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Whether and when to liberalize capital account and financial services

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World Trade Organization
Economic Research and Analysis Division

<p>WHETHER AND WHEN TO LIBERALIZE CAPITAL ACCOUNT AND FINANCIAL SERVICES</p>

John Williamson: *The World Bank*
Zdenek Drabek: *WTO*

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WHETHER AND WHEN TO LIBERALIZE CAPITAL ACCOUNT AND FINANCIAL SERVICES

John Williamson*

with a *foreword* by Zdenek Drabek

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ABSTRACT

Discussions about international capital movements raise extremely important and controversial questions. Why should countries open up their capital accounts, especially considering that unrestricted international capital movement is a relatively new phenomenon? For example, many OECD countries have not eliminated their foreign exchange restrictions only until the 1980's. If the answer is unequivocally affirmative, does it matter how fast should countries do so? Should they wait until "all essential pieces" of the policy package are in place before they eliminate all restrictions? How are international capital movements related to domestic financial sectors? Is there a difference between opening to competition an industry such as car manufacturing as compared to the banking sector? Should the opening of the banking sector be governed by different rules?

Rules about foreign exchange restrictions are already in place in the IMF Articles. Until recently, the IMF Articles only called for the elimination of foreign exchange restrictions on the current account. The ongoing discussion and the controversy about globalization that calls for the capital account liberalization introduces, therefore, a relatively new element into the whole discussion.

These questions have also implications for the World Trade Organization. It is well known, that the Uruguay Round Agreements have already provided a coverage for a number of aspects that are directly related to foreign investment. Rules established elsewhere such as in the context of changes to the IMF Articles will obviously have an important bearing for the implementation of rules agreed in the Uruguay Round. This raises a variety of other questions in the mind of some observers. Who should decide about the rules on capital account liberalization? What rules? IMF? What is the role of the WTO? How does one link the two?

All of the questions raised above are clearly extremely important and most of them are discussed in the following paper by John Williamson. Mr. Williamson's presentation is based on his lecture and discussion which was delivered on 17 June 1999 at the WTO. The actual text that follows is a transcript of that lecture.

Key Words: Capital Movements, Capital Account Restrictions, Financial Services.

JEL Classification No. [F31]; [F32]; [620]; [628]

Foreword

Zdenek Drabek

Suppose that one were to make a survey among the delegations of developing countries to the WTO and asked them the following question : "What was your main concern after the 1997/98 financial crisis in Asia and other parts of the world ?" It is my guess that most would have answered that they worry about similar fate for their own countries. They would be afraid that foreign capital could severely destabilize their economies and reverse their developmental efforts. Never mind that most of the developing countries have virtually no access to foreign capital and that they receive virtually no foreign investment.¹ The reality of the current situation is that most developing countries tend to be worried about the adverse impact of international capital movements even though the risk of them facing such a crisis at present time is almost zero.

But the apprehension about the Asian crisis is not only limited to developing countries. As the depth of the crisis and its contagion among different countries in and outside the region indicate, the crisis was partly brought about by rapid and panicky reactions of foreign investors. Many investors have felt that they had to act fast in order to protect the value of their investment. But in doing so, their question typically was – "What next? Shall we ever return? How will the affected countries react? Will they introduce capital controls as Malaysia has done or will they be able to main a relatively unlimited access into their markets?"

Negotiators in the World Trade Organization have also got rather nervous. The financial crisis could not possibly have come at a worse moment since it happened right in the midst of negotiations on financial services, one area left over for further negotiations from the original Uruguay Round Agreements. The fact that an agreement on financial services was eventually reached must be seen not only as major achievement of those who actively pushed for its conclusion but also as a streak of luck that the negotiators were probably unable to fully digest the consequences of the crises. Now, with the lapse of time, there is no doubt that many countries and their negotiators suddenly feel threatened by the crises and, and if the actual negotiations were to be held few months later, they might not have led to the same success.

All these fears have one common denominator - enormous expansion of international capital flows and dramatic openings of markets for financial capitals. The rapid growth of foreign capital flows has been made possible, *inter alia*, by two kinds of measures - a reduction in foreign exchange restrictions on international capital movements, sometimes popularly known as measures leading to the introduction of "capital account convertibility", and by the liberalization of financial sectors. The former allowed freer access to foreign capital by domestic residents and the latter enabled an access by foreign investors to enter domestic financial institutions as partial or sole owners.

Some critics of "globalization" have pointed out that both processes – the liberalization of capital account and opening of financial sector industries – have been the outcome of external pressures. They argue, for example, that the push for liberalization of financial markets has come from the providers of financial services themselves (i.e. read banks, hedge funds, pension funds, insurance companies etc.) which are only thinking of their own profits. Cynics also suggest that many developing countries have no choice but to liberalize due to pressures from international financial institutions. Thus, the countries have to open up their markets if they want to have access to external finance.

