

CENTRE FOR CO-OPERATION WITH THE EUROPEAN ECONOMIES IN TRANSITION

EXCHANGE CONTROL POLICY

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

- to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The original Member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became Members subsequently through accession at the dates indicated hereafter: Japan (28th April 1964), Finland (28th January 1969), Australia (7th June 1971) and New Zealand (29th May 1973). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).

Hungary and Poland participate in the OECD Programme "Partners in Transition", which is managed by the Centre for Co-operation with European Economies in Transition.

Publié en français sous le titre :

POLITIQUE
DE CONTRÔLE DES CHANGES

© OECD 1993

Applications for permission to reproduce or translate all or part of this publication should be made to:
Head of Publications Service, OECD
2, rue André-Pascal, 75775 PARIS CEDEX 16, France

FOREWORD

The purpose of this volume, part of the series of publications by the OECD Centre for Co-operation with European Economies in Transition, is to add to the understanding of the problems which the policy makers of Central and Eastern European countries (CEECs) face in designing and implementing exchange control policies.

This report is based on documents prepared by the Secretariat for a series of informal meetings on exchange controls held in Paris with the CSFR, Hungary and Poland in 1992 and with Bulgaria and Romania in the first half of 1993.

These meetings were arranged in the framework of the Centre's work programme under the auspices of the OECD Committee on Capital Movements and Invisible Transactions (CMIT), with the participation of national experts and representatives of other international institutions, in particular the International Monetary Fund and the Bank for International Settlements. The meetings reviewed current exchange controls, problems arising at the implementation stage and the scope for further liberalisation in transition countries, drawing on a wide spectrum of experiences in OECD countries. They also provided an opportunity for the officials from CEECs to familiarise themselves with the principles and procedures of the Codes of Liberalisation of Capital Movements and Current Invisible Operations, which are the main legally binding instruments of the OECD.

Part I of this volume provides an assessment of the lessons that may be drawn from the past experience of OECD countries with exchange controls. Exchange controls have now been removed in virtually all OECD countries. Despite still important differences between OECD countries and CEECs, this experience may shed some light on the expected benefits, the associated risks, and the optimal pace of capital control liberalisation in CEECs as their transition to a more market-based and financially developed economy proceeds. Early versions of this part of the report benefitted from comments by members of the CMIT. Part II describes the current regimes of exchange controls in five CEECs and addresses issues of direct policy concern to them.

FOREWORD

The purpose of this volume, part of the series of publications by the OECD Centre for Co-operation with European Economies in Transition, is to add to the understanding of the problems which the policy makers of Central and Eastern European countries (CEECs) face in designing and implementing exchange control policies.

This report is based on documents prepared by the Secretariat for a series of informal meetings on exchange controls held in Paris with the CSFR, Hungary and Poland in 1992 and with Bulgaria and Romania in the first half of 1993.

These meetings were arranged in the framework of the Centre's work programme under the auspices of the OECD Committee on Capital Movements and Invisible Transactions (CMIT), with the participation of national experts and representatives of other international institutions, in particular the International Monetary Fund and the Bank for International Settlements. The meetings reviewed current exchange controls, problems arising at the implementation stage and the scope for further liberalisation in transition countries, drawing on a wide spectrum of experiences in OECD countries. They also provided an opportunity for the officials from CEECs to familiarise themselves with the principles and procedures of the Codes of Liberalisation of Capital Movements and Current Invisible Operations, which are the main legally binding instruments of the OECD.

Part I of this volume provides an assessment of the lessons that may be drawn from the past experience of OECD countries with exchange controls. Exchange controls have now been removed in virtually all OECD countries. Despite still important differences between OECD countries and CEECs, this experience may shed some light on the expected benefits, the associated risks, and the optimal pace of capital control liberalisation in CEECs as their transition to a more market-based and financially developed economy proceeds. Early versions of this part of the report benefitted from comments by members of the CMIT. Part II describes the current regimes of exchange controls in five CEECs and addresses issues of direct policy concern to them.

The main contributor to this publication was Pierre Poret of the Directorate for Financial, Fiscal and Enterprise Affairs. The report is published on the responsibility of the Secretary-General of the OECD.

Salvatore Zecchini
Assistant Secretary-General
Director of the CCEET

TABLE OF CONTENTS

Part I

THE EXPERIENCE OF OECD COUNTRIES WITH EXCHANGE CONTROLS

I.	INTRODUCTION	9
II.	EXCHANGE CONTROL IN AN HISTORICAL PERSPECTIVE	9
III.	OBJECTIVES OF CONTROLS AFTER THE POST-WAR RECONSTRUCTION PERIOD	11
	Weak currency	11
	Capital shortage	14
	Inflationary capital inflows	14
	Complement to financial policy tools	15
	"Productive" investment <i>versus</i> "speculation"	16
	Prudential concerns, tax control and data collection	16
IV.	TECHNIQUES OF RESTRICTION	16
	Current-account operations	16
	Capital-account operations	17
V.	INSTITUTIONAL ASPECTS OF CONTROLS	18
	Legal framework	18
	Enforcement procedures	19
VI.	MOTIVATIONS BEHIND LIBERALISATION	20
	Growing efficiency concerns	20
	1. <i>Developing the financial system</i>	20
	2. <i>Strengthening the non-financial business sector</i>	21

Priority to long-term price stability	22
Decreasing effectiveness of controls	24
International liberalisation obligations	26
VII. PATTERNS OF LIBERALISATION	27
Speed	27
Reversibility	29
Sequence of liberalisation of capital movements	31
1. <i>Operations</i>	31
2. <i>Operators</i>	32
VIII. EFFECTS OF LIBERALISATION	33
Short-term impact on capital flows	33
"Premature liberalisation"	33
Exchange-rate and interest-rate volatility	35
Reporting systems	37
IX. SUMMARY AND CONCLUDING REMARKS	38
Notes	41
References	44

Part II

**EXCHANGE CONTROL POLICY
IN CENTRAL AND EASTERN EUROPE**

I. INTRODUCTION AND SUMMARY	49
II. EXCHANGE CONTROL REGIMES IN CEECs	51
General legal framework	54
Free access of resident firms to foreign exchange for most import payments	55
Move towards unified exchange rates	55
The problem of personal travel allowances	56
Privilege of individuals to operate foreign-currency accounts	57
Surrender requirement for export proceeds	59
Restricted convertibility for non-residents	60
Flexible rules for direct investment	61

Barriers to portfolio investment and real estate operations	62
Commercial credits, financial loans	65
III. ARGUMENTS FOR CAPITAL CONTROLS IN CEECs	65
Political uncertainty	67
Insufficient macroeconomic stabilisation	68
1. <i>Inadequate fiscal control</i>	68
2. <i>Ineffective transmission of monetary policy</i>	71
3. <i>Unreliable macroeconomic indicators</i>	72
Exchange rate policy	72
Foreign debt problem	73
Underdeveloped financial system	74
IV. EFFECTIVENESS OF CONTROLS	76
V. POLICY OPTIONS AND PRIORITIES	78
Notes	83
References	87

Annex

THE OECD CODES OF LIBERALISATION OF CAPITAL MOVEMENTS AND CURRENT INVISIBLE OPERATIONS	89
---	----

Part I

**THE EXPERIENCE OF OECD COUNTRIES
WITH EXCHANGE CONTROLS**

I. INTRODUCTION

There is a considerable body of literature on the role of exchange controls and the conditions of their abolition in both advanced and developing economies¹. While exchange controls have been extensively studied in relationship with the conduct of monetary policy, this first part of the report provides a review of the experience of OECD countries which focuses on the technical and institutional aspects of the implementation of capital controls after the post-WW II reconstruction period and on reasons for their full liberalisation over the last ten years in virtually all OECD countries².

The remainder of this first part of the report is organised as follows. Section II situates the use of controls in western economies in a long-run historical perspective. Sections III to V describe the reasons for controls, techniques used and institutional aspects of controls since World War II. Sections VI to VIII review the factors behind the abolition of controls, and the patterns and possible effects of liberalisation. Section IX summarises the lessons which may be drawn from the OECD experience.

II. EXCHANGE CONTROL IN AN HISTORICAL PERSPECTIVE

In a long-term historical perspective, exchange controls do not appear to be a natural or permanent feature of western economies. Empirical evidence going

back as far as the 18th century suggests that international capital mobility was not lower in earlier times than in the 1980s³. In particular, the gold standard system before 1914 as well as other experiences of fixed exchange rates after World War I were virtually free of controls⁴.

The rudimentary state of communication technology did not represent an absolute physical obstacle to quick and sizable capital movements. In earlier times, it was a matter of days but not of months for major international capital markets to adjust -- a delay short enough to undermine the autonomy of monetary policy in a scenario of fixed exchange rates⁵. It has been argued that no administrative measures were necessary to achieve exchange-rate objectives in fact because governments pursued orthodox, non-discretionary fiscal policy⁶.

Since World War II, all OECD countries have resorted to exchange controls at one time or another. Only a few countries did not build up a permanent exchange control regime in the past: Canada which has had no exchange controls at all since the early 1950s, the United States and Switzerland which never had a long tradition of controls, and Germany which abolished the bulk of its restrictions as early as 1958. Even so, these three latter countries all used exchange controls episodically in the 1960s and 1970s.

Extensive and permanent exchange control regimes originated in the exceptional economic circumstances of World War II. While Australia, Canada, Finland, New Zealand, Sweden and the United Kingdom established the hard core of their exchange control regimes in preparation for, or during, the war, in a majority of other countries they were put in place during the immediate post-war reconstruction period. In the face of devastations caused by the war and a situation of acute shortages, controls, together with widespread trade restrictions, were used as emergency measures to reconstitute depleted international reserves and allow the imports of much needed equipment and basic goods such as food and energy.

Capital controls survived, however, beyond the 1950s. They fitted well in the 1960s and early 1970s in the general belief that state intervention was necessary in many areas (subsidised interest rates, privileged financing channels, industrial policy, price control) to optimise economic growth. In a context of rapid growth as economies recovered, many countries did not see really serious reasons to call this policy into question.

The prevailing view was also that controls were needed to ensure the necessary protection against adverse external shocks and preserve the independence of national policies. Monetary policy in particular was used in most countries to serve two objectives simultaneously: full employment and a stable international monetary order within the framework of the Bretton Woods system of fixed exchange rates. Low real interest rates were used to serve the former purpose while capital controls were designed to ease possible resulting pressures on the exchange rate and to preserve official reserves⁷.

This was in full compliance with the Articles of Agreement of the International Monetary Fund (IMF), which under Article VIII provide for a liberalisation of controls on payments and transfers for current international transactions only, as an essential condition for an open multilateral trade system. Capital controls, on the other hand, were regarded by the framers of Bretton Woods as a legitimate -- and even necessary -- instrument of economic policy. Although policy makers were concerned not to interfere with certain operations, such as debt amortisation and commercial credits, considered to be necessary to economic growth, extensive capital controls could therefore be maintained.

Despite the collapse of the Bretton Woods system in the early 1970s, controls were maintained in a number of countries until well into the 1980s. The two oil shocks in the 1970s and the resulting monetary disorder were not propitious to a rapid removal of controls. Countries like Australia, New Zealand and Japan moved to a managed float but, nevertheless, maintained some form of exchange rate commitment. Many European currencies began to be linked each other through the "snake" from 1973 to 1979 and then through the European Monetary System (EMS). From the mid-1970s to the early 1980s, however, many countries reduced the level of ambition of their exchange control regime to what was considered as strictly necessary to the autonomy of monetary policy⁸. It is only in the course of the 1980s that countries still maintaining capital controls began dismantling them as supply-side reform gained strength and it was recognised that controls were less and less effective for monetary autonomy.

III. OBJECTIVES OF CONTROLS AFTER THE POST-WAR RECONSTRUCTION PERIOD

Controls were often used for influencing long-term developments in the exchange rate and the balance of payments, as suggested by the fact that foreign exchange outflows were restricted by a larger number of countries, and on a more permanent basis, than inflows were (Table 1). Controls were also used for eliminating excessive volatility in the interest rates and exchange rates as short-term operations have been subject to control more frequently and for longer periods than long-term operations. Reasons for controls were, however, quite varied over time and across countries, and several factors could be present simultaneously in a country.

Weak currency

The most widespread justification for capital controls was to counter market pressures for a depreciation of the exchange rate without the need for a rise in

Table 1

OPERATIONS RESTRICTED FROM THE END OF WORLD WAR II TO THE EARLY 1990s

	Foreign exchange outflows		Capital inflows (other than direct investment and real estate operations)
	Capital transactions	Travel allowances	
Australia	until 1983		
Austria	until late '80s		early '70s to mid-'80s
Belgium/Luxembourg	channelled through separate markets from 1955 to 1990		
Canada	until 1951		
Denmark	LT. securities until 1978 ST. financial credits until 1988		LT. securities until 1971 ST. op. until 1988
Finland	until mid-'80s	until 1985	securities until 1979 credits until 1986
France	until 1986	until 1958 1968-1970 1983-1984	credits from 1971 to 1974 other op. until 1986
Germany	until 1958	until mid-'50s	until 1958; 1972-1975
Greece	LT. op. until 1992 ST. op. still restricted	until 1992	credits until 1987 ST. op. still restricted
Iceland	LT. securities still restricted other LT. op. until 1990 ST. op. still restricted		credits until-1992 ST. op. still restricted
Ireland	LT. op. until 1988 ST. op. until end-1992		until end-1992
Italy	LT. securities 1973-87 credits until 1988 ST. op. until 1990	1973-1984	credits until 1988 ST. op. until 1990

Table 1 (cont'd)

	Foreign exchange outflows		Capital inflows (other than direct investment and real estate operations)
	Capital transactions	Travel allowances	
Japan	until 1980	until 1964	1970-1973 1977-1978
Netherlands	credits until 1986 other op. until 1960		credits until 1983 other op. until 1960
New Zealand	until 1984	until 1971	credits until 1984
Norway	until late '80s ST. op. until 1990	until 1984	credits until early '80s LT. securities until 1989 ST. op. until 1990
Portugal	LT. securities & trade credits until late '80s other op. until end-1992	until 1990	LT. securities & trade credits until late 1987 other op. until end-1992
Spain	ST. credits until 1991 and in october 1992 other op. until 1989-90	until 1979	ST. credits until feb.1992 other op. until 1986-87
Sweden	until 1989	until the '50s	until late '80s
Switzerland			securities from 1972 to 1980
Turkey	until 1989 trade credits until 1983	until 1983	until 1989 trade credits until 1983
United Kingdom	until 1979	until 1977	
United States	1963-1973		

Legend: LT. = long-term;
ST. = short-term;
op. = operations.

domestic interest rates, which would be damaging to economic growth. Within the framework of Bretton Woods, many countries considered a devaluation of their currency as the most visible manifestation of policy failure. This is still true for those European governments that declare the achievement of a stable exchange rate to be the key criterion of policy credibility.

Hence controls, even when not binding, were permanently maintained by precaution in potentially weak-currency countries. Controls, of course, were especially extensive in countries facing persistently large fiscal deficits, chronically high inflation and recurrent capital flight.

Capital shortage

Controls on foreign exchange outflows were also used in catching-up OECD countries in an early stage of development where typically domestic saving was scarce and foreign currency reserves were often needed to finance the balance-of-payments deficit.

In a fully integrated financial world, capital would flow from mature countries to catching-up countries where investments offer more attractive returns. In this context, the question of capital shortage would be irrelevant. Furthermore, capital controls would be counter-productive here; even if controls could really prevent outward investment attracted by higher returns and more diversified assets abroad, they would weaken, at the same time, incentives of residents to save and encourage consumption⁹; as these controls may also contribute to keeping domestic rates of return artificially below international levels, they may reduce capital inflows as well. On the whole, the net effect in terms of additional investment could well be eventually zero.

The situation becomes, however, quite different in cases of international market imperfections, in particular widespread controls on capital outflows in the other countries as was the case in the 1950s and 1960s. Then there was an understandable lack of confidence in spontaneous capital inflows and a logical incentive for an otherwise liberal individual country to retain restrictions on its capital outflows in turn, since it was denied free access to offsetting capital inflows. This factor seems nevertheless to have persisted beyond its validity, well into the 1970s and 1980s.

Inflationary capital inflows

By contrast, restrictions on foreign exchange inflows have been more episodic and more closely related to short-term monetary policy. For instance, following the decision of the United States government to no longer ensure the convertibility of the dollar into gold within the Bretton Woods system in 1971,

refuge-currency countries such as Germany and Switzerland imposed limitations on capital inflows. The purpose was to keep control on domestic monetary expansion and to prevent an unchecked accumulation of large local-currency balances abroad as compared with the size of these economies, while limiting currency appreciation. Between 1973 and 1975, other countries received large capital flows as a result of shifts in portfolios away from US dollar assets and introduced similar controls.

In the course of the 1980s, macroeconomic stabilisation programmes in Finland, Norway, Portugal and Spain were accompanied by restrictions on capital inflows attracted by high interest rates resulting from an unbalanced mix of tight monetary policy and loose fiscal policy. The main objective here was to prevent these capital inflows, too large to be fully sterilised, from spurring already strong inflationary pressures.

Complement to financial policy tools

In the past, certain less advanced OECD countries were characterised by a rudimentary payments system, often poor public debt management, typically underdeveloped financial markets and a banking sector sometimes fragilised by a large stock of non-performing loans. As a result, the possibility of using indirect, market-based monetary policy instruments, such as central bank lending interest rates and open market operations, was extremely limited. Therefore, administrative ceilings on domestic credit, together with restrictions on international capital movements, were used to effectively control the liquidity of the economy. This was until the late 1980s the situation in certain southern European countries.

Generally, these countries also imposed compulsory investment requirements on commercial banks and institutional investors to finance the public sector and certain targeted industries at below-market yields. To preserve their profit margins, banks were led to maintain wide positive spreads between lending rates to the non-privileged private sector and deposit rates offered to the public. Against this background, exchange controls were called for to prevent domestic savers from investing abroad in more attractive placements and to discourage unfavoured firms from financing themselves abroad more efficiently and at lower costs. Although often financial underdevelopment was to a large extent due to intrusive financial policy, the "infant industry" argument has also been applied to the banking sector of less advanced countries as a for controls on capital outflows.

"Productive" investment versus "speculation"

Many OECD countries, still in the 1970s and the early 1980s, adopted an "industrial" approach to capital movements liberalisation, ascribing little value to consumer considerations. The mood was to consider that purely financial transactions were less necessary than other capital movements, in particular direct investment. Thus, countries, notably Nordic countries, restricted the acquisition of real estate abroad by their residents on the grounds that this did not contribute to improving the performance of the economy. Similarly, short-term financial placements by industrial companies for treasury management purposes have been sometimes regarded as a deviation from normal business activities.

There was heavy reliance on the banking system for financial intermediation in many OECD countries, notably in continental Europe and Japan. Bond and equity markets were not regarded as essential to a well-functioning market economy and remained of limited depth. Often capital markets were suspected to be inefficient, subject to irrational bubbles and not to reflect the fundamentals of the economy. Still today, the role and efficiency of the foreign exchange markets are widely debated.

Prudential concerns, tax control and data collection

Finally, exchange controls were used to serve a variety of non-macroeconomic purposes such as: protecting domestic investors in the face of possibly inadequate supervision abroad, preventing evasion of the laws (notably tax fraud, financial malpractices and money laundering) or securing the collection of balance-of-payments statistics. Although ascribing certain tax control, statistical and supervisory functions to the exchange control administration saved budgetary resources, this proved later to cause delays in the abolition of exchange controls in several countries, because it was necessary to put in place new reporting systems prior to liberalisation.

IV. TECHNIQUES OF RESTRICTION

Current-account operations

The making of payments and transfers for current international transactions was liberalised in most OECD countries in the course of the 1950s, in compliance with Article VIII of the IMF Agreement. However, certain restrictions on current payments and transfers have been maintained when they were deemed necessary to prevent unauthorised capital transfers. Thus the access of residents to foreign

exchange for travelling abroad continued to be limited on a more or less permanent basis in fourteen OECD countries (Table 1).

