Capital Account Liberalization: Experience from the Emerging Market Economies

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I. Introduction

The liberalization of the capital account of the balance of payments is rooted in economic theory. Not only can it help to bridge savings and foreign exchange gaps in national economies, and hence promote higher economic growth, it can also lead to greater efficient allocation of resources internationally and greater portfolio risk diversification, among others (Obadan, 2005). Perhaps, in the light of this, and against the background of developed financial markets, the industrial countries set the pace in capital account liberalization in the 1970s following the collapse of the Bretton Woods fixed exchange rate system. The liberalization was further accelerated in the 1980s. But, perhaps, because of underdeveloped domestic financial markets and less favourable environments, many developing countries commenced moves from the mid-1980s to liberalize their capital accounts with promptings from the Bretton Woods institutions, namely the IMF, and the World Bank. Indeed, it was not until the 1990s, in the context of various structural adjustment programmes inspired by the Bretton Wood institutions that many developing countries stepped up capital account liberalization (CAL). Actually, the IMF initiated moves in the mid 1990s to amend its articles to incorporate capital account convertibility/ liberalization as part of its mandate. But then, until, perhaps, recently the downside of capital account liberalization had not been adequately acknowledged. And a good number of the developing countries went through financial liberalization without taking precautionary measures or meeting the pre-conditions in order to minimize risks and obtain desirable outcomes. With the crises and associated problems that have tended

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to accompany CAL, the opening of capital account has been a subject of intense debate with an emerging consensus on the need to manage the risks posed by rapid and large flows of short-term capital in a very liberalized environment.

In the light of the foregoing, this paper explores the experiences of the developing countries, in particular, the emerging market economies, in capital account liberalization. To this end, the paper is divided into five sections. To provide the necessary background, section 2 which follows, reviews and clarifies some issues. This is followed by section 3 which overviews capital account liberalization in developing / emerging market economies. Section 4 discusses some individual countries' experiences at liberalization. The last section concludes the paper by drawing attention to some lessons and pre-conditions for orderly and successful liberalization outcomes.

II. Conceptual Clarification

Emerging Market Economy

Antoine W. van Agtmael of the World Bank Group, in 1981, defined an emerging, or developing market economy (EME) as an economy with low-to-middle per capita income (Heakel, 2003). In practice, relatively big and small economies have fallen into the emerging market categorization because of their developments and reforms. EMEs are considered to be fast growing economies and characterized as transitional. The latter means that they are in the process of moving from a closed to an open market economy while building accountability within the system. The economic reform programme embarked upon by an EME is expected to lead it to stronger and more responsible economic performance levels, as well as engender transparency and efficiency in the capital market. Apart from implementing reforms, an EME is most likely receiving aid and guidance from larger donor countries and/or international financial institutions such as the World Bank and IMF. Besides, an EME tends to experience an increase in both local and foreign investment. Emerging market investments entail bigger risks and bigger rewards, thus providing an opportunity for investors to diversify while adding risk. Among the notable EMEs are China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, Argentina, Brazil, Chile, Colombia, Mexico, Venezuela, Egypt, Israel, South Africa, Turkey, Hungary, Poland and Russia.

Concept of Capital Account Liberalization

The capital account is the second broad component of the balance of payments. It records both the borrowing and lending of the residents of a country. Thus, items in the account are essentially transactions in financial assets which directly affect wealth and debt and hence national income in future periods. Capital account liberalization (CAL) refers to freedom from prohibitions on transactions on the capital and financial accounts of the balance of payments (Eichengreen and Mussa, 1998). It entails lifting restrictions on foreign capital inflows and outflows. According to Stiglitz (2003: 65), capital account liberalization has also meant eliminating the rules and regulations in developing countries that could stem the flows of speculative and volatile hot money - short-term loans and contracts that are usually no more than bets on exchange rate movements - into and out of countries. Correspondingly, a liberalized or open capital market is one in which individuals and firms can access international financial markets freely.

An open capital account implies capital account convertibility which refers to the freedom to convert local financial assets into foreign financial assets, and vice versa, at market determined exchange rates. In other words, it means the removal of foreign exchange controls. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by the rest of the world (Schneider, 2000: 6). However, capital account convertibility does not necessarily imply removal of tax-like instruments imposed on the underlying transactions which need not be viewed as incompatible with the desired goal of capital account liberalisation (Eichengreen, 1998). An open capital account also implies currency convertibility. A country is said to have achieved full currency convertibility of its currency when residents and non-residents are allowed to convert the local currency, at prevailing exchange rates, into foreign currencies and to use the latter freely for international transactions (Nsouli and Rached, 1998; Obadan, 2005: 5).