All this is hotly disputed by the proponents of liberal market policies. They emphasize the enormous benefits from open market policies and point to empirical evidence to support their case. In addition, the globalization forces are often spontaneous and are generated completely outside government institutions and their policies. It follows, therefore, that any attempt on the part of governments to stop

¹For a comprehensive evidence see recent issues of *World Investment Report*, Geneva, UNCTAD.

the process would be futile since the forces of globalization will always find ways of identifying attractive markets. Moreover, free capital movement, they would argue, is vital in support of free trade. Hence, if countries wish to benefit from more trade, they need to liberalize their trade regimes and reduce and/or eliminate the remaining foreign exchange restrictions.

The discussion about international capital movements clearly raises extremely important and controversial questions. Why should countries open up their capital accounts, especially considering that unrestricted international capital movement is a relatively new phenomenon? For example, many OECD countries have not eliminated their foreign exchange restrictions only until the 1980's. If the answer is unequivocally affirmative, does it matter how fast should countries do so? Should they wait until "all essential pieces" of the policy package are in place before they eliminate all restrictions? How are international capital movements related to domestic financial sectors? Is there a difference between opening to competition an industry such as car manufacturing as compared to the banking sector? Should the opening of the banking sector be governed by different rules?

Moreover, rules about foreign exchange restrictions are already in place in the IMF Articles. Until recently, the IMF Articles only called for the elimination of foreign exchange restrictions on the current account. The ongoing discussion and the controversy about globalization that calls for the capital account liberalization introduces, therefore, a relatively new element into the whole discussion.² To repeat, what is new about the present discussion are the proposals to eliminate the remaining foreign exchange restrictions on the capital account.

All of this obviously has also implications for the World Trade Organization. It is well known, that the Uruguay Round Agreements have already provided a coverage for a number of aspects that are directly related to foreign investment.³ Rules established elsewhere such as in the context of changes to the IMF Articles on foreign exchange restrictions on the capital account) will obviously have an important bearing for the implementation of rules agreed in the Uruguay Round. All this raises a variety of other questions in the mind of some observers. Who should decide about the rules on capital account liberalization?⁴ What rules? IMF? What is the role of the WTO? How does one link the two?

All of the questions raised above are clearly extremely important and most of them will be discussed in the following lecture by John Williamson, a scholar and an economist who is arguable best qualified to talk about this subject. He has been writing on these and related questions for almost thirty years, first as an adviser to HM British Government, later as an academic at Universities of Warwick and York and Pontificia Universidade Catolica do Rio de Janeiro, and later as a scholar, researcher and adviser at the Institute for International Economics and the IMF. He is currently Chief Economist for South Asia in the World Bank.

One last word of the editor. Mr. Williamson's presentation is based on his lecture and discussion which he delivered on 17 June 1999 at the WTO. The actual text that follows is a transcript of that lecture. For this reason, the text tends to be verbose rather than technical. This suits well the purposes of this publication which is intended as a guide to those who are less familiar with the literature and to those who may only have elementary foundations in economic theory. As such, the lecture should well serve modern policy makers, negotiators of international financial agreements as well as representatives of non-profit sectors. The text should be particularly useful in developing countries where the topic has become highly relevant, controversial yet vital for the design of sustainable policies for economic growth.

²This is a part and parcel of the discussion about new "international financial architecture".

³These include GATS, Plurilateral Agreement on Government Procurement, TRIPS, TRIMS, Agreement on Subsidies and Countervailing Measures and on Dispute Settlement.

⁴This issue is perhaps for many observers a foregone conclusion. Since the issue refers to the treatment of balance-of-payments questions, they would argue that the matter belongs to the IMF.

Whether and When to Liberalize Capital Account and Financial Services

When Zdenek invited me on behalf of the WTO to give a lecture on the question of the liberalization of financial services, his original idea was to address the topic in terms of "a challenge to the IMF and the WTO". Since I did not wish to give the impression that I would dare to tell the WTO and the IMF what they ought to do (even though I only have a few months left in the World Bank!), we eventually compromised on a somewhat less presumptuous title. This gives me a chance to start by talking about something that I have thought about for some time, namely capital flows, and whether they should be managed, and, if so, how. I shall then proceed to say what I can about financial services liberalization. This is a topic with which I am less familiar, even though I recently concluded a survey of financial liberalization with my colleague Molly Mahar⁵ which touched on this subject. I shall conclude by drawing what I see as the linkages between these two fields: I hope that this will provide a simple but clear framework for discussion of these important topics.

I. Capital Account Liberalization

Let me start by talking about capital account liberalization. First of all, it may be useful to remind ourselves of what economists would think of as the classic economic benefits of capital mobility.

(i) *Savings – Investment Imbalances.* Capital flows represent an inter-temporal trade between two countries; they allow a country that has excess savings in a given period to transfer these savings to another country which has excess investment opportunities. Since the rate of return in the latter country is presumably higher than in the former, both countries gain as this trade takes place. Underlying this trade are the classical forces of thrift and productivity. This is a process that, to my mind, ought to be capable of giving the world great benefits in the coming decades. As I see the world today, there will be very big demographic changes taking place; we already see a rapid process of aging in the industrialized world, but we have not yet reached the position where the "baby-boomers" are in the retirement phase of their life cycle. They are in the pre-retirement phase which is the highest saving phase, and which also has relatively low investment demands. There is, therefore, a presumption that developed countries as a group are going to generate surplus savings. In contrast to that, you have much of the developing world which is in a position to move into the catch-up phase of the growth process in which urbanisation and industrialization – capital intensive processes - can proceed very rapidly, in which one expects to have high rates of return potentially available. So, there ought to be a possibility of mutually beneficial capital flows from what we broadly call "the

⁵See *A Review of Financial Liberalization*, International Finance Section, Department of Economics, Princeton University, November 1998.

