FINANCIAL AND MACROECONMIC MANAGEMENT UNDER A LIBERALIZED CAPITAL ACCOUNT: OPPORTUNITIES AND RISKS

Paper presented at
The 5th Central Reserve Bank Governors Forum

Organized by
Macroeconomic & Financial Management Institute of Eastern and Southern Africa

Euler Hotel, Basel, Switzerland

June 12 and 13, 2001

Yoon S. Park
Professor of International Banking & Finance
George Washington University
Washington, D.C.

Financial and Macroeconomic Management Under a Liberalized Capital Account: Opportunities and Risks

Capital account liberalization can have significant benefits for a country by enhancing the country's ability to access international capital markets and by improving resource allocation through increased competition for financial resources. Capital is a development resource, just as manufacturing inputs and labor are resources, the availability of which determines whether and which programs and projects are undertaken. As a key element of investment and growth, the efficiency with which financial resources are distributed within an economy largely determines economic growth. No matter what resources countries have in abundance, "the biggest difference between rich and poor is the efficiency with which they have used their resources. The financial system's contribution to growth lies precisely in its ability to increase efficiency."[1] Development of efficient financial systems in developing countries has been severely constrained by the neglect of institution building in both private and public sectors. In recent years, however, promoting the efficient functioning of financial institutions and markets has become a major policy goal for many developing countries. The process of financial development has two dimensions: domestic financial deepening and international financial integration. While both dimensions are important to economic growth, they may become the cause of either success or failure of an economic plan, depending on the sequence and intensity of their implementation.

Domestic financial deepening refers to the promotion of financial activity and capital formation resulting from an increase in the level of competition in domestic financial markets. Some of the measures frequently used include elimination of credit controls and credit rationing, interest rate ceilings, differential reserve requirements, and also elimination of discriminatory practices and capital requirements that curtail free entry of local participants into domestic financial markets.

International financial integration occurs when capital controls are removed and the capital account is freed to allow financial resources to flow freely in and out of the country. Barriers to the entry into the local market by foreign financial institutions are removed and their access to various financial services and market activities is liberalized. As a result, the domestic economy acquires the characteristics of the international economy, such as entrepreneurship, competition, innovation and dynamism. The free market compensates for domestic inflation with adjustments in the exchange rate and domestic interest rates. In theory, the speed with which inflation, exchange and interest rates reach equilibrium is evidence of the degree of integration between the domestic financial system and international financial markets.

[1]World Bank, World Development Report 1989, p.26.

Objectives of Capital Account Liberalization

Financial policy in developing countries has increasingly focused on the objective of improving the efficiency of the financial system, without, however, neglecting the two other main objectives, namely to ensure the stability and soundness of the financial system and to maintain an adequate level of investor protection. Efforts towards modernizing national financial systems have gathered considerable momentum since the early 1980s under the impact of increasing internationalization of financial markets and intensifying competition within and between national financial systems. Competition policies have become a major, although not the only, policy tool for improving the efficiency of the national financial systems. In this context it needs to be stressed that competition is not seen as a goal in itself; the ultimate objective is efficiency. In implementing policies towards improving the efficiency of national financial systems, a wide range of measures have been devised to stimulate competition and strengthen the role of market forces. These measures include the deregulation of interest rates and other financial service fees such as stockbroker's commissions to promote price competition and the liberalization of various financial activities to enhance the role of market forces.

A most striking feature of developments on the supply side of the markets for financial services has been the trend towards diversification and decompartmentalization, or blurring of demarcation lines between formerly separated sectors of the financial system. The driving forces behind this trend have originated both from the market side and from the government side. While financial institutions have used diversification strategies as a major weapon for competing vigorously in the rapidly growing and increasingly widening markets for financial services and products, the government authorities have generally supported this trend also, often in connection with broader financial reforms designed to improve the efficiency and the functioning of their countries' financial systems.

The diversification and despecialization process has no doubt been one of the major factors contributing to intensified competition in the vast markets for financial services and products, although the speed and intensity of this development has varied from country to country depending on differences in historical and legal frameworks and on regulatory changes. In the process of regulatory reform designed to build more integrated financial systems, the authorities have often paid considerable attention to the question of competitive equality and have taken measures to ensure that the "players" in the market compete with equal weapons on a level playing field.

Financial integration manifests itself in two major formats: functional and international.

(a) Functional financial integration has lessened the operational identities among those financial institutions with formerly distinct product lines, such as commercial versus investment banks, savings and loan associations, insurance companies, postal offices, and consumer credit companies. Policies towards despecialization and diversification of financial services and products which banks and other financial institutions are allowed to offer, were generally more important in countries with historically more segmented financial systems than in countries with more open and homogeneous systems.

