

CAPITAL ACCOUNT CONVERTIBILITY AND THE FINANCIAL SECTOR

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*“Time present and time past
Are both perhaps present in time future,
And time future contained in time past.”*

T. S. Eliot

(Four Quartets, 1935)

I. Introduction

As if there were a need for another reminder, the events that have been under way in Asia now for more than a year have confirmed with a vengeance the importance of efficient, sound financial sectors for sustained economic development and growth in a closely integrated global economic setting. This is a fact that holds true for a closed economy of course; but it acquires mounting importance in an open one, not only because of the well-known adverse consequences of sudden **outflows**, but also because of the potential of **inflows** for underwriting inadequate policies or masking institutional weaknesses. Many, including the IMF and other international financial

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institutions, have been increasingly aware of the reality of this relationship for some time. I need only refer here to an IMF study published in 1996 which noted that nearly three fourths of the institution's membership had experienced "significant banking problems" in the preceding decade and a half.¹ Even where these problems had not developed into full-blown crises, banking sector vulnerabilities had contributed to undermine macroeconomic performance and stability.

As 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.² 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 borrowing policy areas (e.g., Dornbusch, 1998a); others stress the presence of weak financial sectors

¹ See Carl-Johan Lindgren, Gillian Garcia and Matthew Saal (1996). For earlier analyses of similar problems, see V. Sundararajan and Tomás Baliño (1991).

² The ingenious and colorful analogy of Joseph Stiglitz (1998) comparing small open economies with storm-tossed row boats can be misleading. Unlike storms, large capital flows do not normally occur independently of the action (or inaction) of those in charge of the boat. As my colleague Axel Palmason pointed out, row boats have made it across the Atlantic, but the Titanic sank.

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., Radelet 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).

An important consideration, however, typically understressed at turbulent times in discussions of risks associated with capital flows and capital account convertibility, is that the relationship between the liberalization of the capital account and financial sectors is not, by any means, always or necessarily a negative one. Capital account liberalization can make (and has made) important contributions to the development, efficiency and soundness of domestic financial sectors and economies at large, provided policy makers are ready to foster this process with proper economic management. Indeed, in terms of both potential benefits and risks, capital account liberalization is analogous to domestic financial liberalization and the arguments made for and against it parallel closely those voiced for and against ending domestic financial repression.

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).

In this paper, I propose first to examine a few necessary points about the macroeconomic environment required for capital account liberalization. I will then elaborate briefly on the analogy between the liberalization of capital transactions and that of domestic financial sectors. This will pave the way for

a discussion of the specific consequences of capital account convertibility for financial sectors. And after a brief review of the implications for the pace and sequence of liberalization, I will conclude with a few comments on how the IMF envisages its role to evolve with regard to capital account liberalization.

II. Macroeconomic Environment

The main focus of the paper is on the relationship of capital opening with the microeconomic aspects of financial sectors. But a proper discussion requires a quick overview of the macroeconomic setting, as well. Microeconomic or sectoral action—for example, in the areas of prudential regulation and official supervision—may be necessary but is not sufficient to avert or resolve difficulties associated with large and persistent capital movements. The macroeconomic environment, with its powerful influence over the incentive structure that drives capital flows, has much to do with why and how external liberalization and capital account convertibility affect domestic financial sectors. And of course, as I have already noted, these sectors can have themselves much to do with macroeconomic performance.

In the last two decades, a substantial shift has taken place in the conception and implementation of macroeconomic management, including the monetary and exchange policy areas. In these domains, the shift has involved a move from direct regulatory control of the balance sheet of financial institutions and the price of financial intermediation services toward market-based methods of financial management. Behind this evolution loom a number of important considerations, such as the microeconomic benefits of deregulation, doubts about the effectiveness of controls and more broadly, questions regarding the effectiveness of policies that rely mainly on direct regulatory and administrative restrictions. The shift, which began in a range of industrial countries, soon spread well beyond them to encompass many developing countries as well.³ In hindsight, it can

easily be argued that the change reflects a hard lesson learned during periods of grappling unsuccessfully with persistent inflation, often coupled with recession. Progressively, country governments came to the view that a key requirement to rein inflation in and to experience sustained growth was a macroeconomic management framework that operated **through** market forces, not **against** them.