Strategies for Opening the Capital Account

There have been debates among economists on the approaches to capital account liberalization in terms of the pace and sequencing of liberalization. In this direction, two broad approaches stand out, namely, the 'big bang' approach and the gradualist approach. The gradualist approach entails a more deliberate and phased strategy to economic reform that emphasizes reforms in the capital account. Under this approach, the phasing of liberalization may be based on distinctions between residents and non-residents as was done in India and South Africa. India liberalized current transactions and related controls on non-residents and effected some relaxations on FDI by corporates. Similarly, South Africa followed the sequence of abolishing controls on current transactions; abolition of exchange controls on non-resident investment by domestic corporates, etc. The gradualist approach also entails the liberalization of inflows before outflows. In the liberalization process, uses were made of both prudential limits in the form of quantity controls and price controls. The management of the open capital account by the use of price instruments and prudential limits was for the purpose of transforming the maturity structure of capital flows and insulating the impact of large and volatile flows on monetary and exchange rate policy. The experiences of Chile, Colombia and Malaysia are illustrative of this approach. In general, the gradualist approach takes cognizance of the need to prevent instabilities generated by financial liberalization before adequate institutional safeguards are put in place and hence stresses the wisdom in moving reforms in the real sector, improved financial regulation and current account liberalization before finally liberalizing the capital account.

The 'big bang' approach entails a more rapid transition to open capital account, in some cases involving a one-step process in simultaneously liberalizing controls on capital inflows and outflows. The argument is that since resources are lost through obstacles to free capital flows (as with any protectionist policy), the sooner it is liberalized the better. A number of countries have moved to open capital accounts in a one-step process. Among them are Hong Kong, Costa Rica, Jamaica, Kyrgyz Republic, Mauritius, Uganda, Singapore, Trinidad and Tobago and Venezuela.

On the question of whether or not it is sensible to liberalize gradually or adopt a big bang approach, a consensus seems to have emerged. According to the report of a conference on "Capital account liberalization: A Developing Country Perspective", 2000, "given the potential benefits and costs of capital account liberalization and the fact that the poorly developed institutional structure (primarily in the financial system) of developing countries heightens the risk of crisis, the balance of evidence suggests that countries should adopt a gradual movement towards CAL within a broad reform effort".

Capital Account Liberalization and Crisis

The classic case for international capital account liberalization is that flows from capital abundant to capital-scarce countries raise welfare in the sending and receiving countries alike on the assumption that the marginal product of capital is higher in the latter than the former. Indeed, in autarky, the rate of return in the domestic market is assumed to exceed the rate in the rest of the world. And once the capital account is opened up, this differential generates a capital inflow and a larger capital stock in the home country. In the final equilibrium, GDP is higher because of the large capital stock. Domestic labourers gain at the expense of both domestic and foreign owners of capital, so also GNP is higher (Hanson, 1992: 2). Thus, CAL achieves an efficient allocation of world savings as capital scarce countries (with a correspondingly high marginal product of capital) can borrow from the rest of the world. The capital movements from rich to poor countries accelerate domestic accumulation and convergence (Gourinchas and Jeane, 2002: 5). Besides, CAL, it is argued, does not result only in enhanced growth and efficiency, but also creates opportunities for risk sharing and portfolio diversification, intertemporal consumption smoothing and trade, technology transfer and spillovers, among others (Eichengreen, et al, 1998: 12; Obadan, 2005).

However, the advertised benefits of capital account liberalization are dependent on certain pre-conditions and accompanying factors, in the absence of which the elimination of controls on capital account may lead to macroeconomic instability and unstable financial markets. Indeed, in a significant number of countries, both domestic financial and external account liberalization have been associated with costly financial crises. As Eichengreen and Mussa (1998) have argued, although this association may somehow be deceptive, given that financial crises are complex events with multiple causes, there have been enough cases where financial liberalization, including CAL, has played a significant role in crises. International capital flows which result from capital account liberalization have tended to precipitate a crisis where capital flows out of a country suddenly. Although financial problems can result from the mismanagement of virtually any financial transaction, short term capital has tended to pose special problems for the maintenance of financial stability. In recent years, a large proportion of the increased international financial flows consist of liquid short-term capital attracted by arbitrage margins and prospects of speculative capital gain, rather than by long-term yields on productive investment. They are extremely volatile and subject to bandwagon effects, capable of generating gyrations in security prices, exchange rates, and trade balances. They make little contribution to the international allocation of savings or diffusion of technology and hence to a reduction in international disparities in per capita income (UNCTAD, 1997:94).

Capital account liberalization heightens the risk of crisis and amplifies the effects of policy distortions through a number of channels. First, is the inflow and outflow of short-term liquid and speculative capital as described above. Second, by allowing the entry of foreign banks, CAL, like domestic financial liberalization, can squeeze margins and remove domestic banks' cushion against loan losses. Third, like domestic financial liberalisation, it can facilitate gambling for redemption, in this case by offering access to elastically supplied offshore funding and by allowing access to risky foreign investment[1]. Fourth, a currency crisis or unexpected devaluation can undermine the

[1] *Gambling for redemption refers to the pursuit of high-return but low probability investments by institutions with low or negative net worth*

solvency of banks and bank customers who have been allowed to accumulate large un-hedged foreign exposures by open capital accounts and lax regulations. Crisis can also be triggered by such factors as herd behaviour and bandwagon effects and contagion. Through the above channels, asymmetric information and policy distortions can give rise to crises with special force when the financial system has been liberalized.

A number of crisis episodes have occurred in the last two and half decades, the most notable ones being the Southern cone currency and banking crises of the early 1980s, the 1992 Exchange Rate Mechanism (ERM) crisis in Western Europe, the Mexican crisis and its spill-over effects in 1994 -95; and the East Asian currency and financial crises in 1997/98. In a number of cases, the crises occurred in the context of newly liberalized capital accounts. The susceptibility to financial crises has been heightened in those developing countries that went through the process of financial liberalization without taking precautionary measures or adhering to guidelines to minimize the risks. The financial crises that hit some developing countries, especially in Asia and Latin America, in the 1990s, with resultant huge economic costs, point to the negative effects of volatile short-term capital flows and the grave risks and dangers that accompany careless financial liberalization.