Leads-and-lags in trade payments were also tightly regulated in several countries, notably in Japan from 1950 to 1980, and in Italy and in France where domestic enterprises were required up until the late 1980s to surrender their export proceeds. These provisions are not considered as restrictions under Article VIII of the IMF Agreement, although they are now so regarded under the OECD Code of Liberalisation of Capital Movements¹⁰.

Certain countries in the post-war period also maintained restrictions on the transfer abroad of interest earnings from bank deposits or other portfolio investments by non-residents, as a means of discouraging speculative capital inflows.

Capital-account operations

Direct quantitative limits on capital transactions were the most widespread form of controls across countries. Weaker forms of controls were, however, used in some cases.

Switzerland from 1950 to 1954 and the Belgium-Luxembourg Economic Union from 1955 to 1990 had a dual foreign exchange market in which current-account transactions and capital transactions (possibly including access of residents to foreign exchange for travel purposes) were undertaken through separate channels. Such a system was established in France from 1971 to 1974 and in Italy in 1973-74. These two-tier exchange systems did not conflict with the provisions of Article VIII of the IMF Agreement so long as a uniform exchange rate was used for current-account transactions, the definition of which could for the occasion not include travel abroad. Although, at the time when they were introduced, they represented some form of liberalisation such systems are now regarded as restrictions under the Capital Movements Code if the exchange-rate differential exceeds 2 per cent continuously for a period of several months.

France also introduced from 1981 to 1986 a market, known as "marché de la devise-titre", where residents holding foreign securities could sell them to other residents, thus leaving more flexibility for portfolio adjustment. Somewhat similar arrangements existed in Sweden and the United Kingdom, in the form of "investment currency" markets where the purchase of foreign securities could be made only from the sale of existing foreign securities or from foreign-currency borrowing.

The main advantage attributed to a dual foreign exchange market is that it insulates current-account transactions from the influence of the exchange rate which applies to financial transactions, without, by so doing, prohibiting

international capital movements. In practice, this system entailed heavy administrative management and proved of limited effectiveness in cases of crisis unless reinforced by supplementary restrictive measures¹¹.

Also, penal reserve requirements were imposed on banks in a variety of countries, with varying effects depending on the importance of banking intermediation in their financial system. Finally, discriminatory taxes were also used in a few cases to restrict capital outflows. In the 1960s, for instance, the United States imposed an interest equalisation tax on foreign securities purchased by residents.

V. INSTITUTIONAL ASPECTS OF CONTROLS

Legal framework

With the exception of the United States, Canada, Germany and Switzerland which never put in place a permanent legal framework for their limited and episodic use of exchange controls, the law in other countries provided that all transactions were restricted unless otherwise specified. This provision was largely of a precautionary nature, so as to allow governments to take steps backward in case of necessity. It is only at a later stage, when a country committed itself to move towards a full liberalisation of the core exchange controls, that the opposite approach, declaring operations *a priori* all free, was adopted¹².

Although the legislation was modified in France in November 1968 following the May events, in Portugal after the 1974 Revolution and in Spain with the change in government in 1979, the general legal framework since World War II has been remarkably stable in countries maintaining controls. This was possible because controls could be adapted to new circumstances by way of regulations issued by the central banks and Ministries of Finance.

Current-account transactions and trade credits were generally administered under a general permit procedure, whereas other capital transactions were more often subject to case-by-case authorisation. While law or tradition gave relatively narrow authority to the administration for issuing and interpreting regulations in countries such as Germany, the Netherlands, New Zealand, the United States and most Nordic countries, wide discretion was left to regulators in other countries¹³.

Exchange control instruments have generally been applied on an *erga omnes* basis as concerns capital inflows which are primarily responsive to interest rate differentials and exchange-rate expectations such as short-term portfolio investment and financial credits. Otherwise non-residents could have easily circumvented controls through triangular investment from countries which were not affected by the restrictions. And, to the extent that the "rest of the world" is

large relative to the size of individual countries, there is practically no limit to capital inflows through such channels. Belgium and Luxembourg had, however, a common exchange control regime vis-à-vis third countries as they form a monetary union. This was also the case for countries belonging to the Sterling Area in the past.

Regarding inward direct investment, the acquisition of real estate by non-residents and access of foreign borrowers to the domestic capital markets, country discrimination was technically easier and some discriminatory policies are still in place. Restraints on capital outflows imposed by the United States in the second half of the 1960s did not apply to investment in Canadian assets, for instance. Many European Community (EC) countries did not initially extend to non-EC Members the benefit of liberalisation measures in these fields, although a trend in that direction has gathered strength over time.

Enforcement procedures

In the vast majority of countries, the banks played a key role in the implementation of controls. Transactions had to be carried out through "authorised" commercial banks and certain other foreign exchange dealers, which were delegated authority to grant permission for properly documented operations in certain categories or up to specified amounts. Extensive reporting requirements, sometimes on a daily basis as in Belgium and Luxembourg, were imposed on these agents.

Customs officers were heavily involved in the enforcement of exchange controls at the frontier. Customs authorities sometimes had powers superior to those of the police in some respects, such as the authority to proceed with search without warrant in France. There was also close cross-checking of information between the customs administration and commercial banks.

Such controls were more cost-effective when managed with computers, but there were limits to what could be achieved through electronic data processing because of human errors in entering data. As a result, *ex-post* surveillance by the administration was generally exercised through sample techniques and on-the-spot verification of banks' accounts. In Portugal, the administration was also used to carry out systematic verification depending on transactions and periods.

On the whole, it appears that procedures to enforce effective controls imposed a significant burden on commercial banks and the government administration. As an order of magnitude, there were 750 staff just at the Bank of England occupied with exchange controls before their abolition in 1979. Relative to the size of the population, there was a similar proportion of agents within the Belgian-Luxembourg Exchange Institute during periods of tensions on the foreign exchange market.

The credibility of controls required the application of extensive sanctions in case of non-compliance with regulations, with certain violations being even regarded as criminal offences. First, the license accorded to authorised banks and foreign-exchange dealers could be withdrawn. This threat proved in many instances to be effective because licensed banks were concerned to preserve their privilege to charge generally substantial commissions on foreign exchange operations undertaken on the account of their clients. The risk of losing clients in applying exchange controls too scrupulously was, on the other hand, limited at a time when the banking sector was not yet subject to competition as intense as it is today.

Strong penalties could also be inflicted on enterprises and persons guilty of evading controls. They ranged from fines equivalent to several times the amount of fraudulent transfers to one or more years of jail. In some countries, the vehicles of defrauders could also be confiscated when crossing the frontier. Such severity may appear, by current standards, somewhat excessive. In practice, it was intended primarily to exert a dissuasive effect and most extreme sanctions were rarely applied.

VI. MOTIVATIONS BEHIND LIBERALISATION

Growing efficiency concerns

In the face of high inflation and poor growth performance in the 1970s despite expansionary macroeconomic policy, growing attention was paid to the costs of microeconomic distortions generated by government intervention. A new approach was followed, focusing on financial deregulation and other market-oriented structural reforms. It is in this context that OECD countries began reconsidering the role of capital controls.

1. Developing the financial system

The 1980s saw a wave of financial-sector reforms and interest-rate deregulation, designed to enhance the competitiveness of financial institutions, to modernise the payment system and to develop domestic money and capital markets. Withdrawal of exchange controls was considered as an essential element to the achievement of these objectives.

Certain countries in the 1980s such as France regarded the relaxation of controls as necessary to improve the international attractiveness of their financial centre. In the face of the rapid growth of offshore markets in London and Luxembourg, similar considerations already had motivated the decision of the

United States, Germany and Switzerland to lift the controls they had imposed in the 1970s. If British controls did not prevent the expansion of the Euro-currency market in London, this was because banks were allowed to make loans denominated in any currency except sterling and to accept foreign-currency deposits by non-residents. The dual foreign exchange market which was in place in the Belgium-Luxembourg Economic Union also left enough flexibility for Luxembourg to develop its banking and financial industry.

More generally, controls clearly represented a handicap for domestic financial intermediaries to compete effectively in global financial markets. Market shares could be easily lost because of bans on cross-border operations. Non-interest bearing deposit requirements and compulsory minimum holdings of domestic government bonds imposed on banks and institutional investors for exchange control purposes also increased their costs and reduced their competitiveness. In addition, the public could circumvent controls by extensive use of cash instead of cheques or payment cards, thereby retarding the implementation of a modern payments system in less advanced OECD countries.

On the other hand, greater freedom for capital movements widens the possibilities of portfolio diversification, in particular for financial institutions, thus providing a better protection of domestic savers against country-specific investment risk. It also enlarges the number of market participants and products, thereby making the capital markets deeper and more liquid to the benefit of the enterprise sector. Turkey provides a clear-cut example of internal financial modernisation which has been accompanied by a parallel liberalisation of access to domestic markets by non-resident investors and foreign banks and of portfolio investment abroad by residents¹⁴.

However, it was clear from the outset that for the free movement of capital to deliver expected efficiency gains, more rigorous prudential supervision and progress in the harmonisation and mutual recognition of regulatory arrangements across countries were necessary.

2. Strengthening the non-financial business sector

Governments were increasingly concerned that restrictions on capital outflows may have contributed to maintaining clearly unviable firms by keeping domestic savers captive, while restricting capital inflows could deprive potentially profitable firms of needed financial resources. Such optimal fund allocation concerns received particular emphasis in the United Kingdom, Australia and New Zealand when opting for a fast liberalisation approach.

Controls on certain capital outflows evidently discouraged urgently needed inward direct investment in countries such as Greece which maintained restrictions on non-residents when wishing to take out of the country the proceeds of liquidation of direct investment.

It was also recognised that exchange controls could encourage rent-seeking behaviour and discretionary exemptions. There was the perception in particular that exchange controls could perpetuate discrimination against small, local enterprises in favour of large-sized enterprises, trade-oriented firms and multinational corporations which in practice enjoyed easier access to foreign exchange operations. On some occasions, these privileged enterprises began acting as financial intermediaries outside the reach of prudential supervision.

There was finally a risk of significant resource diversion due to time-consuming efforts by private enterprises and individuals to circumvent restrictions. In certain countries, notably in southern Europe, incentives to evade exchange controls also fostered an already prosperous underground economy whereas the policy priority was clearly to ensure a minimum of compliance with most basic rules of the game of a sound and equitable market economy, such as the payment of taxes and the absence of corrupt practices.

Priority to long-term price stability

The dismantling of exchange controls in the OECD area in the 1980s was completed at a time when governments had become less and less inclined to accommodate inflationary shocks and to exploit a trade-off between inflation and unemployment which appeared to exist only in the short term. Price stability has increasingly been regarded as the best contribution that monetary policy can make to economic growth in the medium term.

In this context, one key concern of the monetary authorities was to establish credibility-enhancing mechanisms. The abolition of controls has been seen as one of the means of signalling to the market participants the firm commitment of authorities to stick to announced adjustment programmes. Indeed, with more open money and capital markets, most visible deviations from initially stated monetary policy objectives would be more rapidly and more severely sanctioned¹⁵.

This approach was followed even by countries which opted for a pegging exchange rate policy. Many EMS countries made it explicit that they expected additional credibility gains from the dismantling of controls. Belgium, for instance, removed its dual exchange market in 1990, at the same time as it announced its intention to link its currency more closely to the Deutschemark. In 1990, Italy adopted the narrow 2.25 per cent fluctuation band for its exchange rate within the ERM and abolished all remaining exchange controls¹⁶. A number of EFTA Nordic countries followed a similar approach. In 1991, Sweden, for instance, moved to a peg of the krona to the ECU after completing the dismantling of controls. At the same time as it embarked on an ambitious adjustment programme whose one main goal was to achieve price convergence

with the EC average by 1995, Portugal decided, in 1992, to join the ERM and a few months later to abolish all remaining controls.

The removal of controls was moreover seen by many central banks as desirable for the sake of optimal decision making. It was increasingly considered that capital controls could mask timely and useful signals by the market that corrective policy measures are needed¹⁷. This move was simultaneously supported by domestic financial deregulation which increased the efficiency of indirect, market-based policy tools, thereby making it easier to give up exchange control instruments.

Implicit behind this new approach to monetary policy is a re-assessment that financial markets do not deviate from "fundamentals" of the economy for long periods of time. By the same token, it was increasingly recognised by several governments that they did not always possess superior information on what the equilibrium exchange rate should be. In particular, in countries vulnerable to large terms-of-trade shocks such as Australia and New Zealand, it proved difficult to distinguish capital flows reflecting changes in fundamentals from purely speculative or cyclical capital movements -- which could call for controls rather than deep policy revisions, thereby avoiding unnecessary adjustment costs¹⁸.

Along a similar line of argument, in countries wishing to introduce a pegging exchange-rate policy, greater freedom for capital transactions could enable the authorities to obtain some indication of an equilibrium level that market participants regard as sustainable and at which to start pegging the exchange rate. This was one of the reasons for liberalisation plans in the early 1990s in Iceland, for instance.

However, the move towards free international capital movements was not without raising difficult challenges to the conduct of economic policy in countries pursuing a pre-announced fixed exchange rate target. In such a framework, financial markets become especially alert to any sign of a weakening in authorities' commitment towards monetary and fiscal policy convergence which may call into question the sustainability of the exchange rate objective. As it takes time to establish anti-inflation reputation and confidence, governments have constantly to anticipate possible reversals in market sentiment so as not to be caught by surprise, experience showing that it is difficult to calm the market after strong exchange rate pressures have already emerged.

In sum, the abolition of controls is a necessary but certainly not a sufficient condition for enhancing the credibility of exchange-rate policy. This was confirmed on the occasion of the European currency turmoil in Autumn 1992 -- for many continental European countries the first major currency test for the wave of liberalisation measures taken in the recent period.

However, although some commentators have blamed ill-intentioned foreign speculators for the attacks against certain currencies during the ERM

turbulence¹⁹, there was still a broad consensus among OECD countries that the adoption of corrective policy measures which pass the test of free financial markets represented a long-run investment which offered a better guarantee for economic stability in the future than a return to controls. It is certainly worth noting that the only three ERM countries (Ireland, Portugal and Spain) which tightened existing foreign exchange regulations or re-introduced certain restrictions during Autumn 1992 finally removed all remaining exchange controls by the end of 1992, in conformity with their initially announced schedule.

Decreasing effectiveness of controls

The limited effectiveness of controls was also one of the key reasons advanced by OECD countries when they decided to abolish their exchange control regime. Three lessons can be drawn from the practical experience of the OECD countries with the implementation of controls over the past four decades:

- It proved especially difficult to keep controls effective when market participants' incentives to circumvent restrictions were strong. In retrospect, this may seem somewhat disappointing, since controls were intended to be especially useful during periods of currency unrest;
- To make controls durably effective, it was necessary to minimise loopholes in regulations. Loopholes proved, however, difficult to close unless the authorities were willing to interfere with normal trade payments²⁰ and legitimate exchange-risk management by enterprises²¹;
- Erosion of controls accelerated as they were kept in place for an extended period and the market could thus learn how to circumvent them²².

Already in the 1970s, in the light of the rapid development of Eurocurrency markets, OECD countries were aware that the effectiveness of controls should not be over-stated. Attempts by Germany and Switzerland to restrict capital inflows in the 1970s were early recognised to have been largely unsuccessful²³. When these countries decided in the end to let the exchange rate appreciate, this proved to be a much more rapid and powerful way of stopping excessive capital inflows. It was also clear to the United States administration that there were important limits to what could be achieved through the controls put in place from 1967 to 1973 because, as the major reserve centre, the United States abstained from acting against non-resident funds²⁴. These three countries rapidly removed or reduced their controls following these experiences.

Nonetheless, other countries still felt it more prudent to maintain capital controls, considering that they helped to gain time in order for the authorities to

take correcting measures. This expectation was subsequently deceived on the occasion of major currency crises faced by a number of countries in the 1980s.

In France, although controls probably affected the timing of currency realignments, the extreme tightening of restrictions did not prevent three devaluations largely undertaken under the pressure of the speculation, by more than 25 per cent in total between 1981 and 1983, in about 18 months. Italy faced similar currency unrest during the same period²⁵. The decision to dismantle all capital controls in Australia in December 1983 and in New Zealand in December 1984 was preceded in each case by episodes of massive capital flight that controls were unable to arrest.

Several factors may account for the fact that controls did not deliver the expected protection against capital outflows. To the extent that the purpose of controls is to avoid a rise in the domestic interest rates or a depreciation of the exchange rate, the only instrument left in practice to the authorities to calm the markets is the budget. However, the announcement alone of a tighter fiscal stance in the future may not suffice to make it credible, while the implementation of fiscal adjustment measures takes time and cannot always be expected to exert its effects sufficiently rapidly before the market finds ways of getting around the controls. This is especially true because attempts to tighten controls undermine public confidence further and can precipitate a crisis.

Another practical reason which led OECD countries in the 1980s to reconsider the usefulness of capital controls was the recognition that they were increasingly difficult to administer effectively. Multinational corporations, which can easily move funds abroad through transfer pricing and other internal techniques, had rapidly developed. Capital markets and new technologies had become ever more sophisticated and close substitutes to unauthorised capital operations had emerged. Stronger competition pushed financial institutions to be increasingly active in exploiting the opportunities provided by non-regulated, innovative financial instruments to better serve their clients. Therefore, in a general climate of public expenditure restraint, the opportunity cost to the budget of strengthening the exchange control administration -- as would have been required to keep controls effective -- was seriously reconsidered.

Only in Greece and Iceland where capital markets remain underdeveloped are exchange controls still felt to perform well enough, at least in the short term, for their abolition to be worth being delayed. Until the end of the 1980s, Greece maintained "financial repression" to finance its budget deficit and direct credits towards targeted industries. This contributed to retarding financial modernisation and thereby facilitated the implementation of exchange controls. Offshore/on-shore interest-rate differentials suggest that controls were binding in particular during the periods of national elections²⁶.

Even so, financial underdevelopment did not prevent several major balance-of-payments crises in Greece in the 1980s. The unofficial parallel foreign

exchange market, to which both companies and individuals have easy access, was functioning relatively smoothly during the 1980s, with a low premium except during very short periods of time²⁷. More recently, during the European currency turmoil of Autumn 1992, despite a tightening of existing regulations, the Bank of Greece has had to intervene massively to defend the Drachma and the inter-bank money market rates rose by 10 percentage points.

Iceland is a different case. This country is still essentially a mono-sector economy, highly dependent on the fishing industry. Therefore the need for more developed capital markets was not felt to be pressing while the interest of foreign financiers in the small Icelandic market was necessarily modest.

International liberalisation obligations

Another important factor at work was the undertaking by OECD countries of international liberalisation obligations, even if most major reforms by large industrial countries were initiated at the individual country level. The role of international obligations in the field of capital movements is probably broader than just exerting a pressure on particular countries. International agreements may also help to solve possible "coordination failure" problems. Individual countries are better off if they collectively remove capital export barriers but may lose if they do so unilaterally, without some assurance that the others will follow the movement by easing the access of foreign borrowers to their capital markets.

In acceding to membership of the IMF, countries are committed to remove restrictions on payments and transfers for current international transactions. Membership of the European Communities or the OECD implies an additional commitment to progressively liberalise capital operations.

OECD countries gave priority to fulfilling the conditions of Article VIII of the IMF Agreement which gives official international recognition that a country has achieved full current-account convertibility. In the context of the OECD Code of Liberalisation of Capital Movements (see Annex), experience shows that the system of peer group pressure through country examinations and recommendations by the Council also exert effective pressure on Member countries to accelerate the process of liberalisation of capital controls and avoid backsliding. Often, national policymakers working to pursue liberalisation in their own country found that an internationally recognised forum such as the OECD constituted a valuable source of support.

