Brigid Gavin* and Jerôme Haegeli**

International Investment Rules and Capital Mobility

Considerations in Light of the Asian Financial Crisis

In the wake of the Asian financial crisis a number of questions related to free movement of capital are being reconsidered. Is it desirable to have full capital mobility for emerging market economies? Will capital account liberalisation lead to a growing number of financial crises which will threaten the stability of the international financial system?

The international institutional architecture, which was designed to deal with the post world war two economic situation, has become outmoded. The legal framework governing international trade, which was established under the General Agreement on Tariffs and Trade (GATT), has been revised and expanded under the new World Trade Organisation (WTO). But it has no comprehensive set of rules for multinational corporations (MNCs) which are major locomotives of investment in the global economy. The founding charter of the International Monetary fund (IMF) did not equip the organisation to deal with the enormous private capital flows which have grown in the global economy since the 1980s as portfolio investment flows and international bank lending have increased dramatically.

The existing international investment regime is a patchwork of numerous bilateral treaties and a growing number of regional and multilateral agreements. This is an unbalanced architectural structure based on weak foundations and multiple layers of overlapping and inconsistent regulations. The debate about international investment rules so far has concentrated on foreign direct investment (FDI). This type of investment is increasingly considered to be an alternative mode to traditional exporting as a means for companies to service foreign markets. Consequently, the well know principles, which have been used for the liberalisation of trade, are now being applied to FDI.[1]

But foreign investment is more complex than foreign trade because investment requires capital mobility as well as market access. Therefore, a comprehensive set of rules for foreign investment must cover both the trade and finance related aspects of investment. This implies the need for joint implementation of rules between the international institutions with competence in matters of trade and finance. Furthermore, the process of establishing multilateral rules based on the codification of best existing practices currently embodied in bilateral investment treaties and in regional economic agreements is a necessary but not sufficient condition for the establishment of a strong and credible legal framework for global investment. Of equal importance is the restructuring of the competences of existing international organisations to ensure consistency between the two sets of rules governing international trade and finance.

A future multilateral agreement on investment (MAI), which is expected to be negotiated in the WTO, will need to establish a coherent set of rules for the liberalisation of 'full investment'.[2] The scope of the

* Europa Institut, University of Basle, Switzerland. ** University of Basle, Switzerland, and Harvard University, USA.

[1] See the Multilateral Agreement on Investment, Consolidated Text and Commentary, OECD, Directorate for Financial, Fiscal and Enterprise Affairs Negotiating Group on the MAI, Paris 1997.

[2] For the EU position on multilateral investment rules in the WTO, see European Commission: A Level Playing Field for Direct Investment World Wide, Office for Official Publications of the European Communities, Luxembourg 1995. For the position of the developing countries see A. V. Ganesan: Strategic Options available to Developing Countries with regard to a Multilateral Agreement on Investment, United Nations Conference on Trade and Development (UNCTAD), Discussion Paper No. 134, Geneva 1998.

agreement should go beyond FDI to include portfolio investment including stocks and bonds, and debt capital including bank lending. Such an agreement is necessary because the different channels through which capital flows internationally have now become integrated to such an extent that a sectoral agreement for FDI alone would not only be discriminatory but also infeasible from the point of view of its administration.

A multilateral agreement which seeks to liberalise 'full investment' would require complete liberalisation of the capital account of the balance of payments, in other words complete freedom of capital movement. For the industrialised countries, this has already been largely achieved as their financial markets have become increasingly integrated since the 1980s. In emerging markets the liberalisation of capital markets has gathered momentum since the 1990s. This has been accompanied by – and perhaps also motivated by – increasing discussion in academic and policy-making forums on the need for financial liberalisation as an instrument of economic growth in these countries.[3]

But in the wake of the Asian financial crisis a number of questions related to free movement of capital are being reconsidered. Is it desirable to have full capital mobility for emerging market economies? Will capital account liberalisation lead to a growing number of financial crises which will threaten the stability of the international financial system? There is, therefore, need for careful consideration of how investment rules should deal with capital mobility.

This paper will focus on investment rules and capital mobility and the implications for the stability of the international financial system. First, we shall analyse the growing links between the three major categories of private capital flows in the global economy. We shall then present an analysis of the main features of the Asian financial crisis and examine the issues concerning investment and capital flows which have emanated from this crisis. This will be followed by a discussion of the existing institutional arrangements for the liberalisation of capital movements. Finally we shall discuss how future negotiations for investment liberalisation present an opportunity which should be used to strengthen the architecture of the international financial system.

International Investment and Capital Flows

Foreign investment requires capital mobility, primarily in equity and debt, across national frontiers. Capital flows in the global economy are comprised of three major categories, direct equity investment, portfolio equity investment and international bank lending. As will be shown below, the boundaries between these three categories have become increasingly blurred.

Foreign Direct Investment

The conventional distinction between foreign direct investment (FDI) and foreign portfolio investment hinges on whether the foreign investor can exercise control over managerial decisions of the business. In the standard definition of FDI given by the IMF, direct investment is made to acquire a 'lasting interest' in an enterprise operating in a foreign country and the investor's purpose is to have 'an effective voice in the management of the enterprise'.[4]

The investing firm acquires an effective voice or control in management by owning a certain equity capital stake. It is considered by the IMF that a stake of 10 per cent of the ordinary shares or voting power is the threshold for achieving control. However, not all countries follow IMF guidelines. There are substantial differences between countries' definitions of control. Some countries, such as Germany, define 20 per cent of share ownership or higher as the threshold for control. Therefore, the boundary between direct and portfolio investment is somewhat arbitrary. A further grey area is found in the measurement of FDI.