III. Overview of Capital Account Liberalization in Emerging Market Economies

Substantial differences exist among the developing countries in terms of experiences with capital account liberalization. Regional differences also exist in the pattern of liberalization although CAL accelerated in all the regions in the 1990s. In general, those countries that liberalized before 1980, started from a strong balance of payments position (for example, Malaysia, Indonesia and Singapore). But more recently, developing countries have undertaken capital account liberalization under less favourable external conditions even in the presence of external arrears (Eichengreen, et al, 1998). The regional patterns reveal that Latin American countries were relatively open during the 1960s. But the 1970s witnessed some increase in the number of Latin American countries maintaining capital account restrictions. The prevalence of controls increased in the early and mid 1980s, as highly indebted countries imposed restrictions on capital outflows in the wake of the external debt crisis. However, capital account liberalization resumed in the late 1980s and early 1990s.

A different pattern occurred in Asia reflecting a steady decline in the number of countries imposing capital account restrictions since the late 1970s. As the debt crisis affected East Asia less than Latin America, there was no increase around the time of the debt crisis. Capital account liberalization accelerated in the 1990s. In the Middle Eastern and European developing countries, no clear liberalization trend was visible until the early 1990s. The same observation applies to African countries where restrictions on capital account transactions were applied in virtually every country during the 1970s and 1980s. In the transition economies, capital account liberalization has proceeded speedily since 1990.

The experiences of emerging market economies in CAL can be examined from various angles such as sequencing and speed of liberalization, roles of monetary and exchange rate regimes, prudential supervision, developments following liberalization, etc.

Sequencing

In the context of the two broad approaches ('big bang' and 'gradualist' approaches) discussed earlier, the emerging markets embody a variety of experiences with respect to the sequencing of liberalization. A number of countries initiated 'big bang' liberalizations of the capital account, freeing all external transactions in a short time or rather abruptly. Among these countries are Argentina, Peru, Costa Rica, El Salvador, Jamaica, Trinidad and Tobago, Kenya, Venezuela, Honk Kong S. A. R, Singapore, Mauritius, etc. For example, Argentina, Peru and Kenya liberalized current and capital accounts simultaneously. Many other countries sequenced CAL before moving, at different paces, to liberalize the capital account. Thus, capital account liberalization in a number of developing countries has occurred gradually. It has been part of an overall approach to economic and structural reform and has occurred after the establishment of current account convertibility. Chile, for example, liberalized current account transaction in 1977 and moved gradually to liberalize the capital account over the 1985 -94 period. In the same way India, after accepting the IMF's Article VIII obligations in 1994, moved cautiously in liberalizing the capital account, allowing convertibility only for non-residents. Indonesia and Korea both accepted Article VIII obligations in 1988 and pursued increased capital account liberalization in the early 1990s. Even then many restrictions still remained.

Monetary and Exchange Regimes

Considering that in an economy with an open capital accounts the influence of international variables is transmitted more quickly than in an economy with a relatively closed capital account, it is important for an open capital account management to have an exchange rate policy that is flexible, with market participants bearing the exchange rate risk instead of the balance sheet of a central bank (Schneider, 2000: 28). However, in the developing world, CAL has been accompanied by a "polarization" in the choice of exchange rate regime, with countries responding to the environment of increased capital flows by either adopting hard currency pegs or moving toward greater nominal exchange rate flexibility. In other words, approaches to the choice of exchange rate regime have tended to be mixed. A fixed exchange rate regime backed by a currency board was adopted by Argentina, Estonia, and Lithuania, providing a strong institutional commitment to exchange rate stability and low inflation. Some developing countries instead opted for a more flexible exchange rate along with full convertibility, e. g., El Salvador, Peru, Venezuela. Others such as Mauritius, Trinidad and Tobago abandoned their formal pegs altogether. Yet, other countries, Indonesia, Malaysia and Singapore, adopted managed floating regimes, with a view to ensuring the competitiveness of export industries.

Financial Sector Reform

Opening the capital account exposes the domestic financial system to foreign competition. In the light of this, most developing countries have attempted to implement financial sector reforms either prior to, or in conjunction with liberalizing the capital account or soon after the capital account reform. These reforms typically include freeing interest rates on loans and deposits, developing indirect monetary instruments such as treasuring bills, and abolishing credit ceilings. Freedom from controls on capital movements heightens the role of domestic interest rates in avoiding destabilizing capital flows. Competitive domestic financial markets would ensure the achievement of market-based interest rates. Real interest rates were positive in most, but not all cases at the time that full convertibility was adopted. In some other countries, reform of the financial sector took place together with broader reforms that included capital account liberalization. For example, in the Baltic countries where a financial infrastructure did not exist, reforms had to be undertaken on all fronts simultaneously.