This important sea-change in policy conception cannot but be stressed in any discussion of capital account liberalization.⁴ The reason is that the maintenance of capital controls would have been quite incompatible with this fundamental evolution in policymaking views, a point succinctly and forcefully made by Jeffrey Shafer (1995). Working through market forces requires both **policy credibility and consistency**. From this standpoint, capital controls collide with the very foundations of “market-friendly” policy management. On the other hand, action to liberalize capital movements and thus, to establish capital account convertibility, not only signals consistency, which fosters credibility, but also indicates acceptance of the discipline to which market forces will subject policy, which underpins consistency.

This reasoning departs sharply from some of the arguments typically voiced in favor of capital controls; that is, the preservation of macroeconomic policy “autonomy.” Indeed, it is not so long ago that capital controls were advocated as necessary to maintain monetary and fiscal policies, which, if implemented in a liberal setting, would lead to inflation, or to depreciation of the nominal exchange rate or to capital **outflows** or all three. And arguments have also been put forth in the opposite direction:

³ See William Alexander, Tomás Baliño, and Charles Enoch (1994) for a discussion of the change in the design and formulation of monetary policy. For recent examinations of the experience with economic policy in general, see Manuel Guitián (1997) and Guy Pfefferman (1998).

⁴ It will be recognized that the sea-change relates to what John Williamson labeled at the beginning of this decade the “Washington Consensus;” see John Williamson (1990); see also Bartolini and Drazen (1997) on the subject of capital account liberalization as a signal.

capital controls as necessary instruments to prevent nominal exchange rate appreciation or to keep monetary conditions from feeding inflation or both; here the focus is on capital **inflows**, instead. The alternatives to capital controls in these circumstances are generally recognized as transitory (as is the case with sterilization of the inflows) or not sufficiently flexible or well-suited for this purpose (as is the case with compensatory fiscal adjustments).⁵

The issue at stake here is one of consistency among policy objectives and within policies themselves. The arguments and literature dealing in a closed economy context with domestic policy objective trade-offs between inflation and short-term output growth or employment are well known, of course. A similar trade-off arises in an open economy setting between inflation control and short-term external competitiveness. Inconsistent monetary and exchange rate policies will create incentives for capital flows that can threaten either or both of the objectives.⁶ Controls may repress the consequences of those incentives, but they do not eliminate them, so their effect can only be temporary. Indeed, the incentives for capital to flow simply mutate into incentives for the circumvention of capital controls.

A key issue here is naturally the **choice of exchange rate regime** and its implications for the conduct of domestic macroeconomic policy. The constraints that a fixed exchange rate arrangement place on macroeconomic policy are known and need no elaboration here. The only point worth making is that such an arrangement is perfectly workable provided domestic policymaking is credibly subordinated to it. The cases of Argentina and Hong Kong are obvious examples. What needs stressing is that the required credibility makes the “entry requirements” for this type of regime extremely demanding; that is, policy makers need to be aware of and ready to accept the constraints that this regime imposes on economic policies. This is a far more important point than those that can be derived from discussions of (generally

⁵ For further elaboration, see Susan Schadler and others (1993).

⁶ Further discussion of these subjects will be found in Manuel Guitián (1994).

difficult to devise and implement) “exit strategies;” that is, the search for methods for abandoning smoothly the regime, which are typically hard to devise.