FDI flows are recorded in the IMF balance of payments statistics as long-term capital outflows and inflows between the parent enterprise in the home country and the foreign affiliates which it controls in the host country. According to this approach FDI is comprised of three components: foreign investor's initial equity capital, subsequent reinvested earnings and intra-company loans and debt transactions between the parent and foreign affiliate enterprises. Only internal sources of funds for financing FDI are recorded.

The problem with this method of accounting is that it excludes external sources of funds for financing FDI. Foreign affiliates can finance their investment by

[3] For an overview of the literature on the links between the financial system and economic growth see M. Gertler: Financial Structure and Aggregate Economic Activity: An Overview, in: Journal of Money, Banking and Credit, 20, 1998, Part 2, pp. 559-88. For a discussion of financial development see R. King, R. Levine: Financial Intermediation and Economic Development in: C. Mayer, X. Vives (eds.): Capital Markets and Financial Intermediation, Cambridge University Press, Cambridge 1993.

[4] International Monetary Fund: Balance of Payments Manual, 5th Edition, Washington D.C. 1993.

borrowing from local or international lenders, or can raise funds in the domestic or international capital markets. They can also raise equity capital from local and international minority shareholders if the foreign parent does not hold 100 per cent ownership.[5]

Multinational Corporations and Debt Finance

Multinational corporations are considered as a form of international equity finance but they are also a vehicle for international debt finance. In fact, they have acted as a catalyst for the unprecedented growth of private bank lending since the 1960s through the development of interbank lending. It was the growth of multinational corporations which led to the parallel growth of multinational banking in the global economy.

Multinational banking concerns the ownership of banking facilities in the economy of one country by residents in a foreign country. The initial motivation for the emergence of multinational banks was the 'defensive' strategy of following their corporate clients abroad for fear of losing their business to local banks in the foreign market. But the early practice of multinational service banking rapidly evolved into multinational wholesale banking.[6]

This has created a global network for international capital flows which represents the equivalent of a global federal funds market. It is the multinational wholsale banking network which has become the main conduit for international capital flows through its large volume of interbank lending. Multinational banks may increase the efficiency of international capital flows and if this is so they will be welfare increasing. But if distortions exist in domestic capital markets, then international capital flows may have harmful effects on countries.

Foreign Portfolio Investment

The growth of foreign portfolio investment flows since the 1980s reflects the growing importance of new investors such as pension funds, insurance companies and investment funds on global financial markets. Flows of portfolio investment normally take place through transactions involving shares of companies quoted on stock markets. But they can also take place through flows of finance to unquoted companies via venture capitalists. Portfolio capital inflows contribute directly to the financing of domestic industry in the host country when the investment is made for primary issues on the local stock market or in international markets through equity offerings or issues of depository receipts. Portfolio capital inflows can also be used for share purchases in the local secondary market. The latter indirectly finances local firms by pushing up the price of equity and thereby lowering the cost of capital in the stock market and consequently encouraging new issues. This will upgrade the domestic private sector and, thereby, also make the country more attractive to foreign direct investors.[7]

Concern over portfolio investment flows is motivated by the more short-term, speculative nature

Table 1
Capital Flows and Reserves in Asia and Latin America
(in billions of US dollars, at annual rates)

	1980-90	1991	1992	1993	1994	1995	1996
	Net private capital inflows						
Total	12.9	52.5	81.3	99.1	78.7	77.7	149.8
China	1.9[a]	–1.9	11.7	7.8	14.6	13.9	23.0
Other Asia[1]	4.7	26.2	19.3	34.0	26.8	37.6	56.8
Brazil	3.8	2.5	9.1	9.9	9.1	31.8	35.4
Mexico	1.6	20.6	23.6	30.3	10.3	–13.2	13.5
Other Latin America[2]	0.8	5.0	17.6	17.0	18.0	7.6	21.1
	Net official capital inflows						
Total	13.8	12.8	19.8	13.2	13.8	33.8	0.9
China	1.2[a]	2.9	5.4	5.6	9.3	6.9	7.0
Other Asia[1]	6.8	8.3	13.3	5.7	3.7	1.9	3.8
Brazil	1.0	–1.4	–0.5	–1.2	–0.7	–0.7	–1.8
Mexico	2.1	2.4	2.0	–0.9	0.3	24.5	–10.0
Other Latin America[2]	2.7	0.6	–0.4	3.9	1.2	1.1	1.8
	Net increase in reserves						
Total	13.3	55.5	71.4	59.2	48.5	62.6	83.2
China	2.7[a]	14.1	23.2	1.8	30.5	22.5	31.4
Other Asia[1]	10.5	25.2	25.7	37.1	23.8	16.2	25.8
Brazil	–0.1	–0.4	14.7	8.7	7.2	12.9	9.3
Mexico	0.6	8.2	1.2	6.1	–18.9	10.7	1.8
Other Latin America[2]	–0.4	8.4	6.6	5.5	5.9	0.4	14.9

Note: Capital flows are calculated as the difference between the current account and the the change in reserves; private flows are calcualted as a residual from an estimate of official flows.
[a] 1982–90.
[1] India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.
[2] Argentina, Chile, Columbia, Peru, Venezuela.

Source: BIS 67th Annual Report (1997), p. 99; IMF Balance of Payments Statistics and Institute of International Finance.

[5] See E. M. Graham: Foreign Direct Investment in the World Economy, IMF Working Paper, Washington D.C. 1995.

[6] For the theory of multinational banks see H. Grubel: A Theory of Multinational Banking, in: Banca Nazionale Del Lavoro Quarterly Review, No. 123, 1977, pp. 349-63. See also J. M. Gray, H. P. Gray: The Multinational Bank: A Financial MNC, in: Journal of Banking and Finance, 5, 1, 1981, pp. 33-63.