Prudential Supervision

Opening the capital account could increase the risks for banks, through the impact of increased volumes of capital flows on the deposit base and through a possible increase in exchange rate volatility on banks' open foreign currency positions. Capital account liberalization therefore requires strengthened supervision related to foreign exchange risks, generally undertaken as part of on-going, broad financial sector reforms. But then the area of prudential norms and effective regulation is one that is gravely deficient in many developing countries. Perversely, CAL in several countries has made the situation worse since it has led states to retreat from effective regulatory oversight. However, the experiences show that in many countries, reforms to strengthen prudential supervision and improve standards were under way prior to and during liberalization while in some others (e.g., Indonesia, Peru, Costa Rica) the reforms took place mainly during and after adoption of capital account convertibility. Prudential reforms have focused on improvements in the supervisory framework, especially adopting new regulations and reporting requirements, and increasing the ability of the supervisory authority to enforce regulations. Nevertheless, according to Eichengreen, et al (1998: 38), pre-existing weaknesses in banks' balance sheets and insufficient implementation or enforcement of prudential regulations led to the emergence of severe banking problems in a number of countries that rapidly liberalized their capital accounts, such as Costa Rica, Latvia, and Venezuela. Also, the Mexican financial crisis of 1994-95, occurred against the background of inadequate financial supervision and regulation by the monetary authorities. Consequently, the banking system witnessed a rapid growth of credit to the private sector in the face of weak human resource capacity while imprudent lending practices were very conspicuous as easy access to external resources made it possible to incur debt in foreign currencies without a proper evaluation of exchange risk (Obadan, 2004). Besides, in the East Asian banking and currency crises of 1997-98, financial sector weakness and misdirected investment were major factors. These problems were exacerbated by the rapid liberalization of financial markets without a commensurate strengthening of supervision and regulation.

Post-Liberalization Developments

In the aftermath of capital account liberalization, some notable developments have occurred in emerging market economies in the areas of current account and balance of payments, inflows and outflows of capital, official foreign exchange reserves, inflation, capital controls and financial crises, among others. In general, the elimination of controls on capital account transactions led to an increase in capital inflows, with an accumulation of foreign exchange reserves and some worsening of the current account position. Official external reserve holdings grew in most countries. Besides, many countries that had accumulated substantial external payments arrears were able to reduce or eliminate them altogether through cash payments or rescheduling and, more importantly, to avoid accumulating new arrears. While current account deficits increased in some countries, for example, Argentina, Estonia, Peru and Singapore, they decreased in others, e.g, El Salvador, Jamaica and Malaysia. But then, to a certain extent, a larger current account deficit would be expected as credible reforms lead to larger capital inflows. It is also not surprising that international reserves tended to increase following capital inflows. Furthermore, in a number of Latin American countries Argentina, Mexico, El Salvador, Costal Rica, etc the overall balance of payments positions improved significantly although in some cases they deteriorated in later years.

As a result of financial liberalization, private capital flows to developing countries, particularly emerging market economies, increased in the 1990s. Net private capital flows to the developing countries expanded substantially rising from $44 billion in 1990 to $158.8 billion in 1994 and $299.0 billion in 1997. Tables 1 and 2 have the net capital account and financial account positions of some EMEs. But then, private capital inflows were highly concentrated in a small number of emerging economies. During 1990-97, some 12 countries accounted for 77.0 per cent of total private flows to developing countries. The most important recipients were China, Brazil, Mexico, Korea, Argentina and Malaysia. The East Asian emerging market economies that experienced crises in 1997-98 attracted huge capital inflows. For example, between 1994 and 1996 net private capital inflows as a share of GDP increased considerably, for example, by 7.0 per cent in Malaysia, 6.0 per cent in Indonesia, and 5.0 per cent in the Philippines (Obadan, 2004: 219). Also, Mexico, before its financial crisis in the 1990s, attracted unprecedented amounts of capital into the country, reaching $104 billion between 1990 and 1994. The volume of net capital inflows into Mexico accounted for 11.6 per cent of the total net inflows into developing countries in the 1990-95 period. Capital account liberalization, coupled with years of structural adjustment and macroeconomic stabilization, created a favourable economic outlook and the possibility of better returns to foreign capital. Generally, the increased foreign capital flows to emerging market economies have been due to factors such as liberalization of financial transactions, deregulation of financial markets, and accompanying high interest rates in relation to relatively low rates in the mature markets. Also important was the removal of controls on international capital movements and liberalization of trade and exchange controls.

In some cases, however, deficiencies in financial sector reforms (particularly in the areas of supervision and intervention) and poor macroeconomic policies and conditions have created problems. Indeed, some of the major recipients of the huge capital inflows have experienced sharp reversals causing a deep economic and financial crisis, which affected not only the region but also global financial markets. In both Mexico and East Asia, short-term destabilizing capital flows played notable role in their financial crises. More importantly, weak financial systems and misdirected investment/imprudent lending practices featured prominently in the crisis. In Mexico, against the background of inadequate financial supervision and regulation by the monetary authorities, the banking system witnessed a rapid growth of credit to the private sector, reflecting imprudent lending practices. On the other hand, in East Asia, distorted incentives, inadequate disclosure and supervision, lax regulatory standards, poorly managed financial liberalization, and inadequate disclosure and supervision resulted in weak financial sectors and corporate governance all contributing to the banking and currency crises experienced in the 1990s.

