Summary

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1. Initial conditions for capital account opening

In his opening speech, the Deputy General Manager of the Bank for International Settlements holds the view that a general lesson drawn from previous experiences is that an economy's particular circumstances often determine the risk profile and policy choices related to capital account liberalisation. Even though China maintains foreign exchange controls, it is already open to international capital flows in some respects. There are three initial conditions that may favour China's capital account opening. The first and probably the more important positive element is the high growth rate and saving rate of the Chinese economy. Another circumstance that favours China's capital account liberalisation is that currently, domestic interest rates do not substantially exceed those in international markets. Third, China's healthy balance of payments and sizeable international reserves also represent a major plus. But the fiscal deficit, high level of non-performing loans in the banking system and fragile domestic capital markets could prove more of a challenge. China should take into consideration both capital inflows and outflows in mapping and managing its capital account liberalisation.

The two papers on Japan's capital account liberalisation suggest that Japan followed a gradual, "stop-and-go" process. Acceleration and deceleration of capital account liberalisation sometimes depended upon whether its current account was in surplus or deficit. The sequence of its capital account opening has been generally from long-term investment to short-term investment, from direct investment to indirect investment, and from portfolio investment to bank transactions. Such gradualism seemed to aim at maintaining current account balance, controlling short-term capital flows and avoiding financial crises. However, gradual liberalisation also had its costs, including underdevelopment of currency hedging products, underdevelopment of financial markets, and foreign criticism. With respect to the capital account liberalisation in China, the Japanese experts stress that the pace of capital account liberalisation needs to be aligned with that of domestic interest rate deregulation. Strengthening of China's financial sector through restructuring state-owned enterprises and banks and developing domestic financial markets are also important. The second challenge for China is to manage the risks related to globalisation. If greater exchange rate flexibility is to be envisaged, there will be an increased need for hedging instruments and markets for foreign currency forwards and swaps. Sustained healthy trade balances and foreign direct investment flows are also important. Where currency risk management techniques are underdeveloped or significant market distortions exist, some forms of mild capital controls should not be ruled out. The third challenge is to proactively attract foreign capital in order to facilitate financial sector and corporate restructuring.

In discussing the Indian experience of capital account liberalisation, the participant from the Reserve Bank of India suggests several important liberalisation lessons. (1) Stronger supervision is needed for greater liberalisation. (2) Opening up the capital account entirely is not a prerequisite for all emerging market economies in their efforts to attract foreign capital. (3) Under special circumstances, some capital controls must be retained. (4) For most emerging market economies, it is generally easier to manage capital inflows than outflows. (5) Caution is required to guard against the potential balance sheet risks. In 1997, the Indian government set up a roadmap towards achieving full capital account convertibility and also proposed certain preconditions, such as a ratio of fiscal deficit to GDP below 3.5%, an inflation target of 3-5%, and the ratio of non-performing assets to advances falling to 5% from the 20% of the fiscal year 1991-92. Later, the Indian government slowed the capital liberalisation process due to the Asian financial crisis. Since late 2002, the liberalisation pace has been picking up again. In the liberalisation process, the fiscal deficit and the non-performing loans in the banking system have been the two main concerns of the Indian government, which is now in the process of changing the regulations on bank accounting systems and risk management towards international standards. Generally speaking, the Indian liberalisation experience has been to follow a well thought out, gradual pattern of liberalisation, encouraging non-debt creating capital flows, offering full convertibility to non-residents first but affording greater freedom to resident corporates to enhance their international competitiveness, encouraging capital flows into priority sectors, and not internationalising the Indian rupee prematurely.

2. Sequencing and policy coordination during liberalisation

The seminar paper by the Italian participant characterises Italy's experience of abolishing exchange controls as a two-phase process after World War II. From 1945 to 1988, strict exchange controls were in place. From 1988 to 1990, the controls were gradually relaxed. In 1990, full capital account convertibility was achieved. After full capital account liberalisation, the growth of banking aggregates appears quite high in volume terms but much less remarkable in relative terms. The paper also contends that there is no definite conclusion concerning the costs and benefits of capital account liberalisation. However, the benefits of market-based policy operations seem to exceed the related costs. For Italy and other European countries, once the capital account has been fully opened up, it would be difficult to reverse course.