[7] For an analysis of the role of portfolio investment in emerging markets, and the links between portfolio and direct investment, see United Nations Conference on Trade and Development (UNCTAD): World Investment Report, Geneva 1997.

Table 2
Bank Credit Expansion and Indicators of the Banking Industry in Asian countries

	Bank credit to the private sector[1]			Indicators of the banking industry			
	Annual rate of expansion[2]		As a percentage of GDP	Operating costs		Net interest margin	
	1981-89	1990-97[a]	1997	1990-94	1995-96	1990-94	1995-96
China[3]	12	13	97	1.0	1.4	1.7	2.2
Hong Kong	13	8	157	0.1[b]	0.4	0.2[b]	0.3
Taiwan	15	13	138	1.3	1.3	2.1	2.2
Indonesia	22	18	57	2.3	2.8	3.3	3.6
Korea	13	12	64	1.9[c]	2.1	2.2[c]	2.2
Malaysia	11	16	95	1.6[b]	1.4	4.7[b]	3.2
Philippines	–5	18	52	4.0	3.5	5.3	4.8
Singapore	10	12	97	0.8	0.7	2.2	2.0
Thailand	15	18	105	1.9	1.8	3.6	3.6
Memo items:							
United States	5	0.5	65	3.7	3.4	4.1	3.8
Japan	8	1.5	111	1.0	1.1	1.2	1.5
G-10 Europe[4]	6	4	89	2.1	1.9	2.3	2.0

[a] 1997 data are preliminary. [b] 1993-94. [c] 1991-94.
[1] Annual average. [2] Deflated by consumer prices. [3] Credit other than to central government. [4] Weighted average based on 1990 GDP and PPP Exchange rates.

Source: BIS 68th Annual Report (1998), p. 119.

of such investment compared to direct investment which is considered to be long term and stabilising. In practice, however, the distinction is not so clearcut. Portfolio investment by institutional investors such as pension funds is frequently long term although they do not exercise any managerial control. Similarly, venture capital investors often keep their equity stake in start-up companies for several years and, in addition, provide advisory services. Foreign investors are not inherently more oriented towards short-term speculation than domestic investors. The problem is frequently at a more fundamental level where capital inflows are used to finance large current accounts which are unsustainable and, therefore, signal the need for adjustment. Foreign portfolio investors, becuase their investments are relatively liquid, will move quickly as soon as they sense trouble. But the first best policy in this case is sound macroeconomic policies. If governments resort to capital controls this may only serve to distract the authorities from maintaining sound monetary and fiscal policies. Capital controls may also reduce inflows of FDI as the evidence shows a positive relationship between FDI and FPEI (foreign portfolio equity investment) in both industrial and emerging market economies.[8]

[8] See J. Tatom: Portfolio Flows do not Suggest Risk, in: UBS International Finance, Issue 26, 1996, pp. 9-13.

[9] This section draws from the Bank for International Settlements (BIS) Annual Report, 1997, Ch VI, Financial trends in emerging markets, pp. 97-117, and BIS Annual Report, 1998, Ch. VII, Financial intermediation in the Asian crisis, pp. 117-141.

The Asian Financial Crisis

During the 1990s there was an unprecedented build-up of capital inflows into the emerging markets of Asia. The volume of capital flowing into these countries, which previous to then had been moderate, was predominantly private capital.[9] Table 1 shows the increase in private capital inflows and accumulation of reserves which were far in excess of official capital inflows.

The structure of external financing reveals how these countries were gradually becoming more dependent on short-term capital inflows.

Foreign Bank Lending and Domestic Credit Expansion

There was increasing reliance on international bank and bond finance. Inter bank lending was particularly important. Furthermore the loans were increasingly short-term and denominated in a foreign currency. Almost 60 per cent of total lending was denominated in dollars and the remainder mainly in yen; two thirds of all loans had a maturity of less than one year. European banks were relatively latecomers to the Asian lending boom but they accounted for more than half of the lending to this group of countries between 1995 and mid-1997.

Massive expansion of credit in the domestic economy provided the backdrop to the large foreign borrowing. Bank credit grew by more than 10 per cent a year in real terms during the 1990s and in several countries it was almost double that. Table 2 shows the ratio of bank credit to GDP and the increasing fragility of the banking industry.

The vulnerability of the banks is indicated by the extremely slim margin between the net interest and their operating costs. This indicates that little or no provisions were being made to provide a cushion against risk. This was imprudent at a time when the financial sector was being deregulated and, consequently, facing new and increasing competition from both domestic and foreign banks. But as optimism about the future growth prospects of the whole Asian region continued to ride high – which was based on consistently good performance in the past – other economic agents as well as the banks underestimated the risks of over investing.

Even the credit-rating agencies failed to observe the mounting risk. Despite the availability of information concerning widening current account deficits and increasing short-term external indebtedness, the rating agencies did not downgrade these countries in terms of risk assessment of long-term foreign currency debt. In fact they continued to upgrade them throughout 1995 and 1996. It was only after the crisis broke that they reacted. They then slashed the credit rating of these countries which had extremely painful economic consequences.

Foreign Portfolio Equity Investment

The remarkable development of portfolio equity markets in Asian countries in the 1990s was reflected in the ratio of capitalisation to GDP, which in Asian countries had become comparable to those in the larger European countries, or in Japan. However, the volatility of equity prices in Asian countries continued to be much higher than in industrialised countries. This is shown in Table 3.

