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OECD Members' experience with capital account liberalisation and its relevance to other countries

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As a precursor to my presentation, I wish to give credit where credit is due, namely to my colleague Ms Eva Thiel and numerous other colleagues inside and outside the OECD Secretariat. They have put together a compendium presenting the wealth of OECD Member countries' experience with capital account liberalisation in a single volume. This having been said, the responsibility for any of my statements here today, will of course be mine alone.

The OECD Code on Liberalisation of Capital Movements

The OECD is over forty years old and so is its main instrument to achieve capital account liberalisation: its Code of Liberalisation of Capital Movements. Strikingly, the Code is still the single multilateral legal instrument that requires its adherents to open up their capital markets and refrain from discriminating against foreign investors, although regional instruments also exist, such as the relevant Directive promulgated by the European Commission in 1988.

The OECD's Capital Code is a legally binding instrument. Nevertheless, it is "soft law" in the sense that it is not enforced by law courts and that there are no sanctions for non-compliance. If an OECD member is found to contravene its obligations, there will be consultations in the relevant OECD Committees, peer pressure from the other members, and eventually a recommendation by the OECD Council. This system does work, but the process is sometimes drawn-out and arduous. For all practical purposes, the political commitment that member countries undertake to meet the standards of the Code is more important than its legally binding nature.

The main provisions of the Code are the following:

- *Rollback:* A general undertaking to liberalise cross-border capital flows progressively;
- *Reservations:* The right to lodge reservations against those obligations that the country feels it cannot meet immediately;

- *Ratchet:* For most types of operations, it is impossible to reimpose restrictions that have been lifted, except under temporary derogations in case of serious problems for the balance of payments or the financial system;
- *Non-discrimination:* An obligation not to discriminate among OECD members: any restrictions should be applied equally to all, and once an operation has been liberalised, this too, should benefit all other OECD members;
- *Notification:* An obligation to notify the OECD of any restrictions on cross-border capital flows;
- *Examination:* Restrictions will be examined by the OECD membership and members will advise and exert peer pressure with the aim of limiting any restrictions to a minimum.

The Capital Movements Code should not be confused with another OECD instrument, namely its Declaration on International Investment and Multinational Enterprises. The Code deals with liberalisation of all capital flows. The Declaration deals primarily with the rights and obligations of foreign-owned enterprises: it protects them against discrimination and conflicting requirements and offers them a set of standards for good corporate conduct, the OECD Guidelines for Multinational Enterprises. Furthermore, the Code is adhered to by OECD members only, whereas the Declaration can be acceded to by non-members, and actually is.

Capital account liberalisation: A new paradigm

Having been committed to progressive capital account liberalisation for more than forty years, the OECD Members do have a story to tell on the subject. But I must issue a caveat: not all of our member countries have been with us for the full forty years. Indeed, six of them joined the OECD only during the past eight years: Mexico, the Czech Republic, Hungary, Poland, Korea and Slovakia. The experience of these six new members is not only more recent, it is also more *relevant* for any non-member that may wish to emulate the standards of the Capital Movements Code. I should stress this point even more strongly: it would be misleading to suggest that anything our founding members have done over the past forty years provides a script for any other country that wishes to open up its capital market to the outside world.

This was not immediately obvious to some of our new members. For example, the Koreans set out by arguing that, if many OECD members had taken 20 to 30 years to complete their liberalisation process, they should not be expected to take less. It took a while to convince the Koreans that the times had changed. However, Korea is now convinced, and it is none the worse for it. Indeed, it is no coincidence that the six new members have liberalised much more swiftly than many of the old: their liberalisation was pursued in the 1990s, in an environment that was radically different from that of the 1960s and 1970s, as I will explain in a moment. Even more importantly, unlike some of our founding members, the newcomers have not turned the clock back by introducing new restrictions along the way, barring some minor exceptions. This was all the more striking as some of them were hit by serious financial crises, not least Korea, but also Mexico, and to some extent the Czech Republic.