North" to what we broadly call "the South". None of these processes are certain, but that this is my outlook on what I would expect to see happening if the world goes right for the next 20 or 30 years.

(ii) *Risk Diversification.* The other big source of gain from international capital movements is in terms of risk of diversification. It is important to point out that, in principle, one can have risk diversification without any net transfer of resources. It is perfectly possible to have people in one country lending to another and capital flowing back from the second country to the first, and those flows can in principle be matched, but investors in both countries nonetheless end up holding a different set of assets which diversifies their risks more effectively. Thus, unlike flows of savings and investment, which necessarily involve current account imbalances if they are to achieve their objectives, the risk diversification - type of capital flow does not necessarily involve current account imbalances and a build up of net debt positions; one can still have welfare gains without any net transfers.

(iii) *Gains from FDI.* Finally, in the economists' classical discussion of the gains of capital mobility, one should mention separately the gains from FDI. These gains come about not so much as gains from transferring the capital, for they can be achieved even if a multinational company moves into another country and raises all the capital locally. Very often they do raise capital locally; this is not always a process that involves large international flows of capital. But, once again, even without a net transfer, it is possible to have welfare gains if the multinational company is bringing into the country technology, know-how, managerial expertise, access to markets, some set of skills which are not available in the local country. So, again, we have a possibility of welfare gains without a net capital flow. In fact the net capital flows associated with FDI have been recently very substantial, but this is not an inherent part of the process.

It is possible to get most of these gains, of all three types, without going all the way to complete liberalization of the capital account (capital account convertibility). One can perfectly well have large net flows of capital, and certainly the gross flows motivated by diversification or FDI, while still continuing to have some form of controls on short-term capital movements. There is a tendency in the literature to assume that this is an all or nothing decision, where the capital account is either completely closed or completely open. But those are not the only policy options, intermediate solutions are possible too. As so often is the case, one should indeed search for an intermediate solution.

(iv) *Other Arguments "Pro" and "Against" Full Convertibility.* Let me just mention a number of other arguments that are put forward either favouring or against capital mobility. In favour of capital mobility is a "freedom" argument: that individuals ought to be permitted to do as they see fit with

their own property, so there ought not to be restrictions at the national frontier which prevent them moving their money if they want to. That I find a very persuasive argument when we are talking about small personal transactions. However, I do not find it particularly persuasive that freedom is going to be desperately encroached, if, for example, J.P.Morgan has to face some restraints in shifting a few billion dollars over the exchanges in order to speculate. It seems to me that one can still envisage controls on institutional capital which really do not run into this freedom objection in any substantive way.

Secondly, there is an argument that capital mobility provides a *policy discipline* on countries. Indonesia is a country which liberalized its capital account way prematurely, according to the orthodox sequence (in about 1972), and the argument they always made was that this was a good policy discipline because whenever the government began doing something wrong there was a run on the currency and that meant that the economists in the government were able to rein in the technocrats. (There was a constant battle between the economists and Mr. Habib's technocrats, who wanted, for example, to build an Indonesian aircraft industry.) So, the economists found an open capital account a useful way of disciplining people dreaming of what the economists regarded as expensive and welfare-reducing plans. There is also some econometric evidence that capital account convertibility has tended to limit the size of fiscal deficits.⁶ On the other hand, I think if you look around the world you will quickly come to the conclusion that this is an awfully capricious form of discipline. The capital markets typically are either pouring in too much money or else they have been highly restrictive. It is a case of either feast or famine: in Thailand, for example, there was still too much money pouring in as late as 1996, and then in 1997 it all poured out. Can we really think that this is an efficient disciplining mechanism, when it is so capricious in the way it operates?

Then, there is an argument that the capital account ought to be able to serve to mitigate changes in a country's absorption when it is confronted by exogenous shocks. If you have an adverse change in the terms of trade, then it ought to be possible to borrow in order to prevent consumption falling as much as it would otherwise have to. If you look at the facts, I think it is fairly clear that this works in developed countries and it does not work in developing countries -- even developing countries that have established a fairly good reputation in capital markets, like Chile. Following the East Asian crisis, copper prices fell and all of a sudden the capital that had been trying to get into Chile wanted to get out again. That is, the capital account still operates to amplify rather than to offset exogenous swings. This seems to be something that changes only when a country becomes very deeply integrated into the international economic system, like the well-established industrial countries. I recall the Chileans arguing in 1992 that it was fine to have money coming in, but that it would rush out again just as soon as the price of copper collapsed, i.e. when the money is most needed. I

concluded that it would be a mistake to liberalise the capital account until they became deeply integrated into the international economy, which Ricardo Ffrench-Davis summarised as the Williamson sequencing rule: first join the OECD, then liberalise the capital account. Of course, since then we have seen two countries which did indeed join the OECD, but for both of them it turned out that this was not enough to support an open capital account: both Mexico and Korea suffered a disastrous outflow of capital very shortly after joining the OECD. The Czech Republic – another new OECD member - also had a big outflow in 1997. So, it is something much more profound than joining the OECD that is needed to make the international capital market willing to lend more, rather than try to pull back its loans, when a country runs into trouble. I think that eventually one can expect that many of the present-day developing countries will also acquire the ability to borrow in a way that will stabilise rather than destabilise their economies, but I do not expect this to happen in the next few years and, until it does, I consider it would be foolhardy for them to adopt capital account convertibility.