It was equity markets which gave the first signal of trouble. Stock markets in most Asian countries (with the exception of China and Hong Kong) peaked towards the end of 1993. And the marked declines thereafter suggest that investors had already begun to expect lower profitability from Asian companies. Equities are much more sensitive to changes in profitability than bonds or bank loans. One good reason for this may be that financial bail-outs rarely make good the losses suffered by portfolio investors when there is a financial crisis. Thus the portfolio equity investors were the first to show awareness of the vulnerability of the Asian economies.

Table 3
Equity Markets in Asia: Capitalisation and Volatility

	Capitalisation[1]		Volatility[2]	
	1990	1996	1993-94	1995-96
China	0.5[a]	13.8	26.6	10.5
Hong Kong	111.5	280.8	10.1	5.5
Korea	43.6	25.4	6.1	6.1
Singapore	91.6	169.0	3.9	3.1
Taiwan	62.7	100.5	13.9	8.5
Indonesia	7.1	41.2	8.9	7.3
Malaysia	113.6	315.5	9.0	5.8
Philippines	13.4	97.5	10.2	6.4
Thailand	28.0	54.4	11.0	7.7
Memorandum items:				
United States	53.8	108.7	1.4	2.0
Japan	98.2	67.6	6.0	3.4
Germany	23.6	29.4	3.2	1.7
United Kingdom	86.7	151.0	4.2	2.5
Other G-10 Europe[3]	26.9	47.8	4.7	3.8

[a] 1991.

[1] As a percentage of GDP. [2] Standard deviation of monthly changes over the periods January 1993 to November 1994 and January 1995 to November 1996 (to exclude the crisis-affected months of the Mexican crisis in December 1994). [3] Weighted average based on 1990 GDP and PPP exchange rates.

Source: BIS 67th Annual Report (1997), p. 105.

The Reversal of Capital Inflows

The Asian crisis broke as the enormous inflows of capital suddenly changed to capital outflows in the latter half of 1997. It was the short-term capital inflows which had been channeled through the banks and the portfolio investors which were reversed in contrast to direct equity investment which remained relatively stable. Table 4 shows the extent of the capital outflows.

The Asian financial crisis was linked with the reversal of capital inflows; however it was not capital flows per se which caused the crisis. The capital inflows were used to finance current account deficits which had been progressively widening in the region. In the early 1990s they were far larger than in the 1980s. Between 1985-89 the current account deficits averaged just 0.3 per cent of GDP in the five Asian countries at the centre of the crisis. But between 1990-96 the current account deficits averaged 4.0 per cent of GDP in most countries and they were rising.[10]

[10] J. Sachs, S. Radelet: Onset of the East Asian Financial Crisis, Brookings Institution, Washington D.C. 1998.

Table 4
External Financing in five Asian Economies[1]
(in billions of dollars)

	1994	1995	1996	1997[e]	1998[f]
Current account balance	–24.6	–41.3	–54.9	–26.0	17.6
Net external financing	47.4	80.9	92.8	15.2	15.2
Net Private Flows	40.5	77.4	93.0	–12.1	–9.4
Equity Investment	12.2	15.5	19.1	–4.5	7.9
Direct Equity	4.7	4.9	7.0	7.2	9.8
Portfolio equity	7.6	10.6	12.1	–11.6	–1.9
Private Creditors	28.2	61.8	74.0	–7.6	–17.3
Commercial Banks	24.0	49.5	55.5	–21.3	–14.1
Non-bank private creditors	4.2	12.4	18.4	13.7	–3.2
Net Official Flows	7.0	3.6	–0.2	27.2	24.6
International financial institutions	–0.4	–0.6	–1.0	23.0	18.5
Bilateral creditors	17.4	4.2	0.7	4.3	6.1
Net other residual lending[2]	–17.5	–25.9	–19.6	–11.9	–5.7
Reserves excl. gold (–: increase)	–5.4	–13.7	–18.3	23.7	27.1

[1] South Korea, Indonesia, Malaysia, Thailand and the Philippines.
[2] Incl. resident net lending, monetary gold, and errors and omissions.
[e] estimate; [f] forecast.

Source: Institute of International Finance Inc.: Capital Flows to emerging Market Economies, January 29, 1998, cited in Jeffrey Sachs, Steven Radelet: The Onset of the East and Asian Financial Crisis, Brookings Institution, Washington D. C.

The over-financing of such deficits was imprudent as it only served to detract the policy makers from diagnosing the true nature of the balance of payments disequilibrium.

But it cannot be denied that the sudden reversal of capital inflows amplified the balance of payments crises. In order to counteract capital flight these countries had to do everything to get capital to return. Therefore, as advocated by the International Monetary Fund they raised their interest rates. This further exacerbated the situation as it led to highly leveraged companies in the real sector going bankrupt which, in turn led to banks becoming insolvent. In addition there was a 'fire-sale' of assets to foreigners as many domestic assets were under-valued and had to be sold cheaply. All of this explains why issues surrounding capital mobility in emerging markets need to be given greater attention in MAI negotiations than they have received so far.

Issues Emanating from the Financial Crisis

The succession of financial crises which have occurred since the 1980s is not sustainable. The Asian

Table 5
Official Financing Commitment
(in billions of US dollars)

	IMF	IBRD	ADB	Bilateral Commitments	Total
Thailand	3.9 (505% of quota)	1.9	2.2	12.1	20.1
Indonesia	10.1 (490% of quota)	4.5	3.5	22.0	40.0
Korea	21 (1939% of quota)	10.0	4.0	22.0	57.0
Total	35	16.4	9.7	56.1	117.1
Memo item:					
Mexico	17.8 (689% of quota)	1.5	1.3	21.0[a]	51.6

[a] In addition there was a credit facility of up to 10 billion dollars with G-10 central banks, which was never activated.