Yet, most analyses lean toward the advantages of a flexible exchange arrangement in a liberal capital flow environment.⁷ And the arguments behind those analyses are also well known. If policies are not to be made endogenous, exchange rate flexibility is of course a convenient arrangement.⁸ But it can hardly be considered an easier option. As a general proposition, exchange rate flexibility cannot replace appropriate domestic macroeconomic policymaking on a sustained basis; and even less so in a particular setting where capital flows freely. Attention must be drawn toward the inevitable requirement of economic policy discipline, not diverted toward transitory expedients like capital controls or even exchange rate flexibility; neither of these will isolate a country’s economic policies from the disciplining action of market forces.⁹

III. Capital Controls and Financial Repression

I noted at the outset that in a broad perspective, capital controls are a particular modality of financial restrictions. And the arguments for and against their removal, therefore, closely parallel those advanced for and

⁷ The concept of capital account convertibility in the context of a flexible exchange rate differs essentially from that in a fixed exchange rate setting, of course. For a discussion of “soft” (flexible exchange rate) and “hard” (fixed exchange rate) convertibility, see Manuel Guitián (1996).

⁸ As has been pointed out in many analyses of recent Asian events: see, for example, Rudiger Dornbusch (1998a), Stanley Fischer (1998a and 1998b); Guillermo Perry and Daniel Lederman (1998) and James Tobin (1998).

⁹ These considerations simply underscore the constraints of an open environment on the actions of its component parts. In this context, Larry Summers recently (Summers, 1998) pointed out that market forces make the “right” policies all the more powerful, by giving them a high quality premium. In turn, they increase the costliness of the “wrong” policies, by charging them a stiff low-quality penalty.

against financial liberalization in general. Broadly speaking, I believe it is fair to say that there is widespread agreement that domestic financial as well as capital account liberalizations are beneficial. Differences of view typically arise about the scope, pace, and sequence of liberalization, not on its ultimate desirability. This consensus reflects the well-known analyses of financial repression of Shaw and McKinnon (both 1973), which made clear the adverse effects of interest rate controls on financial savings and investment. More recently, financial liberalization, and the consequent financial development, have been examined in the context of endogenous growth models and empirical evidence has been gathered indicating that financial development, by helping mobilize savings and fostering technical innovation, is associated with higher long-run economic growth trends.¹⁰

This line of reasoning is based on well-treaded grounds. But there is another aspect of international financial integration that rarely comes up in discussions of capital account liberalization, and yet it is important, indeed: namely, open trade in financial services, both through their cross-border provision and through foreign establishment in the domestic economy. In a recent review essay (1998), von Furstenburg notes the link between capital mobility models with those that address a broader concept of financial integration. And he indicates that financial integration may well occur, even without appreciable net capital flows, through foreign entry in domestic banking and financial sectors. This is a particularly important point, if only because it underscores the close linkages that exist among different types of capital flows (including foreign direct investment).

What I wish to stress here is the close interconnection, indeed interdependence, between these three aspects of financial liberalization: **domestic financial deregulation, free trade in financial services, and capital account openness**. Clearly, even if **de jure** there exists liberal entry for foreign banks, not much will occur **de facto** if the domestic setting is

¹⁰ See Levine (1997) for a recent review of these issues.

one where strict controls on domestic or international transactions prevail. In turn, domestic deregulation and liberalization of trade in financial services may not go too far in the absence of capital account opening.

IV. Benefits of Capital Account Liberalization

There are broad benefits from capital account opening at the macroeconomic level, which have been amply examined (as well as contested) in the literature. But I want to focus on specific, 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.¹¹ Here again, these benefits are of the same character as those that underpin domestic financial deregulation, which allow banks and other financial intermediaries to compete among themselves and more to the point, with the informal markets that controls typically encourage.

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

¹¹ At a broader level, capital account liberalization allows competition between economic regimes and economic policy frameworks. Indeed, this is the gist of the argument made above that opening of the capital account can foster improved and more credible macroeconomic management; see for further elaboration Manuel Guitián (1998a and 1998b).

distortions, and promotes robust market infrastructures.¹²

More generally, the typical emphasis on the efficiency-enhancing benefits of competition should not lead to neglect of its other beneficial effects, in particular those that relate to stability. Market opening fosters demands for appropriate and comparable accounting and information disclosure as well as regulatory standards; codes of market conduct and institutional governance; standardized international financial products; and sound, robust clearing and settlement arrangements, in particular, for large transactions. At the individual financial institutional level, competition fosters sound fundamental management practices, as well-informed customers are able to distinguish among financial entities depending on their quality and soundness. These entities, in turn, develop an incentive for proper management, as they have a reputation to protect.