And then the final argument against capital controls is that people always find a way around them, and this can be very corrosive to the rule of law. One has to say that there can be big

⁶Kim, Woomam. 1999. “Does Capital Account Liberalisation Discipline Budget Deficits?”, PhD thesis, Harvard University.

incentives to find ways around exchange controls. And experience in successfully evading one set of controls doubtless encourages people to start evading other laws as well, thus undermining the rule of law. I certainly think that is a legitimate argument against capital controls.

But there are serious arguments the other way as well. The classic one in the textbooks is that capital controls permit the use of monetary policy as an instrument of anti-cyclical policy. This is based on the notion of the "incompatible trinity" of fixed exchange rates (or managed exchange rates, if you like), free capital mobility, and independent monetary policy. If one has to give up one of these three, then many people would argue that the one to be sacrificed is the complete freedom of capital movements.

Another argument for capital controls is that capital mobility creates crises. In George Soros' graphic metaphor, the capital market acted as a wrecking ball in East Asia, swinging from one country to another, knocking over a whole economy, then wildly swinging back somewhere else and demolishing another economy. I think this is indeed basically what happened in East Asia.

An Example: East Asia Crisis. Let me just for a minute dwell on the East Asia crisis. What went wrong in East Asia? I think everybody agrees that a large component of the problem was in the financial structure, that there was too much debt relative to equity; that there was too much short-term debt relative to long-term debt; that there was too much foreign currency debt relative to domestic currency debt; that there were too many non-performing assets in the banking system. Those were the underlying problems in those economies. As long as things were going right, the countries could go on expanding, but any shock that caused investors to wonder whether there might be a problem, left them extremely vulnerable. If one agrees with that diagnosis, one then has to ask the question - how did these countries get into this vulnerable situation?

What I have done, therefore, is to make a list of the various sorts of explanations that we have had of how the East Asian countries got into the crisis. At the bottom of Table 1 are listed all the stories that some people blamed the crisis on, like cronyism and the macroeconomic fundamentals. In Thailand I think it was basically true that the macroeconomic fundamentals were to blame. In the other East Asian countries, all the things that we used to call macroeconomic fundamentals prior to the crisis were just about the strongest in the world; fiscal positions, savings rates, growth rates, inflation rates, all those things were fantastic, current account deficits were mostly under reasonable control, debt levels were not excessive. Thailand was the only country that looked weak on those criteria. So, in my interpretation, Thailand first had a fairly conventional balance of payments crisis and that generated the shock which interacted with the weak financial situation in the other countries in order to cause the contagion that spread the crisis all around the region. It was the open capital accounts

that allowed countries to get into that situation; they built up so much short-term foreign currency debt relative to other types of debt, simply because they opened their capital account and that was what foreigners felt most comfortable lending. No one sat back and asked whether this was a dangerous situation to get into.

Another factor that has often been blamed for the crisis is weak regulation and supervision of financial institutions. Many people have argued that it would have been possible to avoid the crisis if only the banks had been well supervised. Similarly, there is a story that if only investors from the North had been able to see what was going on, they would have noticed and understood that there were a lot of irregularities in the "host" countries, and they would not have lent so much, especially to weak banks. The problem was one of inadequate transparency.

The point that I want to make with Table 1 is that there is really only one of these explanations which serves to distinguish between the countries that were and were not afflicted by the crisis. I take all the significant countries in developing Asia in the big arc from Pakistan to Korea, and I distinguish between countries that succumbed to the crisis and those that succeeded in riding it out according as to whether they had negative or positive growth in 1998. Two countries, the Philippines and Singapore, had near zero growth, so I left them out of the comparison. But look at the other countries, and ask what distinguishes the two groups. Was cronyism more of a problem in Hong Kong than in Bangladesh? Were the banks weaker in Indonesia than in China? Were the macroeconomic fundamentals worse in Korea than they were in India? Was regulation and supervision of financial institutions weaker in Malaysia than in Nepal? Was transparency less in Thailand than in Pakistan? Quite evidently, none of these explanations work. The only explanation that works systematically is the openness of the capital account. Hence I conclude that it was the openness of the capital account that created the vulnerabilities which permitted the financial crisis to spread in the way we saw in East Asia. That seems to me something that it really is important to take on board in thinking about policy towards opening the capital account.