Source: BIS 68th Annual Report (1998), p. 134.

financial crisis, which has been the most serious one to date, raised a number of important policy issues.

The Role of the IMF

The first and most immediate issue to emerge was the management of the financial crisis by the International Monetary Fund through provision of massive official liquidity assistance. The rescue package comprised IMF standby credits, which were extremely large relative to the countries' IMF quotas, complemented by substantial credits from the World Bank and the Asian Development Bank as well as bilateral assistance from the G-10 countries.[11] Table 5 shows the size of the official capital assistance made available for management of the crisis.

Considerable controversy has surrounded the IMF activity. Should the IMF provide financing for member countries faced with balance of payments crisis which have their source in the capital account? Under the original Articles of Agreement, Article VI, Section 1 specifies that IMF resources may not be used to "meet a large or sustained outflow of capital". But already in the 1960s this rule had to be modified to cope with flows of short-term speculative capital. The amendment of the Fund's Articles of Agreement to include the General Arrangements to Borrow (GAB) has led to the G-10 countries having to continually augment resources available for the management of financial crises which could not be handled by a country's reserves and IMF quota. The G-10 countries

[11] The G-10 countries include Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, United States and Switzerland and Luxembourg are closely connected.

recently reached an agreement with other countries to augment the GAB, supplementing it with a second facility of equal size, the so-called New Arrangements to Borrow (NAB).[12] It is inevitable that some degree of protection is afforded to creditor banks in the event of such a financial bail-out. Hence, the main criticism aimed at the IMF activity is that it is increasing moral hazard and thereby sowing the seeds for further financial crises. In order to minimise moral hazard in the future, there will be need for stricter regulation and supervision of banks. In addition, private creditors should bear a part of the burden of dealing with financial crises as suggested by the Finance Ministers of the G-7 countries in 1998.[13]

Financial Liberalisation and Banking Supervision

A second major issue to emanate from the crisis concerns financial liberalisation, the soundness of banks and the stability of the international financial system. Banks are at the centre of the international financial system because they operate the international payments mechanism and they also provide a broad range of financial services. In emerging markets they are the primary financial actors as they account for 80 per cent of all financial intermediation.

The transition from a heavily regulated to a more or less competitive financial system – if it is to prevent shocks to the system – needs to be conducted according to the principles of progressive liberalisation. The classic sequencing of financial sector reforms advocates that internal liberalisation should precede external liberalisation. Internal liberalisation comprises four elements:

- liberalisation of interest rates; elimination of selective credit controls;
- development of financial markets and money markets including the interbank and treasury bill markets;
- strengthening of prudential regulation and supervision of banks; restructuring/liquidation of unsound financial institutions;
- measures to strengthen competition in financial markets.[14]

Once substantial progress on internal liberalisation has been made and, in addition, a country has a con-

[12] B. Eichengreen, R. Portes: Managing Financial Crises in Emerging Markets, Brookings Institution, Washington D.C., April 1998.

[13] This was proposed in the communiqué of G-7 Finance Ministers and Central Bank Governors, following their meeting on February 21, 1998.

sistent record of macroeconomic stability, external financial liberalisation should take place. External capital flows should be liberalised first for current account transactions and later for capital account transactions.

A major contributing factor to the Asian crisis was the fact that external liberalisation was advanced before internal liberalisation had been properly implemented. Of special importance was the lack of adequate prudential regulation and supervision of banks. Consequently, the enormous inflows of capital took place against a backdrop of increasing fragility of domestic banking systems. A future MAI will have to include measures aimed at ensuring the soundness of banks in emerging markets.

Restrictions on Short-term Capital Flows

A third major issue which has emerged from the Asian crisis concerns the economic wisdom of capital account liberalisation for emerging markets. A number of economists have called for restrictions on short term capital movements, notably bank lending and portfolio investment. Compared to direct investment, portfolio equity investment is considered to be more volatile and destabilising as it can be liquidated and reversed in an extremely short period of time. Portfolio investors can liquidate their investment by selling their equity shares in secondary markets. In direct equity investment, companies have 'sunk costs' which imply the existence of exit costs and, hence, act as a deterrent to rapid reversal of capital inflows. The facility of exit in the case of portfolio equity investment can lead to rapid outflows of capital which can create havoc with an economy in a vulnerable situation.

FDI is long-term and welfare increasing as it complements trade in goods and services. This argument rests on the mutual gains from trade which economists have long demonstrated.[15] The evidence that capital mobility can be welfare increasing is much less solid. Dani Rodrik says on capital mobility: "We have no evidence that it will solve any of our problems and some reasons to think that it may make them worse".[16] A future MAI will have to include safeguard provisions to deal with short term capital flows to emerging markets.

Proponents of capital controls cite Chile as the model country. Chile has used capital controls to reduce short term capital flows and to increase FDI since the early 1990s. Chile has three types of controls. First it imposes a prudential tax on capital inflows: 30 per cent of all non-equity capital entering Chile must be deposited without interest earnings in the Central Bank. Second, Chilean banks and companies may raise funds on international markets only if two rating agencies rate their bonds as high as Chile's own government bonds. Third, all foreign capital flowing into Chile must be invested in the country for at least one year. This has acted as a deterrent to mutual funds and investment funds from entering Chile.[17]

The extent and severity of the crisis calls for some new thinking concerning capital movements. But despite the Asian crisis the inescapable truth is that the liberalisation of investment and capital flows go together. Foreign investment is dependent on the free movement of capital; investment flows in the global economy will be distorted or stymied by restrictions on capital mobility. And the benefits from investment flows in today's world are sought after by almost all countries.

