Capital Account Convertibility and Financial Sector Reforms

Anjala Kalsie[1], Chand Tandon[2]

Abstract

There can be no doubt, however, that the risks associated with capital account opening can be potentially severe; nobody denies this. But the challenge is to keep a measure of balance between those risks (which are typically stressed by the domestic ***producers*** *of financial services) and the corresponding benefits (which affect a less vocal group, the domestic* ***consumers*** *of those services).*

This paper focuses on the liberalization of capital account and that of domestic financial sectors. Although it's true that macro economic environment was equally important before going into capital account liberalization the same is not dealt in this paper. The paper is divided as follows Section 2 talks about Capital Account Convertibility, Section 3 is about Prudential and Supervisory Concerns, Section 4 deals with the Problems in Financial Sector Reforms and Section 5 finally Conclude.

1.0 Introduction

It is often emphasized at times of difficulty, openness to capital flows and the establishment of capital account convertibility will bring financial sector problems to a head more rapidly and more clearly than typically is the case in a closed economy, where financial disturbances and imbalances are more amenable to (temporary) concealment. If only for this reason of speed of transmission and transparency, it is clear that the state of a financial sector is crucial for the success and sustainability of capital account liberalization.

But there are other reasons, too: capital flows can reach magnitudes that are large relative to the size of individual domestic economies, or more precisely, relative to a government's ability to cope with them. As such, they bring with them risks for economies at large, and in particular, for financial sectors. In this context, the literature on "twin crises" (currency and financial) has been growing rapidly and numerous additional contributions are being prompted by the critical developments underway in the Asian region. These contributions highlight different facets of the experiences in the area. Some focus on shortcomings in macroeconomic management, in particular those with exchange rate and foreign

[1]*Dr. Anjala Kalsie*
Associate Professor-finance, Fortune Institute of International Business
e-mail: kalsie-anjala@yahoo.co.in
[2]*Ms. Chand Tandon*
Asstt. Professor-Finance ,NDIM
e-mail: Chandtandon@gamil.com

borrowing policy areas (e.g., Dornbusch, 1 998a); others stress the presence of weak financial sectors and faulty regulatory supervision (e.g., Filosa, 1998); yet others note the role of implicit or explicit government guarantees (e.g., Krugman, 1998); or they stress the presence of a financial panic leading to a liquidity crisis (e.g., Rade1et and Sachs, 1998). Many others take an eclectic position, pointing out that numerous factors were at work, including all of the above and stressing that despite their differences, country experiences were interrelated and all of them involved, to a greater or a lesser extent, financial sector weaknesses (e.g., Fischer, 1998a and 1998b; Perry and Lederman, 1998; Angstrom, Garber and Spencer, 1998).

2.0 Capital Account Convertibility

There are broad benefits from capital account opening at the macroeconomic level, which have been amply examined (as well as contested) in the literature. There are microeconomic benefits that accrue from it to financial sectors, particularly in the form of enhanced competition and efficiency. For that is what capital account opening exactly does: it introduces an extra dimension of competition for domestic financial intermediaries, instruments and markets.

Specifically, capital account liberalization allows domestic and foreign economic agents to choose among internal and external financial products, firms, and markets. The resulting competition benefits the consumer of financial services, even in the presence of restrictions on the direct entry of foreign financial institutions into the domestic market. In the process, liberalization fosters the development of deep, active domestic markets for equities and securities as well as of money, foreign exchange, derivative, and other financial instruments. Such evolution broadens the range of liquid assets, opens up better risk hedging - opportunities, eliminates price distortions, and promotes robust market infrastructures[1].

In sum, internal and external financial openness, through its broadening of competition, cannot but strengthen market infrastructure. In exactly the same fashion as market forces arbitrage between policies of diverse quality, they also select those markets with sound infrastructures, practices and standards. And this selection will develop pressure for those infrastructures, practices and standards to be disseminated across borders, thus fostering national as well as international stability.

Risks of Capital Account Liberalization

An increase in domestic financial sector vulnerability and a consequent higher probability of financial disruptions are commonly seen as a risk of financial liberalization in general, and of capital account opening, in particular. And certainly empirical evidence can be adduced to underpin this.

A working definition of capital account convertibility (CAC) is 'the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. 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. CAC can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions which are of a prudential nature[2].

As the definition indicates, capital account convertibility is compatible with prudential restrictions. Temporary measures to insulate an economy from macroeconomic disturbances caused by volatile capital flows are in accord with an open capital account.

