Liberalizing Capital Movements in the ASEAN Region

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Abstract

This study:

1. Reviews international experience with capital account liberalization and highlights lessons applicable to ASEAN countries, including on the sequencing of capital account liberalization and related policy measures;

2. Provides an analysis of the current status of capital account liberalization in each ASEAN country, based on national and international reports and in-country consultations and assesses the expected effects of further capital account liberalization;

3. Relates capital account liberalization to other liberalization efforts in the ASEAN region, including for investment and trade in financial services;

4. Reviews and makes recommendations on a recent draft roadmap for capital account liberalization and develops and recommends a program and sequence of capital account liberalization and other reforms for each ASEAN country, intended to access the benefits of liberalization and minimize the risks and the costs entailed, to progress towards fuller capital account liberalization by 2020, with a thorough discussion of the policy implications and recommendations; and

5. Provides a review of the work of the Financial Stability Forum on the role of Highly Leveraged Institutions, including recommendations on measures to be taken at the international level that assist in ensuring that the risks associated with short-term capital flows are minimized.

This study was prepared for the ASEAN Secretariat under the *Regional Economic Policy Support Facility* (REPSF), a component of the *ASEAN-Australia Development Cooperation Program (AADCP).*

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Abbreviations and Acronyms

AADCP	ASEAN-Australia Development Cooperation Program
ACU	Asian Currency Unit
ADB	Asian Development Bank
ADBI	Asian Development Bank Institute
AIA	ASEAN Investment Area
AFAS	ASEAN Framework Agreement on Services
AFTA	ASEAN Free Trade Agreement
APEC	Asia Pacific Economic Cooperation
ARIC	Asia Recovery Information Centre
ASCU	ASEAN Surveillance Coordinating Unit
ASEAN	Association of Southeast Asian Nations
ASEAN+3	ASEAN plus China, Japan and Korea
BAPEPAM	Capital Market Supervisory Board (Indonesia)
BCBS	Basel Committee on Banking Supervision
BFS	Bureau of Finance and Surveillance, ASEAN Secretariat
BI	Bank Indonesia
BIS	Bank for International Settlements
BNM	Bank Negara Malaysia
BOL	Bank of Lao PDR
BOT	Bank of Thailand
BSP	Bangko Sentral ng Pilipinas
CAC	Collective Action Clauses
CBM	Central Bank of Myanmar
CFA	Chartered Financial Analyst
CLV	Cambodia, Lao PDR and Vietnam
CLMV	Cambodia, Lao PDR, Myanmar and Vietnam
CMI	Chiang Mai Initiative
CPSS	Committee on Payments and Settlements Systems
CNY	Chinese Yuan
C&S	Clearing and Settlement
DBU	Domestic Banking Unit
DVP	Delivery versus Payment
EPF	Employers Provident Fund (Malaysia)
EU	European Union
FATF	Financial Action Task Force
FCY	Foreign Currency
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FSF	Financial Stability Forum
FX	Foreign Exchange
GAAP	Generally Accepted Accounting Principles
GATS	General Agreement on Trade in Services
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
GDSC	Global Documentation Steering Committee
HKD	Hong Kong Dollar
HLI	Highly Leveraged Institutions
IAIS	International Association of Insurance Supervisors

IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IBRA	Indonesian Bank Reconstruction Agency
IFAC	International Federation of Accountants
IFC	International Financial Centre
IMF	International Monetary Fund
INR	Indian Rupee
IDR	Indonesian Rupiah
IOSCO	International Organization of Security Commissions
ISA	International Standards on Auditing
KLSE	Kuala Lumpur Stock Exchange
KRW	Korean Won
LCY	Local Currency
LOLR	Lender-of-Last-Resort
MAS	Monetary Authority of Singapore
MWGED	Multidisciplinary Working Group on Enhanced Disclosure
MYR	Malaysian Ringgit
MNC	Multinational Corporation
MOF	Ministry of Finance
NBC	National Bank of Cambodia
NBFI	Non-Bank Financial Institution
NDF	Non-Deliverable Forward
NPL	Non-Performing Loan
PHP	Philippine Peso
PIN	Public Information Notice
OBU	Offshore Banking Unit
OECD	Organization for Economic Cooperation and Development
RBA	Reserve Bank of Australia
REPSF	Regional Economic Policy Support Facility
RGTS	Real Time Gross Settlement
RIA	Roadmap for Integration of ASEAN
ROSC	Report on Observance of Standards and Codes
SBC	State Bank of Vietnam
SC	Securities Commission
SDDS	Special Data Dissemination Standard
SDR	Special Drawing Rights
SEC	Securities Exchange Commission
SEE	State Economic Enterprise
SGD	Singapore Dollar
SOCB	State Owned Commercial Bank
SOE	State Owned Enterprise
THB	Thai Baht
TWD	Taiwan Dollar
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Commission on Trade and Development
URR	Unremunerated Reserve Requirement
WB	World Bank
WP	Working Paper
WTO	World Trade Organization

Preface and Acknowledgements

This report has been prepared for the ASEAN Secretariat under the *Regional Economic Policy Support Facility* (REPSF), a component of the *ASEAN-Australia Development Cooperation Program (AADCP).*

Its preparation has been undertaken by Erskinomics Consulting Pty Limited of Sydney, Australia (see ***Annex 6*** for further details). The author is Mr Alex Erskine, Managing Director of Erskinomics, supported by advice from Dr Stephen Grenville, former Deputy Governor of the Reserve Bank of Australia, and research by Ms Loh Su Ming, CFA, Singapore. The report was presented in draft to a meeting of the ASEAN Working Committee on Capital Account Liberalization in Bangkok, Thailand, on 31 March 2003, following fieldwork visits to all 10 ASEAN countries in February-March 2003 and an inception meeting in Jakarta, Indonesia in December 2002 (see ***Annex 5*** for details of meetings). An earlier version of the final report was presented in May 2003.

The author has been assisted substantially by many individuals and organizations, especially the REPSF and the ASEAN Secretariat's Bureau of Finance and Surveillance (BFS), led by Dr Worapot Manupipatpong, and the Centre for International Economics, Canberra and Sydney, Australia, in addition to Dr Grenville and Ms Loh. Members of the ministries of finance and/or the monetary authorities or central banks and other agencies of ASEAN member countries provided substantial information and advice during fieldwork visits and subsequently. Many others, including staff of the ADB, IMF, World Bank and various research institutes and financial institutions, also gave very useful suggestions and comments. Without this assistance, the report would not have been possible.

All errors and shortcomings in the report are the responsibility of Erskinomics alone.

Executive Summary

Aim: This study is put forward in response to the terms of reference in ***Annex 1***, in the hope that it will inform and stimulate more concerted, as well as safer, efforts to liberalize capital accounts and help policymakers to develop deeper and more sustained and effective financial systems in all ASEAN countries.

Global Capital Mobility has been Increasing and Pressures to Liberalize Further will Increase: Most observers agree that global capital mobility has been increasing, and that capital account liberalization has played a significant role in the increase. There is a widespread expectation that pressures to liberalize restrictions on exchange arrangements, including capital controls, will increase over coming years.

Capital Account Liberalization Boosts Growth ….: Looking back over recent decades, the international evidence suggests that capital account liberalization, undertaken with appropriate financial sector development and capacity building and paced accordingly, can add upwards of 0.5% pa to a "typical" developing country's real economic growth rate, and typically has added more in Asian countries[*]. The main gains appear to come through higher investment and technological transfer from FDI and from the institutional- and policy-strengthening involved in attracting foreign portfolio investment into local equities and other local currency instruments.

….. but Involves Costs and Carries Risks: However, capital account liberalization brings with it a number of additional financial risks, that need to be managed. Building sound domestic financial institutions and markets and the associated infrastructure and governance regimes is both difficult and costly. The difficulties and costs should not be underestimated, though the investment is desirable in its own right to facilitate economic development. In addition, the price of capital account liberalization is, at a minimum, eternal vigilance. As shown in the Asian financial and economic crisis of 1997-98 and elsewhere, capital flow volatility can exact a terrible price. These capital account crises have been described as "the first of the 21st Century" crises; no doubt they will not be the last". Looking ahead, there can be no guarantees that liberalized capital accounts will not expose a country to costly volatility, even if all obvious risks are policed and good policies are pursued.

A Consensus is Developing on Sequencing for Safer Capital Account Liberalization: Management of the process of liberalization has become the key issue. Following the Mexican, Asian and the Russian/LTCM events in the 1990s, the proponents of early and fuller capital account liberalization have become more cautious. For instance, most now agree that short-term capital flows and loans to non-residents in local currency should be the last items to be liberalized and then only after other measures, including much-strengthened prudential regulation and supervision, have been put in place. Critics have also begun to temper their opposition to capital account liberalization *per se*, recognizing both the benefits of some forms of capital flows and the difficulty inherent in gaining the benefits from participating in world trade without some relaxation of controls over capital flows over time. Thus, both

[*] Such numerical estimates are controversial. It has proved increasingly hard to establish a strong causal connection between international financial integration and growth. Nevertheless, 4 ASEAN members, judged "more financially integrated developing economies", were in the group of 12 "fastest growing economies, 1980-2000", whereas no ASEAN members, and very few "more financially integrated developing economies", were in the group of 12 "slowest growing economies". See Prasad *et al* 2003.

advocates and critics emphasize domestic financial sector development and institution-building, as pre-conditions for a gradual sequence of measures to liberalize capital accounts.

Good Policy is Not Enough – So Make the Structure Less Vulnerable: "There's a lot of ruin in a country" according to Adam Smith, implying that one cannot rely on countries to run good policies in perpetuity. And, while "good policies" certainly help the quest of prevention of crises, crises will still occur, so it is imperative to make the financial and economic structure less vulnerable when the seemingly inevitable crisis does arrive. There has to be recognition of the reality of market failures, including through the behaviour of banks and institutional investors and highly leveraged institutions (herding, momentum plays etc.) and dynamic instability. Even in countries with the soundest and most flexible policies and best practices, capital flow reversals have caused, and will in future cause, significant instability.

Full Benefit from Financial Development "needs" Capital Account Liberalization: The good news is that domestic financial development is a worthy goal in its own right, and contributes to the economic growth and welfare of a country, irrespective of that country's plans for eventual capital account liberalization. A strong basic banking sector is an asset in the development process of any economy. However, the full benefits from domestic financial development available at more advanced stages (such as deep and broad bond and equity capital markets) are unlikely to be achieved without the interactions that stem from fuller capital account liberalization.

Safer and Riskier Types of Capital Flows: There are forms of capital account liberalization that are safer (less volatile) and more beneficial (promoting investment and economic growth) than others. We are certain that FDI flows are safer and more beneficial than short-term capital flows, and that foreigners taking equity exposure is safer than non-trade-related foreign borrowing by residents. Cross-border bank lending and institutional investors' portfolio investments (in both debt and equity securities) have shown behaviour that reflects herding and momentum trading, which increases risk of undesired volatility. We also know that "double mismatches", of maturity and currency, are especially dangerous – particularly where banks or others (corporates or individuals) have borrowed foreign currency on short tenors for investment in longer-term illiquid domestic currency assets.

Linkages with Other ASEAN Agreements for Reform … : After reviewing the extent to which formal ASEAN agreements (AFAS or AIA) compel countries to liberalize capital accounts, we can find little evidence that the capital account liberalization that is involved is overwhelming, so long as the pace and sequence of reform is considered. However, care must be taken with the modes of access that are liberalized for trade in financial services. Also, countries negotiating bilateral trade arrangements do need to consider negotiating strategies and commitments with their prudential regulator, rather than deliver the regulatory bodies a *fait accompli* that materially affects the path of financial reform. Some as yet less articulated plans (for Asian capital markets, moves towards a common currency or and Asian economic community) will have significantly greater implications and will need careful scrutiny.