The representative of the Bank of France reviews France's history and policy stance of exchange control and liberalisation. France's capital account liberalisation process after World War II can be roughly divided into two distinct periods. The first period lasted until the mid-1980s and featured strict foreign exchange controls that suited France's relatively closed, protected and regulated economy at that time. The second period started in 1984 at a time when the situation of French firms and of France's balance of payments began to improve gradually. The foreign exchange controls were completely dismantled in six years. The liberalisation process took place in three steps. In the first step, trade-related foreign exchange controls were gradually liberalised from 1984 to 1986. In the second step, from 1986 to 1988, most financial transactions were also allowed. The last step, from 1988 to 1990, phased out most of the remaining controls: residents were allowed to freely open and keep their own foreign currency denominated accounts in France and maintain foreign currency and franc-denominated accounts abroad; lending in francs by French banks to non-residents was totally liberalised; all remaining administrative restrictions regarding foreign direct investment in France were also phased out. The capital account liberalisation policies in France were designed with the following three considerations. First, capital account liberalisation has to be part of a sound overall economic policy framework. Second, capital account liberalisation has to be part of the broader financial policy framework. Third, capital account liberalisation has to be carefully sequenced. Three main conclusions seem to emerge from the discussion. (1) There is the need to enhance the real and the financial sectors' capacity to manage risks associated with capital flows prior to liberalisation. (2) It is important to coordinate different economic policies in the liberalisation process. (3) The government needs to choose the proper nominal anchors for both the exchange rate regime and monetary policy.

The expert from the South African Reserve Bank points out that monetary policy, interest rate policy and trade policy all mattered in the process of capital account liberalisation in South Africa. The objective of South Africa's capital account liberalisation was to attract capital inflows, especially portfolio inflows. In March 1995, the exchange controls on the movement of funds of non-residents were abolished. Non-residents could transact in the foreign exchange market freely, while resident companies and non-financial institutions were strictly prohibited from doing so. This situation created asymmetry, and corporate residents were disadvantaged vis-à-vis non-residents. From 1997, exchange controls applied to residents were gradually lifted. The foreign exchange regulations changed from a system of general prohibitions save for explicit permissions to a regime of general permissions with explicitly stated exceptions. Exchange controls on non-financial institutions were loosened, with the quota system still in place. Qualifying institutions, ie long-term insurers, pension funds, unit trusts and fund managers, as well as resident individuals, are allowed to invest offshore up to certain ceilings. The present ceilings on offshore portfolio investments are 15% of total assets for long-term insurers and pension funds, and 20% for unit trusts. Though individual transactions account for only 20% of the total foreign exchange transaction volume in South Africa, it is important for maintaining market confidence.

3. Managing capital flows during liberalisation

In their paper on Korea's capital account liberalisation, the two authors argue that in the course of liberalisation before the Asian crisis, short-term capital flows were favoured over long-term capital flows, while short-term borrowing was favoured over foreign direct investment. This policy bias contributed to the greater dependence of Korean corporations on short-term foreign currency borrowing and the lax regulations on short-term foreign borrowing by Korean banks and merchant banking companies. As a result, following the capital account liberalisation, the ratio of short-term debts to Korea's total foreign debts increased rapidly, further heightening the vulnerability of the corporate and banking sectors. Such vulnerability became more visible during the down-cycle, and a string of bankruptcies of Korean banks and corporations ensued. After the 1997 financial crisis and on the basis of the IMF's advice, Korea has completely opened up its capital account. Both the stock and bond markets have been totally opened to foreign investors. On the other hand, this opening has been accompanied by a strengthening of the prudential and supervisory standards. The Financial Supervisory Commission has introduced specific rules regulating the maturity mismatch between foreign exchange assets and liabilities. Since the opening-up, there has also been a huge improvement in Korea's foreign exchange reserves.