Table 1 – Growth in Principal Asian Countries, 1998

Positive Growth	Negative Growth
Bangladesh China India Nepal Pakistan Sri Lanka Taiwan Viet Nam	Hong Kong Indonesia Korea Malaysia Thailand
Marginal growth: Philippines, Singapore	
Explanations offered (of financial vulnerability) <ul style="list-style-type: none"> • Cronyism • Exchange rate policy • Weak macroeconomic fundamentals • Open capital account • Poor regulation and supervision of financial institutions • Lack of transparency • Weak banks 	

Tax Evasion. Let me move on and talk about other objections to capital account liberalization. One is that it facilitates tax evasion. It is much easier to avoid paying taxes on income earned on one's assets if those assets are in some domicile other than that in which one resides, especially one that is known as a tax haven. Switzerland is the best-known example: there is not usually a lot of tax paid on income-earned in Swiss banks. Tax evasion could be overcome by an international agreement on tax information-sharing, plus withholding where there is no assurance that tax has been paid. However, with the exception of an OECD treaty with very limited membership as yet, there is no significant international initiative toward overcoming tax evasion. I believe this is a very important and unduly neglected issue, whether or not we move toward capital account liberalisation, though it becomes ever more critical the more liberal are capital flows..

Another argument in favour of capital controls is that controls are necessary to permit the conduct of industrial policy. Some people find this argument more persuasive than others. There is also the famous case of "immiserizing growth" first analyzed by Richard Brecher and Carlos Diaz Alejandro⁷. Countries that have high tariff barriers may attract FDI, but the FDI may actually have negative value-added at international prices. Foreign companies may nonetheless make a lot of profits, as a result of distortions produced by the high tariffs. Twenty years ago I think it would have been absolutely right to worry about this issue, but thanks to the WTO tariffs are now down to a point where in general one does not need to take it seriously.

So, my judgement is that the dominant issues are - on the one hand – the real economic gains from capital mobility and on the other hand the risks of crisis that come from complete capital account convertibility. Most of the economic benefits, I would argue, can be obtained without going that last step to full capital account convertibility, and, since it is that last step which seems to present big risks of crisis, it makes sense to stop one step short. How does one do that? Some people argue that you can go a long way towards doing it simply through prudential supervision of financial institutions. If you tell the banks they cannot hold big open positions in foreign exchange, and given that foreigners are not going to be prepared to lend in local currency terms, then one could only get big imbalances if local firms are willing to borrow in foreign currency terms. Unfortunately, even that does sometimes happen. Indonesia was a great example in this respect: the Indonesian corporates had borrowed on a large scale in dollars. They thought that they were largely covered because these were mostly companies that were exporting and earning dollars, and so they told themselves that if there was a depreciation of the currency the local currency value of their exports would go up and they would be able to service their debts with no great problem. What they did not foresee was that the changes would be so large and so dramatic that the whole domestic financial system would be undermined, they would be unable to get credits to buy their imports and, therefore, they would be unable to continue manufacturing the exports to service the debt. So Indonesia found itself in a situation where there was a widespread inability to maintain debt service. At one stage, I believe, something like 80 to 90 per cent of the Indonesian corporate borrowers were unable to service their foreign currency debt.

So while the prudential supervision of financial institutions can help, I do not think it will suffice. The second possibility is to maintain old-fashioned prohibitions on short-term borrowing and lending, but that is becoming more and more difficult as the world gets increasingly integrated. It effectively rules out a series of important current account transactions, especially in the service sector.

⁷Brecher, Richard, and Carlos Diaz-Alejandro. 1977. "Tariffs, Foreign Capital, and Immiserizing Growth", *Journal of International Economics* 7(4), 317-22.

Then, there is the Tobin tax, which regularly gets raised on these occasions. It seems to me not to be well attuned to the particular task in hand, because the Tobin tax falls equally on stabilising transactions that you want to encourage and destabilising ones that you want to discourage. It is not true that it would necessarily fall particularly hard on those who hold short-term positions, because these can be rolled over without going through the foreign exchange market, and it certainly would not prevent those with short-term assets staging a run on the currency when the incentive is present.

The one policy that comes out well on those criteria is the reserve requirement against foreign deposits in the domestic economy, or any other type of foreign loan. This is the measure that was implemented by Chile, and also by Colombia, and which on my reading has done relatively well. I know there is some recent literature which claims the contrary, but even authors who deny that there is any perceptible influence on the size of the inflow (such as Sebastian Edwards, 1999⁸) admit that there has been an impact on the term structure of foreign borrowing.

II. Financial Services Liberalization

Benefits. Let me move on and talk about financial services liberalization and what I see as the essential features of the process. The first basic point to make is that financial services liberalization would seem to offer the same presumption of gains as from any other foreign direct investment. Foreigners generally bring in expertise when they set up businesses (otherwise it would not be worth their while), and it is difficult to see why that should not be true in respect to banking institutions or other financial institutions. Indeed, if I look around the countries in South Asia with which I have been working these last several years, it seems to me that the evidence that the foreign banks perform better is pretty conclusive. That is, it is not just a presumption, but there is fairly firm empirical evidence that foreign banks do bring superior technical expertise into the local financial system.