1. The **AIA** involves countries liberalizing controls over inward FDI, which are the safest and most beneficial forms of capital flows, and are therefore the easiest and should be the first to be undertaken.

2. **AFAS** involves commitments to **liberalize trade in financial services** (which are explored in REPSF project RP02/006). Liberalization of barriers to trade in financial services may require extensive capital account liberalization, and attendant risks, if the trade liberalization permits cross-border supply. But a liberalization of barriers to trade in financial services that only involves allowing foreign commercial presence may only require sufficient liberalization to permit flows of FDI for capitalizing financial institutions. Still lesser capital account changes are likely to be required if the liberalization of trade in financial services only involves allowing presence of foreign persons. [In addition, see below for benefits in terms of competition, new technology and stabilization of capital flows that may result from encouraging ASEAN-headquartered and other foreign financial institutions to operate on the ground in the host country.]

3. **Less developed plans** that are becoming part of the ASEAN agenda for financial sector development (capital markets, moves towards a common currency or economic community) have more wide-ranging implications for capital account liberalization. The broader possibilities, such as a common ASEAN currency, would require massive changes to the mode of conducting policy and the structure of the financial system. They will only occur after the emergence of political will, careful analysis and sequencing the implementation of measures (including the liberalization of capital accounts) over many years. Less ambitious endeavours, such as developing equity and bond and derivative markets, may be assisted by some capital account liberalization, for instance to permit foreign portfolio inflows where they are not already allowed. Capital account liberalization can be expected to be an important catalyst in such market development.

… and Linkages with Other International Agreements for Reform: Similar issues arise from bilateral, extra-regional and global initiatives.

1. Liberalized market access has been granted as a result of negotiated trade arrangements and force of circumstance, which involves some liberalization of capital controls. In terms of **bilateral agreements**, for instance, Vietnam has agreed under the USBTA to admit US-owned banks and insurance companies within a timeframe, and Singapore has given commitments to liberalize market access for US banks etc. under the Singapore-US FTA. Thailand and others have agreed to permit full foreign ownership of financial institutions as part of the conditions for bilateral economic support in the recovery from the 1997 crisis. It will be important for the host countries in question to carefully establish what functions banks and other financial institutions are permitted to undertake (whether they are foreign-owned or domestic), in order to ensure that inflows of potentially destabilizing short-term foreign capital are monitored and contained. We understand that the Singapore-US FTA explicitly does not compel Singapore to ease or forego capital account restrictions (though, according to Bhagwati 2003, the US claim may have included such a *proforma* request). The Economist (3 May 2003) eloquently makes the case, which we support, that US negotiators ought not demand countries to forego all capital account restrictions.

2. The move to negotiate agreements between ASEAN and Japan, China and Korea (the so-called **ASEAN+3 negotiations**) has mainly focused on discussion of liberalization of trade in goods. The exception is the Chiang Mai Initiative development of bilateral swap agreements between ASEAN+3 countries. Such swap agreements have obvious, but limited, implications for capital account

restrictions as they apply to the authorities concerned. In the longer-term, any progress towards a common currency for a broad Asian country grouping will have more significant implications.

3. There is little that appears to be compulsion to liberalize capital flows at a **multi-lateral level**. Global initiatives, such as the **WTO's GATS** process, give substantial scope for countries to not liberalize trade in financial services on prudential grounds. The **IMF** does not compel its members to liberalize restrictions over the capital account of the balance of payments, though it does have a process (graduation from Article XIV to Article VIII) for encouraging its members to liberalize existing restrictions over current account transactions and to not apply new restrictions.

Good Reasons for NOT Fully Liberalizing Capital Accounts ….. : The current literature is driven by the most recent experiences, and so focuses on prudential measures that may be helpful in preventing a crisis occurring by restraining certain categories of capital inflows, and on temporary measures that may be helpful if capital inflows reverse and during the recovery process. We include as a good reason the desire to "keep it simple", meaning for the authorities to not be too ambitious and even to hasten slowly, for instance on liberalizing the use of sophisticated derivatives instruments which may shift particular risks to others not especially suited to bear them and – worse – hide the shift as if the risks have been eliminated.

..… and Less Good Reasons for NOT Fully Liberalizing Capital Accounts: But there are many other reasons put forward for not liberalizing capital accounts which are of lesser merit. To mention two: (i) nationalistic (or command-and-control) reasons to oppose foreign ownership, especially of such a sensitive and central sector as banking; and (ii) to forestall capital flight. Both seem short-sighted and inconsistent with the broader goal of sound financial sector and economic development.

1. Regarding **domestic banks**, practical experience confirms there are many good reasons for allowing foreign ownership. Such ownership brings obligatory support from the foreign parent of risky enterprises that, otherwise, host governments will have to support with public money when things go wrong. Furthermore, the stimulus to competition from the injection of foreign banks into the domestic banking marketplace is often a valuable catalyst for improvements in standards and for product innovation. The foreign-owned banks will still be subject to local rules and regulations, and there are few instances where the feared across-the-board market share gains for new foreign entrants are observed. Indeed, as most ASEAN-origin banks with international operations have discovered, opening or acquiring operations in another country is fraught with difficulty. But we readily recognize the political issues in allowing foreign ownership of a significant part of the banking system.

2. Regarding avoiding **capital flight**, permanent controls are likely to be ineffective. Instead, sustained sound economic management is required, so that capital flight is never a rational response from the public. Controls aimed at preventing capital flight are likely to be circumvented in circumstances of well-founded reasons for panic, at least by the well-connected. An ability to apply temporary controls may be desirable, however, in crisis.

What is Needed is Quarantining the Core BECAUSE Things Will Go Wrong: The central objective must be to quarantine the core of the financial sector – the banks and the payments system – from the inevitable volatility of international capital flows. One of the critical issues in judging the appropriate extent of capital account liberalization in a country will be the resilience of the banking system and the strength of prudential supervision. If the banking system has the capacity to hold together in the face of volatile capital flows, then it is very likely that the rest of the economy can wear the shocks. So a central issue will be the adequacy and enforcement of prudential controls on the banking system.

Foreign Investors Must Accept The Risks Of What They Are Doing: It is critically important to create an institutional environment in which the foreign investors accept the riskiness of their investments.

1. For sovereign borrowings, this may be achieved by inclusion of **Collective Action Clauses (CACs)** in the terms of the sovereign debt issue, which will allow an interruption or variation to debt service in event of a crisis. CACs are intended to prevent minorities from blocking restructurings that had been agreed by a large majority of creditors, making default easier to deal with. (At present CAC can be included at little cost in terms of investor appetite and pricing, see Gugiatti, 2003).

2. For private sector equity and direct investments and borrowings, it must be made clear that the state has no obligation to assist the foreign investor in any way in recouping a claim or a venture that has gone awry. Private investment risk can then be priced accordingly, as purely private risk. This process may be supplemented by a statement from the authorities of the possible use of controls that will delay outflows in event of a crisis and **"bail-in" the private foreign investors** (i.e., require private foreign investors to maintain their investments in the crisis country, and possibly even supplement their investment, rather than withdraw). This may serve to repel the more speculative inflows. [One risk, inevitable with this approach, is the possibility that investors will flee as soon as the markets speculate that the trigger is approaching for the determination that some developing adverse circumstances are indeed a crisis.]

Several additional general conclusions must be carried forward to address the needs of individual ASEAN countries:

1. **Flexibility is required in programs and sequencing:** One key feature of the emerging consensus on capital account liberalization is that flexibility is required in applying the proposed general sequence to the evolving and very individual circumstances of a country. For instance, the tasks ahead for ASEAN countries that are in transition to more market-based economies are dramatically different to the tasks ahead for the more advanced ASEAN countries, which have much more experience with capital flows.

2. **Urgent capacity building is needed in less advanced countries:** The resources required for the full analysis and assessment of the financial sector and the scope for capital account liberalization are very large, and often exceed existing capacity in individual countries, let alone the scope of this study. Urgent capacity building is warranted, supported locally and from the region and other agencies – the issues are going to have to be addressed by each country, ready or not, as the pressures from globalization proceed. In addition, it is the less advanced economies that have

the most to gain from increased access to foreign capital, but face the greatest difficulty in attracting the inflows. The ASEAN Secretariat Bureau of Finance and Surveillance could usefully play a focused role in identifying and assessing capacity building needs and facilitating assistance to the less advanced ASEAN member countries.

3. **Determining the exchange rate regime and the prudential framework cannot be rushed:** Some really big issues cannot be resolved quickly. These include the major macroeconomic issues, including over the exchange rate system (especially in transition countries whether to dollarize, de-dollarize, establish a currency board or a "hard fix", or move to managed floating or free floating etc.). Time is also required to make progress with the complex prudential and other micro issues for addressing market imperfections, such as asymmetric information and inconsistent knowledge and standards across jurisdictions. These can impede the development of a deep and broad financial sector with a full complement of institutions, instruments and markets. These reforms require very clear analysis. They involve establishing sound banking systems, new codes of conduct and standards of governance and new market mechanisms. None of these can be achieved *by fiat* or overnight.

4. **Learning by doing often beats waiting:** Some things cannot be learned from a textbook or grafted onto a country's existing processes. They have to be *learned by doing*. A key example is introducing a "credit culture" into a banking system where credit has previously been directed by the authorities. The only way to start the learning process is by making the reforms. This re-emphasizes the need for early and sustained reforms, but it also confirms the desirability of keeping the pace of development of capital account liberalization in rough balance with institutional growth.

5. **Country differences imply at least a two-speed, if not a ten-speed, ASEAN:** The majority of ASEAN members already have substantially liberalized their capital accounts, and we recommend that most of them devote their major efforts to ensuring that the risk of volatility from the liberalized flows is minimized at reasonable cost. Others have not liberalized their capital accounts to any great extent (and a few have still not fully liberalized their current accounts), and they have further to travel to gain the net benefits on offer from a safe liberalization of restrictions on flows across their borders. They have the most to gain, but face the greatest difficulties. Sequences of liberalization and prudential measures have to be prepared individually, for each country. There is no generic template will fit. The sequences of measures recommended in this study for the individual countries in ASEAN are no more than a first cut, that will have to be re-assessed and altered as reforms and development proceed.

6. **Transition economies should concentrate on developing banking systems:** We cannot be sure that the countries still at the early stages of their transformation to market economies and the development of better banking systems will actually be ready before 2020 to liberalize most of, let alone all of, their capital account regulations. We know more about their starting point and the immediate steps that can be made than what will prove possible later in the timeframe of the ASEAN goal. The program or sequencing for these countries concentrates on the early years, and must concentrate on building the basics: a sound banking system.

7. **Some more advanced economies also need to strengthen financial systems:** Some of the more developed ASEAN countries appear to us to have “gone too far” in the liberalization of their capital accounts, in comparison to their need for sounder and more supportive financial systems. The demands from the liberalized state of their capital accounts might be a considerable distraction at times of volatility in global markets from the urgent tasks of rebuilding sound banking institutions and building the capacity of the authorities to prudentially supervise and regulate the banking sector. Thus for some, we recommend some retention, re-imposition or strengthening of restrictions (e.g., on short-term flows), at least until the domestic financial systems are on a sounder footing. Sometimes one has to step backwards to ultimately move forward, as Indonesia showed in January 2001 when it moved to prohibit lending rupiah to non-residents (see next point, below).