Financial crises indeed, and this just after the countries had joined the OECD and undertaken to open up their capital markets. It begs the question whether the OECD had asked these countries to do too much too quickly, thus leaving them unduly vulnerable to external shocks. Legitimate as the question is, the answer must be "no". I will deal with it in greater detail in a few minutes, but already make three points: *(i)* the leading causes of the crises were already in place before the countries' accession to the OECD started, *(ii)* the most volatile segments of the financial and capital markets had not been liberalised when the crisis hit, *(iii)* last but not least, the countries in question tended to accelerate their liberalisation process in response to the crisis: to them, liberalisation was part of the cure, rather than a luxury which they would not be able to afford until after their recovery.

This last point underlines how much we have seen a paradigm shift on capital account liberalisation over the past few decades. The arguments in favour of liberalisation have become more compelling, the arguments against it less so. To summarise the main benefits of liberalisation:

- It offers access to a global pool of savings, which fosters their allocation towards the most productive uses;
- It enhances competition among financial institutions, improving their efficiency;
- It offers investors ways to diversify their portfolios and thereby to reduce risks;
- It familiarises issuers of securities to advanced disclosure and corporate governance standards in foreign markets, which helps to improve such standards world-wide.

Arguments in favour of *restricting* cross-border capital flows had their heyday in the 1960s, when the Capital Movements Code was first established. In those days, restrictions on cross-border capital movements were widespread and seen as a legitimate way of preserving monetary policy independence and the exchange rate. The charter of the IMF expressly allowed for such restrictions, as a complement to the Bretton Woods system of fixed exchange rates. It still does, and only recently has it been a point of serious discussion whether this clause in the IMF's articles of agreement should be amended, but any momentum seems to have been lost in the financial crises of the late 1990s.

Most arguments that countries put forward for capital restrictions were variations on a common theme, also known as Mundell's "impossible triangle": that it is impossible to maintain a fixed exchange rate, independence of monetary policy and freedom of capital flows at the same time. Official arguments for restricting capital outflows were expressed as a need to safeguard monetary reserves, to help maintain external equilibrium, and to protect the currency. Arguments for restricting capital inflows were related to monetary policy autonomy, and also to a policy of preventing foreign control in certain key economic sectors.

The economic environment in those days was not only one of fixed exchange rates. Monetary policy was often conducted differently from today, with a stronger emphasis of direct methods of credit control. For example, my native country, the Netherlands, retained the option until the late 1980s to impose controls on foreign credits, whenever the central bank set a ceiling on domestic credit expansion. Logically, a domestic credit ceiling could be circumvented by borrowing abroad. Given the fixed exchange rates, such credits from abroad would have expanded the money supply, thus undermining the central bank's restrictive monetary policy. Capital controls were therefore seen as a necessary complement to direct credit controls.

Another difference with today's environment was that capital markets used to be more compartmentalised than they are nowadays, with stricter separations between short-term and longer-term markets. This made it easier than it is today to liberalise the longer segments of the markets, while keeping the shorter under tight control.

In keeping with the times, the Capital Movements Code of the 1960s and 1970s was therefore limited in purport: the items it covered included the transfers related to foreign direct investment, trade credits and certain longer-term securities. But it seemed only natural that "hot money flows", short-term capital movements of a predominantly speculative nature, should not be covered. Indeed, the Code would not contain any requirements to liberalise such flows until the 1990s. This extension of the Code to cover short-term capital and a range of other items vastly extended its scope, but also the its importance. This was particularly clear in the mid-1990s, when the accession procedures for six new OECD members started: the Capital Movements Code had taken centre stage as a touchstone for the assessment of candidate countries' willingness and ability to assume the obligations of OECD membership.

