conditions. The privatisation of banks occurred only after that period, during which it was possible for state-owned banks to rebuild their capital base.

4.2. *Economic dimension*

The privatisation process (covering not only banks but all privatised firms) reduced the role of state enterprises in the economy by roughly one-half between 1988 and 1995 (Rosenblum 1999). State enterprises accounted for roughly 20% of GDP and 6.5% of employment in 1989; by 1995 they accounted for an estimated 10.5% of GDP and 3% of employment. During this period, the bulk of privatisations were in the financial sector, with banks accounting for 48% and insurance firms 12% of total privatisation revenues between 1989 and 1995. In relative terms (privatisation revenues as a percentage of GDP) Portugal ranked third among OECD Members during this period, after New Zealand and the United Kingdom. Between 1989 and 1995, privatisation revenues were equivalent to 17% of end-1995 public debt, which in turn corresponded to 12% of 1995 GDP.

4.3. *Strategy*

In the early stages, the privatisation process was, to some extent, demand-driven. The return of some of the family groups that had been important in the pre-revolution economy was facilitated by a strategy which first privatised lower-priced financial firms (usually insurance companies) and only later the banks. Since acquisition of the former was generally less onerous in terms of the amounts involved, their control could be assured more easily and the

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acquired firm was then instrumental in leveraging the family's bid to acquire the more expensive banks.

In general, the strategy was not explicitly acknowledged nor was it part of official policy; the purchases generally took place in competitive bidding processes. However, it fitted in well with the objective of giving domestic entrepreneurial capability with international connections a stake in the convergence strategy.

All in all, privatisations took place gradually in a way that led to the regaining of control of state-owned banks by either the former owners before the 1974 revolution or the new private banks started up after 1985. At the end of the process, when most banks were privatised, the major banks maintained stable management.

4.4. *Local vs. foreign ownership*

One of the issues that arose in the process had to do with foreign participation in the privatisation process. In the design of the process, a core concern was the maintenance of enterprise ownership and management in the hands of Portuguese economic agents. Law 84/88 placed a limit of 5% on foreign acquisitions of privatised firms – a ceiling restated under the new rules defined by Law 11/90 and increased to 25% of capital in 1994. One reason for these limits was that the privilege now being given to Portuguese investors in some sense compensated for the fact that the 1975 nationalisations had spared foreign banks.

The argument was that limitations on foreign capital amounted to an unavoidable cost incurred in order to prevent some political sectors, and lobbyists, from blocking the privatisation process. Banco Totta and Açores, where a Spanish bank used a chain of firms with nominal Portuguese majority to secure effective control of capital, became a test case for the conflict between European rules and privatisation rules, because the government's Privatisation Committee proposed the acceptance of the surplus foreign capital, but blocking its voting rights, instead of cancelling the share registration. The case was eventually solved through the acquisition of the Spanish shares by another Portuguese bank, with government cover.

Despite the limitations on direct foreign participation in the privatisation process, foreign banks contributed significantly to the modernisation of the Portuguese banking system, namely in the provision of know-how.

4.5. *Effects on efficiency and competition*

4.5.1. *Bank operation*

Privatised banks began to operate more efficiently post privatisation, both relative to their own previous performance and relative to their non-privatised peers. This is the case measuring the effect of privatisation on each bank's performance, in terms of efficiency (evolution of assets per worker) and dynamism (growth of branch network). Indicators of efficiency and dynamism were calculated for each bank being privatised, then measured against the average for all public banks for the three years before and after privatisation. This approach made it possible to distinguish between changes due to privatisation and to the liberalisation process and to take into account the fact that different banks were privatised in different stages and in different years. When the two periods were compared, various measures of efficiency show the privatised banks outperforming their public sector peers. In terms of dynamism, privatised banks reduced their staff more rapidly than their public sector peers while at the same time expanding their branch networks more aggressively.

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According to Pinho (1999), a study relying on the estimation of econometric stochastic frontiers for cost and profit functions, using data for 1988-1997, Portuguese banks, in particular those who were privatised, posted a significant improvement in resource allocation and productive efficiency.

4.5.2. T*he stock market*

Another powerful effect of banking reform involved the stock market. This is noted in an analysis carried out at the Bank for International Settlements in 1996 of changing financial systems in small open economies. There, after noting the underdevelopment of the Portuguese capital market when the stock market was closed in 1974, the opening to private banking in 1984 is seen as the first step of reform, even though the stock market reopened in 1976. Again, between 1985 and 1988, a series of institutional reforms (tax incentives, a regulatory body and the adaptation of listing requirements to Community rules) were carried out. Yet "it was only in 1991, when the capital market Code was enacted, that major changes were implemented in the legal, institutional and operating framework of the Portuguese securities market." (p.112.)