8. **Take a cautious approach to internationalizing local currencies:** Singapore excepted, we are not in favour of ASEAN countries internationalizing their currencies very far. We are not against every aspect of internationalization of a local currency. For instance, we do favour encouraging foreigners to invest in local currency assets, including especially in FDI projects (including domestic banks) and in local equities, both for the transfer of real resources and technology and for the incentive given to improve market structures and operations and the conduct of policies. And we also favour residents being able to access foreign funds, invest in foreign assets and hedge currency exposures. But we do not see any advantage in facilitating the exit of foreign investors from their local currency exposures in volatile times. In our view, there are few reasons to allow foreign investors to borrow in local currency [except for the local currency costs of FDI projects]. In addition, foreign banks that enter the domestic banking market must meet the same prudential limits on currency exposures as are required of domestic banks.

9. **All ASEAN countries should take up offers of “free” FSAP & ROSC reviews:** The IMF and World Bank have established a mechanism of external review, the Financial Sector Assessment Program (FSAP). In our view, an FSAP can help, as it will provide a thorough review of financial sector capacity for liberalization by external experts. These are drawn from multilateral and national agencies, including from BNM and the MAS. The FSAP builds on the conventional IMF Article IV annual reviews. Both the Philippines and Singapore have recently participated as subjects for study by an FSAP; others have not yet participated. From our vantage, we see considerable benefit for individual ASEAN countries, and for the region, to invite the IMF to assemble a FSAP team to undertake such reviews. There is of course considerable work required in inviting such a study. Informally, Malaysian sources suggest that this work, and the recent efforts put into their various Master Plans, are the reasons for not inviting in an FSAP. Others yet to participate may not yet have considered the opportunity – the FSAP is only a recent development. The Philippines has also recently completed a slightly different IMF external review, of compliance with standards and codes (ROSC), targeting fiscal transparency. The ROSC reviews are also likely to be very useful to ASEAN member countries as their governance, legal and other approaches develop. The FSAP and the ROSC are not intended to be a substitute for national assessment of financial reform needs or the determination or advancement of national policies: they are studies that can give insights from international experts.

1. The recommended revised ASEAN roadmap for capital account liberalization, intended to minimize risks and maximize benefits is set out in the following table.

Recommended Revised ASEAN Roadmap for Capital Account Liberalization

Sequence of Measures to Liberalize Capital Account Restrictions	Type of Risk	Primary Policy Measures to Limit Risk from Liberalization of Specific Capital Flows	Further Precautionary and/or Facilitative Measures
1. Current account proceeds Ease (i) repatriation and surrender requirements[1] and (ii) unify any remaining dual exchange rates, so that countries can accept the obligations of IMF Article VIII.	Moves to reduce distortions brought about by dual exchange rates and/or trade barriers designed to restrict imports or subsidize exports or measures that affect the timing of payments and receipts may worsen the trade balance, disadvantage some industry and labour and/or upset the government's fiscal balance.	• Develop macro-and micro-economic policies that are conducive to productivity growth and facilitate flexibility in the deployment of capital and labour resources. • Diversify government fiscal exposures by broadening tax base and limiting expenditures and ensuring that government business enterprises face market-based prices and hurdles on return of capital. • Improve tax regime so that there is no tax advantage in not repatriating export receipts.	• Consider Asean technical and fiscal assistance where serious transitional impact would be incurred.
2. Foreign direct investment (FDI) (and, probably later, real estate investment) Ease controls and/or other restrictions on inward and outward investment flows, and on liquidation of investments by non-residents, to implement commitments under the AIA.	Despite being the safest form of capital flows, outward and inward foreign direct investment or real estate investment is often financed by financial institutions, and can give rise to credit risk that may be compounded by various other risks, including in particular foreign exchange risk. Moreover, real estate has proven to be susceptible to price bubbles. Sudden or panicky rushes of outward investment may also be destabilizing.	• Adequate risk management practices by financial institutions, reinforced by prudential regulation and supervision, are needed to mitigate these risks. • Strengthen accounting practices to ensure appropriate valuation, especially for collateral. • Improve insolvency regime. • Guard against misallocation of investment and against price bubbles and substantial currency depreciation by maintaining sustainable prospects for low inflation.	• Maintain policies that create confidence in the sustainable growth and development of the domestic economy.
	Unsound ventures or fraudulent activities.	• Increase transparency and market discipline through strong accounting and disclosure rules.	

[1] Technically, these measures are not capital controls as they involve transactions among residents, but they limit the scope for residents to undertake capital transactions.

Recommended Revised ASEAN Roadmap for Capital Account Liberalization cont./

Sequence of Measures to Liberalize Capital Account Restrictions	Type of Risk	Primary Policy Measures to Limit Risk from Liberalization of Specific Capital Flows	Further Precautionary and/or Facilitative Measures that may be Appropriate
3. Capital and money market instruments (e.g., tradeable securities including equities, bonds, and money market instruments) Ease controls that limit (i) purchases locally by non-residents or (ii) sale and issue locally by non-residents and (iii) purchases abroad by residents.	Sales and purchases by non-residents can result in sudden or large-scale reversals in capital flows, with a boom-bust pattern in asset prices that can spill over to domestic demand and the exchange rate, and entail the risk of an external or financial crisis if market access is curtailed	• Develop deep and liquid domestic markets in these instruments, with efficient payments and settlements systems, well integrated with monetary operations. • Diversify funding sources and improve maturity structure of liabilities. • Develop efficient insolvency procedures to facilitate foreclosure and debt restructuring. • Closely monitor non-resident investors' demand for domestic financial assets, including bank deposits on an *ex post* basis. • Establish appropriate lender-of-last-resort facilities to maintain market liquidity.	• Where appropriate, to limit the risk of volatile capital flows, impose or maintain Chilean-type inflow taxes and/or keep in reserve a Malaysian-style rule delaying outflows. • To gain most from liberalization and yet limit the risk of volatile capital flows, liberalize controls on inflows and outflows of equity portfolio investment before controls on debt portfolio investment. • Delay liberalization of controls over flows involving short-term debt until the end of the liberalization program.
	Sales and purchases by residents involve exposure to market risk (foreign exchange, interest rate, and price), credit risk (except for equity), and liquidity risk.	• Establish prudential safeguards, including limits on shareholdings of domestic banks and other financial institutions, and limits on lending against shares. • Ensure that financial institutions appropriately value these instruments (for example, by marking to market). • Enhance financial institutions' capacity to monitor and manage their direct and indirect (through their clients and counterparties) exposure to these instruments.	
	Mispricing of securities owing to inadequate information. Fraud	• Improve accounting, transparency, and disclosure standards. • Strengthen law enforcement.	

Recommended Revised ASEAN Roadmap for Capital Account Liberalization cont./

Sequence of Measures to Liberalize Capital Account Restrictions	Type of Risk	Primary Policy Measures to Limit Risk from Liberalization of Specific Capital Flows	Further Precautionary and/or Facilitative Measures that may be Appropriate
4. Commercial banks and other financial instruments Ease restrictions on (i) borrowing by residents abroad and (ii) lending to non-residents.	Liquidity or solvency risk related to borrowing by residents.	• Diversify funding sources and improve maturity structure and debt-equity mix. • Improve financial institutions' liquidity management and disclosure.	• Where appropriate, to limit risk of volatile capital flows, impose or maintain constraints on lending to non-residents to limit the internationalization of the domestic currency. Also, if appropriate, impose or maintain Chilean-type inflow taxes and/or keep in reserve a Malaysian-style rule delaying outflows. • Delay liberalization of controls over flows involving short-term debt until the end of the liberalization program.
	Credit risk related to lending to non-residents, which may be compounded by foreign exchange risk.	• Limit financial institutions' exposure to a single borrower or a country. • Implement internationally recognized supervisory practices for capital adequacy, asset classification, and provisioning. • Implement sound practices for credit risk assessment and management. • Develop securitized markets for credits.	
	Mismanagement and fraud.	• Increase transparency and market discipline through strong accounting and disclosure rules.	
	Slow resolution of creditors' claims undermines credit culture and reduces market access.	• Strengthen insolvency procedures that allow rapid foreclosure of assets.	

Recommended Revised ASEAN Roadmap for Capital Account Liberalization cont./

<table>
<tr><th>Sequence of Measures to Liberalize Capital Account Restrictions</th><th>Type of Risk</th><th>Primary Policy Measures to Limit Risk from Liberalization of Specific Capital Flows</th><th>Further Precautionary and/or Facilitative Measures that may be Appropriate</th></tr>
<tr><td rowspan="2">5. Derivatives and related instruments

Ease controls over transactions involving (i) forwards and futures and (ii) other derivatives.</td><td>Counterparty credit risk, which can change substantially with market conditions for underlying shares.</td><td>• Strengthen supervision capacity, including oversight to limit excessive exposures, to assess the risks associated with derivatives.</td><td rowspan="2">• Where appropriate, to limit risk of volatile capital flows, impose or maintain constraints on derivatives and related instruments to ensure that restrictions on internationalization of the domestic currency or on short-term capital flows are not undermined.</td></tr>
<tr><td>Counterparty credit risk, which can change substantially with market conditions for underlying shares.</td><td>• Develop deep and liquid markets for the underlying assets and liabilities.
• Develop risk management capacity in financial institutions, including through hiring and training skilled personnel.
• Strengthen accounting rules to properly measure the risks.
• Strengthen reporting by financial institutions on derivatives risks, and disclosure of counterparty exposures.</td></tr>
<tr><td>6. Additional Regional and/or Individual Country Measures to Minimize Risks of Excessively Volatile Capital Flows</td><td colspan="3">• Undertake thorough research, including preparing an inventory of capital controls, assessing conditions and vulnerabilities, and determining a sequence for capital account liberalization and other policies appropriate for the individual countries.
• Establish Collective Action Clauses to include in the term sheets for sovereign borrowings and establish and announce the “rules of the game” that will “bail private foreign investors in”, in event of a subsequent crisis.
• Continue to improve and implement comprehensive data-gathering, monitoring and surveillance of short-term and long-term capital flows.
• Organize a schedule of ASEAN countries as volunteers for the joint IMF/World Bank Reviews of Observance of Standards and Codes (ROSC) and Financial Sector Assessment Programs (FSAP).
• Monitor and discuss the progress of liberalization against benchmarks in work programs annually. Take care to ensure that the risk of destabilizing capital flows is limited in moves to liberalize trade in financial services.
• Given varying levels of development, consider assisting member countries that have limited capacity to assess and manage risks associated with capital flows and to implement reforms with capacity-building programs.
• Assist all countries select exchange rate regimes that minimize the risk of damage from capital flow volatility in a more liberal capital flow environment. When appropriate, address issues of practicalities of any proposed transition to a single ASEAN currency and develop appropriate convergence criteria that minimize risk of destabilizing capital flows in the transition period.</td></tr>
</table>

Source: Table 18.

A. The Recommended Roadmap or Sequence for the Short-term:

1. Liberalize any remaining restrictions impeding current account transactions (especially the IMF Article XIV countries (see (3.) below) to gain full benefit from trade flows.

2. Commence the move to a unitary exchange rate system, where a dual system persists (i.e., Myanmar), with budgetary support from within ASEAN if necessary to assist the adjustment process, to improve resource allocation.

3. Accept IMF Article VIII (i.e., Lao PDR, Myanmar and Vietnam) to "lock-in" access to the benefits of unimpeded trade flows.

4. Liberalize any remaining exchange control restrictions on inflows and outflows of foreign direct investment (FDI). These are the safest and most obviously beneficial capital flows. Restrictions on FDI motivated by social policy or other national priorities should be implemented outside of the exchange control arrangements.

5. Liberalize exchange control restrictions on inflows and outflows of portfolio equity investments. Controls motivated by social or other priorities should be implemented outside the exchange control arrangements.

