Capital Account Liberalization and the Role of the IMF

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1. This Fifty-Second Annual Meetings of the IMF and World Bank is taking place at a time of profound change in East Asia, propelled by an astonishing record of sustained economic growth, which within less than two decades has improved the living standards of more people, more rapidly, than at any other time or place in history. For the IMF, Hong Kong has for months appeared likely to be the meeting of the capital account and of Fund resources—the annual meeting at which our Executive Board would be given the mandate to complete its work on an amendment of the Articles of Agreement to promote capital account liberalization, and at which agreement could be reached on a quota increase and a special issue of SDRs. Coming a little over fifty years after the original Articles of Agreement put current account convertibility and trade liberalization at the center of the Fund's mandate, and at a time when the globalization of capital markets proceeds apace, the capital account amendment and the increase in resources would enable the Fund to play its full part in promoting the orderly liberalization of international capital markets.

2. But the recent market turmoil in the region has raised two fundamental sets of questions: the first, about the sustainability of the Asian miracle; and the second, about the risks of capital account liberalization. I will not discuss the Asian miracle, except to record my firm belief that, after a relatively brief pause, rapid growth will resume in those economies now adjusting to recent shocks, home- and foreign-made. And there is no reason that growth in other parts of Asia, most notably in India, should not increase to and be sustained in the range of 6-8 percent per annum. It is just a matter of policy—of the right macroeconomic policies, of accelerating market-oriented structural reforms, of improving education, and of opening up to trade and foreign investment.

3. My main focus today will be on the capital account. The question is whether the recent market turbulence in the region—the attacks on the Thai baht and its devaluation, the subsequent devaluations of other currencies in the region, and the contagion effects that have been present in East Asia in 1997, just as they were in Latin America in 1995, and perhaps also in Europe in 1993—does not suggest that the capital account is more often the source of economic difficulties and risk rather than benefit, and therefore that capital account liberalization should be put off as long as possible. If that were so, perhaps the proposed capital account amendment of the Fund's Articles of Agreement would be unnecessary, and everybody—not least the Fund's overworked Legal Department—could be saved a great deal of effort.

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[1] First Deputy Managing Director, IMF. This paper was presented at the seminar, "Asia and the IMF," held in Hong Kong, China, on September 19, 1997. I am grateful to Barry Johnston for his assistance.

4. You will not be surprised to hear that I emphatically reject this view. But the concerns of those policymakers who fear some of the consequences of capital account liberalization cannot and should not be lightly dismissed. What I would like to do is to persuade those of you who remain skeptical about capital account liberalization of three things:

— that the benefits of liberalizing the capital account outweigh the potential costs;

— that countries need to prepare well for capital account liberalization: economic policies and institutions, particularly the financial system, need to be adapted to operate in a world of liberalized capital markets; and

— that an amendment of the IMF's Articles of Agreement is the best way of ensuring that capital account liberalization is carried out in an orderly, nondisruptive way, that minimizes the risks that premature liberalization could pose for an economy and its policymakers.

In making this argument, I will also touch on several critical issues about international capital movements that recent crises have put on the policy agenda. I must though apologize in advance for raising more questions than I can answer.

I. The Growth of Capital Movements

5. First, some background facts and forecasts: Both gross and net international capital flows have increased markedly in recent years, and for many countries capital movements have been a critical factor in the balance of payments. Average annual net capital inflows to developing countries exceeded $150 billion in 1990–96. After a pause in the first half of 1995 following the Mexican crisis, the pace of inflows to developing countries recovered, and has continued to increase since then. A net total of $235 billion in foreign capital flowed to developing countries in 1996, and this rate of flow appears to have been sustained in the first half of 1997. This is not a small amount: it is nearly 0.8 percent of world GDP, and well above 2 percent of developing country GDP.

6. Asia, in particular, has benefited from recent capital inflows, receiving more than $60 billion a year in 1990–96, and a total of $107 billion in 1996. Asia has received a higher proportion of foreign direct investment, 55 percent of total capital inflows, than other regions. Net inflows to some countries in this region have averaged 5-8 percent of GDP over long periods, often with much of that taking the form of foreign direct investment.