Although the Treaty of Rome of 1957 established the principle of free capital movements within the EEC, it was the Directive on capital movements of June 1988 which made this liberalisation obligation legally binding for EC countries. The EC Directive and the whole Single Market programme proved to be a strong catalyst for a co-ordinated liberalisation within EC countries. In the context of the Agreement on the European Economic Area (EEA), EFTA countries will also

have to comply with the provisions of this Directive. Partly in anticipation of the EEA agreement and as a preparation to entry into the EC, most EFTA countries had in fact already taken the necessary steps in the late 1980s to meet the EC liberalisation obligations. Switzerland, which is not a party to the EEA Agreement, however, achieved a large measure of liberalisation much earlier and on its own initiative.

For low-income OECD countries, compliance with international liberalisation obligations was also seen as a means of accelerating their full acceptance by the community of modern and liberal economies. Late-reformer EC and EFTA countries will complete liberalisation of capital movements partly for similar reasons.

Multilateral agreements generally do not seek to confine the benefit of capital movements liberalisation to signatory countries. Under the 1988 EC Directive, Member States shall endeavour to attain towards third countries the same degree of liberalisation as that which applies to operations with residents of EC countries and the Maastricht Treaty proposes that *erga omnes* liberalisation requirements become legally binding on Member States. The OECD Code provides that OECD countries shall endeavour to extend their measures of liberalisation to all members of the International Monetary Fund. And within the OECD area, the Codes admit only one exception to the principle of non-discrimination: Members forming part of a special customs or monetary system (such as the EEC) are permitted to undertake more rapid or more extensive liberalisation among themselves than for the OECD area as a whole.

VII. PATTERNS OF LIBERALISATION

Speed

In the majority of liberalisation experiences since World War II, a gradual approach was followed. It took more than ten years for continental European countries and Sterling Area countries during the post-war reconstruction period to return to full current-account convertibility. Only in the late 1980s, Portugal and Spain have achieved Article VIII status of the IMF. Turkey and Greece became Article VIII countries in 1990 and 1992, respectively.

As far as capital-account convertibility is concerned, Japan, after its adhesion to the OECD Codes in 1964, took 16 years to liberalise capital movements, little by little. Liberalisation of capital controls in Denmark, begun in the early 1970s, was spread over more than 15 years. Remaining controls were gradually removed from 1977 to 1986 in the Netherlands. Austria tested out the market's reactions

to small *de facto* liberalisation steps over a long period in the 1980s, before officially lifting formal controls.

There are, however, notable exceptions to the gradual approach to capital control liberalisation. Canada decided in September 1950 to removed its controls. By December 1951, they were all dismantled. Germany made its currency fully convertible for capital movements at the same time as it introduced full current-account convertibility, in 1958. The United Kingdom in 1979, then Australia and New Zealand in the early 1980s opted for a "big bang" approach, removing all controls in less than 6 months. Although some measures were already taken in 1984, Turkey moved to almost full convertibility for both the current account and the capital account in one shot, in 1989.

More importantly, it seems that, since the mid-1980s, the time taken in what is commonly called the gradualist approach shortened. Finland, France, Norway and Sweden really started liberalising the hard core of their permanent exchange control regime in 1986-87 and abolished it in less than 5 years. Italy, which maintained relatively tight exchange controls before the adoption of the EC Directive on capital movements in June 1988, achieved a complete dismantling of controls in less than two years.

Although Ireland, Portugal and Spain took liberalisation steps from 1986, these countries had extensive controls on short-term capital movements until the late 1980s and took measures in 1991 and 1992 to lift remaining restrictions. These countries completed the abolition of controls by the end of 1992, in compliance with the deadline set by the European Community. Remaining controls have therefore been abolished in about two years in these countries too.

Several factors may account for the acceleration of liberalisation in the recent period:

- The entry into force of the 1988 Directive on capital movements in EC countries and its application in practice in several EFTA countries in anticipation of the EEA agreement are one explanation;
- The rapid development of domestic financial innovation and ever more attractive opportunities for investment abroad are making it increasingly difficult for late-reformer OECD countries to keep controls effective;
- It is difficult to resist speeding up liberalisation measures beyond a certain "critical mass" of freedom because close substitutes to operations not yet liberalised become available;
- Now that there are almost no barriers in the OECD area to access to foreign capital, constraints on the financing of fiscal deficits and the balances of payments have eased, and there is less point for an individual country to maintain controls on capital outflows.

Reversibility

However, exchange control liberalisation has not been a smooth, linear process. In the face of unexpected serious difficulties, many OECD countries took steps backward. Table 2 provides an indication of major steps backward since World War II by reporting the episodes of invocation of the derogation clauses under the OECD Codes of Liberalisation.

Table 2

DEROGATION TO THE OECD CODES OF LIBERALISATION (1)

	Capital Movements		Current Invisible Operations	
	Invocation of derogation (2)	Cessation of invocation	Invocation of derogation (2)	Cessation of invocation
Australia	09/1972	06/1978	-	-
Austria	11/1972	08/1980	-	-
Belgium	-	-	-	-
Canada	-	-	-	-
Denmark	02/1979	03/1983	05/1969	04/1971
Finland	06/1985	01/1991	-	-
France	-	-	05/1968 11/1968 05/1981 03/1983	09/1968 08/1973 07/1986 01/1986
Germany	06/1972 02/1973	01/1974 11/1980	-	-
Greece	09/1967 (3)	06/1980	09/1967 (3)	09/1977
Iceland	1961 (3) 01/1993	12/1990	1967 (3)	12/1990
Ireland	-	-	-	-
Italy	04/1969	01/1978	05/1974	05/1984
Japan	01/1972 03/1978	11/1973 02/1979	-	-
Luxembourg	-	-	-	-
Netherlands	-	-	-	-
New Zealand	-	-	-	-
Norway	11/1984 08/1986	12/1989 12/1989	-	-

Table 2 (cont'd)

	Capital Movements		Current Invisible Operations	
	Invocation of derogation (2)	Cessation of invocation	Invocation of derogation (2)	Cessation of invocation
Portugal	1968 (3)	1981	1983 (3)	1981
	1977	1981	1977	1981
	1983	1987	1977	1992
	07/1991	11/1992	1983	1987
Spain	1959 (3)	1962	1960 (3)	1961
	07/1982	06/1985	-	-
Sweden	09/1969	06/1986	09/1969	11/1973
Switzerland	03/1964	10/1966	-	-
	07/1972	02/1974	-	-
	02/1978	01/1979	02/1978	01/1979
Turkey	1962 (3)	1985	1962 (3)	1985
United Kingdom	05/1966	03/1971	07/1966	01/1970
United States	01/1968	04/1974	-	-

- Under the OECD Codes of Liberalisation, Member countries are not allowed to introduce new restrictions on operations subject to liberalisation obligations (except for the items on the so-called List B of the Code of Capital Movements). However, when a Member faces serious economic or financial difficulties, it may enjoy a temporary dispensation from its obligations to preserve the freedom of operations not covered by reservations. Derogations are in principle tolerated for no more than 18 months and are examined by the Organisation to ensure that a liberal regime is restored as soon as possible.
A number of countries have also enjoyed in the past a general dispensation from the liberalisation provisions of the Codes when the economic and financial situation justified such a course. This form of dispensation cannot be used again once surrendered.
- The date of the entry into force, or the maintenance, of the restrictive measures which called for an invocation of the derogation clauses by the country concerned are indicated, and not the date when the council of the OECD formally endorsed the invocation in question.
- General dispensation from the liberalisation provisions of the Codes.

Steps backward were more readily accepted when generalised across countries as was the case in the late 1960s and early 1970s in the context of the crisis of Bretton Woods. During this period, nine countries were led to resort to the Code derogation clauses.

Unilateral return to exchange restrictions occurred essentially in countries still retaining extensive controls, such as France in the early 1980s or Nordic countries in the mid-1980s, or of countries having taken only fresh liberalisation measures such as Spain during the ERM turmoil of September 1992.

Reversibility is likely to be technically more difficult in case of attack against the currency in countries where full liberalisation has already been achieved for some time. First, the administrative machinery that the operation of exchange controls necessitates generally no longer exists. Second, non-residents

have been allowed to accumulate local-currency denominated assets which may represent substantial amounts. The re-introduction of controls generally would lead to a further deterioration in confidence and would make non-residents even more anxious to adjust their portfolio rapidly and sale the currency concerned. This is probably the sort of situation now faced by countries such as Finland, France, Italy, Norway and Sweden (which in any event showed no inclination to resort to controls despite intense pressure on their currency in the second half of 1992).

Even if a return to controls appears feasible in the short term, it may have damaging effects in the longer run on the ability of the country concerned to attract investment inflows in the future. As a recent IMF study argues²⁸, investors will generally demand in the aftermath of controls a higher risk premium on the country's liabilities to cover the increased illiquidity risk attached to their claims.

In face of exogenous, non-economic shocks, a number of countries have also considered better advised not to tighten capital controls. For instance, during the Gulf War, Turkey decided to accommodate massive capital flight by taking no action to limit the convertibility of the Turkish Lira. In doing so, the liberal stance of the Turkish approach to currency movements was reaffirmed and, after the war, in effect, capital rapidly returned to the country.

Sequence of liberalisation of capital movements

1. Operations

In lifting exchange controls, OECD countries generally began with less volatile transactions and those more directly necessary to normal business activities, so as to soften the short-term impact of liberalisation on capital movements. Hence, outward direct investment was usually authorised sooner than portfolio investment abroad, and trade credits were liberalised before financial loans. Dealings in shares were liberalised before those in interest-bearing securities -- and when these were liberalised, the OECD countries began with long-term bonds, thus keeping control over money-market instruments for as long as possible.

Of course, these distinctions only make sense if a gradual approach is followed. Although some liberalisation measures had already been taken along the above sequencing before they opted for a shock therapy approach, a fine-tuning liberalisation policy was no longer possible in Australia, New Zealand and the United Kingdom when this approach was implemented. In Turkey, outward direct investment and portfolio investment were liberalised at the same time. Furthermore, as financial-market instruments become more and more interchangeable and liquid in nature, these distinctions have tended to lose some of their point. Hence, Sweden liberalised Treasury bills and longer-term

government bonds together, in 1989; Italy and Ireland liberalised operations on equities and bonds in tandem rather than in sequence.

Several countries, such as France and Norway, maintained restrictions on lending to non-residents in local currency until the latest stage of liberalisation, for fear of easing speculation against the currency. Conditions for issues abroad of domestic securities in domestic currency were also long subject to limitations. In Germany -- a strong-currency country -- the only control which has not yet been lifted concerns the issue by residents of securities denominated in Deutsche Mark on foreign capital markets. This provision is designed to enable the Bundesbank to contact a responsible party in Germany when it comes to implementing its monetary policy objectives. France and Switzerland continue to monitor Euro-franc issues.

In general, the last operations to be liberalised were those affecting deposit accounts with non-resident institutions abroad, and this mainly for tax control reasons. In France, nonetheless, restrictions on resident accounts abroad were linked to the surrender requirement imposed on enterprises until 1987 and were not removed until the latter requirement was lifted.

2. Operators

Generally, OECD countries authorised the corporate sector to engage in foreign-exchange operations sooner than individuals. This was because it was considered more important to ease the access of domestic enterprises to foreign capital markets than encouraging consumers' indebtedness abroad. Tax control and statistical considerations were also involved, as it may be more difficult to keep track of numerous small capital operations by individuals than typically larger transactions by enterprises.

Within the corporate sector, banking and financial institutions generally enjoyed liberalisation later than other enterprises. Still now, mainly for prudential reasons, most often banks are allowed to take only limited open positions when acting on their own account.

However, as "authorised intermediaries" for exchange control purposes, commercial banks were heavily involved in foreign-exchange operations. In countries such as Austria and Norway, a relatively liberal approach was adopted with the view to giving the domestic financial sector the necessary time to familiarise itself with international capital-market practices and to adapt to foreign competition. Banks in the United Kingdom, as well as in Australia and Spain, were also very active in foreign-exchange activities on their own account well before the abolition of exchange controls.

VIII. EFFECTS OF LIBERALISATION

Short-term impact on capital flows

In the period immediately following the abolition of exchange controls, some countries like France, Sweden and the United Kingdom faced large increases in *gross* flows as a result of portfolio reallocations²⁹ but, in general, countries did not experience dramatic changes in *net* aggregate capital flows. Although the sign of net aggregate changes cannot of course be guaranteed, many countries found that doing away with exchange controls did not give rise to the sudden capital flight they had feared.

Several specific, one-time factors may partly explain this absence of major shocks shortly after the abolition of controls:

- Controls were probably less effective than commonly believed;
- Some controls were not binding prior to their formal abolition because they were in practice already applied in a liberal manner, as this was the case in Austria, for instance;
- A softening of restrictions on capital outflows by residents lowers the implicit tax on the option of re-exporting capital later and therefore encourages residents to repatriate their capital from abroad³⁰;
- Foreign investors' confidence increases if removal of controls is judged definitive.

However, it would be imprudent to count on such specific credibility effects to ensure a lastingly positive outcome if capital movements liberalisation is not accompanied by sound and credible macroeconomic policy and consistent reforms of the financial sector and the tax régime for capital income.

"Premature liberalisation"

The academic literature generally recommends to liberalise the capital account last, accordingly to the following sequencing of adjustment programmes³¹:

- Macroeconomic stabilisation, through fiscal consolidation and tight monetary policy, must precede market deregulation. High inflation indeed reduces the information content of prices and prevent markets from functioning efficiently;
- Product market deregulation, including trade liberalisation, and labour market reform must precede financial deregulation, as typically the speed of adjustment is faster in the capital market than in the other markets;

- Internal financial reform must precede the opening-up of the capital account, so to minimise credit misallocations and prudential problems.

Certain experiences have been regarded as "premature liberalisation" because they did not conform to these prescriptions. A case which has been widely discussed in this respect is New Zealand³². Disinflation was not made a precondition for the abolition of controls in 1984 but was expected to be a by-product of the new adjustment programme. Significant progress in reforming the labour market was not made before the early 1990s.

New Zealand has now one of the lowest inflation rates amongst OECD countries, but the growth performance of the economy has not improved until recently. The combination of exchange control liberalisation, high interest-rate policy and downward price rigidities due to still lagging labour market reform has been blamed by some commentators for the sharp appreciation of the real exchange rate and resulting high unemployment in the second half of the 1980s.

However, in the New Zealand government's view, a slower liberalisation of capital movements would have allowed protected groups to lobby against the overall reform programme, delaying further reforms urgently needed in other areas and resulting in higher disinflation costs in the future. Furthermore, experience showed that capital controls and sterilised intervention were ineffective in influencing the real exchange rate in the medium term, mainly governed by changes in the terms of trade in a small commodity-exporting country such as New Zealand. The appreciation of the real exchange rate from 1985 to mid-1988 was seen to be largely inevitable as the terms of trade dramatically improved. Therefore it is not certain whether alternative policies would have involved smaller adjustment costs.

Spain is a more recent case which also did not conform fully with the standard prescription. From the late 1980s until recently, Spain experienced large portfolio investment inflows attracted by especially high interest rates due to the combination of persistently large fiscal deficits and tight monetary policy aimed at fighting high inflation. These inflows were by and large triggered by expectations of no realignment within the ERM, and the peseta maintained itself close to the upper limit of its 6 per cent fluctuation band. When during Summer 1992 market participants' confidence was weakened by uncertainties over the prospect for a European Monetary Union and the Spanish government's ability to stick to its convergence objectives, the peseta went under heavy pressure and was subsequently devalued within the ERM, by 5 per cent in September and by a further 6 per cent in November. Following the first devaluation, limited exchange controls were re-imposed to defend the new parity.

As the overall EMS turmoil appeared more serious and lasted longer than initially expected, the Spanish authorities promptly recognised that controls could not help significantly and that deeper correcting policy measures were called for.

Controls were partly lifted on 5 October and finally abandoned in connection with the second devaluation. Partly, difficulties stemmed from the fact that progress in inflation convergence with the core ERM countries was insufficient to sustain a parity unchanged since Spain entered the ERM in June 1989. Although the Portuguese escudo joined the ERM later, in April 1992, Portugal faced a somewhat similar experience, with unsustainable inflationary capital inflows from 1989 to mid-1992 followed by a downward realignment of the exchange rate in November 1992, despite a temporary tightening of existing exchange controls two months before, and in May 1993. These realignments were also largely induced by the Spanish devaluations.

Finland provides an illustration of the importance of accompanying domestic financial reform. Capital inflows were liberalised in 1986, at the mid-point of a period of unexpectedly long and strong growth. This contributed to excessive risk taking by domestic financial institutions and households' over-indebtedness, which would probably not have occurred as readily if liberalisation had taken place during a cyclical downturn and prudential supervision had strengthened³³. Similar problems with the banking and financial sector were also recently encountered in Norway and Sweden, although they seem to have had more to do with unchecked domestic lending to residents than with the freeing of capital movements as such.

Instead of suspending the abolition of exchange controls, these experiences argue for speeding up macroeconomic stabilisation and reforms in other areas to accompany and consolidate the process of liberalisation. Attempts to fine tune an ideal sequencing of reforms would have probably been at the risk of losing the political momentum for overall change. This is probably one of the reasons why many of the OECD countries which undertook a complete and rapid liberalisation of controls since the second half of the 1980s did not make the elimination of inflation differential, the return to fiscal balance and the existence of a mature financial system absolute pre-conditions for proceeding with the removal of restrictions on capital movements.

Exchange-rate and interest-rate volatility

On the one hand, financial liberalisation could be expected to lead to less volatility in financial asset prices than in the past when interest-rate ceilings and misaligned exchange rates artificially maintained by capital controls were subject to large and sudden jumps as accumulated imbalances became no longer sustainable.

On the other hand, capital movements liberalisation has contributed to sources of potential instability:

- Volumes of transactions on now liberalised foreign exchange markets are much greater and official reserves have become very small relative

to the volume of foreign exchange trading. As a result, interventions by central banks, at least when they are not co-ordinated across countries, are unlikely to be effective in stabilising the exchange rate in the face of reversals in market expectations. This situation was early recognised³⁴ but has been accentuated by the wave of liberalisation measures in continental Europe in recent years;

- The characteristics of the market have changed. Partly as a result of the relaxation in many countries of governmental limitations on their investments abroad, institutional investors such as pension funds and insurance companies have become major players on international financial markets. In conformity with their prudential responsibilities and contractual obligations to their beneficiaries, these institutions promptly proceed with portfolio adjustments or hedge their open positions while retaining ownership of their bonds, so as to limit their exposure to currencies that appear vulnerable. Fear about currency risk may in turn magnify on-going trends on the foreign exchange markets and prove self-fulfilling.

In the 1980s, there has been a widespread increase in the short-term volatility of the exchange rates in the OECD area, while interest-rate volatility has tended to decline somewhat with financial market liberalisation³⁵.

The European currency turbulences since Summer 1992 opened a period of greater instability in both the exchange rates and the interest rates. However, these events were neither typically new nor inherent to free foreign exchange markets.

A number of explanations, not based on supposed market inefficiency, have been put forward to account for recent pressures faced by many European currencies. To a large extent, dramatic swings in exchange rates were commensurate to the size of economic imbalances accumulated over the recent years within and between countries, including *inter alia* the divergence of German macroeconomic conditions from those elsewhere in Europe as a result of re-unification; progressive loss of international competitiveness in countries with comparatively high inflation rates; problems of financial fragility in certain Nordic countries; rapidly rising public indebtedness in Italy.

Until Summer 1992, the market was nevertheless confident that there was an unchallenged political will to pay the output cost of maintaining high interest rates in order to keep the exchange rates unchanged. In the aftermath of the Danish "no" vote to the Maastricht treaty in June and with the approach of the French referendum in September, the market came to doubt that this was indeed the case and began testing currencies one after the other. As a result, only the three countries having a long-standing record of a virtually locked exchange rate vis-à-vis the Deuschemark, namely Austria, Belgium and the Netherlands, experienced no significant pressure on their currency.