6. Continue to improve and implement comprehensive data-gathering, monitoring and surveillance of short-term and long-term capital flows, both for each country and for the ASEAN group of countries. 5 countries are already involved in an ASEAN Secretariat project to improve capacity to monitor short-term capital flows – Cambodia, Indonesia, Lao PDR, Philippines and Vietnam. One means of improving monitoring would be to require all flows to be transacted through authorized intermediaries with commercial presence. The role of the BFS in coordinating surveillance and information-sharing is important and may most usefully focus on early identification of emerging threats of capital flow instability.

7. Where they are not already in place, consider for prudential reasons the introduction of Chilean-type inflow taxes (unremunerated reserve requirements (URR) on specified types of capital inflows) and/or constraints on internationalization of the domestic currency (restrictions on lending domestic currency to non-residents that may be used to speculate against the exchange rate).

8. Establish, through discussion in an ASEAN framework (organized by BFS?), the most appropriate Collective Action Clauses to include in the term sheets for sovereign borrowings, to facilitate interruption to debt service in event of a crisis.

9. Establish, through discussion in an ASEAN framework (organized by BFS?), the most appropriate "rules of the game" to "bail private foreign investors in" in event of a new crisis, to be announced at a time of further capital account liberalization.

B. The Recommended Roadmap or Sequence for the Medium- and Longer-term:

1. Strengthen the supervisory and regulatory regime through the implementation of financial, legal and structural reforms that are required for the liberalization of capital flows and other liberalization programs. Regular BFS coordination of surveillance and peer review will help drive individual country action.

2. Comprehensively address the dollarisation issue in Cambodia, Lao PDR and Vietnam (and Myanmar?), of course having regard to plans, if any emerge, for the introduction of a single ASEAN currency. There may usefully be a role for BFS to contribute to identifying capacity building needs and facilitating delivery of assistance in the countries.

3. Build or improve the effectiveness of institutional investors and security markets and risk management capacities, to reduce reliance on and the dominance of banks and the banking system. Several ASEAN-area initiatives are driving progress in this area: BFS may contribute by initiating periodic regional reviews.

4. Assist countries select the appropriate exchange rate regime that minimizes the risk of damage to the country and the region from capital flow volatility. The majority of ASEAN members have prudently adopted exchange rate regimes with some flexibility in-built, which is the international best practice for emerging markets seeking to implement independent monetary policies and maintain an open capital account. The Brunei currency board arrangement with Singapore, as a “hard-fix”, also conforms to this international best practice. Malaysia’s “soft-fix” against the US, in conjunction with an increasingly open capital account and an independent monetary policy, runs against the conventional “trilemma” wisdom, and may eventually attract destabilizing speculation. The BFS may usefully initiate this discussion in the context of minimizing risks of capital flow instability for the region.

5. Organize a schedule of ASEAN countries as “volunteers” for the joint IMF/World Bank Financial Sector Assessment Programs (FSAP) and Reviews of Observance of Standards and Codes (ROSC), with capacity-building assistance (from more advanced ASEAN member countries?) where that is requested by a member preparing for an FSAP. The following suggested order/timing for ASEAN countries not yet the subject of a FSAP is put forward to initiate discussion: Thailand 2004, Indonesia 2005, Malaysia 2006, Vietnam 2007, Brunei 2008, Cambodia 2009, Lao PDR 2011 and Myanmar 2013. This prioritization takes loose account of the anticipated level of financial sector and other development and the consequence for the region of financial instability in the country in question.

2. The Recommended Program for Individual ASEAN Member Countries

These recommendations for all 10 ASEAN countries, individually, which are reprinted from Chapter 5 of this report, are only a “first cut”. They have been based on the assessments developed in **Volume 2: Country Reports.** They need to re-assessed by the authorities in each country, on the basis of their own analysis, with guidance if necessary from BFS, so that effective and risk-minimized individual country roadmaps for capital account liberalization can emerge consistent with the overall roadmap that is developing for capital account liberalization for ASEAN.

1. **Brunei Darussalam** already has a very liberalized capital account (with some minor limits on inward FDI) and there is no significant set of measures or sequence to liberalize Brunei's capital account to be recommended. The exchange arrangements are also very appropriate, with a currency board that pegs the Brunei ringgit to the Singapore dollar at par. Brunei does not attempt to pursue an independent monetary policy, but "imports" Singapore's monetary policy. Brunei is extremely dependent, therefore, on the quality of financial and economic management in Singapore and any changes in the policy of non-internationalization of the Singapore dollar that were to lead to greater volatility in financial markets in Singapore would be of major consequence. However, Brunei does have a significant task ahead in reforming its financial system. Banks dominate Brunei's small financial system and it would be desirable to see other institutions and instruments develop in order to reduce the risk of periodic financial instability. Prudential regulations and prudential capacity need to be improved, especially if the Brunei International Financial Centre succeeds in intermediating funds, not least to contain and manage the destabilizing consequences of leakage of international funds into the domestic Brunei market. Brunei seems unlikely to need to make any sovereign bond issue, so no Collective Action Clause is required, but a warning that private investors will be "bailed in" would still be appropriate. Brunei might usefully volunteer to participate in an IMF/World Bank FSAP and ROSC once already-planned prudential reforms have been implemented.

2. **Cambodia** has a relatively loose set of restrictions on capital account flows. Our recommended sequence of measures for a safe move to fuller capital account liberalization involves initial imposition of some new restrictions and many financial sector reforms, before capital account liberalization can be safely resumed and advanced. Cambodia is very highly dollarized, with the US dollar and the Thai baht circulating freely. The riel floats. Deposits in the banking system are almost entirely denominated in foreign currencies, as are assets. This dollarization, and the very limited state of development of the financial system, has allowed an open capital account to prevail. Financial intermediation remains very limited, in part because there has been considerable financial sector volatility in the past, so bank liquidity reserve requirements have been set at a high level (80% is required); but the resultant high cost of intermediation has meant that banks do not lend, and would-be borrowers look elsewhere. Reserve requirements need to be reduced as other supervisory means of ensuring bank safety develop. Until the improvements in economic and financial sector management (which have both been significant in recent years) give confidence to the population to hold and transact in riels rather than dollars, the open capital account should be retained. But once de-dollarization commences in earnest (e.g., with the issue of riel-denominated bonds), some limitations on capital flows will be appropriate to contain short-term inflows and avoid internationalization of the riel. This will help support economic recovery and pursuit of an appropriate monetary and exchange rate policy. During this transition, it will probably be appropriate to limit outflows until the domestic savings rate has increased. A Collective Action Clause should be considered for any sovereign issue, along with other means to "bail-in" private foreign investors. Participation in an IMF/World Bank FSAP and ROSC should be scheduled for later, after substantial progress has been made with financial sector development.

3. **Indonesia** has had an open capital account for a long period and a prudent sequence of measures to achieve further liberalization of capital flows must

concentrate on financial sector and governance reforms rather than renewed capital account liberalization *per se*. Indonesia has a floating exchange rate, but is likely to accord a high priority to exchange rate stability (and other aspects of financial sector stability) for the foreseeable future, supported by a move to inflation-targeting for monetary policy. Measures that help avoid capital flow instability are therefore very desirable until the inflation-targeting regime is robustly established. A very appropriate “non-internationalization” restriction was applied from January 2001, preventing banks from lending rupiah to non-residents. The banking sector remains dominant, but is still burdened by NPLs and a lack of creditworthy borrowers. The process of intermediation (beyond consumer lending) has not revived since the crisis, with the major banks, recapitalized by the state, now channelling bank deposits mostly into bonds. The way forward lies with accelerated and effective restructuring of the corporate sector and the banking sector. This will require enormous political will, including a determination to make the legal system work, and effective enforcement of regulations. As local interest rates are likely to remain above global rates, and so attract capital inflows, it may be desirable to impose some tax via an unremunerated reserve requirement on short-term inflows. A Collective Action Clause should be considered for sovereign issues, along with other means to “bail-in” private foreign investors. Indonesia should volunteer for participation in an IMF/World Bank FSAP and ROSC once further early progress has been made with financial sector strengthening.

4. **Lao PDR** has a very regulated capital account and could benefit greatly from well-deployed capital inflows. It pursues a managed float for the kip exchange rate, which has depreciated substantially, at least until recently. There is little evidence of strong international investor appetite. The economy is substantially dollarized (less than Cambodia, but more than Vietnam). There is a small financial sector, which is bank-dominated, unconducive to economic development. The priority issue is development of a sound, broad and effective financial system, based on strengthening of current institutions. A first desirable step may be to make the changes required to be able to accept the obligations of IMF Article VIII. De-dollarization is an on-going goal, though still must rank secondary to strengthening the financial sector. Confidence in holding and using kip will be promoted by improvements in the prudential infrastructure (underway with ADB support) and continued better economic management. Controls over inward FDI should be relaxed first, as the economy progresses. If a securities market is to develop later on, some reform in capital controls will be useful, easing the approvals process to improve access for foreign portfolio investors. For risk minimization, this may also require consideration of a market-based limitation, such as an unremunerated reserve requirement. In addition, the de-dollarization process is likely to require a careful sequence of steps to limit volatility in the early stages, implying a need for controls on lending kip to non-residents. Liberalization of restrictions on outflows might best be delayed until the domestic savings rate has increased. A Collective Action Clause should be considered for any sovereign issue, along with other means to “bail-in” private foreign investors. Participation in an IMF/World Bank FSAP and ROSC should be scheduled for later, after substantial progress has been made with financial sector development.

5. **Malaysia** has had a very open capital account since the 1970s, but made clever and well-timed use of selective capital controls in the 1990s, limiting the actual emergence of financial instability. Malaysia has done more than most to ensure that foreign investors are aware that they may be “bailed-in” were a crisis to

develop. Nevertheless, risks of instability do persist: of all of ASEAN, Malaysia is the only one to now peg its domestic currency, the ringgit, against the US dollar, utilizing a “soft fix”. Nevertheless it has managed, thus far, to retain monetary policy independence despite substantially easing the selective capital controls applied in September 1998. The financial sector is bank-dominated, and the banks are engaged in domestic restructuring, but the financial system is increasingly broad and deep, with healthy progress in bond and equity market development. Prudential supervision is moving to a market-risk basis. Despite having opened its capital account substantially in the 1970s, Malaysia has built a track-record of use of temporary controls over capital flows (on outflows in 1998 and on inflows in 1994) to facilitate the maintenance or restoration of financial stability. The move in 1998 to apply measures to limit the internationalization of the ringgit was especially decisive and successful. The measures have been substantially softened now that conditions have improved. A sequence of measures to liberalize remaining restrictions over capital flows (both in and out of Malaysia) is appropriate, tied to the progress scheduled for strengthening of the financial sector and the development of capital markets. As international investor risk appetite returns, Malaysia may find renewed problems with the maintenance of a fixed exchange rate. An unremunerated reserve requirement may help in temporarily restraining some of the potentially unstable inflows. However, as the ringgit peg is not a “hard-fix” of the currency board variety, it is likely to be more sustainable and less risky to aim for continued independence in monetary policy by moving to a more flexible exchange rate. An alternative risk-minimized strategy would be yet more stringent restrictions on capital inflows and a vigorous encouragement of outflows. Potential leakage of international flows through Labuan International Financial Centre into the domestic banking system may also be a pressure point for exchange controls and prudential supervision. A Collective Action Clause should be considered for any sovereign issue. Malaysia could be an early – and well-prepared – volunteer for participation in an IMF/World Bank FSAP and ROSC.