7. Why have global capital flows increased so much? Let me mention four factors:

— first, rates of return in recipient countries. Capital inflows have responded favorably to successful stabilization and reform efforts. In some cases, especially

where the flexibility of the exchange rate has been limited by policy, short-term capital has been attracted by high interest rates needed to fight inflation;

— second, the liberalization of international capital transactions by both industrial and developing countries. Indeed, in some cases the liberalization of capital outflows has strengthened the capital account by encouraging both foreign investment and a return of flight capital;

— third, the development of stronger financial systems in recipient countries; and

— fourth, external factors—including the declining trend in longer-term interest rates in the advanced economies over the last decade, and the emergence of large institutional investors in industrial countries.

8. International capital flows have by no means reached their peak. Portfolios in the advanced countries are still insufficiently diversified internationally; and the residents of developing countries likewise have much to gain from investing in capital markets in other countries. We can be sure that the volume of gross international capital flows will continue to increase, as information about the potential of developing country markets spreads, as transaction costs continue to decline, and as the liberalization and sophistication of capital markets in developing and advanced countries continue to grow.

II. Benefits and Risks of Capital Account Liberalization

9. There are two arguments in favor of capital account liberalization. The first is that it is an inevitable step on the path of development, which cannot be avoided and therefore should be adapted to. In support of this view, we may note that all the most advanced economies have open capital accounts. This is a powerful argument, and a correct one, even if it begs the question of how rapidly the inevitable has to be accepted. But while sufficient, it is not as satisfactory as the second argument, that on balance the benefits of capital account liberalization outweigh its costs.

10. Put abstractly, free capital movements facilitate a more efficient global allocation of savings and help channel resources into their most productive uses, thus increasing economic growth and welfare. From the individual country's perspective, the benefits take the form of increases in both the potential pool of investable funds and the access of domestic residents to foreign capital markets. From the viewpoint of the international economy, open capital accounts support the multilateral trading system by broadening the channels through which developed and developing countries alike can finance trade and investment and attain higher levels of income. International capital flows have expanded the opportunities for portfolio diversification, and thereby provided investors with a potential to achieve higher risk-adjusted rates of returns. And just as current account liberalization promotes growth by increasing

access to sophisticated technology, and export competition has improved domestic technology, so capital account liberalization can increase the efficiency of the domestic financial system.

11. Abstract as these arguments may sound, they have concrete counterparts in the real world. Access to global savings means in part foreign direct investment, about the benefits of which there is no longer any serious controversy. Governments all over the world borrow in the Euro-markets, gaining access to cheaper financing than they might be able to obtain domestically. Domestic corporations likewise can obtain cheaper and more sophisticated financing by borrowing abroad. The new financial technologies that accompany the entry of foreign participants in domestic markets can upgrade the entire financial system. Residents of countries that permit portfolio investment abroad can hold more diversified, less risky portfolios. These are not abstract concepts, but benefits that every country represented in this room has enjoyed as a result of its access to the international capital markets.

12. Still, what about the risks? International capital flows tend to be highly sensitive to the conduct of macroeconomic policies, the perceived soundness of the domestic banking system, and unforeseen economic and political developments. Accordingly, market forces should be expected to exert a disciplining influence on countries' macroeconomic policies. Normally, when the market's judgment is right, this discipline is a valuable one, which improves overall economic performance by rewarding good policies and penalizing bad. Of course, policymakers do not always welcome discipline of which they are the object, even if it is appropriate; nor are they likely to admit when trouble comes that the capital markets were only the messenger, delivering a verdict on their performance. Rather they may be tempted to shoot the messenger.