So, let me ask what is special about financial services that might distinguish it from other types of FDI in a way that would make it less desirable. One worry people have is that it could be a channel for capital mobility, this accentuating the sort of problems I discussed in the first half of this lecture.

Risks. Suppose you accepted my conclusion in the previous section that excessive capital mobility is undesirable, and that one wants to keep a firm damper on the short end of the market in particular. What is then the danger in foreign banks coming in? The banks are seen as a conduit to let people take money out of the country. This does happen. Private banks exist in order to "scoop up" the savings of the rich and bring them to Switzerland or somewhere else they are believed to be safer.

However, this is something that can (and, in my view, should) be controlled by prudential supervision. Rules which limit foreign currency exposure can be imposed symmetrically to ensure that one does not have too big a switch of funds out of a currency, as much as to avoid a big switch in. What I am saying is that I do not see this as a channel that need increase capital mobility. Indeed, I think it might be possible to take advantage of foreign banks to do the same sort of thing that Argentina has done with its foreign banks in recent years. You may know that in 1995 after the "peso crisis", Argentina was very upset when the foreign banks announced that they were not going to increase their exposure in Argentina to help out the liquidity situation of their local banks which came under pressure. There was a general flight from currency at that time and the foreign banks suffered from it. Everyone had assumed that the way the system would work was that banks would offer enough liquidity as was necessary to keep their local branches afloat. However, the foreign banks in Argentina at that time made the decision not to do that but instead to freeze their exposure to Argentina. This experience led the Argentines in the last four years to persuade the banks to think again, and they have now negotiated repo lines of credit which they can draw on in the event of another emergency. This means that having foreign banks in the country can actually fortify a country's liquidity position in a financial emergency, which makes a great deal of sense. Argentina has negotiated similar deals with some of the international financial institutions, including the World Bank, but most of them have been with commercial banks that have branches in Argentina.

A second way in which banks are distinguished from other forms of FDI is that, because of asymmetric information, there is the danger of what is termed "gambling for resurrection" or "gambling for redemption". If one has weak financial institutions which believe that they are going bust, then their best strategy is to make some high-yield, high-risk loans which, should they come off, will get them back into the black. If they fail, the banks would have failed anyway, the owners have nothing to lose. But of course, if the risks do not come off, which they usually do not, then there is a big bill to be picked up by the taxpayers. And this is why in these financial crises you have tax payers ending up picking up bills for 10, 20, 30 per cent of GDP. It has happened in country after country: as the banks come under pressure, they may start making more and more risky loans in the hope that they will be able to get back into the black, and there is no effective system of prudential supervision to prevent this.

Now, one of the dangers of opening up the sector of financial services is that one will have some marginal banks which are just about coping until some much more efficient foreign banks come in. If at that point the local banks see this as eroding their franchise value down to zero, and conclude that they have to take some risks in order to have a chance of getting back into the game, one can get a lot of bad banking as a result of entry by the foreign banks. This is a real risk, and something that some

^{8c}"International Capital Flows and the Emerging Markets: Amending the Rules of the Game?", paper presented

advocates of financial services liberalization do not seem to be adequately conscious of. Clearly the answer is to strengthen the system of supervision and to strengthen the banks, which may involve recapitalising them (something that should generally be contemplated only in the context of a change in management). Those things need to be there when the international liberalization is done, but doing them takes time and that suggests that it may be necessary to go slowly on financial services liberalization.

The final thing that I mention as being special about the banking sector is that foreign banks bring with them the possibility of international risk diversification. The mere fact that they are foreign banks implies that they are essentially saying to depositors that if you put your money with us you are not all invested in local assets; you have got an international mix of assets standing behind your deposit, and that does have some potential attraction. But it also means that, in a financial crisis, people might suddenly come to regard those attractions as particularly strong, and thereby one could experience destabilising shifts from the local banks to the foreign banks. That is another risk that needs to be taken into account.

Interactions. Let me conclude by asking what are the interactions between these two sets of factors that I have been discussing. I think they are fairly modest. These are largely separate issues; given that it is legitimate to operate a system of prudential supervision in a way that limits foreign exchange exposure in both directions, then I do not necessarily see that there are strong implications of financial services liberalization in terms of increasing capital mobility. And certainly the converse is true. One can have capital mobility without free access by foreigners to the financial services industry.

I think the one conclusion that I would strongly urge is that developing countries should be permitted to require that the head offices of the banks that are establishing a presence there be required, as a condition of access, to give their local branches liquidity support even during balance-of-payments crises. It would be a mistake to have an international agreement whose effect were to prohibit countries from demanding such terms.

DISCUSSION

Question: Your presentation may overstate the potential costs of volatility. Referring to the case of East Asian crisis, take the example of Singapore and Taiwan. The real question is why did Taiwan or Singapore, two countries with relatively open capital account, manage in a way to prevent them from

being drawn into the big turmoil that the other countries were drawn into. I think that if one looks at the high average growth rate over the past 10 years in the "crisis" countries, this demonstrates the substantial benefits of the liberal system.