What a future MAI must provide, therefore, is a global institutional framework which will maximise the benefits from investment and capital flows, but at the same time minimise the risk of financial crises. The MAI process to date, which has been concerned primarily with the liberaliation of FDI, with reliance on existing ancillary arrangements relating to the liberalisation of capital flows and financial services, cannot achieve this goal. The existing international institutional framework is fragmented. Competence for rule-making on matters of capital movement, banking and investment, is shared between a number of international organisations between which there is very limited cooperation. We shall next present an overview of the current situation in order to identify the weak links in the chain of international rules.

The OECD Codes

The liberalisation of capital movements among OECD countries began in 1961 with the adoption of

[14] V. Galbis: Sequencing of Financial Sector Reforms: A Review, IMF Working Paper, No. 101, Washington D.C. 1994. See also R. I. McKinnon: The Order of Economic Liberalization, 2nd ed., Johns Hopkins University Press, Baltimore 1992.

[15] J. Bhagwati: The Capital Myth, in: Foreign Affairs, April-May 1998.

[16] D. Rodrik: Who Needs Capital Account Convertibility? in: Should the IMF Pursue Capital Account Convertibility?, Essays in International Finance, No. 207, Princeton University, 1998.

[17] R. Laban, F. Larrain: The Return of Private Capital to Chile in the 1990s: Causes, Effects and Policy Reactions, John F. Kennedy School of Government, Faculty Research Working Paper R98-02, Harvard University, January 1998.

two Codes: one, a Code of Liberalisation of Capital Movements and two, a Code of Liberalisation of Current Invisible Operations.[18] The Code for invisibles covers a wide range of payments related to trade and investment and, in addition it covers a broad range of service operations.

The capital transactions to be liberalised under the Code are grouped into two categories. The first category contains priority operations which once liberalised cannot be restricted without reference to the Committee on Capital Movements and Invisible Transactions which considers all questions relating to the interpretation and implementation of the Code. The second category of transactions has received more flexible treatment. Members are free to place a reservation even after they have liberalised. This option was granted for financial transactions considered to be quite sensitive such as foreign bond issues on domestic markets and inward and outward credit operations of domestic financial institutions. The first category of transactions include capital movements related to trade and foreign direct investment, while the second category of capital movements relate to financial transactions.

As the importance of capital flows grew in the international economy the coverage of the Codes was expanded. With the latest revision in 1989 the OECD Codes now cover all capital movements and the right of establishment and freedom to provide banking and financial services. However, countries are allowed to take measures such as taxes or deposit requirements, which make international transactions more expensive, as a means of protecting their domestic financial institutions.

Most OECD countries have progressively moved to greater liberalisation since the 1980s. Nevertheless, nearly all countries have made use of the safeguard measures to restrict capital movements at times of adverse monetary conditions, balance of payments problems and currency crises. They have been mainly used to stem capital outflows and in some cases capital inflows. The areas most frequently subject to reservation have been credits and loans unrelated to trade and the issuance of foreign securities on domestic markets.

The European Union Directives

The liberalisation of capital movements has also been stimulated by the European Union (EU). Article 67 of the Treaty of Rome mandated the progressive elimination of restrictions on the movement of capital. Although the first directive on capital liberalisation was issued in 1960, little was achieved on an operational level until the 1980s when the integration of financial markets became a matter of policy priority.

The liberalisation of capital in the EU proceeded in an analogous manner to that of the OECD, that is, in two stages. The first stage was concerned with liberalising capital movements directly related to trade.The second stage went beyond current account transactions to include all transactions of the capital account, including short term capital movements. The 1988 directive established complete and unconditional liberalisation of capital movements.[19] The date for compliance was set for July 1st, 1990, but transitional arrangements took into consideration the special needs of member countries which required longer periods of time to prepare for full liberalisation. In addition, the safeguard clause provided for a country imposing temporary restrictions in the event of monetary or balance of payments turbulence without prior approval by the Commission.

The liberalisation of capital movements in the EU was part of a broader strategy to create a financial common market by 1992 and to pave the way for monetary union at a later date. The liberalisation of capital was accompanied by a series of directives to liberalise financial services in banking, securities and insurance.[20] Provisions for the external liberalisation of capital were incorporated into the Maastricht Treaty. Under Article 73b all restrictions on payments and capital movements between member states and third countries were eliminated.

Parallel to the liberalisation of capital movements under the OECD Codes and the EU Directives, the industrialised countries established minimum international standards for the prudential regulation and supervision of banks. The venue for this activity was the Bank for International Settlements (BIS) in Basle.

[18] See Ch. 3, Experience with Capital Account Liberalization in Industrial Countries, in: Capital Account Convertibility Review of Experience and Implications for IMF Policies, Occasional Paper 131, International Monetary Fund, Washington D.C., October 1995.

[19] Directive 88/361/EEC.

[20] See The European Financial Common Market, Periodical 4/1989, European Documentation, Office for Official Publications of the European Communities, Luxembourg 1989.

[21] A study published by the IMF showed that between 1980 and 1996, of the 181 current member countries 133 have had significant banking sector problems. See C.-J. Lindgren, G. Garcia, M. I. Saal: Bank Soundness and Macroeconomic Policy, International Monetary Fund, Washington D.C. 1996.

The Bank for International Settlements

As the liberalisation of financial sectors in industrial countries gathered momentum, banks were subjected to ever stronger competitive pressures as a result of which they became increasingly prone to crises. Since the 1980s there have been significant banking sector problems in countries in all parts of the world.[21]

The potential threat to international financial stability prompted central bankers and other supervisory bodies to establish standards for the prudential regulation and supervision of international banks. The BIS, which has established a network of central bankers, has been at the centre of this activity.[22] The Basle Committee on Banking Supervision was established as early as 1974 by the central bank governors of the G-10 countries to formulate guidelines for the prudential regulation and supervision of banks. In 1983 the Basle Committee issued the 'Basle Concordat' on the sharing of responsibility between countries for the supervision of international banking activity.