13. However markets are not always right. Sometimes inflows are excessive, and sometimes they may be sustained too long. Markets tend to react late; but then they tend to react fast, and sometimes excessively. Of most concern, market overreactions sometimes take the form of contagion effects, spillovers from a crisis in one market to other, related, markets. Some spillovers are entirely rational and efficient—for instance, when a country devalues, the equilibrium exchange rate for its competitors may also depreciate. But sometimes, including to some extent in the recent East Asian crisis, and certainly in the attack on Argentina in 1995, contagion effects seem to be overreactions, perhaps based on incomplete information, perhaps a result of herd behavior, perhaps based on an inaccurate appraisal of the underlying economic situation. Contagion effects are all the more worrying in light of the possibility that attacks become self-fulfilling prophecies, for instance, because the banking system weakens in the face of an attack that forces a devaluation and higher interest rates.[2]

14. While I believe we sometimes see examples of market overreactions and unjustified contagion effects, I also believe that capital movements are mostly appropriate: currency

[2] These are cases of so-called multiple equilibria.

crises do not blow up out of a clear blue sky, but rather start as rational reactions to policy mistakes or external shocks. The problem is that once started, they may sometimes go too far.

15. To sum up: Liberalization of the capital account can bring major benefits to countries whose residents and governments are able to borrow and lend on more favorable terms, in more sophisticated markets, whose own financial markets will become more efficient as a result of the introduction of advanced financial technologies—and who for all those reasons will attain a better allocation of both saving and investment, and will therefore grow more rapidly in a more sustainable manner. These gains have been seen all over the world where countries have accessed the international capital markets and allowed foreign competition in their own capital markets—and they have certainly been seen in Asia in the last two decades. At the same time, capital account liberalization increases the vulnerability of the economy to swings in market sentiment. Almost always these swings are rationally based, but they may on occasion be excessive, and they may sometimes reflect contagion effects, which may themselves be excessive on occasion. This is a valid concern to those contemplating capital account liberalization, and for the international community.

III. Managing a Liberalized System

16. What is the right response to operating in a system that offers major benefits, but that may penalize mistakes severely, and occasionally burden the economy with inappropriate shocks? The prime need obviously is to avoid policies that can cause rapid capital flow reversals, and to strengthen the structure of the economy and its policy framework so as minimize its vulnerability to sudden changes in market sentiment. Some of what needs to be done is well known and uncontroversial, in particular:

— to pursue sound macroeconomic policies;

— to strengthen the domestic financial system; and

— to phase capital account liberalization appropriately—which means retaining some capital controls in the transition.

There are also more controversial questions about:

— the provision of information to the markets;

— the role of surveillance; and

— the potential need for financing.

Let me take these topics up in turn, touching lightly on those elements on which there is a well-understood consensus, emphasizing rather the more novel or controversial points.

A. The macroeconomic policy framework

17. A sound macroeconomic policy framework is one that promotes growth by keeping inflation low, the budget deficit small, and the current account sustainable. As a formal matter of debt dynamics, the sustainability of the current account depends on the economy's growth rate and the real interest rate at which the country can borrow. But sustainability has another sense, of the ability to withstand shocks, and that is less susceptible to formal analysis. In any case, large current account deficits—depending on the growth rate of the economy, in the range of 5-8 percent of GDP, and certainly any higher—should be cause for concern. Current account deficits financed by longer-term borrowing and in particular by foreign direct investment are more sustainable; sizable deficits financed in large part by short-term capital flows are a cause for alarm.

18. It is sometimes difficult to deal with short-term capital inflows that are a response to high domestic interest rates, particularly in a context in which policy limits exchange rate flexibility. This is the famous capital inflows problem that so many countries seeking to stabilize from moderate rates of inflation have faced. There is no easy answer to this problem, but a tightening of fiscal policy is the first line of defense. A second response is to increase the flexibility of the exchange rate.

19. How flexible should exchange rates be? The recent experience of East Asia has reopened the question of whether any form of fixed exchange rate system is consistent with free capital mobility. The Group of Seven countries, except for those intending to join the European Economic and Monetary Union (EMU), long ago decided on flexible rates. But freely floating rates, even among the major currencies, have moved excessively, and no developing country seeking growth through integration into the world economy would want to live with such fluctuations. East Asian countries were well served over a long period by exchange rate systems that either fixed the exchange rate or limited its flexibility, thus providing exporters and importers with a measure of exchange rate certainty that facilitated their participation in the international economy. Nonetheless, those countries that allowed the rate to float when threatened by an imminent speculative attack made the right choice.