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.

V. 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

¹² 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 see also Armstrong, Garber and Spencer (1998).

view: witness the catalogue and extent of banking sector problems listed in Lindgren, Garcia and Saal (1996), mentioned at the outset; and add to them the 1994–95 crisis in Mexico and those still under way in the Asian region. All these examples underscore the close interaction between domestic financial sectors and experiences of liberalization.

The conceptual approach that links financial liberalization with financial fragility is based essentially on the notion that such liberalization either gives rise to or even encourages undue risk taking. One line of reasoning, which applies to all kinds of markets, is that liberalization brings losses to existing firms in the form of foregone monopoly profits or rents (or diminished “franchise value,” as some writers put it.) Excessive risk taking represents but an attempt to recover those losses, particularly where a large, previously-constrained, demand for credit develops in periods of expansion.¹³ This line of reasoning implies that enhanced competition is a zero-sum game, though. But it need not be, as financial firms, through competition, will tend to become less rent-oriented and to focus instead on increasing their efficiency through inter alia upgrading their risk management techniques.

But even if systemic problems arise from widespread imprudent competition in the wake of liberalization, surely this signals a need to investigate why the incentives for prudent, sound competition are overshadowed by less desirable motives. After all, liberalization does not have to entail a trade-off between efficiency and soundness. What is needed is to underpin liberalization with policies that eliminate perverse incentives, such as those that arise from unwarranted, improperly priced government guarantees,¹⁴ and focus instead on measures that strengthen market discipline and that adapt the regulatory and supervisory framework to a

¹³ Suggestions have been made that in a competitive setting, banks do not have incentives to act more prudently than their competitors, because they would otherwise lose market share; see Charles Goodhart (1985), for example.

¹⁴ Several writers have begun to stress the role of such perverse incentive structures; see, for example, Michael Dooley (1997) and Paul Krugman (1998).

competitive financial market environment.¹⁵ There is a close parallel here between the arguments for capital controls and the old “infant industry” argument for trade protectionism. The problem with this argument was that with protection, infant industries had no sufficient incentive to grow up. Similarly, capital controls that protect rent-seeking behavior will not make it easy for such behavior to disappear.

Actually, perverse incentive structures and fundamentally weak financial sectors are matters to be addressed regardless of capital account liberalization. Financial institutions unable or unwilling to manage the risks associated with international capital movements are unlikely to be in a better position to contend with risks arising in the domestic context. In other words, open capital flows may accentuate the onset of a financial crisis, but they are unlikely to be their cause. Typical symptoms of financial vulnerability are well known: inadequate capital base; large amounts of bad loans; connected lending; inappropriate risk management. The underlying causes are less obvious, though, and they are typically related to domestic distortions, rather than to liberalization per se. Aspects that warrant investigation include:

- insufficient market discipline: absence of competition, restrictions to entry, faulty information.
- inappropriate legal framework for enforcing contracts and for protecting property rights: bankruptcy procedures, debt recovery practices, corporate and bank governance.
- governmental and political interference in bank activities.
- faulty clearing and settlement systems.
- inadequate financial regulation and supervision framework.

All of these constitute basic building blocs to assess the soundness of financial sectors and will require attention in the context of liberalization. In addition, efforts need to focus on ensuring neutrality to the liberalization

¹⁵ These points have been recently stressed by Renato Filosa (1998); Stanley Fischer (1998), and George von Furstenberg (1998).

process, that is, a process that provides a level playing field for the various institutions, instruments, and markets. Preferential regulatory or tax treatment to some sectors or channels at the expense of others will create distortions that may undermine liberalization. For example, in Korea and Thailand, there were elements of the regulatory and policy regimes that biased capital flows toward intermediation by banks, which may have resulted in an undue emphasis on short-term external borrowing.¹⁶

VI. Pace and Sequence of Liberalization

Conventional wisdom leans toward advocacy of gradual liberalization as far as pace is concerned and of liberalizing equity, direct investment and long-term capital flows first, leaving short-term capital movements for the final stages, in matters of sequence. Needless to say, such courses of action will be appropriate in some cases and in certain circumstances. But what is also clear is that they will not be for **all** cases or circumstances. I doubt a general formula exists when it comes to the question of pace and sequence of liberalization of capital (or any other) markets.