Reporting systems

In countries where reporting systems for *statistical* purposes were closely linked to exchange controls and not based on independent surveys, liberalisation led to difficulties in data collection and information checking. They are reported to have been serious in the United Kingdom and New Zealand, for instance. Recently, in Ireland, more comprehensive data from surveys have shown that the move from deficit into surplus of the current account had occurred several years later than originally thought in light of exchange control data of which the quality and coverage had in fact deteriorated as controls were relaxed.

Therefore, following the abolition of controls, countries redefined and strengthened reporting obligations for commercial banks, generally after close consultations with the profession, and put in place systems of declaration by non-bank residents and company surveys to keep track of transactions not operated through the banking channels.

However, the ability of exchange controls to produce always reliable statistics should not be taken for granted. In the case of New Zealand, for instance, balance-of-payments statistics heavily depended on the reporting by commercial banks for exchange control purposes. Their quality was already deteriorating prior to liberalisation because of widespread control avoidance and the increasing number of transactions not involving bank transfers. A further deterioration, expected to be relatively small, was therefore seen as a price worth paying for capital movements liberalisation.

The abolition of capital controls, in particular on operations of deposit accounts abroad by residents, gave rise to increased concerns for evasion of *tax control* on income which is taxed on a residence principle and not on a source basis, such as personal capital income. As to income taxed on a source basis, such as corporate capital income, the problem was rather one of tax avoidance, and several OECD countries have had to lower their effective corporate tax rates in the course of the 1980s to avoid extensive relocation of direct investment flows towards countries offering a more favourable tax treatment.

This does not mean that capital controls were appropriate to ensure compliance with the tax regime in general. Circumvention of controls for the purpose of engaging in unauthorised capital transactions could entail by the same token tax evasion, although the latter was not the primary intention of circumvention. The experience in some countries showed that commercial banks were less zealous in notifying transactions for tax control purposes where such reporting was coupled with exchange controls.

Hence several countries such as Denmark and more recently Sweden built up a system designed to ensure that the tax authorities obtain the same kind of information concerning interest and dividend payments from foreign banks abroad as that received from domestic institutions³⁶. Somewhat similar arrangements

have been put in place in Italy. In other countries such as France, there is now a system of declaration by individual investors for financial operations and capital transfers abroad exceeding a certain amount, with significant pecuniary penalties in case of non-compliance. Banks and other financial institutions are required to provide information to the tax administration upon its request. Spain also took measures, at the same time as controls were abolished, requesting resident holders of bank accounts abroad to inform the central bank of operations effected.

Accompanying measures are also called for to ensure that the legitimate freedom of capital movements does not serve to facilitate *money laundering*. Therefore a number of countries have maintained or introduced limitations on the amount of cash and other highly liquid valuables such as precious metals which persons may carry with them without prior declaration when crossing the frontier. However, capital controls were not appropriate to combat money laundering; more specific measures had anyway become necessary.

IX. SUMMARY AND CONCLUDING REMARKS

Since World War II, all OECD countries, to varying degrees, have resorted to exchange controls at one time or another. During the immediate post-war reconstruction period, controls, together with widespread trade restrictions, responded to a situation of extreme shortage of international reserves and to pressing concerns to meet basic human needs. While current-account convertibility was restored, *dirigist* financial-sector policy and lack of indirect monetary policy instruments to stabilise inflation and the exchange rate largely explained the maintenance of capital controls in many countries beyond the reconstruction period. Even after the collapse of the Bretton Woods exchange rate regime, capital controls continued to be widely considered a legitimate tool to ensure the autonomy of macroeconomic policy.

International commitments towards progressive liberalisation of capital movements go back to the Treaty of Rome in 1957 for the EC countries and to the establishment of the Code of Liberalisation on Capital Movements in 1961 for the OECD area. However, except in Canada, Germany, Switzerland and the United States which had no tradition of controls, it is only from the end of the 1970s that decisive steps began to be taken towards the complete dismantling of exchange controls in OECD countries.

A new approach to monetary policy in the 1980s, growing concern for economic efficiency and changes in the international environment go a long way to explain that almost all OECD countries have now abolished exchange controls. These various changes have affected mature countries as well as less advanced

OECD countries. In the latter countries, capital movements liberalisation is no longer regarded as a distant objective. Greece and Iceland, the only countries which still maintain any capital controls, are committed to removing their remaining restrictions before the end of June and December 1994, respectively.

Over the past ten years, monetary policy has given priority to long-term price stability over short-term considerations and, to this end, to building up credibility-enhancing mechanisms. Controls did not help in this context: they would have undermined the public confidence in governments' anti-inflation commitments and would have unnecessarily delayed ultimately needed macroeconomic policy adjustment.

This approach has been followed even in countries pursuing a fixed exchange rate target. This has not been without raising difficult challenges to those countries, however. The abolition of controls is a necessary but not sufficient condition for enhancing the credibility of exchange-rate policy. It still considerably limits the possibility of adopting non-converging economic policies across countries. Sudden reversals in market expectations may catch governments by surprise if doubts about the sustainability of current exchange-rate parities are allowed to develop.

However, despite difficulties faced by the European currencies in Autumn 1992, there is still a broad consensus among OECD countries that the adoption of correcting policy measures which are credible to the financial markets represents a long-run investment which offers a better guarantee for economic stability in the future than a return to controls.

OECD countries have also paid more attention to the efficiency losses to the economy caused by the manipulation of the financial sector and other forms of government intervention. It is now considered essential to a well-functioning market economy that the rules of the game be as neutral, transparent and predictable as possible. Exchange controls met none of these conditions: they created sectoral distortions, were complicated and generally involved considerable governmental discretion. The abolition of controls was, by contrast, intended to strengthen the business sector, to speed up the modernisation of the financial system and to improve overall resource allocation.

The international environment has also changed. First, domestic financial markets have developed rapidly and have become ever more sophisticated, while attractive opportunities for investment abroad have dramatically increased. As a result, it has been increasingly difficult to administer controls effectively. Second, now that access to foreign capital does not encounter administrative barriers and that constraints on the financing of the balances of payments and fiscal deficits have eased, there was less point for an individual country to maintain controls on capital outflows.

Although, so far, no liberalisation experiences have in themselves caused major balance-of-payments crises, difficulties in certain OECD countries have been judged sufficiently serious to question whether the abolition of exchange controls had not been premature or too rapid. The main lesson from these experiences is that any attempt to fine tune an ideal sequencing of reforms would have been at the risk of losing the political momentum for overall change. Instead of suspending exchange control liberalisation, this argued for speeding up macroeconomic stabilisation and reforms in other areas to accompany and consolidate the process of liberalisation.

The legitimate freedom of capital movements must not be used to facilitate transgression of basic rules of the game in a market economy, however. Therefore, in the experience of most OECD countries, liberalisation was subject to two limiting principles. First, a number of liberalised transactions have to be carried out through banking and financial institutions, so as to combat tax evasion and money laundering and to avoid disruption in the supply of statistics. Second, these institutions are subject to tighter prudential supervision so as to limit excessive risk taking and to enhance savers' protection.

The abolition of controls represents a return to the situation of free international capital movements which prevailed in past two centuries in western economies. Although international agreements preserve the option for countries to temporarily resort to control measures in case of exceptional circumstances, the degree of liberalisation achieved in the OECD area is seen as largely irreversible.

NOTES

1. Recent studies on OECD countries are OECD (1990) and Shafer (1992). An overview of controls in Latin American countries and Asian economies is provided in Mathieson and Rojas-Suárez (1992) and Reisen and Yeches (1991).
2. The only exceptions are Greece and Iceland. There are also still restrictions, mostly sectoral, on inward direct investment and the acquisition of real estate by non-residents in many OECD countries but these restrictions fall under the purview of legislation distinct from exchange control laws and are motivated by national security, political and cultural considerations as much as economic factors.
3. See Zevin (1989) for a review of the literature on international capital mobility before 1914.
4. See Eichengreen (1989) for a description of interwar exchange controls.
5. For instance, Zevin (*op.cit.*) reports findings that the interest rates on short-term deposits of similar characteristics in Amsterdam, Paris and London showed no wider differentials in the 18th century than in the 1970s and 1980s between New York and London.
6. See Obstfeld (1992) along this line of argument.
7. Giovannini (1988) points out that historically, the burden of interest-rate adjustment within fixed exchange rate systems fell mainly on "peripheral" countries so that they were incited to resort more often to controls than the "centre-country" providing the nominal anchor (i.e. the United Kingdom during the Gold Standard, the United States within the Bretton Woods System, Germany in the European Monetary System).
8. This timing is well described in the case of Sweden in Nipstad (1992).
9. This point is developed in Gordon and Levine (1989).
10. For a description of the role and obligations of the OECD Code of Liberalisation of Capital Movements, see Ley (1989).
11. Marion (1991) finds only weak empirical evidence that the European dual exchange markets in the early 1970 insulated official reserves from speculative activity. For a detailed assessment of the Belgian experience, see also Daco (1992).

12. Transactions were declared all free unless otherwise specified in 1961 in Germany, in 1977 in the Netherlands, 1979 in the United Kingdom, 1980 in Japan, 1988 in Denmark and Italy, 1989 in France and Turkey, 1990 in Austria and Norway, 1991 in Portugal and 1992 in Spain.
13. Interestingly, discretion was especially broad in those countries which were late in the liberalisation process, perhaps partly because of the reluctance of the exchange control bureaucracy to give up its extensive prerogatives.
14. See the 1989/90 OECD Economic Survey on Turkey.
15. This does not mean that the freedom of capital movements necessarily ensures strict discipline on national macroeconomic policies. Perhaps the clearest illustration of this is Turkey where, due to inadequate fiscal control, GDP deflator inflation exceeded 65 per cent in 1992 -- a level as high as in 1988 prior to the move to full currency convertibility.
16. Bartolini and Bodnar (1992) provide empirical evidence that the removal of capital controls in Italy increased the credibility of the commitment to the EMS in the second half of the 1980s and therefore contributed to calming devaluation expectations during this period.
17. This was an argument in favour of liberalisation emphasised in particular by the Reserve Bank of Australia (1987).
18. For instance, in response to the term-of-trade losses resulting from the first oil shock, the New Zealand government heavily borrowed abroad while tightening controls on currency outflows to support domestic demand; the fall in the terms of trade proved *ex post* to be of a permanent nature so that controls only contributed to maintaining an overvalued exchange rate and delaying necessary adjustments (Federal Reserve Bank of New Zealand, 1985).
19. For a critical assessment of conspiracy theories, see Portes (1993).
20. Leads-and-lags in trade payments were an important and principle channel for capital outflows in periods of currency unrest. Their role was first stressed in the case of the United Kingdom by Katz (1953). It is also emphasised in the case of Denmark in Freiberg and Hald (1986), Germany in Hewson and Sakakibara (1977) and Japan in Fukao (1990). In the long run, however, the magnitude of financial arbitrage which can be achieved through leads-and-lags is limited by the size of trade flows (Giovannini and Park, 1992).
21. Nyberg (1992 a) makes clear that, once a forward exchange market was put in place so as to allow enterprises to cover their exchange-rate risks, it became much more difficult to insulate the domestic money market from international interest-rate arbitrage. This is the reason why it was not rare in the past that countries temporarily suspended the forward domestic market for their currency, at least for operations not directly linked to international trade.

22. In Australia, the embargo and the bar-depôt were effective when first introduced and then gradually eroded over time (Sanders, 1985). In the case of Ireland, Browne and McNelis (1990) have estimated that it has taken about six months for the market to learn how to circumvent controls when reintroduced in the late 1970s.
23. For a somewhat negative assessment of the experience with controls in Germany, see Hewson and Sakakibara (1977) and Deutsche Bundesbank (1985), and in Switzerland, see Leutwiler (1984). Based on interest-rate parity tests, Marston (1992) suggests, however, that German controls were binding in 1972 and 1973.
24. This point was made, for instance, by the U.S. representatives at the Committee of Twenty (1974).
25. A study by Collins (1992) on the French devaluations between 1981 and 1983 shows that the probability of realignments perceived by market participants was negatively correlated with the level of foreign exchange reserves in the Bank of France and fitted relatively well the timing of actual realignments. This finding is not consistent with the assumption that controls were fully effective. For an analysis of the effectiveness of controls in preventing currency unrest in the early 1980s in France and Italy, see also Gros and Thygesen (1992). These authors argue that controls did not prevent, only prolong, turbulent periods in the foreign exchange markets.
26. See Christodoulakis and Karamouzis (1993).
27. See 1990/1991 OECD Economic Survey on Greece. In 1985, in particular, Greece experienced massive illegal capital outflows. Capital flight typically occurred through tourism, emigrants' transactions and shipping in the form of reduced foreign exchange receipts from these sources.
28. See Goldstein *et al.* (1993).
29. See Artis and Taylor (1989) on the U.K. experience, Lindenius (1990) on Sweden and Girardin (1992) on the French experience during the 1980s.
30. This argument is extensively developed in Kenen (1992).
31. Williamson (1992) provides an overview of the literature on optimal sequencing.
32. See, for instance, Chapple (1991), and Joumard and Reisen (1992) for a critical assessment of the New Zealand experience.
33. Nyberg (1992 b).
34. Jurgensen (1983).
35. Blundell-Wignall and Browne (1991) review empirical evidence on financial asset price volatility in the 1980s.

36. If a resident opens a bank account in a foreign country, this person is required to submit a written statement from the foreign deposit institution that it undertakes to inform the tax authorities of interest and dividends paid.

REFERENCES

- ARTIS, M.J. and TAYLOR, M.P. (1989), "Abolishing Exchange Control: The UK Experience", *Greek Economic Review*, Vol. II, No. 1.
- BARTOLINI, L. and BODNAR, G.M. (1992), "An Analysis of the Process of Capital Liberalization in Italy", *IMF Working Paper*, No. 92/27 (April).
- BLUNDELL-WIGNALL, A. and BROWNE, F. (1991), "Macroeconomic Consequences of Financial Liberalisation: A Summary Report", *OECD Department of Economics and Statistics Working Paper*, No. 98 (February).
- BROWNE, F.X. and McNELIS, P.D. (1990), "Exchange controls and interest rate determination with traded and non-traded assets: the Irish-United Kingdom experience", *Journal of International Money and Finance*, 9.
- CHAPPLE, S. (1991), "Financial Liberalisation in New Zealand, 1984-90", *UNCTAD Discussion Paper*, No. 35 (March).
- CHRISTODOULAKIS, N.M. and KARAMOUZIS, N.V. (1993), "Financial Openness and the Effectiveness of Capital Controls in Greece", *Greek Economic Review* (forthcoming).
- COLLINS, S.M. (1992), "The Expected Timing of EMS Realignment: 1979-83", *NBER Working Paper*, No. 4068, (May).
- COMMITTEE OF TWENTY (Committee on Reform of the International Monetary System and Related Issues) (1974), "Report of Technical Group on Disequilibrating Capital Flows", in *International Monetary Reform*, International Monetary Fund, Washington.
- DACO, D. (1992), "The operation of the Two-Tier Foreign Exchange Market. The Experience and its Lessons", National Bank of Belgium, mimeo.
- DEUTSCHE BUNDESBANK (1985), "The Freedom of Germany's Capital Transactions with Foreign Countries", *Deutsche Bundesbank Monthly Report* (July).
- EICHENGREEN, B. (1989), "The Comparative Performance of Fixed and Flexible Exchange Rate Regimes: Interwar Evidence", *CEPR Discussion Paper*, No. 349 (November).
- FREIBERG-JENSEN, C. and HALD, J. (1986), "Foreign-Exchange Liberalisation and Capital Movements", *Danmarks Nationalbank Monetary Review* (February).

- FUKAO, M. (1990), "Liberalisation of Japan's Foreign Exchange Controls and Structural Changes in the Balance of Payments", *Bank of Japan Monetary and Economic Studies*, No. 2 (September).
- GIOVANNINI, A. (1988), "How Do Fixed-Exchange-Rates Regimes Work: The Evidence from the Gold Standard, Bretton Woods and the EMS", *CEPR Discussion Paper*, No. 282 (October).
- GIOVANNINI, A. and J.W. PARK (1992), "Capital Controls and International Trade Finance", *Journal of International Economics*, 33.
- GIRARDIN, E. (1992), "La fixité des changes et la libéralisation financière en Europe sont-elles sources d'instabilité monétaire et d'indiscipline budgétaire?", *Cahiers Economiques et Monétaires*, No. 40, Banque de France.
- GORDON, D.M. and LEVINE, R. (1989), "The 'Problem' of Capital Flight: a Cautionary Note", *The World Economy*, No.2 (June).
- GOLDSTEIN, M., D. FOLKERTS-LANDAÜ, P. GARBER, L. ROJAS-SUAREZ and M. SPENCER (1993), *International Capital Markets. Part I. Exchange Rate Management and International Capital flows*, World Economic and Financial Surveys, International Monetary Fund.
- GROS, D. and N. THYGESSEN (1992), *European Monetary Integration. From the EMS towards EMU*, Longman, London.
- HEWSON, J. and SAKAKIBARA, E. (1977), "The Effectiveness of German Controls on Capital Inflow", *Weltwirtschaftliches Archiv*, 113.
- JOUMARD, I. and REISEN, H. (1992), "Real Exchange Rate Overshooting and Persistent Trade Effects: The Case of New Zealand", *The World Economy*, Vol. 15, No. 3 (May).
- JURGENSEN, P. (1983), *Report of the G-7 Working Group on Exchange Market Intervention*, La Documentation Française, Paris.
- KATZ, S. (1953), "Leads and Lags in Sterling Payments", *The Review of Economics and Statistics*, (February).
- KENEN, P.B. (1992), "Financial Opening and the Exchange Rate Regime", paper presented at an OECD Development Centre Seminar, 6-7 July 1992.
- LEUTWILLER, F. (1984), "Monetary Policy and Capital Movements: The Experience of Switzerland" in *International Capital Movements, Debt and Monetary System*, Engels, W., Gutowski, W., Wallich, H.C. (eds.), V. Hase & Koehler.
- LEY, R. (1989), "Liberating Capital Movements. A New OECD Commitment", *The OECD Observer*, No. 159 (August/September).

- LINDENIUS, C. (1990), "Exchange Deregulation -- Short and Long-run Effects", *Sveriges Riksbank Quarterly Review*, No. 3.
- MARION, N.P. (1991), "Empirical Evidence on European Dual Exchange Rates and its Relevance for Latin America", *NBER Working Paper*, No. 3809 (August).
- MARSTON, R.C. (1992), "Interest Differentials under Fixed and Flexible Exchange Rates: the Effects of Capital Controls and Exchange Risk", *NBER Working Paper*, No. 4053, (April).
- MATHIESON, D.J. and ROJAS-SUAREZ, L. (1992), "Liberalisation of the Capital Account: Experiences and Issues", *IMF Working Paper*, 92/46 (June).
- NIPSTAD, J. (1992), "The Swedish experience with controls and liberalisation of portfolio investment", Sveriges Riksbank, mimeo.
- NYBERG, P. (1992 a), "Foreign Exchange Deregulation in Finland: Principles, Practice and Consequences", *Bank of Finland Working Paper*, 3/92 (March).
- NYBERG, P. (1992 b), "Regulation-Driven Markets: Some Examples of Distortions in the Finnish Financial Markets", *Bank of Finland Working Paper*, 5/92 (April).
- OBSTFELD, M. (1992), "The Adjustment Mechanism", *CEPR Discussion Paper*, No. 648 (May).
- OECD (1980), *Controls on International Capital Movements: Experience with Controls on International Portfolio Operations in Shares and Bonds*, Paris.
- OECD (1982), *Controls on International Capital Movements: The Experience with Controls on International Financial Credits, Loans and Deposits*, Paris.
- OECD (1990), *Liberalisation of Capital Movements and Financial Services in the OECD Area*, Paris.
- PORTES, R. (1993), "EMS and EMU After the Fall", *The World Economy*, Vol. 16, No. 1 (January).
- REISEN, H. and YECHES, H. (1991), "Time-Varying Estimates on the Openness of the Capital Account in Korea and Taiwan", *OECD Development Centre Technical Papers*, No. 42 (August).
- RESERVE BANK OF AUSTRALIA (1987), "Deregulation -- Is the Honeymoon Over?", *Reserve Bank of Australia Bulletin* (September).
- RESERVE BANK OF NEW ZEALAND (1985), "The Abolition of Exchange Controls", *Reserve Bank Bulletin*, Vol. 48, No. 10.
- SANDERS, D.N. (1985) "Exchange Control -- The Australian Experience", *Reserve Bank of Australia Bulletin* (May).