20. As more normal conditions return, the question of the optimal exchange rate system will be back on the agenda. There is no generally agreed answer to that question. Some conclusions are easy: if the exchange rate is pegged, it is almost certainly better to peg to a basket of currencies rather than a single currency. Beyond that, it may be that countries will return to some form of exchange rate band, with very wide margins, perhaps—depending on domestic inflation—a crawling band. If they do, they should stand ready if circumstances warrant, to move the band. In any case, the level of the exchange rate is bound to be a concern for policymakers, particularly in developing countries relying on export-led growth, and macroeconomic policy needs to be adjusted when the exchange rate (equivalently the balance of payments) shows signs of moving out of desired ranges.

B. Strengthening the financial sector

21. The critical role of the strength of the financial system was becoming clear before the Mexican crisis; it was crystal clear in that crisis and its aftermath; and it has been equally clear in the Thai crisis and its aftermath. The Fund staff's important paper, "Toward a Framework for Financial Stability," provides a detailed analysis of what is required for a healthy banking and financial system. By now, policymakers have a good idea of what needs to be done to strengthen financial systems, by improving supervision and prudential standards, by ensuring that banks meet capital requirements, provision for bad loans, limit connected lending, publish informative financial information, and by ensuring that insolvent institutions are dealt with rapidly. Implementing those changes, particularly in a banking system already in trouble, is frequently difficult, especially where political pressures hamper the supervisory authorities. The task is nonetheless urgent, both in countries now seeking to recover from recent crises, and those that seek to avoid future crises: it cannot be emphasized strongly enough that a healthy banking and financial system is essential for the growth of the economy, and that a weak banking system is both a standing invitation to a macroeconomic crisis and a guarantee of the severity of any such crisis.

C. Phasing and the use of controls

22. There are obvious dangers in liberalizing capital movements in an economy in which the macroeconomic framework and the financial sector are weak. There is thus a case for phasing capital account liberalization, paying due regard to the country's macroeconomic situation (including the balance of payments), the stage of development of its financial markets and institutions, and the impact of existing controls. But in this area, as in the case of more familiar structural reforms, there are few hard and fast rules, and some countries—notably Indonesia—successfully liberalized the capital account very early in the reform process.

23. Absent the coordination of capital account liberalization and financial sector reform, there may be regulatory distortions and regulatory incentives for capital movements that are unrelated to underlying economic conditions. Both factors could risk instability in capital movements. Weak domestic financial institutions may be incapable of efficiently intermediating large flows of funds to which they obtain access as a result of capital account liberalization; they may in addition be adversely affected by movements in asset prices that result from international capital flows. Most important, weak financial institutions are especially vulnerable to potential reversals of capital flows.

24. The obverse side of the phasing of liberalization is the continued use of capital controls. Let me first offer a general perspective on the use of controls. Controls, except for prudential controls, are generally inefficient and costly for the economy. They are viewed by markets as an additional country risk factor, and their prolonged use has often been associated with capital flight. Countries that have already removed controls are unlikely to reimpose them except perhaps on a limited basis, temporarily, for emergency purposes. Countries that now

have nonprudential controls in place will remove them, generally gradually, perhaps in a big bang. Countries that retain some controls may seek to refine them, removing those that cause the greatest distortions, perhaps replacing them with less distortionary controls—just as tariffs often replace quotas at the start of trade liberalization. Against the background of a general trend of progressive capital account liberalization, we need to consider the controls that are likely to be in place during transitional periods.

25. A theoretical case can be made for countries whose financial systems are not sufficiently robust to restrict selected forms of capital inflow, for instance the short-term inflows that produce the capital inflows problem. A judgment on whether any particular restriction in a particular country is desirable would have to take into account the costs of such restrictions, their effectiveness or lack thereof, the speed with which they will lose effectiveness, as well as their potential benefits if any. Whatever controls might be imposed, they are likely to do less damage if they are market-based, for instance taking the form of reserve requirements on foreign deposits, rather than quantitative. Controls on outflows may have been imposed for balance of payments reasons and retained both for that reason and because they provide a captive source of funds for domestic financial institutions. Their gradual removal is generally desirable.