It is reasonable to argue that favorable macroeconomic conditions and policies as well as sound financial sectors and regulatory frameworks ought to be in place before undertaking capital account liberalization. But waiting for all these requirements to materialize may actually delay liberalization indefinitely. In fact, the prevalence of capital controls in itself is hardly conducive to macroeconomic balance and financial soundness. Pushing ahead with liberalization, in concert with supporting macroeconomic and regulatory action domestically, may prove a more efficient route. As I argued elsewhere,¹⁷ there are synergies in that opening the economy can reinforce

¹⁶ It is possible that market forces themselves have favored bank intermediation of short-term flows. But the policy framework in these countries may have skewed flows; see Manuel Guitián (1998b) for a discussion of these points.

¹⁷ See Manuel Guitián (1995) for further elaboration; see also Barry Johnston (1998).

domestic macroeconomic adjustment efforts and contribute to domestic financial efficiency. And conversely, proper macroeconomic management and sound domestic financial intermediation will contribute to a balanced and sustainable process of liberalization.

Similar considerations apply to the often voiced concern that domestic financial sectors should be well developed and solid prior to liberalization or that long-term flows should be liberalized before short-term flows. In the abstract, these concerns are reasonable; but again, the point remains that protective controls are unlikely to foster development and strength in domestic financial system or to promote a balanced capital account maturity structure. As in virtually all economic areas, there is here an issue of balance to be resolved; the extremes are clear: waiting for perfect domestic conditions is equivalent to a recipe for inaction; and pushing ahead in a setting of profound imbalances and financial sector weaknesses is a recipe for disaster; in turn, unduly preventing short-term flows is likely to also deter long-term capital movements;¹⁸ and excessive reliance on short-term sources of financing has typically served as a route toward trouble. The art of policy and decision making lies in correctly identifying where and when, between the two extremes, action should be undertaken. In general, measures to eliminate macroeconomic imbalances and strengthen financial sectors as well as to avoid unduly short debt maturity structures are warranted in themselves, not because of capital account liberalization. The question, thus, is whether appropriate courses of action are more likely to be pursued in a setting of capital controls or in one where those controls are being dismantled. And such art in policy and decision making also requires a balanced approach that acknowledges the interaction between different capital flows and aims at providing them with a level playing field.

¹⁸ See Ricardo Martin and Marcelo Selowsky (1998) for an innovative argument on the relationship between short-term and long-term capital movements.

This line of reasoning underscores that capital account opening must be conceived as only one element, albeit an important one, of a comprehensive policy strategy to be implemented in measures that are internally consistent and mutually-supporting. This often means acting on as many fronts simultaneously as it is possible, e.g., doing as much as you can, when you can.

In my mind, the important judgment to make falls less on the perceived weaknesses of the macroeconomic situation or of the financial sector or on the specific maturity structure of capital flows than on the willingness and ability of the authorities to confront those weaknesses and to understand and accept the consequences of maturity composition of the capital account. If policy makers are conscious of the challenges and determined in their action to meet them, the probability of success is there, despite adverse perceptions of vulnerability.

VII. The Role of the IMF in Capital Account Convertibility

In sum, rather than as the end tail of an action program, capital account liberalization needs to be seen from the outset as an integral and crucial part of a reform policy strategy. Such strategy will typically include institutional, legal, and regulatory actions; macroeconomic, prudential, and competition policies; and a workable, operational, definition of the role of the state in the economy. Despite the importance of the issues of pace and sequence, I would contend that concepts like **mutual consistency** and **incentive compatibility** provide a better guide for the reform process.