Thus, while large capital inflows alleviate liquidity constraints for the recipient country, and foreign direct investment can contribute to increasing productivity through direct and spillover effects, the inflows have tended to pose problems for macroeconomic management, and sometimes led to crisis. Consequently, a number of developing countries have adopted controls on foreign capital. Controls on capital outflows have tended to be imposed or strengthened during periods of economic distress, particularly in countries facing severe capital flight. On the other hand, controls on inflows have been associated with periods of economic boom, typically when confidence rises following macroeconomic stabilization and reform (Eichengreen, et al, 1998: 38). Argentina, Chile, Mexico, and Venezuela reintroduced controls on capital transactions in the early stages of the 1980s debt crisis, as capital outflows mounted. Also, some countries that have experienced destabilizing surges of capital inflows have resorted to exchange controls or related incentives to cope with them. Among these countries are Brazil, Chile, Colombia, Korea, Malaysia, and Mexico.

However, there has been no consensus in the literature on the effectiveness of controls. Studies of the effectiveness of capital controls have tended to suffer, to some extent, from a lack of agreement on what constitutes effectiveness. Nevertheless, capital controls have been found to be effective considering the experiences of Chile, Colombia, Malaysia and even Thailand (Obadan, 2005: 66). Chile and Colombia explicitly used controls to enable them to simultaneously pursue internal and external balance in the context of large capital inflows. Malaysia (1994) and Thailand (1995-96) implemented capital controls to limit inflows and regain a degree of control over monetary aggregates. Again, in 1998, Malaysia introduced control measures to eliminate offshore market for the local currency, provide a degree of monetary independence and insulate the economy from further adverse developments in international financial markets. Malaysia's capital controls allowed it to recover more quickly from the Asian financial crisis, with a shallower downturn (Stiglitz, 2003: 125). The capital control measures have generally taken the form of quantitative restrictions as well as differential reserve requirements on non-residents' deposits, and unremunerated reserve requirements on foreign borrowing, etc, as in Chile. Moreover, the various experiences suggest that controls can be effective in limiting external liabilities, shifting their composition and providing a degree of monetary independence in the short-to, possibly, medium-term (Obadan, 2005: 67).

IV. Experiences of some Individual Emerging Market Economies

Experiences of individual emerging market economies in capital account liberalization have tended to vary, generally, in the spheres of sequencing of reforms, exchange rate policy and results of liberalization. A few of the experiences are reviewed as follows. (See Schneider, 2000: 65-80).

Argentina

The country accepted the IMF's Article VIII obligations in 1968. Article VIII, Sections 2, 3, and 4, provides for freedom of payments and transfers for current international transactions. A member country normally accepts Article VIII only after eliminating all exchange restrictions, as defined by the IMF's Articles of Agreement. Argentina, however, liberalized both current and capital account transactions simultaneously in 1991. It adopted a currency board system of exchange rate management in 1991 that set the exchange rate of the peso to the US dollar at 1:1. In the light of the currency board system, under which the monetary base is determined by international reserves, the country lacked an independent monetary policy. Results of the capital account liberalization included:

Attraction of large inflows of private capital. FDI and portfolio investment reached 11.0 per cent of GDP in 1993 compared with less than 1.0 per cent in 1990.

Improved GDP growth rates and reduced consumer price inflation in the three years following the convertibility plan.

No financial crisis. But the country suffered from the Latin American contagion in the wake of the Mexican crisis of 1994-95.

Argentina's experience suggests that while the sequencing of capital account liberalization is important, strong and credible supporting policies are required to sustain it.

Chile

Chile accepted Article VIII obligations in July 1977 and initially had a policy of rapid liberalization. But this ended in a banking crisis in the mid-1980s. And so, it gradually pursued CAL in the 1988-1997 period. In the initial phase of the recent reform effort (1985-89), the Chilean authorities focused on restructuring the banking system, trade reform, the selective liberalization of direct and portfolio capital inflows, and on creating the institutional independence of the Central Bank of Chile. In the later phases, the authorities concentrated upon the development of financial markets, the adoption of more flexible interest rate and exchange rate policies, and the progressive relaxation of controls on capital inflows and outflows. Indeed, in order to increase monetary independence, discourage short-term capital inflows, restrain real exchange rate appreciation, and limit total capital inflows, the authorities sought to control capital inflows by requiring foreign investors to place an unremunerated reserve (URR) at the central bank. The cost of the URR was inversely proportional to the maturity of the inflow. In 1983, the country replaced a fixed exchange rate regime with a crawling peg that sought to maintain a constant level of the real exchange rate against the US dollar. Later, a crawling band was introduced that enabled the exchange rate to float freely within a $\pm$0.5 per cent band (later $\pm$2.0 per cent).

Over the 1994 - 97 period, Chile attracted a high FDI equivalent to 6.0 per cent of GDP. The macroeconomic environment has been stable with low inflation, a balanced fiscal position and high rates of economic growth. Studies on the effectiveness of capital controls on inflows suggest that:

the controls have provided room for an independent monetary policy by increasing the wedge between domestic and international interest rates;

the controls have lengthened to some extent the maturity structure of capital inflows;

controls had no effect on the level of total inflows and on the exchange rate.