Globalization has come to stay because of the increased internationalization of business opportunities and the development in information and transaction technologies. It is also accepted that if countries are convertible on the current account, capital controls are porous and ineffective. With increasing financial integration of the developing countries with financial markets in the industrialized world, opening the capital account becomes unavoidable, as a country cannot remain isolated.

'If countries do not plan for an orderly integration with the world economy, the world will integrate with them in a manner which gives them no control over events. Thus, the question is not whether a country should or should-not move to capital account convertibility but whether an orderly or a disorderly

transition is desired[3].'

[1] Indeed, one of the lessons that can be drawn from the Asian experiences is the critical importance of uniform liberalization, that is, liberalization that does not bias the opening of the economy toward a particular channel (e.g., banks). This point is discussed later on in the text, but sees also Annstrong, Garber and Spencer (J 998).

[2] Reserve Bank of India, (1997) Report of the Committee on Capital Account Convertibility, Mumbai, p.4.

[3] Tarapore, S. (1998), p. 71.

Following the East Asian crisis and the crises in Brazil and Russia many economists argued that globalization has gone too far and argued for the return of capital controls. Krugman (1999) maintained that 'sooner or later we will have to turn the clock at least part of the way back: to limit capital flows for countries that are unsuitable for either currency unions or free floating.' Bhagwati (1998) and Cooper (1998), argue that in a world with imperfect information, existing distortions get augmented in a world of free capital mobility, create situations of moral hazard, encourage excessive risk taking, and generate major and costly crises.

The forces which have led to globalization in the last decades, are here to stay. The nature of international business and the growing need to diversify risks/returns is aided by the developments in technology that cut across boundaries. The concerns raised by many after the recent crises in world markets opens the debate for the role of capital controls in an open economy and the degree of capital account liberalization, which is consistent with economic fundamentals and the overall reform process[1].

3.0 Prudential and Supervisory Concerns

The internationalization of financial markets also raises concerns regarding the weakness of various institutions around the globe and also many countries in the throes of a crisis. The opening up of the domestic securities market and domestic banking, the relaxation of the constraints on domestic credit foreign borrowing and financial investment by financial intermediaries has led to the emergence of new risk in international financial markets giving rise to a debate on prudential regulations in financial markets. Furthermore, the time available to a country to respond to a systematic disturbance has also become limited, increasing their dependence on authorities in other countries and international organisations such as the IMF.

Country experiences clearly reveal the centrality of effective prudential regulation and enforcement in the financial sector. Capital account convertibility highlights and exacerbates weaknesses of financial intermediation in the domestic economy, as could be seen during the Asian crisis in Thailand and Indonesia.

The case of Thailand in the 1990s highlighted the risks of neglecting these issues. Despite the presence of controls on inflows, Thailand experienced a crisis that was, in large measure, caused by inadequate monitoring and prudential regulation of the financial sector. Before the crisis, only about half of the banking sectors foreign currency loans were to foreign exchange generating sectors.

Capital account liberalization does not mean throwing out the baby with the bath water. Rules and regulations applicable to foreign exchange transactions are a necessary pre-condition to capital account convertibility. Comprehensive work in this direction has been underway under the aegis of the Bank for International Settlements through the Basle Committee on Banking Supervision and the Financial Stability Forum.

Liberalization of the capital account will be a gradual process accompanied by fiscal and financial reforms. International portfolio diversification requires skills in managing interest and exchange risk. It also requires availability of information to all market participants. The modus operandi for tracking information in many developing countries is still not in place. Moreover, many banks and financial institutions have problems in managing domestic interest risk and exchange risk in the domestic forex market. Since market segmentation in the financial sector is still a feature of markets in developing countries, and the banking sector remains vulnerable, a 'big bang' approach will lead to instability and sow the seeds for

an ensuing banking crisis.