This applies in particular to savings institutions that in a number of countries traditionally acted as collectors and guardians of small savings that were to be channeled into narrowly defined uses such as housing finance or government securities. In most of these countries such savings institutions have gradually been allowed to become full-scale retail banking institutions and have thus been integrated with the banking system. In the United States, for example, the S & L crisis in the late 1980s accelerated the trend towards transformation of S & Ls from traditional, narrowly-defined home financing services into broader full-service financial institutions. In a similar way, the financial service powers of post office systems have sometimes been enhanced by the authorities with a view to making more efficient use in the distribution of financial services and products of the wide branch network that postal systems usually have at their disposal.

Another trend within the broader development towards diversification and the blurring of demarcation lines within financial systems has been the process of integration of the banking sector with the securities markets and the specialized institutions operating in them. This process has in particular affected those countries in which the two sectors have historically been separated by law or tradition. Among the industrialized countries, the United States, Japan and Canada were the main examples where the separation between commercial and investment banking used to be maintained rather strictly, whereas in the Continental Europe and other countries the role of banking institutions has been traditionally more widely interpreted and practiced, including both commercial and investment banking activities. In recent years, however, we are witnessing a growing trend toward broadening financial activities by banking institutions. In the United States, the Glass-Steagall Act of 1933, which separated commercial banking from investment banking, was formally removed in 2000, thus freeing U.S. financial institutions to engage in commercial and investment banking as well as insurance business.

(b) <u>International or cross-border financial integration</u> through capital account liberalization is perhaps the most significant financial integration. In fact, among the most noteworthy financial market developments during the recent decades has been the trend toward internationalization, financial innovation, and securitization. While these developments interact with each other, internationalization has been instrumental in providing a fertile ground for financial innovation and securitization. The degree of international financial integration can be seen by various measures to facilitate a free flow of capital and financial services across national boundaries.

<u>Economic Rationales for Capital Account Liberalization</u>

After several decades of preoccupation with the dirigistic and interventionistic role of the government in promoting economic growth, an increasing number of developing countries have shifted their development focus to market signals guiding the allocation of resources in which the role of prices is being emphasized, profits are becoming a measure of economic success for enterprises, and financial markets are being promoted to allocate resources to profitable activities within a competitive environment. Deregulation and liberalization in the financial system is encouraged to nurture competition among various financial institutions and markets and to enhance allocative efficiency in the economy. While the post-war economic development model was inward-oriented, relying upon government intervention to set pricing signals and promoting a strong participation of the state in the production of goods and services, the new approach is outward-oriented through a free market mechanism where the market prices play the dominant allocative role. The role of the government in the new outward-oriented development model is to provide a level playing field for all financial institutions through deregulation and integration. Thus, financial integration becomes an integral part of the new development model. Here the existence of a substantial private sector is a necessary but not a sufficient condition for economic development, which also requires open competition free of oligopolistic and privileged practices perpetuated by protective barriers and subsidized credit.

International financial integration through capital account liberalization and other measures is also predicated upon the efficiency argument. By removing barriers to new entry and promoting competition on a global basis, international financial integration lowers both the cost of funds and the cost of financial services. Liberalized capital movements combined with market-determined exchange rates pull down the domestic cost of funds to that of international level. Furthermore, the elimination of national barriers in financial services stimulates competition among the financial institutions, thus lowering the prices of financial services such as service fees and brokerage commissions. While financial market integration may not mean equalization of financial service prices, price convergence toward the lowest denominator is one of its positive results.

International financial integration also enhances risk diversification for both borrowers and investors. Availability of a wider array of financing sources both domestically and internationally reduces not only the funding cost but also the fund availability risk for a borrower. If one financing source dries up, other sources can be tapped freely. International diversification of funding sources, formerly available mostly for the borrowers from industrialized countries, now becomes a feasible option for LDC borrowers through financial market integration. For international portfolio investors, availability of various investment securities in many capital markets including those of developing countries enhances the risk-return profile of their investment portfolio. A study by Bruno Solnik demonstrates that an active strategy of international portfolio diversification including certain Pacific Basin markets improves the portfolio performance. Especially, he noticed that inclusion of some Pacific Basic capital markets such as Korea, Taiwan and Thailand in the U.S. dollar-numeraire international portfolio significantly improves the risk-return profile.[2]

Capital account liberalization may also bring about the critical mass necessary for a market to enjoy the economies of scale and risk sharing. Modern financial markets require both sophisticated functional expertise and up-to-date market information. Such knowledge cannot be generated in a vacuum; it needs constant innovations and cross-fertilization of ideas among bankers and other finance professionals.[3] Individual national markets, if isolated from other active financial centers of

[2]Bruno Solnik, "Pacific Basin Stock Markets and International Diversification," a paper presented at the Second Annual Pacific Basin Finance Conference, Bangkok, Thailand, 1990.