- SHAFER, J.R. (1992), "Experience with Controls on International Capital Movements in OECD Countries -- Solution or Problem for Monetary Policy?", paper presented at a Bank of Korea Conference, 6-7 November, Seoul.
- WILLIAMSON, J.(1992), "On Liberalizing the Capital Account" in *Finance and the International Economy*, O'Brien, R. and Hedwin, S. (eds), Oxford University Press.
- ZEVIN, B. (1989), "Are World Financial Markets More Open? If So, Why and With What Effects?" in *Financial Openness and National Autonomy*, Marglin, S. (ed.), Oxford University Press (forthcoming).

Part II

EXCHANGE CONTROL POLICY IN CENTRAL AND EASTERN EUROPE

I. INTRODUCTION AND SUMMARY

It is widely agreed that the removal of restrictions on payments and transfers for current international transactions should be a priority in reform programmes for less-advanced economies, as it is a condition for adopting a coherent relative price structure and enhancing competition in the product market. The freedom for foreign investors to repatriate their profits and their capital in the event of liquidation or sale must also be guaranteed if much needed inward direct investments are to be attracted.

Current exchange control regimes, in place since the late 1980s or the early 1990s depending on the country concerned, were built on such a framework in the five CEECs covered by this study (Bulgaria, the Czech and Slovak Federal Republic¹, Hungary, Poland and Romania). With the exception of Romania at the end of 1992 when queues for access to foreign exchange on the inter-bank market reappeared, these countries managed in about one year to make their currencies freely convertible into foreign currencies for the payment of almost all international current payments, in conformity with their membership of the International Monetary Fund. But they have put off, until a later stage in their transition to a market economy, the freeing of capital movements other than foreign direct investment.

The distinction between current-account convertibility and capital-account convertibility may be pertinent only in the short term. In the medium term, the conditions for a sustainable move towards current-account liberalisation are the same as those required for a successful opening-up of the capital account, especially sound economic policies. More importantly, the microeconomic pay-offs expected from current-account convertibility apply to a large extent to capital-account convertibility as well. However, with typically faster adjustment

in financial markets than in product markets, still high inflation and not yet stabilised expectations, and weak prudential supervision of the domestic financial system, the CEECs have opted for prudence and delayed further capital movements liberalisation in the early phase of transition.

In fact, the authorities in many of the CEECs are concerned that the degree of *de facto* liberalisation of capital outflows already achieved could be excessive in some respects. First, in response to the dollarisation of the economy under the former centrally planned system and during the early period of transition, residents have been entitled to freely operate foreign-currency accounts, a privilege which most OECD countries accorded only at the very latest stage of liberalisation. Second, many exchange controls are of questionable effectiveness, due to the lack of coordination, resources and experience. These features may make CEECs' economies particularly vulnerable to unexpected adverse shocks.

It is not nevertheless certain that existing exchange controls could or should be tightened. The need for more elaborate restrictions on capital operations must be carefully weighed against the sectoral distortions they may cause, the resource misallocation resulting from time-consuming efforts by the public to circumvent controls and their administrative opportunity costs while there are pressing needs for improvement in other domains such as tax control, banking supervision and balance-of-payment data collection. More important still, any backward step could be interpreted as calling into the question the authorities' commitment to the maintenance of convertibility and to price stabilisation which were, at the outset, seen as key elements in the overall economic reform programme.

The authorities seem to be steering a middle course between the two extremes of making controls much more stringent or abandoning them altogether. Once the economic climate in general is more settled, public opinion may perhaps be ready to accept adjustments on some points in exchange for more liberty on others -- especially if it is convinced that the ultimate aim is the complete removal of exchange controls.

In no way exchange controls should be used as a substitute for macroeconomic stabilisation policy and to delay necessary market-oriented reforms. At all events, given the limited effectiveness of controls, CEECs have to persevere with, and succeed in, their anti-inflation policy and structural reforms to reduce the risk of capital flight and avoid *de facto* freedom of many capital movements being used for tax evasion, financial malpractices, money laundering and other transgressions to the basic rules of a market economy.

The remainder of this second part of the report is organised as follows. Section II describes the main aspects of exchange control regimes in CEECs. Section III examines the arguments for the maintenance of capital controls in these countries. Section IV reviews their effectiveness. Section V concludes by addressing some policy options and priorities facing the authorities in central and eastern Europe.

II. EXCHANGE CONTROL REGIMES IN CEECs²

The legal framework for exchange controls in CEECs is in several respects similar to the pattern followed by many OECD countries in the past (see Part I). Capital outflows are more severely restricted than capital inflows (Table 1). Short-term operations are more tightly controlled than long-term transactions, generally more directly necessary to business activities.

However, the laws and regulations are not as sophisticated as they used to be in OECD countries. Distinctions between direct investment and portfolio investment or between commercial credits and financial credits are not always formally drawn in CEECs. These distinctions, which were largely irrelevant under the former centrally planned system of resource allocation, are likely to become increasingly important in the design of exchange control regulations in CEECs as capital markets, the banking system and the private business sector expand.

Controls on capital outflows appear more carefully enforced in the former CSFR, partly because of the choice of a fixed exchange rate policy³, and in Hungary. Contrary to Poland and Bulgaria, Hungary has refused debt rescheduling or reduction. This was initially an additional reason for Hungary to maintain stricter controls on capital outflows.

By contrast, Bulgaria and Romania appear to have the more liberal regimes regarding capital outflows, although legally subject to a regime of prior permission in these countries too. These two countries have opted in principle for a float of their currencies. Moreover, Romania enjoys an external debt still low by international standards (Table 2).

Poland is somewhere between these two groups of countries. It adopted in 1989 a regime of greater convertibility for its currency than Hungary, in particular concerning travel allowances, following a shock therapy approach aimed at stopping a crisis of confidence in the zloty. Moreover, Poland, whose the external debt is still high, has interrupted the service of its official debt since the early 1980s and has recently been accorded a significant debt reduction by the Paris Club. The move to a more flexible exchange rate policy, since the abandonment of the fixed exchange rate target in May 1991, also contributed to sustaining the liberal stance of convertibility policy in Poland.

Certain capital inflows regarded as easily self-reversing, typically short-term portfolio investments, financial credits and speculative real estate placements, are also subject to various restrictions for the purpose of keeping a better control on monetary conditions in the CSFR, Hungary and Poland. Such restrictions are for the time being not imposed in Bulgaria and Romania, partly reflecting the still low level of their economic development, the modest flow of foreign investments

Table 1
FOREIGN EXCHANGE REGULATIONS IN CENTRAL AND EASTERN EUROPE
December 1992

	Bulgaria	CSFR	Hungary	Poland	Romania
Direct investment					
- In the country concerned (1)	1	1	1	1	2
- Abroad	3	3	3	3	3
Real estate operations					
- Inflow	2	3	3	2	3
- Outflow	4	4	4	4	4
Portfolio investment (2)					
- Inflow	2	3	2	3	2
- Outflow	4	4	3	4	4
Commercial credits					
- Inflow	1	3	2	2	1
- Outflow	1	2	1	2	2
Financial credits and loans					
- Inflow	1	3	3	3	1
- Outflow	1	3	3	3	2
Operation of deposit accounts in local currency by non-residents:					
- In the country concerned	3	3	3	3	3
- Abroad	4	4	4	4	4
Operation of deposit accounts in foreign currencies (physical persons):					
- In the country concerned	1	1	1	1	1
- Abroad	4	4	4	4	4
Obligation to repatriate foreign exchange export proceeds from abroad	Yes	Yes	Yes	Yes	Yes
Obligation to surrender foreign exchange export proceeds to:					
- commercial banks	No	Yes	Yes	Yes	No
- the central bank	No	Yes	No	Yes	No
Access of enterprises to foreign exchange for current international payments	1	1	1	1	2
Private travel allowances (US\$)(3)	400	250	350	2000	250
Personal capital movements (outflows)	3	3	3	3	3

1. Including liquidation of investment (and capital gains) and repatriation of investment income.
2. Investment in share, bonds, Treasury bills and other securities, which does not give the possibility of exercising an effective influence on the management of a particular enterprise.
3. Per person per year (Poland: per person per trip)

Legend: 1 = free; 2 = partially liberalised; 3 = subject to prior authorisation; 4 = normally not allowed.

Table 2

SELECTED FINANCIAL INDICATORS

	Bulgaria	CSFR	Hungary	Poland	Romania
Reserves as a percentage of imports					
1990	21	16	18	45	4
1991	13	36	53	25	11
1992 ^e	18	21	67	32	13
Net debt as a percentage of goods exports in convertible currencies					
1990	398	117	320	389	9
1991	293	77	246	324	35
1992 ^e	284	61	204	283	66
Net capital inflows (US\$ billion)					
1992 ^e	1.5	1.5	2.1	1.9	1.5
of which:					
Direct investment	0.0	0.8	1.5	0.1	0.1
Commercial bank credits (including interest arrears)	0.4	-0.3	0.9	0.0	-0.9
Other private	0.1	0.1	0.1	0.0	0.8
Official funds	1.0	0.9	0.7	0.8	1.3
Real effective exchange rates*					
<i>Consumer-price based</i>					
Dec. 1991	65	93	113	233	30
Dec. 1992	104	97	127	234	39
<i>Producer-price based</i>					
Dec. 1991	53	100	116	151	65
Dec. 1992	67	106	127	141	59

e: estimate

* January 1990 = 100. For Bulgaria, January 1991 = 100

Sources: National sources and OECD Secretariat estimates.

attracted so far, and perhaps the choice of an exchange rate float policy which may make foreign short-term investments more risky.

General legal framework

As the transition to a market economy began, the CEECs introduced new foreign exchange regulations. The legislation in force in Poland since 1989, in Romania since 1992 and put in place in 1991 in the CSFR follows the general principle that all foreign exchange transactions are free unless otherwise specified. *A priori* such a principle should minimise the need for permanent and extensive screening procedures and therefore confine the use of exchange controls instruments to periods of special financial or economic difficulties. However, this principle also implies that, if newly-introduced financial instruments are to be restricted, new regulations have to be added. This may give the unfavourable impression to the public that the government is taking backward steps. These regulations may also be more easily circumvented as substitutes to unauthorised capital operations are by definition free to develop unless otherwise specified.

In Bulgaria, the 1966 Foreign Exchange Law is still in operation but it was substantially liberalised in 1991. In Hungary, a Law Decree, going back to 1974 and listing the transactions which are restricted unless specifically allowed by the authorities, is still in force. The list is very extensive and comprises almost all possible transactions. There has been, however, room for the foreign exchange authorities to set liberal implementing rules or to abolish the licencing requirement for many operations. This made the undertaking of liberalisation steps more visible to some extent than in the other countries. The new foreign exchange law to be passed in Hungary will be based on the rule that all transactions are free unless otherwise specified, reflecting the increasingly liberal stance of foreign exchange policy over the past two years.

The present legal framework for exchange control in CEECs is far from being stabilised. Given the pressing need to implement the legal framework necessary to the functioning of a market economy, new regulations have been sometimes passed hurriedly or grafted onto old laws, giving rise to possible omissions or inconsistencies which need to be corrected. Moreover, in a context of emerging private businesses and domestic capital markets, the necessary regulations are lagging behind financial innovations and call for frequent adaptations.

All the CEECs covered in this report are preparing new foreign exchange laws with the view to providing for an updated and more rigorous legal framework for the design and implementation of regulations. As a too detailed product-by-product approach would become rapidly obsolete, it may be desirable to keep the law relatively general, leaving implementation issues to be dealt with by way of circulars from the Central Bank and the Ministry of Finance as well

as the necessary freedom to the authorities to tighten controls in cases of unexpected difficulties. However, the difficulty in this more flexible approach is to preserve sufficient transparency and avoid excessive discretion and arbitrariness on the part of the administration which would be prejudicial to the conduct of current business activities.

Free access of resident firms to foreign exchange for most import payments

The liberalisation of imports and related international payments was a prerequisite for eliminating input shortage, adopting a more coherent structure of relative prices and enhancing competition in the domestic product markets in the CEECs. Trade liberalisation has therefore proceeded rapidly along a shock therapy approach, although Hungary took some steps towards opening up its economy as early as the 1970s. By 1992, at least 90 per cent of imports were liberalised in the five CEECs.

Subject to remaining restrictions (quotas on a few number of selected consumer goods and licence requirements for certain strategic products), resident enterprises, including generally unincorporated private businesses, have free access to foreign exchange at prevailing legal market rates for importing *goods* since the late 1980s in Hungary, 1990 in Poland and 1991 in Bulgaria, the CSFR and Romania, disregarding the temporary resurgence of queue phenomena for the access to foreign exchange at the official rate in the end of 1992 and early 1993 in this latter country.

Foreign exchange is also freely available to resident enterprises for imports of *services* and trade-related current invisible transactions, such as transportation, insurance, advertising, etc. There still remain restrictions on business travel in Hungary, in the form of a fixed maximum proportion of turnover which may be spent for this purpose. The authorities fear abuses in state-owned enterprises with still "soft" budget constraints and circumvention of current restrictions on non-business travel allowances.

Move towards unified exchange rates

In the past, under the central planning system, foreign exchange allowances for the making of import payments were allocated selectively and at different exchange rates depending on the product concerned. As part of the move towards internal current-account convertibility, the "tourist" rates, various "commercial" and "non-commercial" rates were unified in a single official rate, set up by the central bank.

Presently there exist other rates at which foreign exchange can be legally bought:

- The exchange rate determined by supply and demand for foreign exchange on the inter-bank market. Except in Bulgaria and Romania where the official rate is the rate prevailing on the inter-bank market at the end of the working day of the preceding session, banks are, however, required to accept daily bid or offers orders only within a relatively narrow fluctuation band around a pre-announced central bank rate;
- Besides banks, the so-called foreign exchange bureaus are specialised in buying and selling foreign exchange in cash, in principle only to individuals and within more or less narrow specified limits depending on the countries. In Poland, since 1991, the central bank rate did not differ from the exchange rate prevailing on this parallel market within a range of more than 1 per cent. In Bulgaria since the beginning of 1992 and in Romania since June 1992, the foreign exchange bureaus have direct access to the inter-bank market to sell their foreign exchange surplus, representing a first step towards the elimination of multiple currency practices. A similar move is being considered in Poland.

The problem of personal travel allowances

Except in Poland, individuals have only limited access to foreign exchange at the legal rate for current invisible transactions, although facilities are generally granted for study abroad. In particular, travel allowances per person per year are very small for individual trips not organised through tour operators: in 1992, despite gradual increases, they did not exceed US\$ 500 in Bulgaria, US\$ 350 in Hungary, US\$ 250 in the CSFR and Romania. Although unused travel allowances can be cumulated in Hungary, such amounts remain insufficient to realistically cover individual travel costs.

By contrast, in Poland, tourist allowances are freely available up to US\$ 2 000 per person per trip. Polish households also have access to foreign exchange for most other current invisible operations.

While internal current-account convertibility can be considered as *de facto* completed in Poland, restrictions on travel seem to constitute the only serious obstacle to be removed for the other countries to achieve full internal current-account convertibility. Then, to achieve Article VIII status of the IMF, which provides an official international recognition of current-account convertibility, only certain, by and large technical, conditions will have to be fulfilled⁴.

As further explained hereafter, physical persons may take out of the country any amount of foreign exchange withdrawn from accounts they have been entitled to open with domestic commercial banks. Against this particular institutional background, the authorities fear to build a permanent bridge for capital flight and

cross-border shopping if more generous access to foreign exchange for travel purposes were to be granted to individuals.

These risks are, however, unlikely to materialise as long as tight monetary policy continues to be pursued. Moreover, with customs controls at the frontier being hardly effective and liberalisation of consumer good imports almost completed, a sudden surge in imports, as it had occurred in 1989 in Hungary following earlier relaxation of travel restrictions, is unlikely. Finally, in Hungary at least, official international reserves in 1992 have considerably improved, representing six months of imports by the end of the year. If reserves maintain themselves at comfortable levels, one can reasonably expect that restrictions on personal travel allowances will be phased out in a not too distant future in this country.

This is what already occurred in Poland, without apparently experiencing a major shock. Bulgaria is envisaging to follow a similar trend in the near future, the new draft foreign exchange law raising by a factor of five the level of allowances. The lifting of exchange controls in the travel area is perhaps easier in countries letting their currencies freely float. In theory, at least, additional demand for foreign currency tends to be automatically discouraged as the exchange rate is allowed to depreciate in parallel, thereby possibly leaving official reserves unchanged.

Privilege of individuals to operate foreign-currency accounts

As a result of creeping dollarisation under the former centrally planned system and also for self-protection against high inflation at the early stage of transition, individuals have accumulated large foreign exchange balances. A large part of foreign currencies acquired by individuals was, and continues to be, brought into the country by foreign tourists and emigrants working abroad.

In order to incite individuals to keep their foreign exchange holdings inside the country, these balances may be held in accounts deposited in authorised domestic commercial banks, and this without having to justify the source of the foreign exchange. These foreign-currency accounts bear interest at rates comparable to those prevailing in western countries. In the initial phase of anti-inflation stabilisation programmes, although there was no legal obligation to surrender individuals' foreign-currency deposits, commercial banks preferred to re-sell them to the central bank as they were short of liquidity in local currency in countries pursuing especially tight monetary policy.

In Hungary, individual foreign-currency accounts amounted to US\$ 2.0 billion in September 1992, an order of magnitude equivalent to 35 per cent of official reserves; in Poland, they reached US\$ 6.1 billion in October 1992, while official reserves amounted to US\$4.1 billion at the same date; and in the CSFR, they totalled US\$ 1.5 billion in July 1992 as compared with reserves of

US\$ 2.1 billion. In Bulgaria and Romania, the amounts involved seem much smaller, perhaps because, in these two countries, resident enterprises are allowed to open foreign-exchange accounts so that there is no particular incentive for them to seek to retain their foreign exchange through the channel of individual accounts, and because overall foreign exchange income sources are more limited.

Any amount of foreign exchange from these individual accounts may legally be taken out of the country at any time and *de facto* for any use, including capital transfers and investment abroad despite *de jure* prohibition.

Foreign-currency holding is in part affected by public expectations concerning the exchange rate and inflation. Potentially, currency substitution implies that more inflation is necessary to finance a given public deficit since the monetary base over which the "inflation tax" could be levied to finance the deficit erodes. On the other hand, it may also limit the autonomy of domestic interest-rate policy. Although this might exert a discipline effect desirable to ensure continued sound monetary policy, countries pursuing an exchange rate objective or having still difficulty in servicing their external debt consider that the right of individuals to operate foreign-currency accounts represents a permanent threat to the adequacy of foreign reserves in case of unexpected adverse events.

The freedom to hold personal foreign-currency accounts is a very liberal provision that most OECD countries offered to enterprises first and to households only at the latest stage of liberalisation (see Part I). However, it is unlikely that steps could be taken to limit the amount of foreign exchange that individuals are allowed to take out of the country from their hard-currency deposit accounts. Any steps backward in this field would have probably serious effects on public confidence and would be interpreted as a precautionary measure in the face of imminent capital flight, which would actually precipitate a crisis⁵. Moreover, such a measure would be difficult to enforce, especially if single depositors manage in practice to have several accounts, maintained under different names at different banks.

To date, balances in foreign-currency accounts do not show a clear-cut tendency to fall, although, except in Romania, interest rates on domestic-currency deposits in 1992 were higher than returns on foreign-currency accounts, even after due adjustment for the depreciation of the exchange rate. But, in the future, unless a relaxation of anti-inflationary policy occurs, the relative share of foreign-currency accounts is likely to decrease as price expectations weaken and more attractive local-currency-denominated saving instruments expand.