4.0 Problems in Financial Intermediation and the Risk of Capital Flight in the Transition Process

4.1 Impediments to Interest Rate Convergence

A consequence of liberalization of capital flows is that it will attract further capital inflows owing to the interest rate differential. Theoretically, one of the advantages of financial liberalization with an open capital account is the convergence of interest rates to international levels. East Asian countries in the 1980s did not lead to convergence of interest rates to international levels. Capital movements were generally free in Indonesia (though there were controls on outflows), Thailand and Malaysia in the 1980s and yet full integration of interest rates did not take place. The experience of these countries emphasizes the point that inconsistent targeting of monetary policy and exchange rates alone cannot explain why interest rates did not converge to international levels. In many countries an increase in demand for credit was observed possibly due to a wealth illusion created by overall liberalization and improved property rights. Also over-valued currencies led to interest rates being maintained at higher levels, as foreign lenders and domestic residents perceived higher exchange risks and demanded higher returns. Today increasing emphasis is also being placed on the structure and organization of the domestic financial market. Microeconomic factors such as segmented capital markets between lending institutions and across uses of funds, oligopolistic structure of the finance industry permitting oligopolistic price behavior, lack of supervision, interlocking ownership of banks and firms, and distress borrowing adding to credit demand and the overhang of bad loans.

Instability in the system can be further aggravated by the credit risk, which accompanies high interest rates that raises the percentage of non-performing assets in the system. In the next section we discuss some of the impediments in developing countries financial systems to aid understanding of the financial intermediation issue.

4.2 Impediments in Financial Intermediation

The need for controlling short-term flows arises because of the inability of financial markets in developing countries to bear the risk for financial intermediation of financial flows from the short to the long end. However, it is tempting for countries to raise capital at the short end because the cost of capital is lower at the short end and higher at the long end of the yield curve. The experience with financial crisis shows that it is advisable to bear the higher cost of capital at the long end of the yield curve and avoid short-term debt driven crisis at a stage when financial markets are not well developed. There is a growing consensus that the build – up of short-term debt was an important factor behind the East Asian debacle. Furman and Stiglitz (1998) remark on the ability of this variable to predict the crisis of 1997. Almost all the crisis-ridden countries have one thing in common, large ratios of short-term debt, whether public or private to international reserves. Rodrik and Velasco (1999) also analyze the role of short-term debt in generating a crisis in a framework that simultaneously determines the debt maturity and the term structure of interest rates. In his view the term structure of interest rates is determined by the riskiness of different debt maturities.

There is justification for controlling short-term and other flows in the transition phase, as lengthening of maturities can reduce vulnerability to a crisis. The experience of industrialized countries and Chile, Colombia and Malaysia shows that controls of different kinds alter the maturity composition of loans from abroad, without reducing the overall volume of capital flows. But in the long run as well developed financial markets gain sophistication; short-term debt will play a successful role in financial intermediation, increasing both the demand and supply for short-term debt[1].15

4.3 Segmented Markets

We now discuss some of the problems with domestic financial intermediation, which needs to be resolved before the economy can intermediate global capital. Financial reforms in many developing countries have encouraged the emergence of market determined interest rates and the move from direct to indirect instruments of monetary policy. The freeing of interest rates has however not resulted in the emergence of an interest rate structure that reflects the differences in liquidity, maturity and risk. The prevailing interest rate structure in many countries is indicative of a segmented financial system. Liquidity

shortages/surpluses in the short end of the market do not get automatically adjusted through financial intermediation in other segments of the financial market.

In any financial system there are important linkages between the money market, the capital market, government securities market, the forex and the inter-company deposit market. Volatility in one segment of the market gets transmitted to other segments of the market. Financial intermediation between these segments should act as shock absorbers and contain volatility. The impediments to the working of a seamless financial market can range from purely psychological factors to those that require institutional changes in the banking system, other segments of the financial market and policy changes by Central Banks in these countries.

4.4 Asset Liability Management and Non-Performing Assets

In some countries, the banks role as intermediary in allocating financial resources in the system gets seriously impaired by the health of its own balance sheet. Maturity mis-matches and non-performing assets are common problems in many banks. Legal reforms for the recovery of bad loans and procedures for their recovery need to be introduced. The Basle Committee recommendations address many of these issues. For better asset liability management it'is imperative to have an integrated treasury for the government securities, forex and money desk as well as the treasury department of foreign branches abroad. The banks need to consolidate information on its own operation in different segments to enable it to better manage their maturity and risk structures. A second much needed step in many developing countries banking systems is to move away from average pricing to marginal pricing in their operations. Training of personnel in asset liability management is imperative.