[3]Yoon S. Park, "The Economics of Offshore Finance Centers," Columbia Journal of World Business, Winter, 1982.

the world, cannot benefit from new financial techniques and products and tend to be dominated by tradition-bound financial institutions that often behave oligopolistically. Integration brings about the critical mass necessary for the financial intermediaries to experiment with new techniques and to stay competitive and innovative. The critical mass argument is particularly relevant for the financial markets of developing countries, which by themselves remain too small and too fragmented to engender the innovative and entrepreneurial spirit essential for modern financial market activities.

Economic Costs of Capital Account Liberalization

At the same time, however, the opening of the capital account entails certain risks, if not accompanied by the necessary structural reforms and macroeconomic policies. While international financial integration promotes competition and enhances market efficiency and financial innovations, it can also have a destabilizing effect on an economy, particularly when attempted prematurely. Developing countries are especially prone to this negative effect. One reason is that the financial infrastructure of developing countries, when compared with mature economies, is too weak to withstand the economic shock of changing suddenly from an inward-looking economy to an open economy. Capital account liberalization may even aggravate other deficiencies existing within various sectors of the economy, thus producing an overall negative impact and not achieving the desired outcomes.

An example is the experience of Argentina, Chile and Uruguay, which pursued open market reforms starting in the mid-1970s. In varying degrees, they eliminated constraints on capital flows, decontrolled interest rates, and relaxed many trade restrictions. Initially some efficiency gains were made but these were ultimately overshadowed by problems with policy inconsistencies, implementation difficulties, and overlooked market frictions. A main cause of the failure was the fact that, at the time reforms started, the three countries were experiencing severe macroeconomic imbalances, including foreign exchange shortages and high inflation. Another contributing factor was the absence of adequate prudential regulatory constraints on financial activities. The adoption by the Southern Cone countries of tablita (pre-scheduled exchange rate devaluation table) initially induced capital inflows, as domestic interest rates were higher than foreign interest rates even after the adjustment for exchange rate depreciation. Subsequently, however, tablita also raised domestic inflation due to both money supply expansion induced by free capital inflows and driving up the prices of nontradables.

There are many reasons for the high risk of failure of premature or hastily implemented capital account liberalization, especially in developing countries. Despite recent progress in some developing countries, most LDC financial markets are still shallow and repressed with no required depth, liquidity and breath as in developed markets. LDC capital markets suffer from poor financial infrastructure. Licenses for new financial institutions are too strictly controlled by governments, even though the proper role of a government in the securities market, which is quintessentially based upon the private initiatives, should be limited to that of a prudential regulator rather than a controller or interventionist. Such areas as proper accounting and auditing standards, legal rights of investors, and adequate disclosure rules and so on should be the main areas of concern to the government in promoting financial markets. One of the major hurdles to development of well-functioning financial markets in developing countries is the infant stage of private institutional investors. Private pension funds and insurance companies are not yet important investors in capital market instruments, mostly keeping the bulk of collected funds in time deposits with commercial banks or tax-exempt savings certificates issued by deficit-burdened governments. In many developing countries, mutual funds are predominantly government operated, and life insurance and unit trust sectors are also dominated by government-owned institutions. Thus, the financial markets are often overwhelmed by government actions and policies, with little room for the private financial institutions to maneuver.

Furthermore, the financial systems of most developing countries still lack the proper balance. In almost all developing countries, commercial banks still play an overwhelmingly important role in the entire financial system. This condition has been the result of both an institutional inertia and the government policy orientation. Securities markets are essentially related to an advanced form of business finance, and as a consequence many developing countries find their securities markets at only an early stage of development. Both the volume as well as the institutional structure is inadequate compared to that of industrialized countries where securities markets have played a vital role in the overall allocative process of savings and investment funds. Not only the securities markets but also nonbank financial institutions (finance companies, development finance institutions, investment and merchant banks, insurance companies, pension funds, venture capital firms, and so on) constitute a relatively small part of the financial system in a typical developing country. Instead, commercial banks play the dominant role in intermediating a nation's financial flows among various sectors of the economy. Commercial banks necessarily tend to view securities markets as their competition and have no incentive to encourage the latter's development. Such hostility on the part of commercial banks toward securities markets is shared equally among private as well as government-owned commercial banks. The dominant position of commercial banks in most LDCs stifles both innovation and competition in the financial system essential to the healthy growth of securities markets.