The paper by the staff of the Bangko Sentral ng Pilipinas (Central Bank of the Philippines) illustrates the current status of capital account management in the Philippines. The country started capital account liberalisation from the early 1990s, but has retained so far certain restrictive and approval requirements in order to optimise the utilisation of banks' foreign exchange funds and to maintain the convertibility of the Philippine peso. Specifically, there are no restrictions on the inflow of foreign investments except in areas included in the Foreign Investment Negative List. Registration of foreign investment with the Central Bank of the Philippines is not mandatory. Outward investments are also allowed to some extent. In the case of external borrowings, prior approval of the Bangko Sentral is needed for all public sector borrowings. Private banks are also required to seek prior central bank approval for their foreign borrowings, except for normal short-term interbank transactions. Meanwhile, non-bank private sector entities are, in general, free to contract foreign loans unless they intend to fund payments of principal and interest on the obligations with foreign exchange purchased from the banking system. Short-term foreign borrowings, to be serviced with foreign exchange to be purchased from the banking system, may finance exclusively foreign exchange costs of eligible projects payable to foreign beneficiaries. Medium- and long-term borrowings may finance both local currency costs and foreign exchange costs payable to foreign beneficiaries. The Philippine central bank makes a distinction among the following three cases of foreign borrowing by private non-bank corporates: foreign currency borrowings by residents, foreign currency borrowings by non-residents from banks in the Philippines, and local currency borrowings by non-residents from banks in the Philippines. The intensity of management and regulation varies across these three cases. There are no restrictions on the disposition of foreign exchange receipts of residents. However, purchases of foreign exchange from banks in the Philippines are subject to certain documentary requirements.

The paper submitted by the JP Morgan participant offers an overview of the background and evolution of the Qualified Foreign Institutional Investor (QFII) system in Taiwan, China. The introduction of the Foreign Investment Plan set the stage for a three-phase policy. First, foreign indirect investment was allowed through buying beneficiary certificates of trust funds. Second, direct foreign investment in securities by QFIIs was introduced. Third, direct investment in securities by non-resident individuals of Taiwanese origin or otherwise was sanctioned. The QFII policy framework, including regulations on foreign exchange, the establishment of financial institutions, and the Securities and Exchange Law, was also gradually liberalised and became more accommodating over time. Operationally, foreign investors seem to have four key considerations when they make decisions on whether to participate in the Taiwanese securities market: (1) the application process; (2) the investment quota; (3) the settlement mechanism; (4) the reporting process.

4. Cross-border movements and offshore circulation of currency

The paper presented by the participant from the Federal Reserve Bank of New York cites three main benefits of the overseas circulation of US dollar banknotes. First, foreign holders of US banknotes benefit by acquiring a liquid, secure and stable asset. Second, overseas circulation of US dollar banknotes helps to maintain the stability of the payment system. Third, overseas circulation of

US dollar banknotes brings considerable seigniorage benefits. Currency in circulation increased at a rate of 4.7% in recent years. Excluding the factor of economic turbulence in some economies, the growth trend is relatively stable. As of May 2002, total currency in circulation was about USD 620 billion. Of this total, 50-70% is estimated to circulate outside the United States. For 2000, the securities counterpart to total Federal Reserve banknotes earned USD 32.7 billion in interest income. There are, however, challenges in overseas banknote circulation. The first challenge associated with the international use of the dollar is the responsibility to ensure that the dollar is not used for illicit trade or activities. At the moment, about 5% of the dollar banknotes in circulation are used for “grey markets”. The second challenge is counterfeiting. The third one is potential complications of targeting monetary aggregates. The Extended Custodial Inventory Program has been established, in part to meet these challenges. However, the US Federal Reserve has neither encouraged nor set overseas currency holding as one of its specific policy objectives.

The paper contributed by the Deutsche Bundesbank expert summarises the Bundesbank’s experience of managing cross-border movements of Deutsche mark (DEM) banknotes. The DEM banknotes which used to be issued by the Bundesbank were released at the counters of various Bundesbank branches, as are euro banknotes now. The Bundesbank’s customers (counterparties) and partners in monetary policy operations are essentially commercial banks. The Bundesbank does not ask customers how the currency withdrawn from its accounts at the Bundesbank is later to be used or where the cash is to be transported. It only knows the stocks of currency the credit institutions hold at given times on the basis of reports which the commercial banks have to submit every month. In the 1990s, currency in circulation abroad increased due to rising number of travellers and “guest workers”, resulting in a circulation abroad equivalent to around 30 to 40% of the total DEM currency in circulation. In absolute terms, this amounted to between DEM 65 billion and DEM 90 billion. It should be noted that the Bundesbank has never fostered the overseas circulation of DEM banknotes. As of 1 January 2002, the date of the official introduction of the euro as legal tender, all reporting requirements on the import and export of banknotes in existence up to that time were lifted. Given the size of the euro area and the amount of euros in circulation, which is far larger than the circulation of DEM banknotes before the introduction of the euro, it will certainly not be easy to obtain data on the circulation of euros outside the euro area.