4.5.3. R*emaining challenges*

Quoting again the 1999 S*urvey* (p. 105), "As regards capital, most barriers to adjustment have been eliminated within the EU with the liberalisation of capital movements and entry regulations. Some barriers indirectly affecting the adjustment remain however, including some co-operative arrangements between banks, which in practice may represent a barrier to entry. In the case of Portugal, these arrangements do not at present seem to raise serious competition concerns. On the other hand, competition authorities should establish mechanisms for guaranteeing access by eliminating regulatory constraints and other private arrangements that may limit competition, especially those that prevent the take-over mechanism from working. For instance, a significant barrier to entry into the Portuguese banking system has derived from domestic banks' recent actions to prevent hostile take-overs by changing internal statutes governing the distribution of voting power among shareholders – a measure that seems to be in large part directed at foreign institutions."

5. Monetary and exchange rate policies

As mentioned above, direct credit limits ceased to operate in 1991 and the new regime of indirect monetary control was initiated with tight monetary conditions, characterised by high nominal and real interest rates. That allowed, with recourse to market instruments, the containment of credit growth within prudent levels. Besides, it is worth mentioning that the transition to indirect monetary control based on market mechanisms was preceded by the fostering of both short and long term public debt markets and the liberalisation of most banking lending interest rates. Still in 1991,a convergence program was presented, but the decision to request entry of the *escudo* in the ERM was a genuine surprise nonetheless. On 4 April, 1992 – the weekend following the approval in parliament of the 1992 budget – the Community responded to the government's application to join the ERM at a proposed rate of 180 *escudos* to the ECU. After the assessment by the Monetary Committee, a notional central rate of 178,735 gathered consensus.

In the turbulence that followed ERM entry, the lack of external credit familiarity with Portugal had to be overcome. As soon as the currency was fully convertible, therefore, a strategy of making the Treasury known in international markets was designed, which involved a

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planned return to international borrowing, successively in yen, marks and dollars. International investors were ready to believe that economic policy in Portugal would retain a medium term orientation.

The ERM crises were felt by the *lira* and sterling, which left the grid on 17 September 1992 when the *peseta* also realigned but the *escudo* did not. In financial circles, the opinion was to stick to the parity with the Deutschmark. Against this, Portuguese exporters were sensitive to the bilateral rate with the *peseta* and had been pressing for a devaluation of the *escudo* relative to the *peseta*. As it turned out, the peseta devaluation rate of 23 November was matched by the escudo and those on 14 May 1993 and 6 March 1995 were followed in part, without the loss in financial reputation usually associated with initiating a realignment. This is confirmed by quarterly data on capital flows reported in the 1997 European Commission report on Portugal, by the pattern of weekly variations in the bilateral exchange rate against the Deutschmark and by available intervention data.

In the second half of 1992 economic activity experienced a pronounced slowdown, coincident with the ERM crisis (September 1992). That conjuncture was not favourable to investment and consumption of the private non-financial sectors, which, in fact, did not exhibit significant debt growth. In particular, credit growth to non-financial corporations halted during the recession and remained subdued for a relatively long period afterwards. In this period, banks resorted to households as a new strategic target market, still relatively unexplored and posting a low indebtedness level.

Meanwhile, it is important to recall that the external front was fully liberalised only at end-1992, with the lifting of the remaining limits to cross-border financial flows and the entrance into force of the Second banking Directive. This was almost coincident in time with the ERM crisis in 1992, which, in some sense, worked as a vivid example of the risks banks could incur when involved in international activities and possibly playing a role in contributing to banks' prudent behaviour subsequently.

Quoting again the 1999 *Survey*, the success of financial sector reform in Portugal was in part a result of the macroeconomic context at the time these reforms were carried out (p.95). "The end of the second phase of reforms, when most liberalisation measures took place, coincided with the ERM crisis of 1992, an escudo devaluation and a steep recession in Portugal. As a result, the incipient boom in private credit was quickly reversed. Also playing a significant role in preventing a boom-bust cycle were the prudent macroeconomic policies pursued throughout the 1990s, in particular monetary policy. On two occasions, financial market reform measures led to the release of 'structural' excess liquidity, which was promptly 'mopped up' by the issuance of public-debt securities, worth approximately 12% of GDP each time. In 1991, this was related to the move to indirect monetary control and in 1994, to the reduction in reserve requirements. These operations were crucial in controlling the growth of broader monetary aggregates, reducing credit growth and preventing a sharp drop in saving ratios, occurrences that preceded the onset of financial crises in many countries."