Given this reasoning, does maintenance of controls over specific modalities of capital movements (e.g., short-term, speculative flows) make sense? In principle, I would argue not.¹⁹ But in practice, a reasonable case can be made for their usefulness as a means to provide the leeway necessary to implement fundamental policy reforms. This said, though, it

¹⁹ For a provocative, yet most persuasive analysis against capital controls, see Rudiger Dornbusch (1998b).

must be stressed that the leeway can also be used precisely to resist those reforms. Here we have yet again another issue of judgment, on which categorical answers do not exist. A practical consideration worth keeping in mind is the doubtful durability of the effectiveness of controls. While the jury may still be out on this issue, financial innovation and technology have increased the scope for circumvention of controls, as noted by Obstfeld and Rogoff (1995).²⁰

A subject which encompasses as many issues of balance and judgment as capital account liberalization does, requires a framework of sufficient flexibility, but also of clarity in intent to be able to function properly. I will now summarize the approach we plan to take in the IMF to guide our activities in the capital transactions area. The aim and direction of the approach is toward liberalization, a point on which there is clear consensus in the membership. On the implementation of this aim, there is, of course, far less consensus. Yet I believe that the approach we are taking is flexible enough to accommodate the broad diversity of views that currently exists in the area of practical implementation.

The approach includes a provision for **transitional arrangements** which will allow countries to maintain their capital controls until they are ready and able to remove them on a sustained basis. Thus, countries may set themselves the pace and sequence of liberalization, in consultation with the institution, of course. It also encompasses acceptance of **temporary resort to controls** in response to balance of payments or macroeconomic difficulties; the temporariness of the acceptance will depend on the nature and magnitude of the need as well as on the strength of the measures to be undertaken to render the controls unnecessary. In addition, generally accepted **prudential measures** that might have restrictive features would be considered appropriate for members to adopt. And finally, restrictive measures related to the need to foster financial **market and institutional evolution** would also

²⁰ But see also on the subject of effectiveness of capital controls, Sebastian Edwards (1998), Cardoso and Laurens (1998), and Barry Johnston and others (1997).

be transitorily acceptable, until they become redundant through fundamental policy reform.

This approach has been time-tested in other contexts and it has served the IMF membership well in promoting current account convertibility, for example. Its flexibility is even better suited for capital account liberalization; the approach does make clear that the aim is **orderly**, not unfettered, liberalization, based on **commonly agreed norms and practices**, that is, norms and practices that balance the various aims of integration, financial prudence and sensitivity to country-specific circumstances and situations.

The current environment clearly indicates that capital account convertibility and financial liberalization are essential, if not inevitable, for countries to benefit from participation in the open world economic system of today, characterized by fast-changing technology and rapid communication.²¹ Such a world environment, needless to say, also gives rise to risks and disturbances. But sound macroeconomic management, proper prudential policies and adequate supervision, as well as other agreed norms to guide capital movements, can be important safeguards against those risks and disturbances.

In conclusion, I opened this paper by quoting T.S. Eliot's view of the inextricable linkages that bind time past, present, and future. The reason is that I wished to stress my belief that there is little essentially new in current debates of the pros and cons of capital account liberalization. Seminal thoughts hardly ever are totally new or completely old. They appear to mutate over time and develop into distinct strains that conform to the period in which they are formulated. On the subject of capital movements, the gist of virtually all of the strains of the debate can be found in the writings of Keynes, Nurkse and Friedman, among others.²² There is thus much wisdom in keeping time past and time present in our sights as we look toward time

²¹ See on this point, International Monetary Fund (forthcoming).

²² See John Maynard Keynes (1930); League of Nations (1944); and Milton Friedman (1953).

future. By so doing, at least we may be able to escape from the well-known prophecy:

“Those who cannot remember the past are condemned to repeat it.”

G. Santayana

(The Life of Reason, 1905)

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