Furthermore, it would be also necessary to remove tax exemptions which, as in Hungary, favour foreign-currency accounts. In Romania, the attractiveness of foreign-currency accounts is also reinforced by their safety from creditors' claims and the ability to raise bank loans on the collateral of these accounts. Finally, these accounts were opened partly because households felt they were denied access to foreign exchange for the purpose of legitimate transactions and

have not forgotten past governments' arbitrary reversals in this field; this precautionary reason might therefore lose its force once current restrictions on travel allowances and other personal remittances are perceived as definitely abandoned.

Surrender requirement for export proceeds

Foreign exchange income earned abroad by enterprises must be repatriated and deposited with resident commercial banks in all the CEECs. While in the former CSFR and Poland exporters have to repatriate their export proceeds without delay, they have one month to do so in Bulgaria. No clear time limit is formally set in Hungary and Romania.

In order for the authorities to retain a certain control on the country's foreign currency reserves, to encourage the use of local currencies as the mean of payment between resident firms within the country and to secure adequate volume of foreign exchange traded on emerging inter-bank markets, enterprises are required to surrender their export proceeds in foreign currency to authorised commercial banks within 8 days in Hungary and upon receipt in the former CSFR and Poland. Banks then were required until recently to re-sell a certain percentage of these foreign exchange to the central bank.

Although the imposition of a surrender requirement may be considered as a restriction⁶, it reflects a significant improvement compared with the inefficient arrangements prevailing under the former centrally-planned system, where individual enterprises were allowed, though not in Hungary, to keep a large share of export earnings in foreign currency but did not have access to more foreign exchange in case of necessity.

By contrast, in Bulgaria and Romania, no surrender requirement is imposed on enterprises. Like individuals, firms may therefore freely operate foreign-currency deposit accounts. Until 1991, Bulgaria and, until early 1992, Romania maintained such a requirement but removed it once a minimum of reserves was reconstituted. Early in 1993, in Romania, the extreme shortage of foreign exchange led the Ministry of Finance to propose to re-introduce a compulsory surrender for enterprises. Although this proposal was opposed by the central bank and was not implemented, it was reported to have led to precautionary capital flight.

To some extent, as Bulgaria and Romania have opted for an exchange rate float, there is less need for an administrative return of foreign exchange to the central bank in order to defend a particular exchange rate target. The absence of surrender requirement is also seen in these countries to have certain advantages:

- Past experience of these countries with the enforcement of surrender requirements proved rather negative: many enterprises shifted further to

barter transactions or simply ceased to repatriate their foreign exchange proceeds in order to escape the obligation to sell them to the banks. Therefore it was far from being clear that surrender measures were effective in reducing the risk of dollarisation of their economies;

- Enterprises that need to turn around their funds relatively quickly are not hit both ways by bank commissions -- quite high in most CEECs -- if they can keep their foreign exchange earnings;
- In the absence of a forward foreign exchange market -- as is the case in Bulgaria and Romania -- the enterprises obliged to sell their foreign exchange may incur serious exchange rate risks in countries whose currencies are rapidly depreciating;
- Treating enterprises less favourably than individuals could be a factor of distortion.

However, in the absence of a surrender requirement to the central bank, it is essential to establish, from the outset, a well-functioning inter-bank foreign exchange market aimed at ensuring a reasonable level for the exchange rate at which foreign exchange holders may be willing to sell foreign currencies to their banks. The latter can then re-sell the foreign exchange to other banks which need them on the account of their clients.

Bulgaria and Romania established a legal framework for such a market as early as February 1991. While the inter-bank market seems to work reasonably well in Bulgaria, Romania has had in Spring 1992 to substantially modify the rules to increase the volume of foreign exchange traded through its market. Early 1993, queues for access by enterprises to foreign exchange on the inter-bank market reappeared because of pressures exerted by the authorities on commercial banks to keep the exchange rate at an overvalued level.

A full-fledged inter-bank foreign exchange market is now operational in Hungary since July 1992. In this connection, commercial banks are no longer required to surrender their foreign exchange to the National Bank. The CSFR and Poland accelerated steps towards the creation of an inter-bank market in the second half of 1992. In this context, the extent to which the surrender requirement could be relaxed was being reviewed as well as the banking rules for authorised exchange rate fluctuation bands around the official rate and the ability to take an open position.

Restricted convertibility for non-residents

With the exception of operations falling under the legislation on foreign direct investment, non-residents are normally not allowed to convert into foreign currencies existing local-currency balances they might hold abroad, notably in former CMEA countries. The authorities' concern here is that allowing such

"external" convertibility could exert excessive strain on official reserves which are seen to be still insufficient although the size of local-currency holdings abroad is not well known. More important, if non-resident convertibility were to be permitted on a permanent basis and in the country concerned, it would be difficult to prevent residents, in complicity with foreigners, from using non-resident deposit accounts convertible in hard currency in order to obtain unlimited access to foreign exchange.

The fact that external convertibility is restricted has several other implications:

- Resident enterprises can make only limited use of the domestic currency for the making of import payments abroad but this does not cause real difficulties for the conduct of international trade as long as the access of domestic enterprises to foreign exchange is guaranteed. With variations across CEECs, it is possible for non-resident exporters to accept payments in domestic currency provided that the local-currency balances are deposited in special accounts with resident banks and used to make bilateral compensating trade or credit-related payments to resident firms or to finance authorised investments in the country concerned. This provision may save transaction costs and also facilitate bilateral trade with certain former CMEA countries lacking hard currencies;
- Until recently at least, in several CEECs, the repatriation abroad of interest earnings on government debt securities acquired by non-residents normally needed authorisation from the exchange control authorities, which may limit access to foreign capital to finance the budget deficit;
- Transfers abroad of wage income by non-resident workers were subject to prior authorisation in the CSFR, which may hinder certain foreign direct investors. In Hungary, non-resident employees in joint ventures or foreign-controlled enterprises can repatriate up to 50 per cent of their income. The proportion is 70 per cent in Bulgaria. There are no such limitations in Poland and Romania.

Flexible rules for direct investment

Given large potential capital needs and the inefficiency of their old capital stock, the five CEECs have given high priority to attracting foreign direct investment. Formally, *inward* direct investments are now allowed without prior approval in many sectors, unless they violate environmental protection regulations or damage public order. Investments are, however, forbidden in areas affecting national security and, except in Romania, subject to special authorisation in some "sensitive" sectors such as banking and insurance. Repatriation of liquidated

capital principal, including capital gains, and the transfer abroad in foreign currency of investment income are guaranteed by the laws, a guarantee often reinforced by bilateral international investment agreements.

In contrast, *outward* direct investment is in principle not permitted. Special individual authorisations may be granted on a discretionary basis. In practice, the authorities in the CSFR and Hungary accorded permission in a relatively liberal manner. In 1992 nearly 400 enterprises with Hungarian interests were reported to be set up abroad. This involved the export of capital amounting to about \$25 million. Early 1993, there would be a total of more than 1 000 Hungarian enterprises operating abroad worth \$115 million. In the future, Hungarian enterprises might be allowed to take participation in foreign ventures more automatically. At the beginning, automatic authorisation might be granted for limited amounts, financed from abroad so as to avoid tapping the country's foreign exchange reserves.

There is still a tendency in CEECs to use export performance or profitability tests as conditions for permission and to attempt to monitor the activity of domestic firms abroad. This tendency should be discouraged, because in practice firms can easily demonstrate that their project meets market tests, while the central administration is unlikely to be competent to judge the soundness of a particular private business.

While portfolio investment may be an easy channel for capital flight, outward direct investment involves more specific operations with high transaction costs, motivated by long-term expansion opportunities. It might therefore be desirable to set a legal framework treating direct investment abroad more favourably than other capital outflows, which for the time being is not the case in any of the CEECs. This requires adopting a formal line of demarcation between direct investment and portfolio investment in the legislation, based on the intention to effectively influence the management of enterprises abroad⁷. Additional reasons for making the distinction between the two are securing appropriate capital-account statistics and preventing potential inconsistencies between laws on foreign investment and exchange control regulations. In some cases, the latter could indeed impose certain restrictions on portfolio investments whereas they are protected by the former (see below).

Barriers to portfolio investment and real estate operations

Regulation of *inward* portfolio investment is still fragmented. Stock markets have been reopened only recently (June 1990 in Hungary, April 1991 in Poland, February 1992 in Bulgaria and April 1993 in the Czech Republic). The amount of tradeable equities is still limited. For the moment, interest-bearing securities are mainly issued by governments although in the former CSFR and Hungary

there are small bond issues by enterprises and banks. In Bulgaria and Romania, the fiscal deficits are currently financed mainly through the banking system.

However, with especially attractive interest rates on bank deposits, increased use of debt finance by governments, the prospect of establishing secondary, liquid markets and the on-going privatisation programmes, portfolio investment by non-residents is likely to increase rapidly, at least in the most advanced CEECs.

Until recently, the monetary authorities, in the CSFR, Hungary and Poland, sought, however, to retain some influence on foreign investment in government debt securities and local-currency bank deposits not related to direct investment operations, so as to prevent difficulties in keeping money supply under control and undesirable upward pressures on the exchange rate. Signs of such difficulties were considered to be already visible, to varying degrees, in the three countries. In Hungary, in particular, even though the first issue of government bonds open to foreigners in December 1992 was significantly under-subscribed by foreigners, the central bank is reported to have faced problems in sterilising larger than expected capital in flows in 1992⁸. There is also a concern, in Poland in particular, that, in the longer term, the debt service burden resulting from foreign portfolio investment in a context of exceptionally high interest rates could, at a certain level, exhaust official reserves, at least in a scenario where the authorities would resist a depreciation of the exchange rate.

Initially, it was therefore not envisaged to remove the restrictions, in countries where they exist, affecting the transfer abroad of interest earnings from foreign non-direct investment on the grounds that they constitute *de facto* barriers on the acquisition by foreigners of government debt securities. Would profit opportunities become strong enough, however, these restrictions can be circumvented through re-investment of interest income in shares which can be repatriated, together with dividends. Controls on the underlying capital transactions seem then more appropriate. Such direct controls are anyway preferable because they are not restrictions on interest payments -- which pertain to current transactions and as such should be liberalised -- and are more transparent.

This is now the case in Hungary. Foreigners may normally buy registered government bonds only with individual permits. Also, since January 1992, participation of non-residents in mutual funds specialised in government debt is possible but limited to 20 per cent at the beginning, then to 40 per cent since May 1993. For the first time, in December 1992, an issue of five-year government bonds was opened to non-residents, under the condition, however, that they are not allowed to resell their assets before maturity. A newly-adopted security law in the Czech Republic liberalises foreign portfolio investment in bonds with a maturity of more than one year but still needs to be implemented. More generally, the tendency, in most advanced CEECs, will be to gradually open long-term capital markets and to maintain short-term securities markets closed.

Preference is also being given to closed-end funds which involve less easily self-reversing and speculative investment than more liquid open-end funds.

In Bulgaria and Romania, the situation is less clear. For the time being, no formal provisions specifically restrict investments in government securities and repatriation abroad of resulting interest income. In Bulgaria, the law on direct investment protection includes in its definition of foreign investment the acquisition of "treasury bills and other securities issued by the government". The absence of strict distinction between direct investment and investment in government debt securities may reflect the fact that, at the early stage of transition, there was no precise line of demarcation between the financing of the public sector enterprises and that of the budget deficit. Moreover, capital and money markets are just emerging or still non-existent.

A liberal regime regarding portfolio investment in Bulgaria and Romania may be anyway appropriate for two reasons:

- These two countries have enjoyed so far quite modest direct investment flows and cannot afford to be too selective in choosing between various forms of foreign capital;
- To the extent that these countries float their exchange rate, speculative capital inflows would be less of a problem than in countries having a pre-announced exchange rate objective where short-term placements may be perceived as less risky.

As for outward direct investment, portfolio investment *abroad* by residents is normally not allowed. Shares of certain foreign-owned firms are now issued on the Budapest stock exchange. But the companies in question are all established in Hungary and are therefore considered as resident companies. In case of liquidation, only the proceeds corresponding to the share of initial capital paid in foreign exchange could be taken out of the country. A first important step towards liberalisation of outward portfolio investment has made, however, in Poland, in December 1992, with authorisation being granted to Polish mutual funds to invest up to 10 per cent of their capital in foreign assets.

Real estate operations are in several respects treated along an approach similar to that applied to portfolio investment in the CSFR, Hungary and Poland. Apart from certain real estate associated with a direct investment operation, real estate placements of a purely financial character by foreigners may be restricted. In Hungary, for instance, non-residents cannot freely repatriate abroad capital gains from the liquidation of their real estate. The concern here is to avoid speculation in a context of generally expanding real estate markets. However, it is not clear on which criteria one may in practice identify specifically speculative operations and why there should be a discrimination between non-residents and residents in this respect. Non-discriminatory taxes on capital gains would probably be more appropriate to deal with the problem. If it is really necessary

to restrain certain capital inflows, it is anyway preferable to do it directly rather than through non transparent restrictions on the re-sale of real estate assets held by non-residents.

Commercial credits, financial loans

In the CSFR, *commercial borrowing abroad* by resident enterprises may be subject to prior approval which is liberally granted. In Hungary, import payments may be deferred without limitation. Until recently, foreign credits to enterprises were met mainly through borrowing by the central bank which could thereby control external borrowing by domestic enterprises. Since December 1991, commercial banks are allowed to borrow abroad on their own account without prior permission from the central bank. In Poland, only the granting of trade credits to residents in excess of US\$ 1 million requires an individual permit by the National Bank. A liberal regime seems to prevail in Bulgaria and Romania.

As the CEECs want to encourage exports, *commercial credits to non-residents* are favourably treated, although they amount to capital outflows. In Hungary, trade credits are freely granted, according to international standards since the recent creation of a new export credit guarantee agency. In Poland, trade credits to non-residents are treated in the same way as credits to residents; they are not restricted below US\$ 1 million. Prior approvals were needed but liberally granted in the CSFR.

Purely *financial* credits and loans are more severely regulated than trade-related credit operations, because they are supposed to be of a more speculative nature. Financial loans to *residents* need prior authorisations in the CSFR, Hungary and Poland. Financial lending to *non-residents* is normally also prohibited, except for authorised domestic banks in the CSFR and Hungary, and requires individual permits in Poland.

The distinction between commercial credits and financial credits is not clearly made in Bulgaria and Romania. A provision in the May 1992 Regulations concerning foreign exchange operations in Romania indicates, however, that banks credits with maturities of more than one year are subject to prior approval by the National Bank. Bank credits in this context are interpreted by regulators as referring to financial borrowing from abroad.

III. ARGUMENTS FOR CAPITAL CONTROLS IN CEECs

While the CEECs have managed to achieve almost full current-account convertibility much more rapidly than most western European countries after

World War II, they have not yet established a clear strategy for removing remaining restrictions on capital transactions, beyond the general intention stated by certain CEECs to move to full capital-account convertibility before the end of the decade.

Reformers in CEECs do not challenge the view that an open capital account is a key ingredient of a well-functioning market economy. In a medium-term perspective, the payoffs expected from current-account convertibility apply to capital-account convertibility as well. By allowing trade competition, current-account convertibility forces resident enterprises to adapt to market laws. A similar reasoning holds regarding capital-account convertibility: the freedom for residents to invest in foreign assets puts pressures on domestic firms to become profitable and on financial institutions to offer more attractive saving instruments; free access of residents to foreign finance abroad enhances competition and hence efficiency within the domestic financial sector. Also, international portfolio diversification allows a spread of investment risks and reduces the vulnerability of the economy to domestic shocks. All these factors would contribute to a better allocation of saving and investment in CEECs.

While the objective of on-going structural reforms pursued in other areas is to improve resource allocation, it is also undeniable that exchange controls in CEECs can perpetuate or introduce important sectoral distortions. Many of the allocative efficiency losses which were recognised in the OECD countries (see Part I) are likely to arise in CEECs' economies as well:

- To the extent that exchange controls are effective, they could artificially maintain misaligned real exchange rates for a long period of time in high-inflation CEECs. This would impose an unnecessary squeeze on the tradeables sector the performance of which critically determines the success of the transition process;
- Capital controls, even if limited to nationals, contribute to creating a climate of uncertainty for prospective foreign direct investors, as they may fear more extensive restrictions in the future if the authorities come to the opinion that they become necessary;
- They may distort competition between domestic enterprises and established foreign firms which in practice enjoy a more favourable treatment regarding foreign exchange operations;
- Enterprises may be disadvantaged with respect to individuals in countries where the right of households to operate foreign-currency accounts is not extended to firms. Enterprises have indeed to pay either a premium to individuals on the parallel markets, or a commission to authorised banks, to acquire foreign exchange. Alternatively, preventing individuals from engaging in operations abroad may result in an

undesirable concentration of hidden financial activities within the enterprises at the expense of their productive function;

- Exchange controls may encourage rent-seeking behaviour, corruption and a deterioration of legal compliance in general as the public tries to circumvent regulations, all time-consuming and resource-diverting activities which were already especially prosperous under the former central planning system.

However, the abolition of capital controls in CEECs would involve a number of dangers which are judged by the authorities to be sufficiently serious to outweigh the potential payoffs expected from liberalisation, at least for the time being. Against a background of still fragile and limited progress in macroeconomic stabilisation and financial reform, there is the perception of important risks of capital flight and loss of control over domestic monetary conditions in the absence of restrictions. Arguments for capital controls, nevertheless, deserve further scrutiny and are examined in the remainder of this section.

Political uncertainty

An immediate rationale for capital controls in the early phase of the transition was, and still is in some CEECs, that they protect the country's foreign exchange reserves against possible currency crisis in a climate of political instability due to frequent changes in governments, emerging inter-ethnic conflicts and latent regional tensions. The massive selling of Federal banknotes for foreign exchange by the public during the days following the split of the CSFR into two separate States in January 1993 is a case in point; strong demand for foreign currency from Czech commercial banks was reported to have drained more than one third of the Czech central bank's reserves in less than two weeks. Strong pressures were already present as early as November 1992 in anticipation of the separation.

However, it is by no means certain that controls would be the appropriate response even in such circumstances. The attempt to tighten controls on capital outflows might further undermine public confidence and eventually precipitate a crisis. If a crisis were due to temporary non-economic factors, countries might benefit from financial facilities from the international community, panic would subside and capital would eventually return to the country. The positive experience of Turkey with rapidly reversing capital flight during the Gulf War was a clear demonstration of this (see Part I). The Czech authorities, which decided not to take any restrictive measures in January 1993, seem to be experiencing such a favourable scenario.

Insufficient macroeconomic stabilisation

Controls could also be viewed as a response to unsound macroeconomic policy. Should the tendency to inflationary fiscal deficits and negative real interest rates not be reversed, free capital-account convertibility could lead to large capital outflows and the depletion of foreign reserves. But, in such a policy configuration, the whole transition process would be at risk. Whether or not capital controls are in place would not make much difference then. Once the current account has been opened up as this has been from the start of the transition in the five CEECs, controls on capital outflows, even if effective, are not sufficient to avoid recurrent balance-of-payments crises. Insufficiently tight fiscal and monetary policies have similar negative effects on foreign reserves, through a surge in imports. At best, the difference is one of speed: the collapse of international reserves with a current account deficit occurs more gradually than through capital flight⁹. Repeated devaluations are unlikely to help significantly in this context.

In fact, as the transition to a market economy began, the five CEECs embarked on courageous and ambitious stabilisation programmes. Established in agreement with the IMF, the central objective of these programmes was to achieve lower and more stable inflation. As price liberalisation proceeded, inflation initially increased dramatically (in Bulgaria, Poland and Romania up to triple digit levels). But thereafter, inflation declined, with most impressive results being achieved in the CSFR, Hungary and to a lesser extent Poland (Table 3). Although price increases exhibit high volatility, real interest rates, at least *ex-post* real borrowing rates, are now positive in most CEECs.