A touchstone for OECD membership candidates

New members are not required to drop all their capital account restrictions overnight before acceding to the OECD. Rather, they will be asked:

- To refrain from restricting payments and capital transfers in connection with *permitted* international transactions;
- To have an open and transparent regime for foreign direct investment;
- To have liberalised all or most long-term capital movements, in particular those involving shares and longer-term bonds;
- To provide a timetable for the future liberalisation of any restricted operations.

As a general rule, the six new OECD members have stuck to their agreed undertakings and timetables. The main problem occurred with Poland, which had originally committed itself to abolishing all its restrictions on portfolio capital by the end of 1999, but in the end adopted a foreign exchange law that maintained certain safeguard measures to restrict all non-FDI capital flows in case of unspecified "extraordinary risk" to Poland's financial system. OECD members found this to be not quite in line with Poland's earlier undertakings. Nevertheless, it is important to note that all new members have stuck to their commitments to liberalise their capital accounts according to plans, without invoking any derogation clause, and this in spite of circumstances that were much graver than foreseen at the time of their accession. Why is that capital restrictions are no longer seen as a serious policy option among OECD member countries and that even the new members have accomplished their liberalisation in much shorter timespans than many of the founding members? Important reasons are:

- The cure may be worse than the disease: reneging on earlier commitments undermines governments' credibility, which is the last a country needs in times of crisis and the effects of which may be felt even long after the crisis has passed;
- The advantages of capital liberalisation have become more manifest and widely accepted than they were until 15-20 years ago;
- Restrictions can be more easily circumvented, as capital markets have become more sophisticated, with the emergence of advanced instruments blurring the distinctions between their short-term and long-term ends, so it makes more sense to "go all the way" swiftly, rather than to opt for a drawn-out sequencing of liberalisation;
- Monetary policies have changed and now rely less on direct controls than indirect, market-based ones, and therefore less on the option of (re)introducing capital controls;
- Maintaining capital controls requires an enforcement apparatus, *i.e.* an infrastructure of controlling officials and authorised foreign exchange banks, which in most OECD countries has been dismantled and cannot be easily resurrected.

While all these arguments militate in favour of sticking to liberalisation commitments, even if times are bad, there is a legitimate question as to whether such commitments should not be allowed to wait until a country's domestic financial system has become sophisticated enough to withstand external shocks: the sequencing question. This is precisely the concern raised by Korea during its negotiations on OECD membership in 1995 and 1996, in the knowledge that its banking system was already weak at the time.

One answer is that, yes, a less advanced domestic financial system will be more vulnerable to external shocks than a more sophisticated. However, this is only part of the story, the reason being that domestic financial reform and capital account liberalisation are not two separate processes: they mutually reinforce each other. This is so because both capital account liberalisation and domestic financial reform will enhance the role of foreign banks on the domestic market. This will reinforce competition in the banking sector, introduce advanced financing techniques involving foreign capital and, finally, introduce advanced standards for supervision, disclosure and corporate governance. It is worth noting that Korea, after the outbreak of the financial crisis in 1997, decided to liberalise the participation of foreign banks on its domestic market in full, and to take a number of other liberalising measures, for example on inward financial loans. These were moves which Korea had still resisted ahead of the crisis.

This brings me to my final point: did Korea's liberalisation, agreed in the context of its OECD accession, aggravate its 1997 financial crisis? It must be remembered that a leading cause of the crisis was the existence of currency and maturity mismatches which resulted from cross-border borrowing by Korean banks on the interbank market. These operations were already liberalised long before Korea's accession to the OECD and played no role in the accession negotiations. Furthermore, the OECD did not require Korea to liberalise foreign investment in short-term capital market instruments and financial credits, which remained fully restricted at the time of Korea's accession. Finally, the OECD did point out the prevailing weaknesses in Korea's financial system, and not least the need for modernising its supervisory framework. To quote the former Permanent Representative to the OECD, Dr Soogil Young: "Korea's financial crisis happened because of problems at home and had nothing to do with its accession to the OECD." With this, I rest my case.