4.7 The Risk of Capital Flight16

Developing countries faced with the decision to liberalize capital outflows are often in a dilemma for fear that liberalization will lead to capital flight[1]. The loss of domestic savings and the ensuing fall in investment and income is a risk, which no policy maker can afford, particularly as liberalization of outflows also involves pension funds moving out of the country. There are two sides to this argument. Those in favor of a big-bang approach or a faster rate of liberalization argue that an open capital account provide opportunities for risk diversification and financial intermediation leading to an increase in welfare. They also opine that if economic fundamentals are in order and the country's policy is credible, capital flight will not take place. It is also often argued that capital controls are ineffective in stemming outflows of capital, and therefore their removal will not increase the export of capital.

It is necessary at this stage to enumerate the various factors, which can possibly motivate capital flight. In order to do so a distinction is made between a real resource transfer or one-way capital flight; and capital flight as part of a two-way flow. One-way capital flight is motivated by one or a combination of the following set of factors: Taxes (deviations from world levels), inflation, fears of devaluation, threat of default on government obligations due to high or unsustainable fiscal deficits, taxes on financial intermediation, and potential confiscation due to political instability. Capital flight as part of a two-way flow can be motivated by the differences in taxes and their incidence between residents and non-residents, differences in the nature and incidence of country risk, and asymmetries arising due to differences in the application of guarantees, interest rate ceilings for residents, differences in the availability of information and differences in the nonresidents access to foreign exchange denominated claims. The impact of a real resource transfer does lead to a decline in saving, investment and growth. The consequence of capital flight being part of a two-way flow is an erosion of the domestic tax base. This variety of capital flight turns harmful when flight of capital by domestic residents signals to foreign investors that conditions are not so stable in the county resulting in the pulling out of capital by the foreign investor[2].17

Section 5 Conclusion

The main impediments in the way of capital account convertibility are the weak initial conditions related to the health and development of the financial sector and problems related to asset liability management of the banking system. Of crucial importance are measures addressing bank soundness, interest risk

management, hard budget constraints for public enterprises, the oligopolistic structure of the banking industry, and market segmentation. Without underlying changes in the structure of the financial system, macroeconomic and financial instability is a predictable consequence of moves towards capital account liberalization.

Capital flight may be a problem for economies opening their capital accounts. The overall investment climate, political and economic instability, and asymmetric risk and information motivate capital flight. Capital can also leave through leads and lags if the current account is convertible and the capital account remains restricted. Further work is needed based on country experiences to determine which restrictions on the current account can be used effectively in the transition phase. Evidence on unrecorded capital flows demonstrates that capital can leave through various channels under both closed and open capital account regimes. While unrecorded flows may occur because appropriate information systems are still not in place, they also reflect genuine capital flight motives. The porosity of the capital account emphasizes the need to bring about the necessary reforms to control unrecorded capital flows. The conditions for liberalization discussed in this paper will be conducive for the return of past capital flight.

Offshore centers can play a role in a financial crisis and create havoc for a developing economy. Harmonization of tax regimes, financial liberalization under prudential oversight, and capital account liberalization can reduce the appeal of offshore centers. A process of coordination between onshore and offshore supervisory authorities will also contribute to financial stability in the world economy.

References

Ariyoshi, A. *et al.* forthcoming. *Country experiences with the use and liberalization of capital controls*, advance copy, Washington DC: International Monetary Fund.

Bhagwati, J. 1998. 'The Capital Myth: The Difference between Trade in Widgets and Dollars,' *Foreign Affairs*, vol.77, no.3 (May/June), pp.7-12.

Bhinda, N., S. Griffith-Jones and M. Martin. 1998. 'The Scale and Monitoring of Capuital Flows'.

Cardoso, E. and I. Goldfajn. (1998) 'Capital Flows to Brazil: The Endogeneity of Capital Controls', IMF *Staff Papers*, vol.45, no.1 (March), pp.161-202.

Chang, H., H. Park and C. Yoo. 1998. 'Interpreting the Korean crisis: financial liberalisation, industrial policy and corporate governance', *Cambridge Journal of Economics*, vol.22,special issue, pp.735-746.

Cooper R. 1998. 'Should Capital Account Convertibility be a World Objective?', In P.Kenen(ed.), 'Should the IMF Pursue Capital Account Convertibility?', *Princeton Essays inInternational Finance*, no.207 (May), Princeton, N.J.: Princeton University Press, pp.11-19.

De Gregorio, J., Edwards, S. and R. Valdes (1999) 'Capital Controls in Chile: An Assessment', manuscript, Central Bank of Chile, March.

Dooley, M. 1996. 'A Survey of the Literature on Controls Over Internatiional Capital Transactions', *IMF Staff Papers*, vol.43 (December), pp.639-687.