John Williamson: There is no question that if you take the whole package of policies and ask whether one should prefer the policy package of the countries in the right-hand column or the policy package that was pursued by the countries of South Asia in the left-hand column⁹ over the last 30 years, then the right-hand column, East Asia, would win hands down. But that is not the comparison that I am making here. You have to ask how much of the East Asian success was due to this particular component of having relatively free capital flows, which in several countries is a very recent phenomenon, e.g. Korea only liberalised its capital account (and then only the short end) in the last few years. A country which is already investing 35 per cent of GDP and then imports capital to the tune of another 5 per cent plus and boosts investment by that much, how much does it get out of that extra capital on its growth rate compared to how much it builds up its external debt exposure? It seems to me that the impact on the growth rate from the incremental increase is going to be pretty small. Some of the rates of return on capital in East Asia in fact do appear to have gone down to quite low levels in recent years. Other parts of the policy package were, I think, overwhelmingly responsible for the superior performance of East Asia. As a matter of fact, one of the things that I spend my time doing in India these days is to tell people: "yes, I thoroughly agree that it is good that you did not liberalize the capital account too soon, but that does not mean that it is sensible to retain quantitative restrictions on imports of television sets and washing machines, and other things like that." Most of these other failures to liberalize really have been costly, and there is absolutely no argument from the East Asian experience for wanting to backtrack from trade liberalisation, or against liberalising the labour market, or against getting rid of small-scale industry reservation, or for retaining the Urban Land Ceiling Act...

In terms of the particular countries on the list, I just want to make one remark. China is another example which supports my point that prudence in opening the capital account is a wise policy. J. Stiglitz likes to make the point that if one breaks China down into its individual provinces and counts them as individual data points, then the ten fastest growing countries in the world for the last decade would all have been Chinese provinces. It is very much a high growth area. But, of course, Taiwan is the really interesting case on that list, as Taiwan did not liberalize its capital account. It has had a relatively closed capital account even though it has done all the other reforms. As a result, it came through the crisis relatively well.

⁹Please, refer to Table 1 above.

Question: I noticed that you have talked about foreign branches of banks as opposed to subsidiaries. I wonder whether you would draw any distinction that perhaps letting in branches which presumably are supervised from the host country is a better idea than subsidiaries. And I also like any comments you may have on the "moral hazard" question in the crisis and whether, as it seems to me, one of the main aims of the West has been to ensure that their banks which may lend foolishly did not suffer in the end. I also wonder about your view concerning the role the banks should play if they have made foolish investment decisions. You did mention the lack of transparency but I think if banks were really looking into the matter as they should have, they would have taken account of this in their lending regime.

J.W.: On the first question, I spoke carelessly. I would have wanted to include subsidiaries as well as branches.

On the second question, I do worry about moral hazard on the part of the lenders. I think it is an awfully difficult issue to address because one would like to see that the banks which overlend be forced to restructure their assets. However, once you raise that possibility you also raise the likelihood of crisis. The standard way of trying to head off a crisis is to offer a pot of money sufficiently large that nobody needs to worry as everybody is going to get repaid. If instead we get on the other road, and say that as soon as there is a crisis then the banks are going to have to "take a haircut", it is going to mean that crises will come about more quickly, more frequently, and that they will actually be more difficult to resolve without actually the banks taking their hair-cut. I do find this a case where the interior solution is really very difficult. I worry that we will get the worst of both worlds by first putting in some money and letting a number of creditors get out, and then, if that does not resolve it, we declare that it is necessary to restructure some debts. Korea got its first loan in the first week of December 97 and many banks got out, and then the ones that still were not completely out by the third week were called in and told that they were going to have to restructure their debts (from 3 months to 3 years, though with an extra 3 per cent on the interest rates as a sweetener). So, it is not clear that they suffered that much, but it was something that was imposed on them at that stage. I have not worked out in my own mind how one can resolve this and whether or not one ought to go to one extreme or the other. The one thing that does seem to me perfectly clear is that you want to prevent the build up of that type of debt which creates this problem in the first place. Once it is there and leads to a crisis, how it is best handled I find very difficult to see.

Question: I would like to ask you a question about banking secrecy. You mentioned it a couple of times in your lecture, in the context of tax evasion and in the context to the capital outflows from developing countries. These are two important areas, and the whole issue of tax evasion is being extensively discussed in the European Union, and within the European Union there is a number of

countries that still have banking secrecy, notably Germany, Luxembourg and Austria. Given the vital importance of financial information today and the principle of transparency, is it not time to confront head on the principle of banking secrecy? Can it be justified any longer in a world where financial markets are being increasingly integrated?

J.W.: I do have some problems with the principle of banking secrecy. I thought you were going to mention my own country. Britain has fought against measures to try to combat tax evasion, and I must say this is one area in which I find Mr. Blair incredibly reactionary. Just how far one has to go in terms of eliminating banking secrecy I am not sure. What I am worried about is tax evasion. I could live with a practice of allowing the retention of secrecy, provided that the price were that taxes on the secret assets were paid into a common fund, using some minimum common withholding rate. The taxes of those who want to be so secret that they do not want to tell their government who they are could go into some fund to help finance the UN (or maybe the WTO?). I think maybe that could be the basis for a compromise, but there is a real problem. The trouble is that there are still some regimes in the world from which perfectly honourable men, or women, may want to remain not known to their government. Mr. Mobutu has disappeared now so we do not have the old easy example, but there are still some pretty nasty regimes around, and if you are a citizen of one of those countries you may well not want your government to know how much money you have. Under such circumstances, if one does not end up paying taxes to that particular government, I do not mind, but that should surely not offer the rich a free ride.