26. Prudential controls on foreign capital are already in place in many countries, for instance restrictions on the open positions domestic banks can take in foreign currency. Similar restrictions could be contemplated on open positions taken by corporations. Such controls, intended to reduce the vulnerability of domestic institutions to shifts in foreign capital flows, could well form part of internationally accepted prudential standards.

27. Every currency crisis produces demands to do something about hedge funds and speculators. Usually the anger at the speculators would better be aimed closer to home, and in practice nothing much has yet been done to tame them. Still, occasional cases of market overreaction raise the question of whether better provision of information to and by market participants, as well as improved prudential regulations, could increase the efficiency of the markets. Since speculative positions have counterpart transactions in the domestic economy, we need to ask whether prudential regulation of the domestic economy could reduce the occasional excesses of speculative attacks, perhaps thereby also increasing the efficiency of the international capital markets. These are issues that deserve serious analysis.

D. Information provision

28. One of the many lessons drawn from Mexico was that the extent of the crisis was worsened by the poor quality of information supplied to both the official sector (including the IMF) and the markets. Specifically, information on reserves was provided with a long lag, and information on the structure of the external debt was not readily available. As a result, the IMF's data standards initiative was initiated and the Special Data Dissemination Standard was established in early 1996. Considerable progress has been made with the development of the

associated Dissemination Standards Bulletin Board.[3] The Thai crisis reinforces the argument for better and more timely provision of information, including information on central bank forward operations. There are two arguments for the provision of such information. First, better informed markets are likely to make better decisions. In each of the Mexican and Thai crises, this would have meant that the markets would have withdrawn funds sooner than they did, thereby hastening adjustments that needed to be made in each of those cases. Second, the obligation to publish information on certain interventions would affect the extent and nature of those interventions, and help prevent some unwise decisions.

29. There is much work to be done in thinking through the question of the optimal extent and timing of information provision. If the policy game is thought of as a battle between the authorities and hostile markets, then the official penchant for secrecy is easy to understand. If instead, the problem is thought of as one of designing a framework to influence both the choice of policies and the effectiveness of markets in responding to and disciplining policies, then the case for more information provision is strengthened. As that framework is developed, we will also have to consider the information that market participants need to make public in order to discipline their own actions and increase the efficiency of markets. These issues will surely be on the agenda in the next few years.

E. The role of surveillance

30. Since the Mexican crisis, the IMF has placed increased emphasis on timely surveillance of market developments. It is fair to say that the Fund's new surveillance procedures worked well in the case of Thailand, and reasonable to expect they will work well in future. But it would be a mistake to imagine that the Fund or any other surveillance could ever be made perfect. The Fund will surely miss the warning signs of some future crisis, and just as surely will predict some crises that do not happen. The international system cannot be built on the assumption that improved surveillance, or the increased provision of information to markets, will prevent all future crises, even though they should reduce the frequency of crises. The effectiveness of Fund surveillance is also limited by the fact that a country may be warned but not take action. Because the Fund's ability to conduct its surveillance depends on its privileged access to information, it is not in a position to enlist the markets in the cause of surveillance by making its concerns fully public. That is a limitation that we will have to accept.

31. IMF surveillance operates at the global level. There is in addition room for mutual surveillance within smaller groups of countries, such as those in the Organization for Economic Cooperation and Development (OECD), or in the European Union. Such mutual surveillance enables countries with similar experiences, or likely to be affected by what their

[3] This electronic bulletin board on the Internet provides information concerning countries' economic and financial data systems. As of September 1997, there were 43 subscribers, including Hong Kong, China.

neighbors do—for instance different groups of Asian countries—to become more familiar with the policies of fellow group members, and to exert mutual pressures for good policies. To be effective, such surveillance should be based on a sound analysis of the economic situation, and here the Fund is willing to play its part in supporting regional and other groups.