Edwards, S.1999. 'How Effective are Capital Controls?', *Journal of Economic Perspectives*,vol.13, no.4, Fall, pp.65-84.

Edwards, S. 1984. 'The Order of Liberalization of the External Sector in Developing Countries', *Princeton Essays in International Finance*, no.156, Princeton, N.J.: Princeton University.

Eichengreen, B. *et al.* 1998. 'Capital Account Liberalization: Theoretical and Practical Aspects', Occasional Paper, no.172, Washington, DC: International Monetary Fund.

Furman, J.and J.Stiglitz. 1998. 'Economic Crises: Evidence and Insights from East Asia', *Brookings Papers on Economic Activity*, no.2, pp.1-135.

Gallego, F., Hernandez, L. and K. Schmidt-Hebbel. 1999. 'Capital Controls in Chile: Effective? Efficient?', Working Paper, no.59, Santiago: Central Bank of Chile.

Hanson, J. 1994. 'Opening the capital account: costs, benefits, and sequencing'. In S.
Edwards (ed.), Capital Controls, *Exchange rates and Monetary Policy in the World Economy,*Cambridge: Cambridge University Press, pp. 383- 429.

IMF. 1999. Exchange rate Arrangements and Currency Convertibility: Development and
Issues
James, H. 1999. 'Is Liberalization Reversible?,' *Finance and Development,* vol.36, no.4
(December).

Johnston, B. 1998. 'Sequencing Capital Account Liberalizations and Financial Sector
Reform,' IMF Paper on Policy Analysis and Assessment, PPAA/98/8 (July), Washington,
DC: International Monetary Fund.

Kahn, B. and J. Leape. 1997. 'South African Exchange Control Reform: An Update,'
Quarterly Review (July), Centre for Research into Economics and Finance in Southern
Africa, London: London School of Economics.

Kaminsky, G., S. Lizondo and C. Reinhart. 1998. 'Leading Indicators of Currency Crises',*IMF Staff Papers,* vol.45, no.1 (March), pp.1-18.

Little, I., T. Scitovsky and M. Scott. 1970. *Industry and Trade in Some Developing
Countries: A Comparative Study,* Oxford: Oxford University Press.

Lopez-Mejia, A. 1999. 'Large Capital Flows: A Survey of Causes, Consequences, and PolicyResponses,' IMF Working Paper, WP/99/17 (February), Washington, DC: InternationalMonetary Fund.

MacDougall, I. 1968. 'The Benefits and Costs of Private Investment from Abroad: A
Theoretical Approach.' Reprinted in R. Caves and H. Johnson (eds.), *Readings in
International Economics,* London: Allen and Unwin, pp.172-194.
Persson, T. and L. Svensson. 1985. 'Current Account Dynamics and the Terms of Trade:
Harberger-Laursen-Meltzer Two Generations Later,' *Journal of Political Economy,* vol. 75,pp.43-65.

Reinhart, C. and T. Smith. 'Temporary Capital Controls', mimeo, August 1997.
Reserve Bank of India.1997. *Report of the Committee on Capital Account Convertibility,*
Mumbai: Reserve Bank of India.

Svensson, L. 1988. 'Trade in Risky Assets,' *American Economic Review,* vol.78 (June),
pp.375-394.

Tarapore, S. 1998. 'An Indian Approach to Capital-Account Convertibility'. In P.Kenen
(ed.), 'Should the IMF Pursue Capital Account Convertibility?', *Princeton Essays in
International Finance,* no.207 (May), Princeton, N.J.: Princeton University Press, pp.66-75.
Valdes, S. and M. Soto (1998) 'The Effectiveness of Capital Controls: Theory and Evidencefrom Chile', *Empirica,* 25 (2).

Villar, L. and H. Rincon. (2000) 'The Colombian Economy in the Nineties: Capital Flows and Foreign Exchange Regimes', paper presented at a conference at the University ofToronto, June 1-2.

Williamson, J. 1993. 'A Cost-Benefit Analysis of Capital Account Liberalization.' In B.
Fischer and H. Reisen (eds.), *Liberalising Capital Flows in Developing Countries: Pitfalls,Prerequisites and Perspectives,* OECD Development Centre Studies, Paris: OECD.

Zahler, R (1993) 'Monetary policy and an open capital account', *CEPAL Review,* no.48, p.157-166.