6. **Myanmar** has a very regulated capital account and could benefit greatly from well-deployed capital inflows. A risk-minimized sequence of measures to liberalize controls over capital flows however has to start with some very fundamental reform. Myanmar is the only ASEAN country with a dual exchange rate, having an official rate fixed against the SDR for a small number of official transactions and a parallel or market rate that has depreciated sharply in recent years and applies to the majority of transactions. The financial system is dominated by banks, but intermediation is not vigorous and remains unconducive to economic development. Development of the financial sector must be a priority to catalyze economic development, and easier access for foreign investors would be a stimulant as Myanmar re-engages with the international community. Moving to a unified, and flexible, exchange rate is the first necessary step, and would facilitate acceptance of the obligations of IMF Article VIII. However, a unified exchange rate will impose significant transition costs on the budget, and may warrant ASEAN support through the transition. A second step is reform of the prudential infrastructure to supervise the risks in a more market-driven financial system. Over time, replacing the “everything is controlled” set of exchange controls with more market-sensitive measures would be appropriate. Risks could be minimized by imposition of an unremunerated reserve requirement and delays on portfolio outflows, and by specifying that banks may not lend kyat to non-residents. Liberalization of restrictions on outflows might be delayed until the domestic savings rate has increased. A Collective Action Clause should be considered for

any sovereign issue, along with other means to "bail-in" private foreign investors. Participation in an IMF/World Bank FSAP and ROSC should be scheduled for later, after substantial progress has been made with financial sector development.

7. The **Philippines** has had a quite open capital account for a long period, which has been progressively liberalized over recent years. A prudent sequence of measures to achieve further liberalization of capital flows must concentrate in a balanced way on financial sector and governance reforms, as well as capital account liberalization *per se*. The Philippines has a floating exchange rate for the peso and has moved to an inflation-targeting regime. Following the external debt crisis in the early 1980s, its exchange control arrangements focus on limiting access to the banking system for foreign exchange obligations. The financial system is bank-dominated, with banks and others having both domestic operations and Foreign Currency Deposit Units (FCDUs). Prudential supervision (and governance generally) is impeded by a weak legal framework, and needs urgent improvement. Many desirable improvements to financial sector arrangements are likely to have been reviewed by the recent IMF/World Bank FSAP and ROSC. The "non-internationalization of the peso" aspects of capital control might usefully be amplified, making explicit that bank lending of pesos to non-residents is forbidden. An unremunerated reserve requirement may usefully tax short-term inflows, if they are strong as a result of interest rates higher than world norms while inflation is brought down to sustained low levels. Over time, the capital flow approval process might be put on a more market-driven basis, depending less on official judgement. A Collective Action Clause might be considered for sovereign issues, and other means to "bail-in" private foreign investors.

8. **Singapore** is in an enviable position having substantially liberalized its capital account flows, and there is hardly a sequence of liberalization measures to propose. The monetary authority uses the Singapore dollar exchange rate, which floats, as its guide for monetary policy. The exchange control regime has been in place since the 1970s, and has focused on the non-internationalization of the Singapore dollar, together with the promotion of Singapore as a competitive international financial centre. It has high credibility. Initially focused on banking development, prudential and exchange controls split banking books into Domestic Banking Units (DBUs), regulated closely and conservatively, and Asian Banking Units (ACUs), which faced much lesser costs. To help encourage the development of Singapore's capital markets for international issuers, aspects of the restrictions have been eased, and the non-internationalization policy now extends only to not lending Singapore dollars to non-resident financial entities for use in speculative purposes and a requirement for conversion of Singapore dollars raised in Singapore by non-residents into foreign exchange before their use overseas. Over time, as prudential standards and capacity in the industry continue to increase, there will be advantages in further easing these limited restrictions, to reduce any remaining costs of the approval/transacting process. Some improvements to financial sector arrangements are likely to have been suggested by the recent IMF/World Bank FSAP. Singapore will of course be aware of the desirability of avoiding financial sector instability from capital flows in its increasingly sophisticated financial sector, not only because of the consequences for Singapore's welfare but also because any instability will flow through directly to Brunei's more fragile markets.

9. **Thailand** has had an open capital account for a long period, though some prudential restrictions on internationalization of the currency have now been imposed. A new sequence of measures to gain net benefits from further liberalization of capital flows must also concentrate on financial sector and governance reforms. Thailand manages the float of the baht exchange rate and has moved to inflation-targeting. Since just before the crisis in June 1997, the authorities have put in place a set of exchange restrictions on the supply of baht to non-residents, thus moving to limit the scope for non-residents to speculate against the exchange rate. Previously, the capital control regime was very open. Measures that created an official offshore market were reversed in 1998. The financial system is bank-dominated, but is broadening, with gradual development of other institutions and capital markets. Prudential supervision is moving to be more risk-based and focused on governance standards. Before significant further capital account liberalization is appropriate, the improvement in train in the financial sector needs to be effected, which may be accelerated by some increased foreign entry. The authorities face a dilemma. On the one hand, maintenance of stability and avoidance of risk would be facilitated if a tax, such as an unremunerated reserve requirement, were available to limit the risk of excessively strong inflows when economic momentum and inflation pick up and interest rates rise. On the other hand, in order to promote development of the securities and derivatives markets, the approvals process for non-residents seeking to issue securities in Thailand might best be eased, and risk management through derivatives also facilitated. A Collective Action Clause might be considered for sovereign issues, and other means to “bail-in” private foreign investors. Thailand should volunteer for participation in an IMF/World Bank FSAP and ROSC after further early progress has been made with financial sector strengthening.

10. **Vietnam** has extensive controls over capital flows, which are being gradually liberalized. The economy could benefit greatly from access to well-deployed capital inflows and, later, from access to opportunities obtained from capital outflows, provided risks of instability can be minimized. Of all the new ASEAN members, Vietnam most closely reflects the original members and is attempting to grow through the same strategies earlier deployed. However, Vietnam has adopted a managed float for the dong exchange rate, with the flexibility acting as a safety valve. The IMF has not yet accepted that Vietnam complies with the obligations of Article VIII on current account convertibility. Resolution of the underlying issues is desirable. The financial reform agenda is substantial and also needs early progress. The financial system is bank-dominated and saddled with a heavy burden of NPLs from SOEs, though there has been some progress with the commencement of operations of a stock market, bond tenders and insurance sector development. Prudential and legal standards are being worked on, together with improvements to operational efficacy in the major banks. Risk minimized capital account liberalization depends substantially on further financial sector strengthening. With a development plan that depends on substantial access to international capital, an early easing of restrictions on inflows (especially over FDI and other means for non-residents to take local currency risk) is appropriate. A Collective Action Clause should be considered for any impending sovereign issues, and other means to “bail-in” private foreign investors. Liberalization of restrictions on outflows might be delayed until the domestic savings rate has increased. Vietnam should volunteer for participation in an IMF/World Bank FSAP and ROSC after further progress has been made with financial sector strengthening.

Practicalities and Impracticalities of Sequencing: Robbie Burns, the renowned Scottish poet, wrote that "*the best laid plans o' mice and men oft gang astray*". The fact is that liberalization of the capital accounts in individual ASEAN countries, safe or otherwise, will not occur without strong political commitment and drive. Given the difficulties involved in any such complex task, the optimal sequence of measures may prove impractical. Most countries (including, individually, the ASEAN-6) have proceeded by doing what was politically possible at the time, even if the sequencing was back-to-front, then "learning by doing", fixing problems as they emerge, sometimes soon enough, some other times only after a crisis. The important issue in practice is to ensure that the country's capacity to address the problems is developed *pari passu* with the policy changes, so that the issues can be addressed when they arise, as they inevitably will. The degree of openness must not run ahead of the capacity of the authorities and the bankers to understand, manage and administer the risks that arise. Thus, a central bank needs to develop its risk management and supervision skills if new riskier products are to be permitted.

Local Responsibilities and Actions … : "Having to cope" with and make decisions about the degree of openness of the capital account, whether or not a country wishes to gain the net benefits that liberalization offers, has become an inevitable feature of economic development and of the world as it presently is evolving. Technological progress is a driver that cannot be wished away. Individual countries have an incentive to reap the benefits of well-managed capital account liberalization. With guidance from within ASEAN on risk minimization, the rewards of progress will be sounder financial systems and faster and more sustainable growth both for individual countries and for the region.

…. and Regional Responsibilities and Actions: The more that ASEAN (through its members and offices) can do to establish common goals and ways of thinking about issues and the provision of a forum for peer pressure, the greater the prospect that capital account liberalization can be pursued with risks minimized. The more developed ASEAN countries might provide assistance to less developed member countries, particularly in achieving convergence towards a common set of rules or minimum standards for governance (e.g., sharemarket listings, corporate law, etc.). The more advanced might also ensure that outward investment to the less advanced ASEAN members brings with it net benefits for the receiving economy. There should also be sustained urgency in developing a common monitoring system for capital flows and surveillance of economic and financial developments more generally. In addition, an ASEAN-area common approach to "bailing in" private foreign investors would be useful, aligned to rules for access to the Chiang Mai Initiative ASEAN+3 currency swap arrangements. Also, while it may not be feasible or desirable to develop any regional (or ASEAN) codes and standards, it might be possible to develop regional responses to the international standards, and achieve some regional uniformity in implementing them.

The Benefits for All in the Region from Reducing Risk in Each and Every Country: Perhaps the most beneficial contribution that the ASEAN-6 can make to the advancement of financial and economic development of the more recent ASEAN members would be to continue to develop sound financial systems less prone to volatility. There is a spillover from one country to all in the region as each puts its financial system on a sounder path. Proactive coordination of surveillance, monitoring of capital flows, provision of a conduit for information exchange and discussion of lessons learned is a very important function.

1. Objectives and Conduct of the Study

This study is put forward in the hope that it will inform and stimulate more concerted, as well as safer, efforts to liberalize capital accounts and help policymakers to develop deeper and more sustained and effective financial systems in all ASEAN countries.

The ASEAN goal of full [or fuller] capital account liberalization by 2020 will not be fulfilled unless there is more concerted action across ASEAN, by individual countries. There is rich experience to guide any more concerted action, to ensure that capital account liberalization proceeds in the safest possible way. It is important not to let the understandable caution that has followed the 1997 Asian crisis prevent further initiative and progress, where that can be a net benefit to the region and the countries in question.

The ultimate purpose of this study is to provide useful guidance for member countries in sequencing their capital account opening, in line with the ASEAN Vision to create a freer flow of capital in the region by year 2020. The report is drafted on the basis of latest 'best practice' thinking on the pros and cons of capital account liberalization and means of risk minimisation, tailored to each country, after fieldwork and a review of the status of the financial sector and its infrastructure.

The project has been carried out in late-2002 and early-2003, and has involved visits to every ASEAN country for consultations with relevant officials and others in February and March 2003 (see ***Annex 4***).

A comprehensive reassessment of the merits of extensive capital account liberalization and the measures that assist in limiting risks from volatile flows has followed the Asian financial crisis. This is more fully explored in **Chapter 2**.

Overhanging the preparation of this study is the realization that no guarantees can be given that even the most ideal sequence of liberalization and other measures will ensure that capital flows will not in due course be disruptive. We have learned, from Asia in 1997 and other crises, how markets overshoot and how international and national businesses (including banks, institutional investors and even MMCs and local corporates) behave like a herd. Such pro-cyclical and destabilizing behaviour will not be easy to change.

However, there is also near-unanimity that some forms of capital flows are hugely beneficial in economic development and that controls to block certain flows do carry a cost, which at this stage may not be fully known. In these circumstances, it is not surprising that, even though there is an emerging consensus on how to proceed in practice, there is considerable diversity in emphasis and philosophy. Policy makers will be aware of the differences between the approaches to capital account liberalization taken by the Asian Development Bank Institute/Asian Policy Forum Secretariat, and the International Monetary Fund. To foreshadow the conclusion, we find the differences in approach to be more semantic than real.