32. After a crisis, we in the Fund sometimes hear the refrain, generally from policymakers but sometimes from the markets, "But no-one—including the Fund—warned us of the dangers we faced." When such a complaint is accurate, and after every crisis, we need to draw the lessons and seek to improve our performance. At the same time, it is important not to lose sight of where the primary responsibilities lie. The prime responsibility for pursuing the right policies rests with the national authorities; the Fund and neighbors can provide information, analyze, suggest, seek to persuade, and cajole. But, ultimately, it is the government that has the duty to evaluate the situation and make the right decisions. There is also a responsibility on market participants to appraise the underlying economic situation accurately; if they do so, market incentives will ensure that markets operate efficiently. The prime responsibility for correctly evaluating the economic situation rests with market players, provided they are given the information they need.

F. The need for financing

33. No matter how much information is provided to markets, surveillance is strengthened, prudential regulations are refined, and government policies improve, crises will happen. In a crisis, private sector financing evaporates, and countries are forced to take painful adjustment measures. One of the purposes of the IMF set out in the first Article of Agreement is "To give confidence to members by making the general resources of the Fund temporarily available to them under appropriate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." The Fund—that is, the international community—has shown its willingness to act in this way in many crises. The Fund will continue to act in accordance with its purposes, and to provide financing, with the conditionality that provides the safeguards referred to in Article I (v), to countries faced with the need to take actions to stem the destructive effects of an external crisis.

34. The Mexican and Thai crises, and the proposed capital account amendment of the Articles of Agreement have raised two important interrelated questions about Fund lending: first, whether the increased scale of international capital flows requires a reexamination of the criteria that determine the size of Fund loans; second, whether the Fund's willingness to lend in such circumstances creates a moral hazard. The answer to both questions is yes. As the efficiency of the international capital markets improves, it is reasonable to expect that there will be fewer crises requiring official funding in future, but it is also likely that they will be on a larger scale than typical in the past. In both the Mexican and Thai crises, the Fund was able to provide very large loans relative to the country's quota by invoking the "exceptional circumstances" clause, and such a route will be available in the future. But if capital account

liberalization increases the likelihood of larger, even if fewer, crises, it would also be appropriate to review Fund lending criteria, to ensure that Fund loans—in some cases together with supporting funding—will remain adequate to their task.

35. There is no question that the Fund's willingness to lend to countries in trouble creates a moral hazard. The hazard is not that the availability of Fund financing in emergencies encourages countries to behave recklessly, for Fund conditionality is such that governments in trouble are usually too slow rather than too fast to come to the Fund. Instead the hazard is that the private sector may be too willing to lend because it knows that a country in trouble will go to the Fund rather than default. Spreads in some markets are so low as to support this view. The international community has struggled with the question of how to reduce this moral hazard, but has not yet found a good solution. We need to find one, a way of ensuring that the private sector shares in the financial costs of dealing with crises.

36. The regional roles in financing in both the Mexican and Thai crises raise the question of whether more permanent regional financing arrangements need to be put in place, to provide reassurance to countries that they will receive adequate help in crises. We see an important role for regional groups in the prevention of crises, by improving surveillance. We are more skeptical about the establishment of large regional funds for crisis financing, especially when their creation runs the risk of reducing the conditionality attached to crisis financing. The existence of such funds would also increase moral hazard, by making it clear to speculators that more official financing is available if a crisis hits.

37. One classic rule of lender-of-last resort financing, intended to reduce moral hazard, is not to be too clear about the circumstances and amounts in which such lending will be available. There is thus a tradeoff between the volume of funds known to be available to deal with crises, and the likely size of crises. This is a consideration that has to be weighed in considering both the size of Fund lending limits, and the desirability of prepositioning regional support funds rather than leaving them to be arranged on an ad hoc basis.

IV. The Role of the IMF and the Capital Account Amendment

38. Finally, let me turn briefly to the proposed amendment to the Articles of Agreement to extend the Fund's jurisdiction to capital movements. Against the background of the increased importance of capital movements for the operation of the international financial system, many countries have been liberalizing the capital account. Such decisions have potentially important effects on the balance of payments and on the demand for Fund resources. De facto, the Fund has become increasingly involved in helping member countries liberalize in a manner that does not undermine economic and financial stability. Yet the only formal jurisdiction the Fund has in this area is the right to require countries to impose capital controls in certain contexts.