In OECD countries, the view according to which price stability is the best contribution that monetary policy can make to economic growth in the medium term was one of the reasons for the abolition of capital controls. Many central bankers indeed considered that controls weakened the credibility of their commitment towards price stability and could mask timely market signals that corrective policy measures were needed (see Part I). In CEECs, however, although exchange controls were not intended to dispense them from pursuing anti-inflationary policies, the authorities consider that macroeconomic stabilisation confronts difficulties which are specific to post-communist economies and which prevent full implementation of the modern, OECD approach to monetary policy for the time being.

1. Inadequate fiscal control

The conduct of stabilisation policy in CEECs remains a much more difficult task than in OECD countries because market-based instruments which are routinely used in developed countries are still lacking or just in process of being put in place¹⁰.

Although authorities in most CEECs have resisted so far mounting political pressure for a relaxation of fiscal discipline in the recent period, government deficits are far from being fully under control. After an initial swing of the budget into surplus which reflected sharp cuts in subsidies, all five CEECs have been facing significant falls in government revenue due to recession, output restructuring, and difficulties in collecting taxes as a result of fiscal reform and easy tax evasion. At the same time, growing unemployment and the need to establish a social safety net make public expenditures hard to contain.

As a result, except in the CSFR which managed to stabilise the general government deficit around 1 per cent of GDP in 1991 and 1992, fiscal deficits are high in Bulgaria, Hungary and Poland (Table 3). The low fiscal deficit figures for Romania do not take into account rapidly growing off-budgetary expenditures and also reflect high taxes on state enterprises obtained at the cost of their decapitalisation; when using Western accounting standards, the true deficit may amount to 5 per cent or more of GDP¹¹.

A premature removal of restrictions on capital outflows would probably accentuate current difficulties with the collection of government revenues, at least in the absence of international tax information-sharing treaties or solid tax verification arrangements with domestic banks. Evasion of residence-based taxes such as personal capital income taxes becomes indeed easier once the operation of deposit accounts and portfolio investments abroad are allowed. Also, most CEECs have lowered their corporate income capital tax rates towards international standards to avoid creating incentives to place funds abroad or have granted tax advantages to foreigners to attract inward direct investment; in both cases, this was costly to the budget.

A high public deficit becomes a factor of instability and potential capital flight when it is not matched by an increase in private domestic saving. In this case, indeed, it has to be financed either by an expansion of central bank credits to the government, which would rapidly feed into higher inflation, or through borrowing abroad, which may, in the medium term, lead to an unsustainable external debt and subsequent currency crises if public investment does not generate the additional income required to service the debt burden.

Furthermore, if, in the meantime, tight monetary policy is pursued in an attempt to dampen the inflationary effect of a large fiscal deficit, this may trigger speculative short-term capital inflows driven by high interest rate differentials and borrowing abroad by domestic enterprises as well. As a result, foreign exchange reserves would dramatically increase, the monetary base would further expand and inflation would accelerate. While the real appreciation of the exchange rate resulting from capital inflows could partly limit inflationary pressures, it would, at the same time, impede export growth.

Table 3

INFLATION AND FISCAL DEFICIT

	Bulgaria	CSFR ¹	Czech Republic	Slovak Republic	Hungary	Poland	Romania
Consumer prices (percentage changes from previous year)							
1989	6	1	..	..	17	251	1
1990	26	10	..	..	28	585	4
1991	334	58	..	..	35	70	165
1992	90	11	..	..	23	43	210
1993(f)	90	..	16	20	21	40	165
1994(f)	60	..	10	20	12	30	70
Official discount rate (%)							
1991	51	9.7	..	..	27	53	14
1992	49	8.9	..	..	20	39	63
General government financial balances as % of GDP (2)							
1990	-8.5	-0.3	..	..	0.2	0.2	1
1991	-3	-1.1	..	..	-5	-5	-1
1992	-6	-1.5	-0.2	-2.8	-7	-6	-1
1993(e)	-8	..	0	-7	-6	-6	-4

1. On 1 January 1993, the Czech and Slovak Federal Republic split into two independent states: the Czech Republic and the Slovak Republic.
 2. Bulgaria: cash basis, excluding accrued interest on foreign debt. CSFR, Hungary and Poland: state budget, excluding local authorities.
- (e) estimate (for Bulgaria: maximum target announced by government).
(f) forecast.

Sources: *OECD Economic Outlook*, No. 53, June 1993, *Short-Term Economic Indicators -- Central and Eastern Europe* and national sources.

In this classical scenario, faced by many developing and OECD countries when implementing stabilisation policy, controls on short-term capital inflows become necessary, in addition to restrictions on capital outflows. Despite likely imperfect substitutability between foreign and domestic assets, and the room for accelerated foreign debt pre-payments in indebted countries, capital inflows from the rest of the world are virtually unlimited and may easily exceed the sterilisation capacity of the central bank. A relaxation of restrictions on capital outflows may not significantly help either. Portfolio diversification incentives for domestic

investors may not be powerful enough to offset interest-rate-driven capital inflows. Furthermore, when, later on, capital inflows will revert in the face of country's difficulties in servicing its foreign debt, a return to controls to prevent capital flight would be technically more difficult if the administrative machinery to operate controls on capital outflows had been dismantled.

2. *Ineffective transmission of monetary policy*

Unlike OECD countries, CEECs have no full-fledged markets for government securities capable of mobilising domestic saving directly, although Hungary and Poland in particular have already taken significant steps in this direction. To a large extent, the financing of the fiscal deficit is effected through the banking sector.

Even in such circumstances, a typical OECD country could still offset the increase in the money supply resulting from bank advances to the government by raising the central bank interest rates. This would in turn restrain commercial bank credits to the rest of the economy and increase saving deposits as well. However, lessons from stabilisation experiences in CEECs to date suggest that there were important limits to what can be achieved through increases in nominal interest rates in economies in transition.

Although achieving positive real interest rates was clearly desirable for the sake of optimal allocation of saving and investment, tighter interest rate policy alone seems to have exerted only limited effects on credit expansion. Many state-owned enterprises continued to borrow at prohibitive costs, while those which could not do so resorted to inter-enterprise credit facilities. This was possible in particular because bankruptcy laws were either non-existent or not yet seriously applied. Given the large share of non-viable firms, banks had no option but to refinance the resulting increase in the debt service of indebted enterprises and extend additional credits to those to whom net arrears are owed¹². This trend was also facilitated by frequent interlocking ownership relations between commercial banks and borrowers and the existence of a large stock of non-performing loans which weakened the incentive for the banks to allocate new credits on market criteria.

On the whole, both credit growth and inflation decreased by less, and real interest rates were lower *ex post*, than could have been expected in a normally-functioning market economy¹³. Against this particular background, CEECs had to rely heavily on non-market-based instruments, such as credit ceilings, income policy and exchange controls, to influence monetary conditions, at least at the earlier stage of their stabilisation programmes.

In the recent period, however, the CEECs, notably Hungary, have made significant progress in implementing modern tools for the conduct of monetary policy, such as auctions of refinancing credits at market rates and open-market

operations. Their use is gaining effectiveness as the private business sector expands and harder budget constraints are imposed on state enterprises, thus paving the way for a reconsideration of certain capital controls in most advanced countries.

3. *Unreliable macroeconomic indicators*

An additional factor, nevertheless, which still calls for prudence in capital movements liberalisation is the lack of reliable indicators to assess the extent to which macroeconomic policy is currently appropriate. Money demand is indeed made highly instable by currency substitution and financial reform. General-government financial balances are affected by large and somewhat unpredictable swings due to on-going restructuring of the fiscal system. There are wide and often erratic discrepancies between balance-of-payments statistics and customs data.

Given higher transaction costs, the speed of adjustment is typically slower in the product markets than in the capital market. If policy errors are found, policymakers will have time to correct them even if the current account is opened up, whereas capital flows and exchange rate overshooting may instantaneously result if the capital account were liberalised prematurely¹⁴. As already pointed out, a rise in central bank interest rates, which in normal circumstances could be immediately adjusted, is not as effective as it would be in a developed market economy in coping with changes in financial market expectations.

Exchange rate policy

The adoption of an exchange rate objective may be especially appealing in CEECs as a means of lowering inflationary expectations. The exchange rate could presumably provide a nominal anchor simpler to implement, easier to understand and more visible to the public than targets for monetary aggregates or interest rates might be. This might therefore argue for exchange controls in order to help achieve exchange rate stability if the target proves to be not immediately credible.

However, by imposing exchange controls, the authorities may at best hope to buy time to implement macroeconomic policies consistent with the stated exchange rate objective. Beyond the short term, there is no value in artificially maintaining a misaligned exchange rate. This would impose an excessive burden on the exporting sector and thereby compromise the credibility of the overall adjustment programme. The experience of many developing countries suggests that, when supporting policies are slow to be delivered, the exchange rate target has anyway to be abandoned as accumulated external disequilibria become unsustainable.

Thanks to strict fiscal policy and especially low inflation, the CSFR was able to stick to its initial fixed exchange rate objective in 1991 and 1992. This country was the only one to do so.

Hungary moved towards a more neutral and flexible exchange rate policy in the course of 1992, allowing for more frequent, small discrete devaluations so as to avoid a real appreciation of the forint¹⁵. In Poland, after the dramatic devaluation of the zloty in May 1991 and the subsequent abandonment of the fixed exchange rate target set up in January 1990, the authorities moved to a controlled peg allowing for a monthly depreciation of 1.8 per cent. Although this policy is intended not to fully accommodate inflation, Poland experienced a second large devaluation in February 1992. As a result, the real effective exchange rate of the zloty showed no tendency to appreciate over the last year (Table 2).

Because of the lack of international reserves, Bulgaria and Romania were, from the outset, committed to a free float of their currencies, the central bank intervening in principle only for short-term and seasonal smoothing operations. In Romania, there were attempts at the end of 1992 and early 1993 to prevent the official exchange rate from depreciating in line with market forces to contribute to political and social stability in a period of elections and governmental changes. However, the currency was then overvalued, official reserves rapidly diminished and foreign exchange rationing reappeared. Thus, these attempts proved in the end simply prejudicial to the credibility of the monetary authorities¹⁶.

Foreign debt problem

A final macroeconomic argument for controls on capital outflows relies on the distinction between flows and stocks. The capital account must ensure not only the financing of the trade balance but also the servicing of the foreign debt (i.e. the cumulation of balance of payments deficits). Even when policymakers pursue the right macroeconomic policies allowing for an immediate move towards current-account convertibility, inappropriate policies in the past may have led to excess external indebtedness, calling for restricted capital-account convertibility.

Assuring the service of the external debt, even though inherited from the former communist regime, may be warranted by the need to maintain or to re-establish normal access to international capital markets. However, with private agents anticipating heavier future taxes to service debt obligations, there may be a serious risk of capital flight in the absence of controls on capital outflows¹⁷.

In fact, the debt level in Hungary was high, comparable to those of the most indebted Latin American countries, until 1990. As Hungary refused debt rescheduling or reduction, this implied maintaining adequate official reserves and might have justified retaining restrictive controls on the use of foreign exchange by residents. But since 1991, Hungary's debt ratios have been improving

significantly (Table 2). Therefore, the debt justification for capital control seems to be losing relevance in this country.

Poland and Romania still have high external debt. But Poland services only minimal amounts of debt and is seeking a reduction of its private debt similar to that recently reached with the Paris Club for its official debt. However, in the future, Poland will have to resume capital repayment and interest payments on a significant scale. Bulgaria suspended debt service payments in 1990 and is negotiating debt reduction arrangements with its creditors. In the CSFR and Romania, foreign debt was traditionally kept low and has not been until now a real problem.

Underdeveloped financial system

A conventional microeconomic rationale for postponing the liberalisation of capital operations is the need to protect the development of the infant financial industry by keeping savers captive. Given the lack of a sound financial system in CEECs, the fear here is that domestic financial intermediaries cannot compete with foreign financial centres on a level playing field if the capital account were to be opened up.

Money markets and capital market instruments are still rudimentary, notably in Bulgaria and Romania, as compared with financial products offered abroad. Institutional investors, such as pensions funds and insurance companies, which are important saving collectors and major players in financial markets in developed countries, are hardly emerging.

Domestic commercial banks suffer from a legacy of bad assets and a concentration of risks with relatively few large borrowers. They are also disadvantaged vis-à-vis foreign competitors by the lack of a timely and efficient payments system, the imposition of high reserve requirements, and in several instances, the maintenance of obligations to invest in government paper. These features, together with the oligopolistic structure of the state-owned banks, appear to have contributed to large spreads between bank borrowing rates and lending rates.

With consumer price increases being much higher than producer price inflation, this resulted in hardly positive real interest rates on household deposits and quite high borrowing rates for enterprises¹⁸. Such a gap may discourage both savers from placing their money with resident institutions and encourage viable enterprises to finance themselves abroad.

Finally, in the absence of adequate prudential supervision and credit rating system, financial liberalisation may intensify excessive risk taking by domestic financial institutions and facilitate the development of financial malpractices and moral hazard problems.

It is important, however, that capital controls not be used as a substitute for necessary reforms. Often, delays in the creation of financial markets and a competitive banking sector are simply due to the reluctance of governments to pay a market price on their debt and distorting regulations such as sectoral price controls. Strengthening banks' balance sheets, supervisory structure and prudential regulations is also a top priority for a successful transition to a market economy, whether or not a relaxation of exchange controls is involved.

In fact, all CEECs have now passed banking laws which take the necessary legal steps in these directions. Administrative ceilings on bank credits have been phased out and interest rates have now been deregulated, although the problem of "bad loans" within the banking sector has not yet been resolved. The lack of information about the current balance-sheet situations of enterprises as well as the relative inexperience of supervisors, auditors and commercial bankers seem to be the main practical obstacles to a rapid and effective implementation of recent financial reforms¹⁹.

One effective and rapid remedy to financial under-development is to promote foreign direct investment in the banking and financial industry on national treatment conditions. Foreign participation can contribute to recapitalising the banking sector and at the same time import modern technology and human capital necessary to build up an efficient financial system. For the time being, the legislation in CEECs allows foreign greenfield investments but, except in Romania, limits foreign participation in existing domestic banks, unless special permission is granted. These limitations should therefore be removed.

A more direct approach for assisting the infant banking and financial industry, through tax advantages for domestic saving instruments for instance, may also be to some extent less distorting than broader protection, through capital controls which insulate this sector from competitive pressures. As the experience of lower-income OECD countries such as Turkey suggests (see Part I), well-dosed liberalisation of capital controls, accompanied by consistent internal financial reform, may actually help the development of the domestic financial system rather than inhibit it. Freer access of non-residents to domestic capital markets make them deeper and therefore less volatile than markets limited to resident participation. Access to foreign markets provides an opportunity to residents, notably financial intermediaries, to familiarise themselves with international financial practices.

IV. EFFECTIVENESS OF CONTROLS

Lack of reliable or comparable data precludes formal tests, such as closed and covered interest-rate parity tests, to assess the degree of effectiveness of controls in CEECs. There is, however, anecdotal evidence suggesting that controls may not be fully effective:

- Foreign currencies are bought in black markets with now virtually no premium on the exchange rates prevailing on the legally recognised markets. Although the convergence between the black market rate and the legal market rates partly reflects a situation where the pursuit of an appropriate monetary policy and the introduction of current-account convertibility make controls just less binding, the elimination of a premium may as well suggest that there are effective non-official ways to meet extra demand for foreign currencies for capital-account operations;
- Recorded individual foreign-currency deposits with commercial banks are subjected to episodic increases of a magnitude larger than what legal access to foreign exchange should have normally permitted to envisage;
- There seem to be large statistical discrepancies between certain CEECs' trade figures and trading partners' data. While there are a number of technical reasons for inconsistent or fragmented trade data, these discrepancies may partly reflect disguised capital operations operated through overvoicing imports and undervoicing exports. Such practices, typical in many developing countries²⁰, are reported in the press to be a problem in CEECs. An official source, the January-June 1992 Report of the Bulgarian National Bank, goes as far as referring to a "widespread practice of cheating on customs declaration". PlanEcon Report of 5 April 1993 identifies undervoicing of exports as one key source of the large discrepancy which appears between customs data and balance-of-payments data in Poland, for instance;
- On the capital inflow side, it has been observed in Hungary that foreigners created phantom joint-venture companies as a way around the restrictions that prohibit foreign portfolio investors from holding domestic-currency bank accounts. The money is converted into forint, held in saving accounts bearing high interest rates, and later withdrawn and repatriated abroad. It is likely that similar opportunities have been seized in countries whose currency has been appreciating in real terms. Tax incentives for the creation of joint-venture companies may have aggravated this phenomenon.

Even if controls on operations specifically covered by formal restrictions are effective, there are inevitable loopholes in the system which can be legally

exploited to operate financial transfers. A well-documented way of doing so is the use of commercial credits and leads-and-lags in normal trade payments. A simple calculation shows that, with exports and imports averaging 25 per cent of GDP in the CEECs, a two-month lag in the payment of exports and a one-month lead in the payment of imports would allow potential capital outflows to exceed 6 per cent of GNP²¹, a proportion roughly equivalent to the size of CEECs' foreign reserves in 1991. In Hungary, for instance, in anticipation of a forint devaluation, delays in repatriation of earnings by domestic exporters were estimated to amount to US\$ 600 million in the first quarter of 1991²². Although the authorities may seek to limit the possibility by enterprises to use leads-and-lags, there are limits to what could be achieved through repatriation requirements, especially in countries, such as Romania, for instance, where barter transactions represent a very high share of international trade. Multinational corporations established in the country can also routinely transfer funds abroad, in excess of their normal profits, through internal accounting.

A related factor accounting for the likely limited effectiveness of controls in CEECs is the weakness of the enforcement procedures. Partly, this is due to the lack of administrative means. Under the former régime of a command economy, the exercise of the exchange control function was not separated from the centrally planned allocation of resources, included foreign exchange, to the state-owned enterprises. The need for specific bodies of exchange controllers arose only with the transition to a private, market-based economy. Currently, relative to the population, the number of civil servants in charge of exchange control is about five times smaller than what was required in the past in a typical OECD country to maintain effective controls.

The legislation provides that commercial banks have certain obligations in the administration of controls but the latter lack both experience and willingness to implement controls. At the same time, the increasing number of private banks recently created appears to be exceeding central bank supervisory capabilities in many CEECs. An additional difficulty is the existence of foreign exchange bureaus specialised in buying and selling foreign exchange in cash. These institutions operate with lower costs than banks; in particular they do not have reporting requirements for tax or statistical purposes as strict as for banks. As a result, these bureaus charge much lower commissions on the selling and purchase of foreign exchange than banks and are flourishing, except in Hungary where the bureaus have only limited rights to sell foreign currencies. Given their rapid expansion, they are not tightly supervised and many of them do not comply with their obligation to implement exchange control regulations on the central bank's behalf. Only a rapid establishment of a more efficient computerised banking payment system is likely to reduce the attractiveness of the parallel market in the future.

Another indispensable pillar of an effective exchange control regime is the customs administration. But this too suffers from limited resources, as reflected

in frequent disruption in the supply of trade statistics. Furthermore, cross-checking of information between the customs administration and commercial banks is weak or non-existent, because, except perhaps in the former CSFR, no computerized network sufficiently efficient is yet in place. In particular, ensuring compliance with the repatriation requirement of export proceeds proves to be especially difficult. With some 30 000 joint-ventures engaged in foreign trade operations, controls are recognised in Hungary to be for the moment largely ineffective. A similar situation certainly prevails in other CEECs.

A last important obstacle for more effective controls is the difficulty encountered by the authorities in designing and imposing rapid and severe sanctions in cases of violation. Partly, the problem results from features specific to the CEECs:

- The fact that individuals can open foreign-currency accounts without the need to justify the source of the cash foreign exchange they deposit does not invite compliance with regulations;
- Although legal prohibitions probably exert a "moral" dissuasion effect on a majority of the population, there is still a widespread impression that a market economy and the absence of any rules of the game are synonymous²³;
- Although the licenses accorded to authorised banks and foreign-exchange dealers have been withdrawn in cases of gross offences to banking principles, the authorities are concerned that domestic banks could lose market shares and waste precious staff resources if they are pressed to apply exchange controls to the letter, at a time when restoring bank profitability is a top priority;
- Finally, one cannot exclude the possibility that certain state-owned industrial enterprises, long accustomed to dealing with the central administration, successfully manage to obtain discretionary exemptions.