With the benefit of hindsight, the lengthy discussion preceding *escudo* entry into the ERM showed the precarious position of the parity grid, which was going to imply the departure of the lira and of sterling a few months later. It also suggests that, had the decision been delayed, the *escudo* might have been unable to join the ERM in time to meet the EMU criterion of two years' membership. It would have trailed with the Greek drachma outside the parity grid, rather than accompanying the *peseta* inside.

A Revised Convergence Program was approved with the 1994 budget, which kept the nominal ceiling on non-interest expenditures but adjusted the deficit for the revenue shortfall. This was well accepted by international investors who heavily oversubscribed a global

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bond issue of one billion dollars in September. In early 1994, a global bond issue in ECU was received with the same success. Another reflection of the continuity of the convergence strategy is that the expenditure ceiling was extended into 1997, in spite of the change in government in late 1995.

In any event, the central rate the *escudo* kept after the last realignment of the ERM in March 1995, around 196, would have been difficult to reach without the benefit of the ERM code of conduct, which transformed an agreement between central banks into a powerful convergence instrument. The ERM code of conduct also implied financial reputation for countries, such as Portugal, with recent experiences of high inflation.

The 1994 Revised Convergence remained the basis for the excessive deficit procedures until a Convergence, Stability and Growth Program from 1998 to 2000 was approved by the ECOFIN in May 1997. It was followed by a Stability and Growth Program for 1999-2001 shortly after the *escudo* joined the euro at a rate of 200.482.

The various documents continued listing structural reforms, especially in the public administration, but unfortunately dropped the nominal ceiling on non-interest expenditures. As a consequence, there was a surge in non-interest expenditure during the period 1999-2001, placing Portugal's primary expenditure/GDP at a level some 4 percentage points above the EU average.

6. Financial liberalisation and convergence

The real and nominal effective exchange rates against 23 industrial countries produced by the EC stabilised after the widening of the ERM bands in August 1993. As mentioned above, the rules of the ERM allowed the escudo to realign following the peseta without loss of financial reputation, or with a smaller loss than would otherwise have been the case. Nominal relative factor rewards reflected relative productivities together with the succession of exchange rate arrangements. Thus, wage increases and long-term interest rates converged to the European average.

Portugal was perhaps in a unique position in that it was able to meet the convergence criteria with minimal fiscal adjustment. The significant decline (of some ten percentage points) in inflation rates – and interest rates – in the early 1990's gave the budget a "free ride" equivalent to about five percentage points of GDP in the late 1990's. In this sense, nominal convergence brings with it the risk of giving a temporary illusion of fiscal discipline.

In addition to fiscal affairs, the pace of structural reforms has remained slow in what pertains to both the enlarged public sector (justice, home affairs, social welfare, education and others areas of public administration) and the discretionary regulation of private enterprise.

7. Conclusions

As is pointed out in the Summary and Conclusions of the Main Report, economic reforms must be completed throughout the economy – half liberalised systems can give rise to severe imbalances, which may be extremely costly to address from an economic, financial and social standpoint. Portugal's experience is a case in point, showing that if fiscal policies are not sound, then the benefits of currency stability do not materialise even under favourable international and domestic conditions.

A further lesson from the Portuguese experience has to do with the timing of financial liberalisation. When compared with other experiences, Portugal's financial liberalisation was remarkably problem-free. No banks failed and there was no sudden surge in careless lend-

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ing. The major difference between Portugal's liberalisation and that of certain other OECD countries was that Portugal's took effect in an economic downturn, when banks were in a cautious mood, concentrating on recovering outstanding debt rather than actively exploring new lending opportunities. By contrast, in the Nordic countries which liberalised their banking systems in an economic boom, banks rapidly overstretched their limits of prudent lending. The lesson is that the authorities should not wait for a "favourable" economic climate of strong growth to liberalise.

In conclusion, for Portugal the role peer pressure can play in improving national policy making was first evident through adherence to the OECD Codes of Liberalisation and certainly did not disappear with the country's accession to the euro area and the success of nominal convergence. Peer pressure will continue to promote genuine structural reforms, as it did in the financial markets.

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Notes

1. This paper has been prepared in consultation with the OECD Secretariat and Banco de Portugal, who provided funding for part of the underlying research.
2. As an example, new legislation adopted in 1985, inspired by the OECD Capital Movements Code as well as legislation in several peer member countries removed a number of restrictions on capital account operations and enabled Portugal to withdraw the corresponding reservations to the Code.
3. The liberalisation of bank interest rates was gradual and was initiated in 1984, in what concerns deposit rates and in 1985, for lending rates. Interest rates on some classes of operations were still subject to restrictions after those dates and were progressively liberalised up to 1989, in the case of lending rates, and 1992, in the case of deposit rates.

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OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(20 2002 13 1 P) ISBN 92-64-17612-8 – No. 52563 2002