Some analysts have, however, argued that the URR has increased the cost of capital significantly (over 21.0 per cent), especially for small, and medium-sized Chilean firms that found it difficult/impossible to evade the controls on inflows. Nevertheless, the Chilean experience demonstrates that an incremental process of capital account liberalisation within a strong supporting reform framework can be very effective. Chile had a strong institutional capacity to manage a capital control regime that allows it to be implemented efficiently and insulated it from corruption. Another lesson is that controls can be used flexibly to both encourage capital inflows and diminish their potentially more harmful effects on monetary independence.

Korea

Throughout its period of rapid industrialization from the 1960s to the late 1980s, the Korean economy was characterized by extensive government intervention. Over the course of the late 1980s, Korea pursued a policy of gradually liberalizing the domestic financial system and the capital account, but this was accelerated in 1993 under the administration of Kim Young Sam. The country accepted Article VIII obligations in 1988, ensuring full convertibility for current account transactions. Liberalization of the capital account was gradual and selective and a comprehensive liberalization plan was not adopted until 1993. Even then, Korea's policy towards capital account transactions was guided by developments in the current account. Financial sector reform, including efforts to improve regulation and supervision, was pursued concurrently. But this later turned out to be inadequate with the eruption of the East Asian financial crisis. As part of the reform process, Korea moved from pegging the won to a basket of currencies to the Market Average Exchange Rate system in order to allow the exchange rate to be determined more by market forces.

The capital account liberalization led to increased access of Korean financial institutions to external financing and a rapid expansion of foreign debt which nearly trebled from $44.0 billion in 1993 to $120.0 billion in 1997. The worrisome aspect of this debt was its structure which showed that the share of short-term debt rose from an already high 43.7 per cent in 1993 to an extremely high 58.3 per cent at the end of 1996. Besides, although measures were taken in the 1990s to liberalize and strengthen the financial sector, persistent weaknesses of oversight and regulation remained which helped to propel the country into a crisis in 1997 in the context of the Asian crisis. The rise in the short-term debt to reserves ratio and concerns about the stability of the financial sector encouraged continual pressure against the won. When the won was forced out of its trading bank, its value promptly collapsed, from an average of 804 won per US$1.0 in 1996 to an average of 1401 won per US$1.0 in 1998. One major lesson from the Korean experience is the danger of liberalizing the capital account in the context of inadequate prudential regulation and an unreformed financial system. The regulatory regime failed to monitor the activities of the finance companies and this greatly increased the vulnerability of the country to sudden capital flow reversals. With the absence of state coordination and poor financial intermediation, funds flowed into low quality investments in sectors which already had problems with overcapacity. The Korean experience points to the need to comply with appropriate conditions for liberalization in terms of financial sector reform, improved regulation and sequencing. Korea experienced failure in sequencing by liberalizing short-term flows first as part of crisis management in 1997-98 before liberalizing long-term flows.

India

After decades of inward-looking and interventionist policies, India, over the course of the 1990s, began a cautious and gradual move towards more capital account openness. Capital account convertibility has proceeded gradually in the context of a broad reform agenda that encompasses trade, competition and industrial restructuring. Emphasis has been placed on reform of the financial system as a pre-condition for CAL. India accepted Article VIII in 1994. The Tarapore Committee on capital account liberalization, in 1997, recommended a cautious approach that seeks to establish the preconditions for liberalization on a sound footing. These include fiscal consolidation, an inflation target and, most importantly, the strengthening of the financial system. As a result, more stable flows such as direct and portfolio investment were liberalized first, followed by partial liberalization of debt-creating flows, derivative transactions and capital outflows. Financial sector reform continued concurrently. The exchange rate policy has focused on flexible exchange rates in the context of a managed float.

Despite the liberalisation efforts, India has maintained capital controls. Controls which have been quantity based rather than market-based have been oriented towards limiting the country's external debt, particularly reducing excessive exposure to short-term foreign debt. India's experience shows that controls have been largely effective in two ways:

limiting measured capital flows and in shifting their composition towards long-term flows;

preventing, along with other factors, a build-up of short-term external liabilities that could increase the country's vulnerability to externally-generated crisis; and

insulating the country from the 1997 Asian crisis.

Although capital controls did not prevent India from experiencing high levels of external indebtedness and BOP crisis in 1980 and 1991, they effectively shifted the composition of capital inflows towards more stable, long-term flows. Thus, India could receive the benefits of capital account liberalisation and limit vulnerability.

Malaysia

Malaysia accepted Article VIII obligations in 1968. The capital account had always been relatively open. From the mid-1980s, portfolio inflows have been free of restrictions and banks' foreign borrowing and lending in foreign exchange have been free (except for net foreign exchange open position limits). Before the Asian financial crisis, cross-border activities in the national currency, ringgit, were also free. Financial sector reform has been accelerated in the wake of the crisis. Before the July 1997 crisis, Malaysia operated a managed float of the ringgit. But it was pegged to the U. S. dollar with the imposition of controls in September 1998.