V. POLICY OPTIONS AND PRIORITIES

This section of the report examines general principles for the conduct of future exchange control policy in CEECs. It also offers more concrete suggestions which do not, however, pretend to be necessarily applicable to all countries at the same time.

Western European countries maintained capital controls for a long period of time after World War II, most of them well beyond the reconstruction period.

Over the last ten years, however, all remaining capital controls have been rapidly dismantled in most of them.

In several respects, it is this recent experience rather than the post-war period that is the most relevant to the CEECs:

- At present, CEECs evolve in an international context of almost full financial integration and ever increasing opportunities for investment abroad; they are therefore likely to encounter more difficulties than western countries after World War II in resisting domestic pressures for the opening-up of their capital account;
- Most CEECs have expressed a desire to model their economic structures and regulations on OECD countries for which the freedom of capital movements has now become the current institutional standard, not a distant objective to be attained only progressively as it was for many Member countries before the 1980s;
- From the outset, CEECs in transition have shared the consensus which had become prominent in developed countries only in the 1980s according to which the central objective of monetary policy is to achieve long-term price stability. The fact that this commitment may not be credible under a regime of restrictions on capital movements was one of the reasons why late-reforming OECD countries decided to give up their controls;
- CEECs have also been quick to adhere to the modern view that developed capital markets and a competitive banking sector are essential to economic growth -- another concern which explained the wave of domestic and external financial liberalisation measures in OECD countries in the 1980s.

On the other hand, there are serious arguments for a gradual approach to the liberalisation of exchange controls. Unlike western European economies in the post-WW II period, many of the CEECs are still in the process of establishing basic market mechanisms and institutions, without which even sound macroeconomic management aimed at preventing destabilising capital flows cannot work. In some of them, in particular there are still no organised capital markets and the banking reforms are only in early stages of implementation.

As the experience of many developing and developed countries has shown, there are, however, two major difficulties with controls. First, controls in CEECs may not be effective, at least for the time being. Second, even if controls were effective, there is no guarantee that the level of foreign capital inflows and domestic saving will be kept unchanged; on the contrary, controls may have significant disincentive effects.

In the face of the limited effectiveness of current controls in CEECs, several policy options are possible.

The authorities might seek to strengthen enforcement procedures and minimise loopholes in the control system. There are, however, a number of problems in connection with this approach:

- A much stricter application of existing controls may be interpreted by the general public as calling into question the authorities' long-term commitment to full currency convertibility and compromise the credibility of the overall transition programme;
- Tighter exchange controls may conflict with financial modernisation. Admittedly, the effectiveness of controls could improve to some extent in the future with better training of commercial bankers and on-going efforts to enhance tax collection and customs controls. But they could also become more difficult to implement to the extent that the degree of sophistication of financial markets will be increased and competitive pressure will push commercial banks to serve their customers in a more and more diligent manner²⁴;
- As over time enterprises learn how to get around foreign exchange regulations, making controls durably effective may not anyway be achieved without seriously interfering with the normal functioning of a market-based economy;
- Building up a strong exchange control administration may entail a non-negligible opportunity cost in CEECs. By the time controls have become effective, they might well appear less and less necessary as further progress towards a stable market economy will have been made. And limited administrative resources could be better used in other domains where there is a pressing need for improvement, such as tax control, banking supervision and balance-of-payment data collection.

Alternatively, the authorities might decide to dismantle all exchange controls at once on the grounds that, after all, this legalisation would not result in a major shock to the economy. However, one cannot exclude the possibility that formal prohibitions exert some dissuasion effect even if enforcement procedures are insufficient to prevent operations from being carried out by enterprises or individuals having sophisticated financial knowledge. Moreover, the abandon of controls by the government if viewed as ceding too easily to pressure may be interpreted as a sign of weakness and open the door to abuses in other areas.

Between these two extremes, therefore, it may be preferable to find a middle ground. To begin with, as the general economic climate improves, it might become acceptable to the public to envisage adjustments in certain areas with the view to ensuring compliance with basic rules of the game of a sound market

economy in exchange for more freedom in others where economic efficiency gains may be particularly important. Possible examples include the following:

- Enterprises could be granted more freedom to operate abroad, in particular automatic permission to make direct investments abroad; as a counterpart, the repatriation requirement should be more strictly enforced at least because, for the time being, this seems to be a condition for the government to get a clearer picture on the international reserve position of the country;
- Households should be accorded free access to foreign exchange for *bona fide* current invisible operations; at the same time, one might consider checking that foreign exchange deposited in cash on individual accounts, for substantial amounts, have not been acquired in violation of existing laws and regulations;
- In the context of the move towards the creation of a full-fledged inter-bank foreign exchange market, the surrender requirement of foreign currencies, at least to the central bank, might be relaxed in countries maintaining such provisions, at the same time as more stringent prudential limits would be put on the extent to which financial institutions can take open positions.

If this liberalising approach were to be adopted, it would be important that the authorities establish a pre-announced programme for progressive liberalisation and do their best to stick to it. It would be ill-advised to use liberalisation measures in an "opportunistic" manner, according to short-sighted monetary policy considerations. Instead, this programme should be built on the official recognition that such a move would provide structural benefits of a permanent value to the economy. Otherwise, liberalisation measures could be perceived as easily reversible and could lead to excessively rapid portfolio adjustment and exchange rate over-shooting for fear of steps backward in the future on the part of the authorities.

Within this framework, the immediate priority would be to remove regulations which would not appear mutually consistent or which are used for objectives other than monetary policy (such as tax control, balance-of-payments data collection, anti-money laundering measures) to the extent that they could be met by other means. Also, restrictions which *de facto* have a low probability to be enforced in a reasonable time frame should be rapidly liberalised because maintaining ineffective controls may compromise the credibility of the regulatory authorities.

A next or parallel step would be to move to full current-account convertibility and thus to achieve Article VIII status in the IMF. At present, remaining restrictions essentially concern private travel and certain personal remittances which should be liberalised in a relatively short time.

The final step would be the abolition of capital controls once macroeconomic stabilisation and financial pre-conditions are met. In no way exchange controls should, however, be used as a substitute for macroeconomic stabilisation policy and to delay necessary market-oriented reforms. At all events, given the degree of *de facto* capital movements liberalisation achieved so far, CEECs are already bound to persevere with the combat against inflation to reduce the risk of open capital flight and with tax and financial reform to avoid the freedom of capital movements being used to violate basic laws and rules of conduct in a market economy.

It is encouraging to observe that, since the beginning of the transition to an open economy, most CEECs have succeeded in avoiding any major balance-of-payments crises. In early-reforming countries, Hungary, Poland and the former CSFR, significant progress towards disinflation is being made and the effectiveness of indirect monetary policy instruments is improving. Equally important, pragmatic exchange rate policies have generally been followed in countries where price inflation was high, instead of unrealistically rigid policies which would have led to a major collapse of trade and reserves. In fact, in most advanced CEECs, the most important and persistent obstacle to a rapid and sustainable move to full capital-account convertibility seems to be the underdevelopment and fragility of the banking and financial system which may not be capable of attracting and absorbing capital flows on a large scale with the necessary transparency and safety, although by and large the legal, regulatory and supervisory framework is now in place.

NOTES

1. Unless otherwise specified, this report deals with the exchange control regime prevailing in the Czech and Slovak Federal Republic (CSFR) until 31 December 1992. Since then, the CSFR has been split into two independent States. Although the former Federal legislation on exchange controls has been transposed into national laws, the new States might move towards distinct exchange control systems now they have introduced their own currency. At the time of writing (May 1993), no significant legal steps were yet undertaken, however.
2. Exchange controls include restrictions on transfers and payments in connection with current transactions and capital movements. However, inward direct investment and the acquisition of real estate by non-residents generally fall under the purview of legislation distinct from foreign exchange laws. Information on these operations is nevertheless provided for completeness.
3. In the context of the separation of currencies between the two republics of the former CSFR in 1993, however, it is uncertain whether the Slovak Republic could continue with a strict fixed exchange rate policy as was the case for the CSFR as a whole between the split of the Federation. The Financial Times of 5 March 1993 reports that the Slovak authorities refused the IMF's suggestion to float the Slovak crown and in practice blocked hard currency payments for undefined non-essential imports.
4. Such as the full liberalisation of certain personal remittances not yet freed, a complete unification of legal exchange markets for current transactions, the free convertibility in foreign currency of balances in CEECs' currency officially held abroad and the removal of bilateral exchange arrangements which may subsist between the CEECs and the former CMEA countries.
5. Restricting the free transfer abroad of foreign exchange withdrawn from individual foreign-currency accounts would also be politically delicate in certain CEECs because this measure would risk to be interpreted as a serious interference with basic civic rights.
6. This is the case under the OECD Code of Liberalisation of Capital Movements but not under Article VIII of the IMF Agreement however.
7. The OECD/IMF definition of a direct investment is focussed on a 10 per cent share of capital as a proxy for "effective influence on the management of enterprises".
8. See OECD (1993b).

9. See Park and Sachs (1987) on the timing of exchange regime collapse with capital controls.
10. For a recent overall evaluation of stabilisation policy in CEECs, see *OECD Economic Outlook*, No.52, December 1992.
11. See OECD (1993a).
12. For an analysis of the phenomenon of mounting inter-enterprise arrears, see for instance Nuti (1992).
13. For a discussion of possible inflationary effects of high interest rate policy in CEECs, see Calvo (1992) and Bennett and Schadler (1992).
14. See Frenkel (1982) along this line of argument.
15. This was, at least, how the Hungarian exchange rate policy in 1992 was described in the October/November 1992 issue of the National Bank of Hungary Monthly Report.
16. See OECD (1993a).
17. There is a "free rider" problem here: taken separately, individuals behave rationally in wishing to dispose freely of their saving but, given positive externalities attached to continued debt servicing, they may be better off individually if they are collectively forced to keep capital at home.
18. As an extreme example, between March and August 1992 in Romania, producer prices increased by 17 per cent at an annual rate compared with 90 per cent for consumer prices, while the interest rates approached 50 per cent. Such a large price gap was, however, due to price controls on producers.
19. Blommestein (1993) provides an assessment of recent progress in banking reform in most advanced CEECs. On general financial reform issues in connection with the move towards capital-account convertibility, see Fisher and Reisen (1992) and Reisen (1992).
20. Estimates of undervoicing of exports in developing countries are within a range from 10 to 20 per cent of exports. For instance, see Arriazu (1983) and Kamin (1991) on Argentina and Vos (1992) on Philippines.
21. That is, 25 per cent times 3/12 months.
22. See OECD (1991).
23. In the September 1992 issue of the National Bank of Hungary Monthly Report, one can read for instance that "an increasing number of organisations refuse to provide compulsory cash flow data, deeming that acting otherwise would be contrary to the principles of a market economy".

24. In particular, Hungary has now put in place a forward exchange market and no other CEECs are planning to create such a market in the near future so as to allow enterprises to cover their exchange-rate risks. But, as OECD experience shows, once forward operations are allowed, it becomes very difficult to insulate the domestic money market from international interest-rate arbitrage.

REFERENCES

- ARRIAZU, R.H. (1983), "Panel Discussion on the Southern Cone", *International Monetary Fund Staff Papers* (March).
- BENNETT, A. and SCHADLER, S. (1992), "Interest Rate Policy in Central and Eastern Europe: the Influence of Monetary Overhangs and Weak Enterprise Discipline", *IMF Working Paper*, 92/68 (August).
- BLOMMESTEIN, H.J. (1993), "Financial Sector Reform and Monetary Policy in Central and Eastern Europe", in D.E. Fair and R. Raymond (eds), *The New Europe: Evolving Economic and Financial Systems in East and West*, Kluwer Academic Publishers (forthcoming).
- CALVO, G. (1992), "Are High Interest Rates Effective for Stopping High Inflation? Some Skeptical Notes", *The World Bank Economic Review*, Vol. 6, No.1 (January).
- FISCHER, B. and REISEN, H. (1992), "Towards Capital Account Convertibility", *OECD Development Centre Policy Brief*, No.4.
- FRENKEL, J.A. (1983), "Panel Discussion on the Southern Cone", *International Monetary Fund Staff Papers* (March).
- KAMIN, S.B. (1991), "Argentina's Experience with Parallel Exchange Markets: 1981-1990", *International Finance Discussions Papers*, No.407 (August).
- NUTI, D.M. (1992), "The Role of the Banking Sector in the process of Privatisation", *EC Economic Papers*, No.98 (November).
- OECD (1991), *Hungary, OECD Economic Survey*, Paris.
- OECD (1993a), *Romania: An Economic Assessment*, Centre for Co-operation with European Economies in Transition series (forthcoming), Paris.
- OECD (1993b), *Hungary, OECD Economic Survey* (forthcoming), Paris.
- PARK, D. and SACHS, J. (1987), "Capital Controls and the Timing of Exchange Regime Collapse", *National Bureau of Economic Research Working Paper*, No.2250 (May).
- REISEN, H. (1992), "Full Currency Convertibility in Eastern Europe ?", *Intereconomics*, Vol. 7, No.5 (September-October).

VOS, R. (1992), "Private Foreign Asset Accumulation, Not Just Capital Flight: Evidence from the Philippines", *The Journal of Development Studies*, Vol. 28, No.3 (April).

Annex

**THE OECD CODES OF LIBERALISATION
OF CAPITAL MOVEMENTS
AND OF CURRENT INVISIBLE OPERATIONS**

The OECD has the vocation to promote the liberalisation of international trade in goods and services as well as of capital movements. These objectives are set out in the OECD Convention and find a concrete expression in the twin Codes of Liberalisation of Current Invisible Operations and of Capital Movements.

The Current Invisibles Code covers most invisible transactions; new liberalisation obligations were introduced in February 1992 in the field of banking and financial services and the establishment of branches by non-resident financial institutions. The Capital Movements Code covers almost all capital transactions, including since February 1992 money-market securities, swaps, options, futures and other "innovative" instruments.

The OECD Codes of Liberalisation have the legal status of an OECD Decision which creates binding obligations for participants. Countries adhering to these Codes are expected to progressively take all steps necessary to achieve the ultimate objective of full liberalisation. All measures should apply to all Member countries on a non-discriminatory basis. There should be no attempt by countries to bargain for reciprocal concessions with their neighbours individually. This obligation also means that a Member country not yet in a position to liberalise a given operation continues to receive the economic advantages of liberalisation of this operation by other Members. The only exception admitted to the non-discrimination principle relates to Members part of a special customs or monetary union, such as the EC, which may apply additional measures of liberalisation between themselves without extending them immediately to other Members.

However, the Codes do not require unqualified and immediate liberalisation. While expected to take place at reasonable scope, the speed and the sequencing of the liberalisation process are decided by each Member country individually.

Member countries unable to meet liberalisation obligations immediately are given the right to maintain restrictions by lodging "reservations" on the items concerned. These reservations may be lodged at the time a Member adheres to the Codes, whenever specific obligations begin to apply to the country, or when new obligations are added to the Codes.

Once a reservation has been withdrawn, it may not be lodged anew, except in the case of items under the so-called List B of the Code of Capital Movements. However, when a Member faces serious economic or financial difficulties, it may enjoy a temporary dispensation from its obligations to preserve the freedom of operations not covered by reservations. Derogations are in principle tolerated for no more than 18 months and are examined by the Organisation to ensure that a liberal regime is restored as soon as possible.

The Codes also contain a standard clause preserving countries' rights to take measures for the maintenance of public order or the protection of national security. Member countries are allowed to take the necessary action for preventing evasion of their laws and regulations (e.g. in the field of taxation and prudential supervision of the financial system). Members are allowed to impose notification and reporting procedures to ensure the availability of statistics.

In terms of procedures, Member countries must notify the Organisation of all measures affecting their position under the Codes and are required to explain the reasons for their action. Periodical examinations of Member country positions are undertaken by the Committee on Capital Movements and Invisible Transactions (CMIT). On these occasions, the nature and purpose of restrictions are discussed and efforts are made to identify operations that could be freed from restrictions, thus allowing for the limitation or withdrawal of reservations. To give legal effect to such changes to Member countries' positions, a draft Decision is submitted by the CMIT for adoption by the OECD Council.

The CMIT may also, when it identifies areas where it believes further liberalisation could take place, invite the Council to make "recommendations" to a Member. Experience shows that recommendations exert some pressure on Member countries to complete the process of liberalisation. Often, national administrations which want to pursue liberalisation in their country find that an internationally recognised forum such as the OECD constitutes a valuable source of support.

Publications in the CCEET Series

OECD Economic Surveys/CCEET. 1991-1992 Series:

Poland

July 1992 Format 16X23 202 pages
(09 92 03 1) ISBN 92-64-13723-8 FF90 £13.00 US\$20.00 DM37

Hungary

August 1991 Format 16X23 202 pages
(09 92 01 1) ISBN 92-64-13554-5 FF90 £13.00 US\$20.00 DM37

Czech and Slovak Federal Republic

December 1991 Format 16X23 148 pages
(09 92 02 1) ISBN 92-64-13607-X FF90 £13.00 US\$20.00 DM37

**Price for the three surveys: Hungary, Poland,
Czech and Slovak Federal Republic** FF230 £32.00 US\$52.00 DM95

Methods of Privatising Large Enterprises

January 1993 Format 16X23 180 pages Bilingual
(14 92 07 3) ISBN 92-64-03709-8 FF150 £26.00 US\$36.00 DM62

Trends and Policies in Privatisation. No. 1: Volume 1

February (1993)
(06 93 01 3) ISBN 92-64-03714-4

Per issue	FF90	£15.00	US\$21.00	DM37
Subscription	FF 150	£ 20.00	US\$ 30.00	DM 50

Prices charged at the OECD Bookshop.

THE OECD CATALOGUE OF PUBLICATIONS and supplements will be sent free of charge on request addressed either to the OECD Publications Service or to the Distributor in your country.

NOTES

1. Unless otherwise specified, this report deals with the exchange control regime prevailing in the Czech and Slovak Federal Republic (CSFR) until 31 December 1992. Since then, the CSFR has been split into two independent States. Although the former Federal legislation on exchange controls has been transposed into national laws, the new States might move towards distinct exchange control systems now they have introduced their own currency. At the time of writing (May 1993), no significant legal steps were yet undertaken, however.
2. Exchange controls include restrictions on transfers and payments in connection with current transactions and capital movements. However, inward direct investment and the acquisition of real estate by non-residents generally fall under the purview of legislation distinct from foreign exchange laws. Information on these operations is nevertheless provided for completeness.
3. In the context of the separation of currencies between the two republics of the former CSFR in 1993, however, it is uncertain whether the Slovak Republic could continue with a strict fixed exchange rate policy as was the case for the CSFR as a whole between the split of the Federation. The Financial Times of 5 March 1993 reports that the Slovak authorities refused the IMF's suggestion to float the Slovak crown and in practice blocked hard currency payments for undefined non-essential imports.
4. Such as the full liberalisation of certain personal remittances not yet freed, a complete unification of legal exchange markets for current transactions, the free convertibility in foreign currency of balances in CEECs' currency officially held abroad and the removal of bilateral exchange arrangements which may subsist between the CEECs and the former CMEA countries.
5. Restricting the free transfer abroad of foreign exchange withdrawn from individual foreign-currency accounts would also be politically delicate in certain CEECs because this measure would risk to be interpreted as a serious interference with basic civic rights.
6. This is the case under the OECD Code of Liberalisation of Capital Movements but not under Article VIII of the IMF Agreement however.
7. The OECD/IMF definition of a direct investment is focussed on a 10 per cent share of capital as a proxy for "effective influence on the management of enterprises".
8. See OECD (1993b).