While ADBI prefers a "risk-based" approach, which it is developing, over what it sees as the IMF's "overly complex integrated" approach, in practice we can expect that similar considerations and prescriptions will prevail. Both agree that earlier more enthusiastic approaches to capital account liberalization have been replaced by more cautious and more comprehensive prudentially- and institutionally-focused approaches.

The net result is substantially greater caution in proposing and implementing capital account liberalization measures. Some capital controls are now considered appropriate by most advocates of eventual full liberalization. The favoured controls are either measures to repel short-term inflows while financial sector development proceeds, or temporary measures restraining outflows during and immediately after a crisis or potentially long-lasting measures to prevent speculation by non-residents against the currency. Nevertheless the balance of opinion still favours liberalization in the long-term, because of observed net benefits, especially from FDI and portfolio equity investments, provided measures are taken to minimize risks. Furthermore, the unstoppable march of technological progress means that all countries, even those that choose to maintain a range of capital account restrictions, must respond to the evolving pressures for global economic integration. The IMF has articulated its recommended approach in several recent papers and these provide a practical template, outlined in **Chapter 2**, for the assessments of individual countries. The Chapter thus closes with generic lessons on sequencing of reforms.

Chapter 3 reviews the current status of capital account liberalization and other financial sector developments in individual ASEAN countries. This draws on published information, the analysis of different national and international officials and researchers and our in-country fieldwork. The draft roadmap for capital account liberalization in ASEAN is reviewed, and some recommendations made for its revision, in **Chapter 4**. Recommendations of measures and the sequencing of further reforms proposed for individual ASEAN countries are put forward in **Chapter 5**.

The deliberations of the Financial Stability Forum group of countries regarding measures to control Highly Leveraged Institutions (HLIs) and appropriate policy actions are considered in **Chapter 6**. Some concluding suggestions on the role for the ASEAN Secretariat in the pursuit of risk-minimized capital account liberalization are given in **Chapter 7**. Five annexes provide supporting information, while **Volume 2: Country Reports** provides a "first cut" of assessments that each country needs to undertake to finalize its individual roadmap for risk minimized capital account liberalization. The **Addendum** outlines in summarized form the exchange arrangements applying in 2002, drawn from the IMF's excellent Annual Reports.

What the Report does NOT cover

1. Rules and regulations on **real estate investment**. Inclusion would add significantly to the amount of detail in the report.

2. **Taxation**. There should be a level-playing field facing business. Foreign investors and local investors should face the same taxation regime, neither more nor less favourable. Inclusion would add significantly to the amount of detail in the report.

3. **Anti-money laundering regulations**. Many agencies have observed to us that the global requirement for anti-money laundering legislation and action "freezes in place" the prevailing set of exchange and capital controls. This report is about risk-minimized and benefit-maximizing capital account liberalization. There are countries with very open capital accounts that meet the international requirements on anti-money laundering, so this ought not be a real constraint to liberalization.

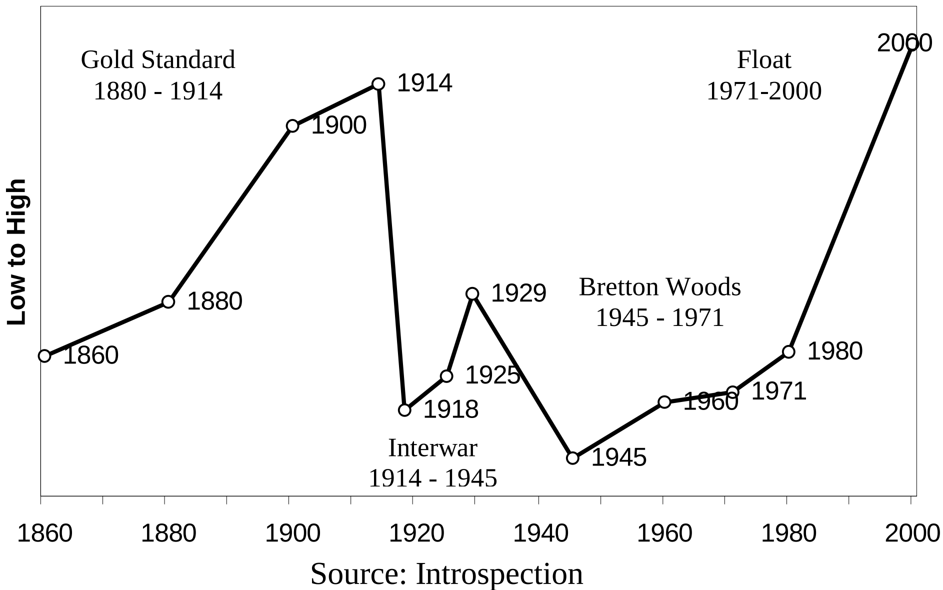
2. Lessons Learned on Capital Account Liberalization, including Generic Recommendations on Sequencing Reforms

Introduction

Capital account liberalization has become a more controversial economic policy prescription since the emerging market financial and economic crises of the 1990s. This chapter reviews the benefits and costs of liberalization and what we have learned from the experience about managing the risks of liberalization.

All observers agree that global **capital mobility has been increasing**, and that capital account liberalization has played a significant role in the increase. One authoritative impression of changes in global capital mobility over the last century or so is given in figure 1.

Figure 1: A Stylized View of Capital Mobility in Modern History



Source: Obstfeld 2002.

Several other studies have observed a purposeful and decisive reduction in barriers to capital flows across a wide range of industrialized and emerging market economies, for instance when comparing the 1990s with earlier decades, adding support to these conjectures (e.g., as summarized in Prasad *et al*, 2003).

In theory, economic growth should be raised by greater integration with the global financial system. The potential boost to economic growth can come through direct or indirect channels. Direct channels include a boost to domestic savings, a lower cost of capital due to better risk allocation, improved transfer of technology and accelerated development of the financial sector. Indirect channels include promotion of specialization, inducement for improved macroeconomic and microeconomic and institution-building policies and enhancement of capital inflows by signaling better policies.

In practice, building sound domestic financial institutions and markets and the associated infrastructure and governance regimes is both difficult and costly. The difficulties and costs should not be underestimated, though the investment is desirable in its own right to facilitate economic development. In addition, the price of capital account liberalization is, at a minimum, eternal vigilance. As shown in the Asian financial and economic crisis of 1997-98 and elsewhere, capital flow volatility can exact a terrible price. These capital account crises have been described as "the first of the 21st Century" crises; no doubt they will not be the last", according to Ghosh, 2002. Looking ahead, there can be **no guarantees that liberalized capital accounts will not expose a country to costly volatility, even if all obvious risks are policed and good policies and practices are pursued**.

Management of the process of liberalization has become the key issue. Following the Mexican, Asian and the Russian/LTCM events in the 1990s, the proponents of early and fuller capital account liberalization have become more cautious, for instance agreeing with critics that short-term capital flows be the last item to be liberalized and then only after other measures, including much-strengthened prudential regulation and supervision, have been put in place. Critics have also begun to temper their opposition to capital account liberalization *per se*, recognizing both the inevitability and the benefits of some forms of capital flows and the difficulty inherent in gaining the benefits from participating in world trade without some relaxation of controls over capital flows over time. Thus, both advocates and critics emphasize domestic financial sector development and institution-building, as pre-conditions for a gradual sequence of measures to liberalize capital accounts. This emerging consensus has been reinforced by lessons from more recent crises in Argentina and Brazil.

"There's a lot of ruin in a country" according to Adam Smith, implying that one cannot rely on countries to run good policies in perpetuity. And, while "good policies" certainly help the quest of prevention of crises, crises will still occur, so it is imperative to make the financial and economic structure less vulnerable when the seemingly inevitable crisis does arrive. There has to be recognition of the reality of market failures, including through the behaviour of banks and institutional investors and highly leveraged institutions (herding, momentum plays etc.) and dynamic instability. **Even in countries pursuing the soundest and most flexible policies and best practices, capital flow reversals have caused significant instability.**

The good news is that **domestic financial development is a worthy goal in its own right**, and contributes to the economic growth and welfare of a country, irrespective of that country's plans for eventual capital account liberalization. A strong basic banking sector is a proven asset in the development process of any economy. However, the full benefits from domestic financial development available at more advanced stages of economic development are unlikely to be achieved without the interactions that stem from fuller capital account liberalization.

There are **forms of capital account liberalization that are safer** (i.e., less likely to cause volatility) **than others**. We are certain that FDI inflows are safer than short-term capital flows, and that foreigners taking equity exposure (which includes foreign exchange risk) is safer than non-trade-related foreign borrowing by residents. We also know that "double mismatches", of maturity and currency, are especially dangerous, particularly where banks and corporates and/or individuals have borrowed foreign currency on short tenors for investment in longer-term illiquid domestic currency assets.

The approach taken in this study is a focused literature review, drawing on recent work from proponents and critics of capital account liberalization as a prescription for emerging market economies such as ASEAN member countries. The prime document is **IMF Occasional Paper 211 "Capital Account Liberalization and Financial Sector Stability", 2002**, supplemented by lessons learned from relevant countries by researchers from ADB, ADBI, APEC, ASEC, IMF and WB and other Asian-focused research institutes and authorities. For a fuller bibliography, see Annex 5.

Benefits of liberalization

The most obvious benefit of access to international capital is the relaxation of the domestic budget constraint on growth, but several other benefits can be found.

"*The October 2001 issue of the IMF's World Economic Outlook estimates that, on average, a country that has a "typically" liberalized capital account can enjoy benefits in the order of half a percent or more of GDP growth per annum. This is, of course, **a substantial potential benefit**.*" So said Tadao Chino, President of the ADB in October 2002to the ASEAN+3 Seminar on Management of Short-Term Capital Flows and Capital Account Liberalization. [emphasis added]. Compounded annually, this is a very worthwhile gain.

A fuller extract from the relevant IMF WEO elaborates this opportunity:

"Recent experience has made it clear that international financial market liberalization can have both favorable and adverse effects. On the positive side, over time liberalization can significantly raise domestic investment, create spillovers to the rest of the economy from technological transfer (particularly for FDI flows) and deepen domestic financial markets (particularly for portfolio flows). Estimates reported in [Chapter IV of the WEO] provide evidence that, for a "typical" liberalization, these benefits are associated with an increase in growth of a **half of a percent a year or more (a quarter percent from higher investment, a quarter percent from greater domestic financial development, and up to a quarter percent from FDI spillovers).** As experience has shown, however, liberalization entails significant risks. In particular, weak financial supervision and inconsistent macroeconomic policies can be associated with excessive capital inflows that are allocated inefficiently and lead to rapid capital outflows. As a result, strong overall growth benefits from liberalization are difficult to identify.

*The challenge for emerging market countries, therefore, is to **maximize net benefits from liberalization***." [emphasis added] IMF. 2001."World Economic Outlook." October. Chapter IV

The benefits flow from an expanded access to finance (where domestic savings are limited), improved resource allocation as a result of "allocative efficiency", "better policies" driven by the need to maintain confidence amongst a broader base of investors, and the efficiency gains from increased competition.

Of course, the benefits depend not only on liberalization of the capital account but also other market developments. There is considerable **interdependence**. For instance, across Asia there is an eagerness to develop deeper and more effective bond markets, for both government and corporate issues. However, without quite open capital accounts, bond market development is likely to be stunted. For instance, one of the principal catalysts for bond market development in Australia was the full liberalization of the capital account in 1983 (see McCray, in ADB 2001 "Government Bond Market Development in Asia.").