In 1988 the Basle Accord established internationally agreed capital adequacy ratios for banks. The objective of this regulatory convergence was to strengthen the soundness and stability of the international banking system. Furthermore, the rules should be applied in a consistent manner in countries so as to diminish sources of competitive inequality which are derived from divergent national regulations.[23] More recently it has been understood that capital adequacy is only one of a number of factors to be taken into account when assessing the soundness and stability of banks. Therefore, in 1997, the Basle Committee issued the Basle Core Principles for Effective Supervision. They contain 25 principles covering all the major areas of banking and are the most comprehensive international standards to date. They are expected to be endorsed by all bank supervisors by the end of 1998. The BIS has, until very recently, been preoccupied almost exclusively with the affairs of industrialised countries. But since 1996 it has been gradually opening up to emerging market economies.

The International Monetary Fund

A survey of capital controls existing in the developing countries at the end of 1993 showed that of the 155 members of the IMF, 25 per cent had free movement of capital. These results must be taken with some caution as countries are not obliged to give full information to the IMF on their capital account liberalisation. Many developing countries use the 'positive list approach' which means that they report only on transactions which are freely allowed. In other developing countries capital controls are not specifically reported but are included in a general statement of declaration of capital account restrictions.

The International Monetary Fund does not have competence for capital account liberalisation.[24] Article VI of the Articles of Agreement permits countries to impose and maintain capital controls for balance of payments reasons and exchange rate stability. However the IMF has a mandate for surveillance (Article IV, Section 3(b)) of member countries' policies and can exercise influence through this activity in consultations which take place on an annual basis. Generally, the IMF has restricted its policy recommendations to obliging member countries to liberalise current account transactions, discriminatory currency practices and convertibility of foreign held balances in line with Article VIII.

In its consultations with developing countries the IMF has taken a case-by-case approach with respect to capital account liberalisation. Generally, the IMF has supported a gradual approach to capital account liberalisation and is against using capital controls for balance of payments difficulties. But the IMF has deliberately refrained from an activist policy of advocating capital account liberalisation in developing countries. The exception has been the countries of central and eastern Europe where liberalisation of capital movements was strongly urged as a means of achieving significant liberalisation of FDI.

However, the original role assigned to the IMF under the Bretton Woods agreement has been overtaken by events. Following the demise of the fixed exchange rate regime and the subsequent growth of private international capital flows, its role has evolved over time. The IMF's mandate on surveillance was expanded by a decision taken in 1977 when the Executive Board made a decision on exchange rate surveillance which includes provisions for dealing with capital controls. In 1995 the surveillance mandate of the IMF was further amended at the Biennial Review

[22] See Bank For international Settlements: Profile of an International Organisation, June 1998, http://www.bis.org.

[23] For a critical evaluation of the Basle Accord see M. J. B. Hall: The BIS Capital Adequacy "Rules": A Critique, in: Banca Nazionale Del Lavoro Quarterly Review, No. 169, June 1989, pp. 207-229.

[24] See Ch. IV: Experience with Capital Account Liberalization in Developing Countries, in: Capital Account Convertibility Review of Experience and Implications for IMF Policies, op. cit.

in order to take into account the reality of increasing financial integration and private capital flows. In September 1997, the IMF took a big step forward at its annual meeting in Hong Kong where it issued a statement virtually endorsing the move towards capital account convertibility.

The World Trade Organisation

As a result of the Uruguay Round, an agreement on the liberalisation of trade in financial services was concluded under the framework of the General Agreement on Trade in Services (GATS). The first interim agreement was in place between 1995-97 with the conspicuous absence of the United States - albeit the most vociferous demandeur of the agreement.[25] In December 1997, however, a global agreement on trade in financial services was signed by 102 countries - including the United States which signaled the achievement of greater liberalisation than in the previous agreement.

The Agreement has very wide coverage. Financial services are defined as any service of a financial nature offered by a financial service supplier of a member. The full list of financial services (which is given in Appendix 2 of the Annex to the agreement) shows that all financial transactions are covered by this agreement.

The Agreement defines four modes of supply for financial services. One, cross-border supply where consumers or financial institutions in one country are free to take loans or purchase securities from banks in another country. Two, consumption abroad where consumers in one country are free to open accounts and deposit money in banks in another country. Three, commercial presence, where foreign banks establish subsidiaries or branches in a foreign country and offer financial services directly in that country. Four, movement of natural persons where personnel linked to the provision of financial services are free to move across borders.

The framework of the GATS for the liberalisation of financial services is composed of three parts. The first part consists of general rules based on well-known trade principles The general obligations of countries under these rules are most-favoured-nation (MFN) treatment of trading partners (Article II) and transparency with regard to its national regulations (Article III). The second part consists of national schedules of market access and national treatment commitments. This is where the real liberalisation takes place. Specific obligations of countries relate to market opening for foreign suppliers (Article XVI) and national treatment for foreign suppliers in the case of establishment (Article XVII). These market opening offers are inscribed in the Schedules of commitments of countries and are listed in the form of limitations or measures applicable.

The commitments made under modes one, two and three are dependent on the free movement of capital. Therefore the Agreement implies the need for partial liberalisation of the capital account. However, countries may introduce restrictions on capital flows, which could affect their liberalisation commitments, for balance of payments reasons under Article XII of the Agreement. But these restrictions are subject to consultation in the WTO committee on balance of payments. The IMF plays a similar role as for trade restrictions by providing a report assessing the country's situation with respect to financial reserves. The Annex to the Agreement contains a prudential carve-out. Countries are granted a large measure of discretion with respect to prudential regulation and no consultations on these measures are required in the WTO.