39. In April 1997, the Interim Committee of the IMF agreed that there would be a number of benefits from amending the Fund's Articles of Agreement to make the liberalization of

international capital movements a central purpose of the Fund and to extend the Fund's jurisdiction to capital movements. In a nutshell, **the prime goal of the amendment would be to enable the Fund to promote the orderly liberalization of capital movements.**

40. In doing so, it is likely that the Fund will develop the analogies for the capital account of the present Articles VIII and XIV that apply to the current account. When they are ready, members accept the obligation under Article VIII to refrain from imposing restrictions on the making of payments and transfers for current international transactions. In accepting the obligations of Article VIII, a country provides confidence to the international community that it will not impose restrictions on the making of payments and transfers for current international transactions without Fund approval and will, therefore, pursue policies that will obviate the need for such restrictions. Until a country is ready to accept Article VIII, it may, under Article XIV, maintain and "adapt to changing circumstances" existing restrictions that were in place when it joined the Fund, until its balance of payments position is sufficiently strong that reliance on exchange restrictions is no longer warranted. This framework has allowed the Fund to take account of the different starting positions of its members and has, at the same time, provided a basis for dialogue between the Fund and the member on the appropriateness of its restrictions and the policies and reforms that would be necessary to allow for their elimination.

41. Similarly, in the case of the capital account, we can envisage members eventually accepting the obligation to liberalize the capital account fully—though what precisely that means will have to be worked out. Until they are ready to do so, they would avail themselves of transitional arrangements that would be approved by the Fund. Members would be able to adapt to changing circumstances the controls in place when the amendment comes into force. New restrictions could be approved to reflect considerations of market and institutional evolution and for prudential reasons. The Fund might also have provision to approve temporarily restrictions needed to address macroeconomic and balance of payments problems. Similar to the acceptance of Article VIII, a member's acceptance of the new obligations with respect to capital movements would send a clear signal of its intentions to the international financial community, and could serve to strengthen its access to international capital markets.

42. If this framework is adopted, the Fund will have to develop its analysis and evaluation of different types of capital controls, to advise countries on which types of controls are most likely to help them attain their goals, and on optimal methods of liberalization. In doing so, we will need to distinguish between controls on capital inflows and capital outflows; between general and selective controls; between market-based and quantitative controls; between prudential controls and those imposed for balance of payments or macroeconomic reasons; and among controls on different types of capital flow—and no doubt among other categories of controls too.

43. A capital account amendment that provides for a transitional period during which capital controls could remain in place would make it possible for the Fund to encourage the

liberalization of capital flows while paying due regard to the varying circumstances of members. It would facilitate the establishment and application of a universally applied code of good behavior in the application of capital controls, enabling the Fund to determine when macroeconomic, structural, and balance of payments considerations require adherence to—or permit exemptions from—obligations relating to capital account liberalization. This is of particular importance in light of the fact that the Fund may also be called upon to finance the balance of payments problems that are caused by capital movements. And by giving the Fund jurisdiction in the area of capital movements, it would strengthen the Fund's surveillance role over international capital flows. The extension of Fund jurisdiction would thus complement rather than duplicate existing bilateral, regional, and multilateral agreements and initiatives in this area.

V. Concluding Remarks

44. I hope I have explained why we believe a capital account amendment along these lines, including transitional arrangements, will be in the interests of all Fund members. We all recognize that an international environment of free international capital movements provides enormous opportunities, but also entails significant challenges and risks for countries and the international monetary system. Recent developments in this region remind us of these risks. But the many benefits countries in this region have derived from capital inflows also remind us that no country can afford to cut itself off from the international capital markets. The increasing importance of international capital flows is a fact, which needs to be better reflected in the laws and agreements that help bring order to the international economy, and to the process by which individual countries liberalize their capital accounts. The proposed amendment to the Articles of Agreement will serve this purpose and our member countries well.