One key result of the relatively liberalized capital account regime was the attraction of large inflows of foreign capital, comprising both short-and-long-term, in the early 1990s. Capital inflow rose form 5.3 per cent of GDP to 8.3 per cent in 1993. This was induced mainly by a high interest rate differential and expectations of a ringgit appreciation. But then the increased inflows enhanced concerns regarding sustainability and stability. And the high costs of sterilization and its maintenance of high interest rates led the authorities to implement controls on short-term inflows, particularly in the form of borrowing by banks and ringgit deposits opened by bank and non-bank foreign customers. In 1997, in the midst of a financial crisis, Malaysia implemented controls on capital outflows in order to limit downward pressure on the exchange rate and upward pressure on domestic interest rates that were exacerbating the contraction, which was already undermining the financial system. In September 1998, the authorities imposed direct exchange capital control measures which sought to contain ringgit speculation and the outflow of capital by eliminating the offshore ringgit market. The controls on capital inflows were largely successful in achieving their objectives of containing short-term inflows and the monetary expansion and instilling stability in the foreign exchange market. Monetary aggregates significantly reduced and the capital account surplus fell in response to a reversal in short-term inflows in the second half of 1994. Long-term flows such as FDI were not affected in the same way, the controls on outflows imposed in late 1998 were effective in eliminating the offshore ringgit market.

Even though Malaysia's fundamentals were relatively strong (high growth, low inflation, full employment, relatively strong financial system and, in contrast to Thailand and Indonesia, no massive build-up of short-term overseas debt), the country was also hit by the 1997 Asian crisis. This was due to two vulnerabilities that had been developing: a massive accumulation of outstanding domestic credit and a large exposure of the banking system to the property sector and share trading. Speculators viewed the massive increase in bank credit as evidence of a decline in the quality of borrowers and reasoned that an interest rate defence of the ringgit was untenable. The crisis which ensued revealed weaknesses generated by rapid credit expansion and the consequent deterioration of bank asset quality. The Malaysian experience thus suggests the importance of close central bank monitoring of the uses to which foreign funds are being directed and whether their properties are consistent with the type of inflows. Besides, improved bank surveillance and enforcement is required to rapidly ensure provisioning in banks with escalating non-performing loans.

V. Lessons / Conclusions

Capital account liberalisation, in recent years, has been undertaken in the context of increasing pace of globalization. Unlike the developed countries, the developing countries that have liberalized have done so under less favourable external conditions, even in the presence of external arrears. Nevertheless, capital account reforms have been undertaken in view of the expected benefits of enhanced economic growth, greater efficiency, risk diversification, intertemporal consumption smoothing, and technology transfers, among others. But the downside of CAL and the accompanying free flow of capital was until recently, perhaps, not adequately acknowledged or appreciated (Obadan, 2005). Thus, while liberalization is generally beneficial, it also heightens a country's vulnerability to crises; reversals in capital flows can precipitate severe currency, banking and balance of payments crises. Indeed, the record of the last 20 years, particularly, the financial crises that hit some emerging market economies in East Asia and Latin America in the 1990s, with resultant huge economic costs, point to the negative effects of volatile short-term capital flows and the grave risks and dangers that accompany careless financial liberalization. In the past, some emerging market economies liberalized in a big bang way while others adopted a gradualist approach. But given the relatively poorly developed institutional structures, primarily in the financial systems, the balance of evidence suggests that countries should adopt a gradual movement towards capital account liberalization.

Thus, one very important lesson from the past experience is that capital account liberalization needs to be undertaken in a measured way and orderly manner, and pragmatically, more especially as it is not an all-or-nothing affair. Each country has to decide on the degree of CAL based on its own conditions. Besides, countries need to adequately prepare their economies and ensure that a number of both macroeconomic and non-macroeconomic requirements / pre-conditions are met. The macroeconomic requirements include the following:

> tackling of major fiscal imbalances and achieving macroeconomic stability first;
>
> a sound monetary policy that complements and is facilitated by fiscal discipline;
>
> a flexible exchange rate policy;
>
> a higher level of external reserves is needed as a buffer against sudden financial shocks;
>
> inflation control; and
>
> maintenance of current account deficits within prudent limits

The other pre-conditions for successful capital account liberalization include financial sector reform and strengthening, proper sequencing of CAL, appropriate policies towards FDI, and better and effective governance in both public and private sectors. Among these, the central importance of financial sector reform, prudential norms and effective regulatory supervision cannot be overemphasized. Effective banking, supervision and regulation, and observance of prudential norms are crucial for financial sector soundness. Indeed, some have argued that capital account liberalization, per se, has not been the cause of financial crises, but rather the failure of supporting policies prudential regulation and monitoring, weaknesses of the financial sector and lack of flexibility in exchange rate policies. Thus, it is necessary to develop a sound financial sector which will enable banks to invest capital inflows prudently and weather shocks. Very importantly, countries should avoid the danger of precipitously removing restrictions on capital account transactions before major problems in the domestic financial system have been addressed.

Besides financial sector strengthening, the proper sequencing of capital account liberalization is indispensable in order to have orderly and less destabilizing outcomes. The sequencing should be such that the restructuring and liberalization of the domestic financial sector precedes the opening up to foreign investors. The current account should be liberalized before the capital account is liberalized in a gradual way. Even within the capital account, the order of liberalization should be inflow before outflow. Also, FDI should be liberalized first rather than portfolio investment. Finally, the management of the open capital account may need to be supported with capital controls of a prudential nature in order to deal with balance of payments pressures and macroeconomic disturbances generated by volatile capital flows. Both theory and practical experience point to the legitimacy of using capital controls of a prudential nature. Capital controls have been found to be effective as the experiences of some emerging market economies like Chile, Malaysia and Colombia have shown, particularly in the use of price instruments to alter the maturity structure of inflows and their impact on monetary and exchange rate policy. In general, the indirect or market-based instruments of control are believed to be more effective and have less adverse effects.