Even where the private financial sector plays an increased role, the financial system in the developing world is often dominated by oligopolistic institutions. The anti-trust legislation in many developing countries is at an infant stage and large business groups, with privileged access to the government authorities, maintain close linkages with large banking and financial institutions. Thus, in many developing countries the small and medium-sized companies as well as new business ventures suffer from "double crowding-outs" by both the government and the big business groups. As LDC financial markets are both shallow and oligopolistically controlled, financial integration can sometimes be exploited by the privileged groups to enhance their oligopolistic control rather than promoting market competition and efficiency. Large business groups in developing countries are often the first to benefit from international financial integration, resulting in a greater degree of oligopolistic market control rather than enhancement of market efficiency through further competition. This risk is heightened in those developing countries where the real sector is not sufficiently integrated globally. International financial integration without concomitant real sector integration within the overall economy can often lead to further market disruptions instead of economic efficiency.

Lessons in Capital Account Liberalization

Over the past couple of decades, many developing countries have embarked upon capital account liberalization. Studies of their experience have demonstrated certain lessons to be learned in such ambitious endeavors. Prior to such liberalization, a number of developing countries generally practiced various forms of capital controls. Theoretical arguments to justify capital controls include second-best arguments and policy implementation arguments. The former identifies situations in which capital account restrictions improve economic welfare by compensating for financial market imperfections and imbalances. Proposals to address these problems range from improved disclosure and stronger prudential standards to the imposition of capital controls. The latter holds that capital controls may help to reconcile conflicting policy objectives when the exchange rate is fixed or heavily managed. Capital controls could be used when there is an important macroeconomic dilemma faced by policymakers, as in the case of Chile in the early 1990s, when internal balance required domestic interest rates to be higher than those abroad, while external balance was inconsistent with the appreciation of the currency. The Chilean government discovered that the level of domestic interest rates needed to control aggregate demand gave rise to incentives for interest-arbitrage capital inflows. That policy dilemma was behind the imposition of controls on capital inflows in 1991 in the form of unremunerated reserve requirements on foreign borrowing, while at the same time liberalizing capital outflows.

A similar policy dilemma led Malaysia to impose capital controls in 1998 but in the opposite direction in the form of capital controls on capital outflows. In the immediate aftermath of the 1997 Asian financial crisis triggered first by the sudden floating of the Thai baht in July 1997, the Malaysian currency, the ringgit, came under significant depreciation pressure along with other Asian currencies. Much of this pressure occurred through previously unrestricted currency trading in the offshore ringgit market. As speculators took short positions in ringgit in the expectation of a depreciation, offshore ringgit interest rates rose sharply relative to domestic interest rates and caused huge capital outflows. In an attempt to break the link between the domestic and offshore interest rates, the Malaysian government imposed controls on capital outflows. The capital controls were effective in achieving the objective of eliminating the offshore ringgit market and permitted the authorities time in which to implement more fundamental policy reforms, including the correction of macroeconomic imbalances and acceleration of the bank and corporate restructuring programs. Progress made so far in bank and corporate restructuring programs has also contributed to the improvement in investor sentiment toward Malaysia.

While China and India were not immune to the Asian financial crisis of 1997-98, they were less affected by it than other countries in the region. The relatively closed capital account regimes of these two countries have been credited with helping to limit vulnerability to financial contagion, though there were other factors such as strong foreign exchange reserves positions and large and relatively closed economies. Consequently, the two countries experienced only a minor slowdown in their strong economic growth, and the impact of the crisis on their financial systems was limited. On the other hand, since 1991 India has undertaken economic reforms, including partial capital account liberalization, reversing several decades of inward-looking and interventionist policies. Capital account liberalization has thus been part of a broad-based program of economic reform in the country. Many studies have shown that India's decades of wide-ranging capital and other controls practiced until early 1990s may have reduced economic growth compared with other Asian countries with a more open economic system. More aggressive capital account liberalization and international financial integration in earlier decades might have promoted a superior economic performance in the country.