The paper submitted by the two staff members of the Hong Kong Monetary Authority (HKMA) discusses the potential benefits and concerns of Hong Kong dollar (HKD) circulation outside Hong Kong SAR. First, it brings benefits to Hong Kong in the form of seigniorage. When the three note-issuing banks issue banknotes, they are required to submit US dollars (at HKD 7.80 = USD 1) to the HKMA for the account of the Exchange Fund. The US dollar funds are then invested by the Exchange Fund in liquid US dollar assets. The SAR government then earns seigniorage from banknotes held by non-residents. Second, it enhances the intermediation role of the banks in Hong Kong. Third, Hong Kong residents also benefit from savings on foreign exchange transactions when they use HKD notes for transactions on the mainland. The external demand for currency notes also gives rise to some concerns. One is about counterfeiting. Secondly, external holdings of HKD may complicate the interpretation of movements in the amount of currency outstanding and other monetary aggregates. Thirdly, offshore circulation of HKD notes may distort Hong Kong’s balance of payments statistics. In recent years, there are signs of an increase in the holdings of HKD currency on the mainland. One reason is that the renminbi remains a non-convertible currency. Holdings of HKD banknotes - a convertible, stable currency - represent a means of accumulating foreign assets for some individuals and business firms on the mainland. Another reason is that the economic and social ties between Hong Kong and the mainland are becoming increasingly closer. Moreover, the relatively large denominations of the HKD banknotes also play a part. Finally, some regulatory changes on the mainland in the past few years may have also facilitated the increased use of HKD banknotes. In general, there are two possible ways to estimate the portion of the currency stock that is held externally. One approach directly seeks data that measure the size of external holdings. But none of the economies in the world has such complete data. The other, indirect approach uses econometric models to estimate domestic holdings and then take foreign holdings as the residual. There are two main indirect estimation methods. One is based on the trend of the currency-to-GDP ratio. The other takes into account the opportunity cost of holding currency, ie the influence of the inflation rate and real interest rate. Generally speaking, the latest HKMA estimates suggest that a significant amount of HKD currency - in a range of 15-25% of the total outstanding stock - is currently circulating outside Hong Kong.

5. Preliminary insights from the seminar

First, most economies in the world have adopted a cautious and gradual approach to capital account liberalisation. Fiscal stability, low inflation, a sound banking system and corporate sector, and ample foreign exchange reserves are some of the preconditions for capital account liberalisation. However, these preconditions are relative and not absolute.

Second, the sequencing of capital account liberalisation depends on the objective of liberalisation and the starting economic and financial position of the economy. Therefore, there is no universal rule. Generally speaking, long-term, non-debt capital inflows should be opened up first.

Third, capital account liberalisation should be coordinated with monetary policy, exchange rate policy and overall economic and financial policies. Corporate and banking sector reforms to enhance their stability and competitiveness are especially important for the success of capital account liberalisation.

Fourth, in the course of capital account liberalisation, it is important to maintain a proper balance between the treatment of transactions by residents and non-residents, capital inflows and outflows, and different types of financial institutions. The authorities may pay more attention to issues related to capital outflows when inflows are excessive. How to effectively manage capital outflows could present a major challenge to the process of capital account liberalisation.

Fifth, given sound macroeconomic and financial fundamentals, some capital controls may be an effective way to cope with unexpected crises. However, capital controls could only be used as a temporary policy measure with specific aims and should not be a substitute for sound economic policies. More prudential regulations are needed along with the capital account liberalisation process. Both the domestic and offshore activities of the corporate and banking sectors should be supervised.

Finally, the offshore circulation of the home currency is normally not a policy objective but a result of cross-border trade flows and currency stability. However, central banks should strengthen the statistics on and supervision of offshore circulation of domestic banknotes. Also, premature internationalisation of the domestic currency may invite speculation.