Question: You mentioned this point very briefly but I was wondering if you could elaborate on how you see the influence of the foreign exchange regime. For example, whether you could add this to your list of explanations, and whether you see a relationship between the foreign exchange regime and capital account liberalization and whether in fact these two come hand in hand.

J.W.: You have embarrassed me. I knew I had forgotten something from that list because I had seven points on it. I had to reconstruct it this morning, and I knew there was something missing. It was the foreign exchange regime.

Some people argue that the crisis was all because of the lack of floating exchange rates. In fact, most of the countries here had much the same exchange rate regime, which they normally described as floating despite the fact that most of them fixed more or less closely to the dollar. So again, it does not give a good explanation. How important is the exchange rate regime in terms of heading off this sort of crisis? I think that a floating exchange rate does help. Stan Fischer likes to say that there are three countries which almost certainly would have got involved in this crisis had they not had floating exchange rates: Mexico, Turkey and South Africa. I think that is probably right, that it provided a

defence mechanism which enabled them to come through the crisis relatively unscathed. I am still not a great enthusiast of floating exchange rates myself because although I think it is true that they are relatively good at providing a defence against speculative crises, I believe it is also true that it would be difficult to get an export boom of the sort that underlay the "East Asian miracle" on the basis of a floating exchange rate. Suppose that Malaysia had introduced a floating rate regime back in the 1970s, then my expectation would be that the rate would have floated up to a point that the export industries would have ceased to be particularly competitive and the boom petered out. Rather like in Peru which had a floating exchange rate, whereas in Chile, which did not have a floating exchange rate, the boom continued until the collapse of the export market.

Question: My question is related with points already raised but seen from a different angle. If you expand the time horizon for a year - if you look at 1999 - the countries you listed have first shown a negative growth which turned into a positive one. But as far as I know those countries have maintained quite a liberal capital account regime except Malaysia. Is it true that those countries are seriously considering the factors you have described as explanations of the crisis? For example, these factors include cronyism, macroeconomic instability or structural problems and they all raise the credibility issue. I think that you tend to over-emphasize the volatility of the capital account liberalization.

J.W.: What I am arguing is that these countries got into very deep recession. And they were deep recessions. In some of these countries absorption fell by 20 or 30 per cent of GDP. GDP may only have fallen by 10 per cent or less, but on top of that there was a big terms of trade shock and a big improvement in the current account balance, and if you add these up you get figures up to 20 or 30 per cent of GDP. So, this is a big recession. I am not saying that this is the end of the world for these countries. I think they all, even Indonesia, are now recovering. We think that all of these countries will have a positive growth in 1999, except for Indonesia, and even Indonesia now seems to be clearly pulling out of the worst. It is not that this is the end of the world, but it has still been an awfully nasty shock. One wants to safeguard against a repetition of this type of crisis. But do not imagine I go to the other extreme and say that these countries are failures, and we have now learned that crony capitalism à la East Asia does not work: I regard that as absolute nonsense.

Question: The chair has two brief questions to you. The first one is: you have been always very pragmatic and operational. You were one of the first observers who drew serious conclusions from the existence of the so-called "excessive" current account deficits. You were the first one who proposed, for example, to the IMF and other international institutions to use rules of thumb for policy makers to decide about dangers of external disequilibrium, when there already are "flashing signals". Now, do you have a similar suggestion for policy makers who are considering the opening the capital

accounts in terms of the status of the financial sector? If the "OECD criterion" that you have dismissed so convincingly is not the one, what will you tell the governments' officials, under what conditions, are banks ready to engage and be supportive of the capital account opening? Is there any way of telling the policy makers?

J.W.: I think I would normally want to make sure that the financial system is in sound shape. Another situation I could envisage would be one in which the government hopes to get a substantial measure of foreign take-over of the banking system. There are some countries for which, even if you could find foreign banks willing to take over banks of the size that exist in large countries, say India, the Indians would not like this. However, in some small countries they do not mind having the banking system being predominantly foreign, and in that case it may well be a way out of the difficulties just to liberalize them and rely on getting the foreign banks coming in and taking over the whole system. So I see two possibilities. One is that you clean up and make sure there is a sound banking system with good supervision. The second approach would be opening up wholesale in the expectation that foreign banks will clean up the system for you.

Question: The second and last question is as follows: You might have noticed the announcement which came two days ago in the *Financial Times* concerning this week's G-7 meeting which is going to discuss the recommendation made by Finance Ministers. The article to which I am referring starts with the following sentence: "The IMF should be prepared to give moral and financial support to countries imposing capital controls or suspending debt repayments. This is the conclusion of the Industrial Countries Finance Ministers few days ago." Your comment?

J.W.: I did not see that report. I think I have to read it before I believe it.