Reviews of country experiences with the capital account liberalization have suggested that such liberalization has to be accompanied by strong and consistent supporting policies. They include sound macroeconomic programs combined with ongoing efforts to strengthen the financial system and implement associated reforms. In the absence of adequate macroeconomic and financial policies, capital account liberalization may increase vulnerability to external and domestic shocks. Furthermore, orderly capital account liberalization requires a proper pace and sequencing. The conventional view on sequencing is that capital account liberalization should follow the opening of the current account and the domestic financial system. However, the process can be far more complex, as each country may liberalize different components and aspects of the capital account such as direct investment and portfolio capital flows. The process should be consistent with specific aspects of the current account and domestic financial sector, in line with that country's overall macroeconomic objectives. With greater freedom of capital movements, domestic interest rates will increasingly be influenced by exchange rates via covered interest arbitrage flows. Any attempt by a government to set or manipulate both interest rates and exchange rates inconsistent with the covered interest rate parity condition would result in speculative capital flows detrimental to the macroeconomic policy objectives. Thus, with increased capital mobility, the capacity to assign monetary and exchange policies to achieve different macroeconomic targets for internal and external balances is considerably abridged.

There is also a fundamental need for an integrated approach to capital account liberalization and financial sector reform in order to maximize its benefits while minimizing its potential costs. Such an approach will generally involve the coordination of capital account liberalization with domestic financial sector liberalization and reforms. Where financial systems are weak, the governments should address the institutional weaknesses in advance of, or concurrent with, capital account liberalization. Liberalization of foreign direct investment flows is often accompanied with reforms aimed at strengthening the real sector and export potential of the economy, including various measures of corporate restructuring such as modernizing corporate governance and enhancing operational transparency through adequate disclosure rules and modern accounting standards. Liberalization of portfolio investment flows has to be coordinated with domestic financial sector reforms such as liberalization of interest rates, development of indirect monetary control procedures, and the strengthening of financial institutions and capital markets.

Such a coordinated and sequenced program of capital account liberalization does not always imply a gradualist approach. In early 1990s, Argentina and Peru successfully implemented a relatively rapid liberalization of capital account using a big-bang approach. The speed and sequencing of capital account liberalization have generally reflected a country's initial conditions and its broader economic development and restructuring. As a consequence, countries have followed diverse approaches. Big-bang approaches have usually been part of programs intended to signal a strong commitment to reform. In some cases, liberalizing the capital account even before completing other parts of the economic and financial sector reform program may be desirable. More rapid capital account liberalization can provide momentum to the overall reform process by weakening entrenched interests and oligopolistic control of domestic markets.

Bibliography

Caprio, Gerard, Jr. "International Financial Integration: Pitfalls and Possibilities," an unpublished paper, World Bank, June 1998.

Eichengreen, Barry, and Mussa, Michael. Capital Account Liberalization: Theoretical and Practical Aspects, IMF, 1998.

Goodwin, Barry; Grennes, Thomas. "Real interest rate equalization and the integration of international financial markets," Journal of International Money and Finance, Guildford, February 1994.

Greenspan, Alan. "International financial integration: macroeconomic environment," a speech delivered before the Federation of Bankers Associations of Japan, Tokyo, Japan, October 14, 1992.

IMF. Capital Controls: Country Experiences with Their Use and Liberalization, 2000.

IMF. International Capital Markets: Developments, Prospects and Key Policy Issues, September 1998.

Johnston, Barry, et al. "Sequencing Capital Account Liberalization: Lessons from Chile, Indonesia, Korea, and Thailand," in R. Barry Johnston and V. Sundararajan, ed., Sequencing Financial Sector Reforms: Country Experiences and Issues, IMF, 1999.

Kahler, Miles, ed. Capital Flows and Financial Crises, Council on Foreign Relations, 1998.

Park, Yoon S. "The Economics of Offshore Finance Center," Columbia Journal of World Business, winter, 1982.

Pill, Huw & Pradhan, Mahmood. "Financial Liberalization in Africa and Asia," Finance and Development, June 1997.

Shepherd, William. International Financial Integration: History, theory and applications in OECD countries, Avebury, England, 1994.

Schwartz, Anna. "International financial liberalization and exchange rate policies," Cato Journal, Washington, fall 1993.

Solnik, Bruno. “Pacific Basin Stock Markets and International Diversification,” a paper presented at the Second Annual Pacific Basin Finance Conference, Bangkok, Thailand, 1990.

Stern, Blackwell. “International financial markets: integration, efficiency and expectations,” Economic Record, December 1991.

Stern, Jerome. “Integration and efficiency of international financial markets,” Brown University Department of Economics Working Paper: 90 - 9 February 1990.

Thomsen, Stephen. “Recent Trends in Foreign Direct Investment,” Financial Market Trends, OECD, June 1998.

Von Furstenberg, George. “From worldwide capital mobility to international financial integration: A review essay,” Open Economic Review, January 1998.

World Bank. Private Capital Flows to Developing Countries: The Road to Financial Integration, Oxford University Press, 1997.

World Bank. World Development Report, 1989.