The conclusions of some of the more recent studies are summarized in **Box 1**:

Box 1. Researching the Benefits of Capital Account Liberalization

Edison *et al*, IMF researchers, have recently surveyed 10 or more studies that have looked at whether capital account liberalization has boosted or impeded economic growth and have found the evidence "somewhat mixed". Their regression results suggest that the main beneficial effect of capital account liberalization on growth had been seen in East Asian countries. Amongst the stronger conclusions of the studies surveyed are that liberalization provided greater benefits in industrial countries and richer emerging markets than in other developing countries, and that liberalizing foreign access to domestic equity markets tends to promote faster economic growth."
Edison, Hali J. and Michael Klein, Luca Ricci and Torsten Sløk. 2002. "Capital Account Liberalization and Economic Performance: Survey and Synthesis." IMF Working Paper WP/02/120, July.

Agénor, a World Bank researcher, has looked at the same issues. His paper "argues that financial integration must be carefully prepared and managed to ensure that benefits outweigh short-run risks. Prudent macroeconomic management, adequate supervision and prudential regulation of the financial system, greater transparency, and improved capacity to manage risk in the private sector, are important requirements for coping with potentially abrupt reversals in pro-cyclical, short-term capital flows. It differs, however, from some existing assessments by adopting a more sceptical view in two areas. First, only foreign direct investment appears to provide "dynamic gains" and improved prospects for growth; the evidence on the benefits of other types of capital flows remains weak. Second, empirical research on the net benefits associated with foreign bank penetration is far from being conclusive; in particular, the possibility that such penetration may lead to adverse changes in the allocation of credit among domestic firms cannot be dismissed on the basis of the existing evidence."
Agénor, Pierre-Richard. 2001. "Benefits and Costs of International Financial Integration: Theory and Facts." World Bank Conference on Financial Globalisation: Issues and Challenges for Small States, March.

Kaminsky and Schmukler, in another World Bank paper, "examine the short- and long-run effects of financial liberalization on capital markets. To do so, [they] construct a new comprehensive chronology of financial liberalization in 28 developed and emerging economies since 1973. [They] also construct an algorithm to identify booms and busts in stock market prices. [Their] results indicate that financial liberalization is followed by more pronounced boom-bust cycles in the short run. However, financial liberalization leads to more stable markets in the long run. Finally, [they] analyze the sequencing of liberalization and institutional reforms to understand the contrasting short- and long-run effects of liberalization."
Kaminsky, Graiala Laura and Sergio L. Schmukler. 2002. "Short-Run Pain, Long-Run Gain: The Effects of Financial Liberalization." World Bank Preliminary Paper, May.

Chari and Henry, in their NBER paper, find that "in the year that capital-poor countries open their stock markets to foreign investors, the growth rate of their typical firm's capital stock exceeds its pre-liberalization mean by 4.1 percentage points. In each of the next three years the average growth rate of the capital stock for the 369 firms in the sample exceeds its pre-liberalization mean by 6.1 percentage points. However, there is no evidence that differences in the liberalization-induced changes in the cost of capital or investment opportunities drive the cross-sectional variation in the post-liberalization investment increases."
Chari, Anusha and Peter Blair Henry. 2002. "Capital Account Liberalization: Allocative Efficiency or Animal Spirits." NBER Working Paper WP 8908, April.

Some readers might expect the research outlined in **Box 1** to look overly-favourably at the results of liberalization, as it emanates from institutions generally thought to be proponents. However, the very similar conclusions are found in studies undertaken from perspectives as likely to be more sceptical, e.g., by Wyplosz, 2001, for the G-24 under UNCTAD auspices. The message from the literature is that capital account liberalization can produce significant net benefits, especially over a long period, but there is no guaranteed formula and there are risks a-plenty.

Costs of liberalization and risks to guard against

Some of the **potential costs and risks**, seen or feared by observers, including most seen after the Asian crisis, are as follows:

a. Concentration of Capital Flows and Lack of Access, leading to sharp fluctuations in flows of finance and therefore in demand and activity as the sector that has attracted a surge of finance begins to disappoint investors.

b. Domestic Misallocation of Capital Flows, with speculative surges in investment in unproductive assets a common outcome.

c. Loss of Macroeconomic Stability, leading to loss of choice of exchange rate regime and volatility in the level of international reserves.

d. Pro-cyclicality of Short-Term Capital Flows, whereby short-term capital continues to flow into a country even when apparently appropriate policy instruments (e.g., higher interest rates and a rising currency) are being used to slow demand and activity, whereas short-term capital may continue to flow out even when corrective economic policies are implemented to revive an economy hit by outflows.

e. Herding, Contagion, and Volatility of Capital Flows, with financial sector and investor behaviour proving disruptive to the maintenance of stability.

f. Risks from Entry by Foreign Banks, where fears are fanned that domestic banks will not be able to withstand the competitive onslaught if foreign banks, with presumed better access to foreign sources of capital and better technology, are permitted direct commercial presence, and that some domestic sectors of no interest to the foreign banks (e.g., SMEs) will therefore suffer an lack of access to finance. Compounding these fears is a concern that foreign banks may be more prone to engaging in capital account flows that lead to instability.

Many of these potential costs and risks of capital account liberalization are very real, whereas some appear to us to have been analyzed poorly and the wrong lessons have been drawn. It is our contention that they can certainly be managed and reduced (see the continuation of this chapter), but they cannot be eliminated in their entirety.

For instance, many judge that the "**double mismatches**" that banks and their corporate customers had developed in their balance sheets contributed heavily to the severity of the financial and economic downturn in Asia in 1997. These were mismatches of maturity and currency exposure in financial assets and liabilities. Typically, bank and corporate assets were long-term; liabilities were short-term. And bank and corporate assets were denominated in local currency, but liabilities in foreign currency.

Since these "double mismatches" could not have arisen without a permissive capital account environment or without a failure to enforce controls where they existed, many have taken away the message that capital account liberalization is undesirable. Certainly our fieldwork brought to the fore a **profound caution** about thinking about further liberalization, and the little interest that we found was focused on whether controls can help, and if so, in what form and for how long[*].

Capital account liberalization undoubtedly exposes an economy, and especially the financial sector, to **increased and more complex risks**, than are faced in an economy and a financial system without access to international capital flows. As a result, risk management skills have to improve. Banks, central banks and monetary authorities (including supervisors) and corporates all need **increased skills**.

For instance, the **risks in cross-border transactions** include:

- **Credit risk**, including transfer risk, settlement risk and country risk;

- **Market risk**, including foreign exchange risk, interest rate risk repricing risk, yield curve risk, basis risk and risk in derivatives transactions;

- **Liquidity risk**.

With international trade and international integration increasing, whether or not capital account liberalization proceeds, the **cost of acquisition** of such risk management skills has to be seen as a necessary aspect of participating in the global economy.

Another cost attributed to capital account liberalization is the **additional international reserves** that a liberalizing country may seek to hold to ward off potential capital flow instability. Rodrik makes the following calculation of the "**social cost**" of reserves:

[*] It does seem to us that some "solutions" to the "double mismatches" are in the hands of the authorities, which do not require the prohibition of borrowing from abroad by residents. If the banking sector (including the central bank in the management of its international reserves) can be contained from running large mismatched positions, other residents (corporates and/or individuals) may still choose to run "double mismatches" by borrowing from foreigners. If they seek to hedge those positions, as many should, the transactions will have to be done with foreigners/non-residents ("good" foreign investors) who are willing to carry exposure to the local currency. Thus, tight enforcement of limits on the open exchange positions that banks may run and an effective education campaign for borrowers on the risks in foreign currency exposures and the means of managing those risks may go some way to lessening the risks from a build-up of "double mismatches". A lesser willingness to borrow in foreign currencies, and an increased need to attract foreign investors willing to take on exposure to the domestic currency would probably serve to reduce net capital inflows, thereby lowering the risk of destabilizing outflows at times of stress. The mix of macroeconomic policies would have to be rebalanced, with tighter fiscal policies allowing looser monetary policies (lower interest rates, more in line with world rates), and more flexible exchange rates accompanied by less willingness to accumulate foreign currency reserves.

Table 1. "Social Cost" of Reserves

	Foreign reserves (mil $, 2000:I)	Reserves in months of imports	"Excess" reserves (% of GDP)*	Annual social cost of excess reserves (% of GDP)**
South Korea	83,581	7.0	11.7	0.70
Peru	9,041	12.2	11.9	0.72

* "Excess" refers to the level beyond the 3-month benchmark. ** Assuming a 6% spread between the yield on foreign reserves and the marginal cost of borrowing. Source: Rodrik 2000.

Applying Rodrik's methodology to Asian economies for which comparable published data for 2001 is available shows that most "older" ASEAN countries have reserves well above the 3-months-of-imports-equivalent that is the international "rule of thumb" for sufficiency. **The derived estimated social cost of excess reserves is significant.** Reserves have increased strongly since the end of 2001 in most cases. But the **newer members of ASEAN have less reserves**, both absolutely and in terms of months of import cover, and still need to accumulate reserves to reach a safe minimum.

Table 2. Estimated "Social Cost" of Reserves in Selected East Asian Economies

Using Rodrik's methodology	Foreign Reserves (mil $, 2001)	Reserves in months of imports	"Excess" reserves (% of GDP)*	Annual social cost of excess reserves (% of GDP)**
China PRC	215605	10.62	13.0	0.8
Indonesia	27246	10.54	13.6	0.8
Korea	102753.3	8.74	16.3	1.0
Lao PDR	130.93	2.98	na	na
Malaysia	30474	7.69	21.1	1.3
Philippines	13442	5.19	8.0	0.5
Thailand	32355	6.23	14.5	0.9
Vietnam	3674.6	2.76	na	na

Source: see table 1 for methodology, and IMF International Financial Statistics March 2003 for data, using Reserves minus Gold and cif-based imports.

However, whether the "excess" reserves are due entirely, or even in significant part, to capital account liberalization *per se* is very debatable. The higher reserves that are being held could as easily be seen as a **logical consequence** of stabilizing exchange rates at low levels or, more negatively, as the **insurance** necessary to sustain what appear in several cases to be still undesirably rigid exchange rate regimes. Countries with more freely floating exchange regimes (e.g., Australia and New Zealand) have got by with reserve levels closer to the global rule of thumb.

Risk Minimization and Lessons Learned

The volatile experience with capital flows has provided a substantial body of evidence on which to build some **generic prescriptions for sequencing** and pacing measures to liberalize capital flows and putting in place other precautionary measures that serve to reduce the risk of volatility and disruption. Tables 3 and 4 set out a variety of country experience with capital account liberalization:

Table 3. Countries That Avoided Crisis

Country & Crisis	Sequence	Pace	Precautions	Results
Austria integration into regional and global markets	Created stable macroeconomic environment and sound, well-supervized financial system **before** full capital account liberalization	**Cautious and gradual** capital account liberalization from 1986 to 1991. Long-term flows freed **before** short-term flows	Improved capacity of banks, corporates and households to manage risks	Avoided both external and financial crises that afflicted Sweden etc.
Hungary resilience to contagion from the 1998 Russian crisis	Liberalized capital account **after** 1995 crisis, with bank privatization and strengthened prudential regulation and supervision	FDI liberalized early and other long-term flows liberalized **before** short-term flows	Macroeconomic policies returned to sustainable footing **and** financial sector reforms implemented forcibly	Helped limit effects of the 1998 Russian crisis
South Africa contagion from the 1997-98 financial crisis	Established sound domestic financial infrastructure **before** liberalizing restrictions on non-residents' capital flows in 1995	Controls on residents lifted **more gradually**, some controls in place still when crises hit in 1997-98	Sound macroeconomic policies, well-capitalized banking system and low corporate debt	No financial crisis, despite some contagion from emerging markets crises
United Kingdom 1992 ERM crisis	Removed all remaining exchange controls in 1979	**Long history** of foreign investment	Market discipline from financial centre role, and continuous upgrading of prudential policies	Banking system resilient through ERM crisis of 1992

Source: Derived from IMF. 2002. "Capital Account Liberalization and Financial Sector Stability." Occasional Paper 211. Page 17.