Table 1: Net Capital Account Positions of Some Emerging Market Economies

	Brazil	Argentina	Korea	Peru	India	South Africa	Israel	Singapore	Russia
1989	23-0	n.a	-318.4	-19.6	7,212.5	-26.9	357.3	-40.8	n.a
1990	35.0	n.a	-331.2	-25.0	5,528.1	-56.2	728.0	-21.9	n.a
1991	42.0	n.a	-329.5	-31.0	3,450.3	-35.8	856.6	-33.9	n.a
1992	54.0	15.7	-407.0	-33.0	4,075.3	-421.0	1069.7	-37.9	n.a
1993	81.0	16.1	-475.1	-44.5	7,074.3	-57.0	862.0	-71.4	n.a
1994	173.0	17.5	-436.5	-58.32	10,575.6	-66.6	785.6	-84.1	2,408.0
1995	352.0	14.2	-487.6	31.68	3,860.9	-39.9	608.8	-72.7	-348.0
1996	494.0	50.8	-597.6	21.6	11,847.8	-47.1	575.6	-138.7	-463.0
1997	482.0	66.3	-607.6	-49.9	9,634.7	-192.61	552.1	-189.8	-796.0
1998	375.0	72.9	171.1	-57.3	8,583.9	-55.9	397.1	-225.8	-382.0
1999	339.0	149.1	-389.3	-54.3	9,578.6	-61.9	568.7	-191.0	-326.0
2000	272.5	105.9	-615.2	-67.2	11,235.0	-51.9	455.2	-162.8	10,675.0
2001	36.0	156.5	-731.1	-68.2	7,645.3	-31.2	678.9	-161.2	-9,377.9
2002	433.0	406.1	-1086.8	-95.4	11,054.1	-14.9	150.6	-160.4	-12,395.9
2003	298.2	70.1	-1402.1	-93.5	n.a	1.6	45.4	-167.6	-995.0

Source:IMF. International Financial Statistics, CD-ROM, 2005.

Table 2: Net Financial Account Positions of Some Emerging Market Economies.

	Brazil	Argentina	Chile	India	Venezuela	Colombia	Egypt	Israel	Turkey	Poland	Singapore
1989	-11,426	-8,083.0	1,241.0	7,212.5	3,650.0	478.0	360.7	-464.3	780.0	-1,796.0	1,250.5
1990	-5,441	-5,884.0	2,857.0	5,528.1	-4,061.0	-2.0	-11,039.0	592.9	4,037.0	-8,731.0	3,947.4
1991	-4,868	182.0	963.9	3,450.3	2,204.0	-777.3	-4,706.0	641.4	-2,397.0	-4,183.0	2,345.6
1992	5,889	7,630.3	3,132.0	4,076.3	3,386.0	183.0	-168.0	-450.9	3,648.0	-1,045.0	1,793.1
1993	7,604	20,327.6	2,994.9	7,074.3	2,656.0	2,701.4	-762.0	1040.7	8,963.0	2,341.0	-1,211.9
1994	8,020	11,360.0	5,293.6	10,575.6	-3,204.0	3,392.6	-1,450.0	-958.6	-4,194.0	-9,065.0	-8,840.9
1995	29,306	4,989.3	2,356.6	3,860.9	-2,964.0	4,559.7	-1,845.0	4205.8	4,643.0	9,260.0	-1,071.2
1996	33,426	11,713.1	5,660.4	11,847.8	-1,784	6,683.0	-1,459.0	4536.6	5,483.0	6,673.0	-7,925.5
1997	24,918	16,745.8	6,742.1	,634.9	879	6,587.5	1,957.8	7206.8	6,969.0	7,410.0	-11,511.6
1998	20,063	18,935.9	1,966.5	8,583.9	2,689.0	3,306.9	1,901.0	-171.7	-840.0	13,282.0	-17,784.8
1999	8,056.0	14,448.1	237.5	9,578.6	-516.0	-550.9	-1,421.4	2874.8	4,979.0	10,462.0	-14,186.4
2000	29,376.2	7,852.7	787.7	12,235.0	2,969.0	71.2	-1,646.0	3164.8	8,584.0	10,221.0	-5,750.5
2001	20,331.3	-14,971.0	1,362.2	7,645.3	-211.0	2,484.4	189.8	1240.7	-14,644.0	3,173.0	-14,380.6
2002	-3,908.9	-20,582.3	2,097.2	11,054.1	-9,246.0	1,309.0	-3,332.7	-1,526.7	1328.0	7,180.0	-13,558.4
2003	-163.8	-15,812.3	629.8	n.a	-5,124.0	811.7	-5725.0	-2,526.9	6,959.0	8,734.0	-25,088.7

Note: Financial Account comprises inflows (assets) and liabilities on direct investment, portfolio investment (comprising equity securities and debt securities), financial derivatives, and other investment assets (relating to monetary authorities, general government, banks and other sectors).

Source: IMF. International financial statistics, CD-ROM, 2005

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