Thus we see that the liberalisation of capital movements and financial services, together with the establishment of standards for prudential regulation and supervision of banks, was coordinated among industrial countries. For developing countries there was no such coordination. The IMF has a rather ambiguous status with respect to the liberalisation of capital movements while the WTO, which has no competence in capital account liberalisation, addresses the issue indirectly through the liberalisation of trade in financial services. The prudential carve-out in the GATS agreement leaves developing countries to their own devices in matters of prudential regulation and supervision of banking. A future MAI will have to take measures to correct the institutional failures which have become exposed in the wake of the Asian crisis.

International Investment Rules and the Global Financial System

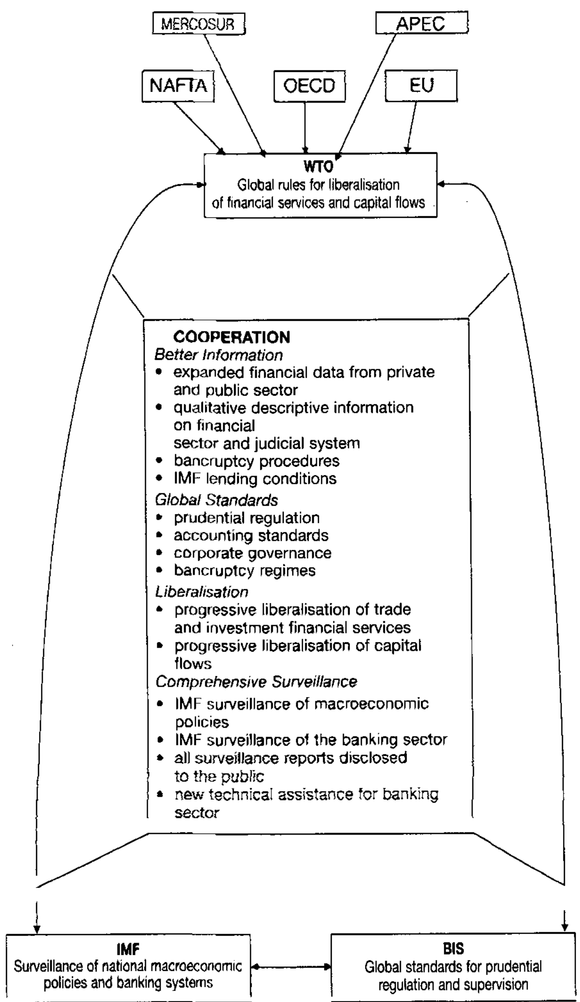
Negotiations for international investment rules so far have been conducted between a limited group of like-minded countries in the OECD. What the Asian crisis has shown is that flawed financial sectors in

[25] For an analysis of the first Agreement see P. Sorsa: The GATS Agreement on Financial Services - A Modest Start to Multilateral Liberalisation, IMF Working Paper WP/97/55, Washington D.C. 1997. See also the study published by the WTO entitled Opening Markets in Financial Services and the Role of the GATS, Geneva 1997.

developing countries and inadequate risk assessment by international creditors and investors can have negative effects throughout the global economy. Therefore, what is needed is a truly global MAI where developing countries are brought on board as active negotiators. The goal of such a MAI implies the need for existing international institutions to adapt to the more complex realities involved in the liberalisation of investment and capital flows than was hitherto imagined. The three international institutions which need to cooperate towards achieving a global MAI are the WTO, the BIS and the IMF.

The major work of the WTO to date has been trade liberalisation. But it has now become involved in the liberalisation of investment as well as trade in financial services and, hence, in the liberalisation of capital flows, through the GATS agreement. Other issues

Figure 1
Architecture of the Global Financial System



related to investment have been opened up under the Trade-Related Investment Measures (TRIMs) Agreement and the Trade-Related Intellectual Property Rights (TRIPs) Agreement under the Uruguay Round. Therefore, the WTO, with a membership of 132 countries, is the appropriate negotiating forum for liberalising investment and capital flows.

The BIS should expand its role in strengthening national financial systems. Because a banking crisis in one country can have negative spill-over effects on other countries there is need for a systematic approach to the supervision of domestic banking systems. The instruments already developed by the BIS will need to be expanded to cover a wider range of areas including, inter alia, accounting standards, full corporate governance systems, bankruptcy regimes etc. The BIS and the WTO will need to cooperate much more closely as the 'prudential carve out' of the current GATS agreement on financial services presents a threat to the global financial system.

The IMF should expand its traditional surveillance of macroeconomic policies to include banking systems. Using its Special Data Dissemination Standards, the IMF should require governments to provide full information on central banks and commercial banks in order to assess the overall health of the financial sector. In this way the IMF can foster better disclosure of financial data not only from the public sector but also from private economic agents. This information should be regularly published by the IMF. The best means of surveillance lies in maximising transparency all round so that early warning signals of impending crises can be signaled.

Our proposal for their role in strengthening the architecture of the global financial system through better cooperation between the three institutions is portrayed in Figure 1.

Conclusions

The negotiation of a global MAI presents an opportunity for achieving the necessary restructuring of international economic institutions in order to strengthen the architecture of the global financial system. This calls for adaptation and closer cooperation between the trade and financial institutions – the WTO, the BIS and the IMF. There is need for joint implementation of rules for the liberalisation of investment and capital flows, harmonised standards for prudential regulation and supervision and comprehensive surveillance of macroeconomic stabilisation policy and microeconomic banking policy.