Table 4. Countries That Experienced Serious Crises

Country & Crisis	Sequence	Pace	Precautions	Results
Mexico 1994-95 crisis	Liberalized FDI in 1989, and continued significant liberalization in early 1990s	Substantially liberalized capital account over 5 years	Growing macroeconomic imbalances **inconsistent** with exchange rate regime, **poorly supervised financial sector,** and **political turmoil**	Financial and economic crisis at end-1994, early-1995, with collapse of *peso* and banks, resulting from excessive short-term foreign borrowings
Sweden early 1990s twin crises	Domestic financial liberalization in early-1980s **and** controls lifted on long-term capital flows **before** further capital account liberalization in late-1980s	Substantially liberalized capital account over 10 years	**Banks not prevented from incurring excessive risks** in more market-based regulatory environment, and macroeconomic policies **too expansionary**	Credit boom fuelled by external borrowing and fixed exchange rate; crisis after bubble burst
Turkey 1994 & 2000 crisis	Liberalized capital flows quickly between 1988 and 1991	FDI liberalized only slightly earlier than portfolio investment	**Inadequate prudential** regulation and supervision, exchange rate policy **inconsistent** with macroeconomic policies, excessive lending by SOBs	Excessive risk-taking led to severe financial and economic crisis in 1994 (similar to Mexico) and again in 2000-01
Korea 1997 twin crises	Gradual capital account liberalization, with outflows liberalized first, in second half of 1980s, but inflow controls then tightened and only gradually loosened later, especially for FDI	**Gradual** capital account liberalization, considerable restrictions still in place when Asian crisis hit in 1997	Regulatory **bias** towards short-term borrowing and **poor** credit culture/directed credit, compounded by **lax** prudential regulation and **fragmented** supervision, produced an **inefficient** financial sector and **over-leveraged** corporate sector	High leverage (inc. short-term borrowings from abroad) and low profitability made *chaebols* and banks vulnerable to shocks
Paraguay 1995-98 crisis	Significant trade and domestic financial liberalization and further capital account opening in 1989 and early-1990s	Relatively **rapid** pace of domestic and capital account liberalization	Serious **weaknesses** in financial sector, **inadequate** prudential regulation and supervision. But foreign banks present, and macroeconomic policies reasonably balanced	Rapid expansion of financial intermediation fueled by large capital inflows led to a financial sector crisis in 1995-98. Foreign banks mitigated the outflows

Source: Derived from IMF. 2002. "Capital Account Liberalization and Financial Sector Stability." Occasional Paper 211. Page 17.

It is a **complex story**. Some countries that liberalized rapidly "got away with it" for considerable periods, as Indonesia and Malaysia did for more than two decades before the Asian crisis struck. Some others who liberalized more gradually still got embroiled in crisis. **The overriding lesson from the "capital account crises" of the 1990s seems to be that sound and strong financial systems have helped to limit the damage done by the disruptions from capital flow volatility.** Nevertheless, **no country can be entirely insulated from such disruptions**.

Other Lessons from Asia

Several studies have observed that East Asian countries have generally been more successful with capital account liberalization, in the sense of it leading to improved economic growth outcomes, than have other countries, e.g., from Latin America. Nevertheless **the sequence in Asian countries, as judged in hindsight, was actually "wrong"** or does not accord with today's emerging conventional wisdom:

1. Most countries in East Asia **liberalized before putting in place the requisite legal structure and rule of law and supervision**. (Kaminsky 2002)

2. Some countries (e.g., Korea) **liberalized short-term bank-based capital flows rather than the safer longer-term flows**. (ASEAN Secretariat. 2000. "A Comparative Analysis on Financial Development and Banking Sector Reform in ASEAN-10: A Critical Appraisal.")

3. Some Asian countries had only **liberalized trade in financial services relating to risky cross-border bank lending and borrowing** (so-called "mode 1 trade", which involves cross-border supply), **but not the safer direct presence**. This exacerbated the risk of destabilizing capital flows and currency mismatches, by facilitating short-term cross-border flows and encouraging use of foreign currency. Direct presence would have been more likely to promote use of local currency. (Kono 1999.)

4. "Too often [in Asia], **financial liberalization** - both internally and externally – has been a **synonym of accelerated development of short-term instruments**. Domestic financial liberalization, with its removal of limits to bank interest rates, credit expansion and required reserves, has often resulted in a fast acceleration of bank credit and … of money aggregates. External liberalization, in turn, has prompted a large upswing of short-term inter-bank funding from more developed to developing economies." (Chang 1999)

The country that successfully avoided most of the problems of the 1997 crisis was **Singapore**. It had done more than most – in a unique way, that is probably not replicable within other ASEAN countries – to both develop a high quality and well regulated financial sector, providing a wide range of financial services through domestic and international providers without unfettered internationalization of the Singapore dollar. (For one fuller account, see Tan Khee Giap and Chen Kang in Asian Development Bank. 1999. "Rising to the Challenge in Asia: A Study of Financial Markets.").

Policies to Manage the Risks of Capital Account Liberalization

There are several key policy measures that countries can put in place to address the types of risks raised by specific capital flows – see table 5 overleaf.

Note that these key policy measures need **not** include prohibition of particular flows or controls on those flows: instead, the purpose of the table is to spell out what key policy measures are required or may be desirable for risk management purposes **if** a particular capital flow is to be permitted.

Table 5. Liberalizing Specific Capital Flows and Policies to Manage the Risks

Type of Risk	Key Policy Measures
1. Tradable Securities (Equity Shares, Bonds, and Money Market Instruments)	
Sales and purchases by non-residents can result in sudden or large-scale reversals in capital flows, with a boom-bust pattern in asset prices that can spill over to domestic demand and the exchange rate, and entail the risk of an external or financial crisis if market access is curtailed	• Develop deep and liquid domestic markets in these instruments, with efficient payments and settlements systems, well integrated with monetary operations. • Diversify funding sources and improve maturity structure of liabilities. • Develop efficient insolvency procedures to facilitate foreclosure and debt restructuring. • Closely monitor non-resident investors' demand for domestic financial assets, including bank deposits on an *ex post* basis. • Establish appropriate lender-of-last-resort facilities to maintain market liquidity.
Sales and purchases by residents involve exposure to market risk (foreign exchange, interest rate, and price), credit risk (except for equity), and liquidity risk.	• Establish prudential safeguards, including limits on shareholdings of domestic banks and other financial institutions, and limits on lending against shares. • Ensure that financial institutions appropriately value these instruments (for example, by marking to market). • Enhance financial institutions' capacity to monitor and manage their direct and indirect (through their clients and counterparties) exposure to these instruments.
Mispricing of securities owing to inadequate information. Fraud	• Improve accounting, transparency, and disclosure standards. • Strengthen law enforcement.
2. Derivatives and Related Instruments	
Counterparty credit risk, which can change substantially with market conditions for underlying shares.	• Strengthen supervision capacity, including oversight to limit excessive exposures, to assess the risks associated with derivatives.
Liquidity risk, legal risks regarding collateral and failed enterprises.	• Develop deep and liquid markets for the underlying assets and liabilities. • Develop risk management capacity in financial institutions, including through hiring and training skilled personnel. • Strengthen accounting rules to properly measure the risks. • Strengthen reporting by financial institutions on derivatives risks, and disclosure of counterparty exposures.
3. Commercial and Financial Credits, and Deposit Transactions	
Liquidity or solvency risk related to borrowing by residents.	• Diversify funding sources and improve maturity structure and debt-equity mix. • Improve financial institutions' liquidity management and disclosure.
Credit risk related to lending to non-residents, which may be compounded by foreign exchange risk.	• Limit financial institutions' exposure to a single borrower or a country. • Implement internationally recognized supervisory practices for capital adequacy, asset classification, and provisioning. • Implement sound practices for credit risk assessment and management. • Develop securitized markets for credits.
Mismanagement and fraud.	• Increase transparency and market discipline through strong accounting and disclosure rules.
Slow resolution of creditors' claims undermines credit culture & reduces mkt access.	• Strengthen insolvency procedures that allow rapid foreclosure of assets.

Table 5. Liberalizing Specific Capital Flows and Policies to Manage the Risks cont./

Type of Risk	Key Policy Measures
4. Foreign Direct and Real Estate Investment	
Outward and inward foreign direct investment or real estate investment is often financed by financial institutions, and can give rise to credit risk that may be compounded by various other risks, including in particular foreign exchange risk. Moreover, real estate has proven to be susceptible to price bubbles.	• Adequate risk management practices by financial institutions, reinforced by prudential regulation and supervision, are needed to mitigate these risks. • Strengthen accounting practices to ensure appropriate valuation, especially for collateral. • Improve insolvency regime.
Unsound ventures or fraudulent activities.	• Increase transparency and market discipline through strong accounting and disclosure rules.

Source: IMF. 2002. "Capital Account Liberalization and Financial Sector Stability." Occasional Paper 211. Page 15.

In an ideal world, the policy measures to contain the risks would be addressed by the regulators and the market participants ***before*** the specific flow is permitted. But the world is not ideal. Instead there has to be learning by doing and a continuous process of improvement and reform. As Prasad *et al*, 2003, surmise: "The review … does not … provide a clear road map for the optimal pace and sequencing of integration. For instance, there is an *unresolved tension between having good institutions in place before undertaking capital market liberalization and the notion that such liberalization can itself help import best practices and provide an impetus to improve domestic conditions*. Such questions can best be addressed only in the context of country-specific circumstances and institutional features." [Emphasis added.]

One clear lesson learned has been that capital account liberalization is especially **unsustainable with weak standards of financial sector governance**. Thus, all programs of measures to prepare an economy for capital account liberalization involve an improvement in standards of governance. As a critic, Rodrik views the cost of these improvements as **costs of liberalization**, whereas in our view they may be better considered as merely the costs of development in a globalizing world, and the improvements in standards as a good thing in their own right.

Rodrik rails that "twelve of these **standards** have been designated by the Financial Stability Forum (FSF) as key for sound financial systems in developing countries, and are listed in Table 6, [see overleaf]. … these are only the **tip of the iceberg**. The full FSF compendium includes an additional 52 standards "considered relevant for sound financial systems," bringing the total number of codes to 64."

For its part, the FSF explains: "The 12 standard areas highlighted here have been designated by the FSF as key for sound financial systems and deserving of priority implementation depending on country circumstances. While the key standards vary in terms of their degree of international endorsement, they are broadly accepted as representing minimum requirements for good practice. Some of the key standards are relevant for more than one policy area, e.g. sections of the Code of Good Practices on

Transparency in Monetary and Financial Policies have relevance for aspects of payment and settlement as well as financial regulation and supervision."

Table 6. Key Standards According to the Financial Stability Forum

Subject Area	Key Standard	Issuing Body
Macroeconomic Policy and Data Transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard General Data Dissemination System[1]	IMF
Institutional and Market Infrastructure		
Insolvency		World Bank[2]
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)[3]	IASC
Auditing	International Standards on Auditing (ISA)	IFAC
Payment and settlement	Core Principles for Systemically Important Payment Systems Recommendations for Securities Settlement Systems	CPSS
Market integrity	The Forty Recommendations of the Financial Action Task Force 8 Special Recommendations Against Terrorist Financing	FATF
Financial Regulation and Supervision		
Banking supervision	Core Principles for Effective Banking Supervision	BCBS
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Core Principles	IAIS

1. Economies with access to international capital markets are encouraged to subscribe to the more stringent SDDS and all other economies are encouraged to adopt the GDDS.
2. The World Bank is co-ordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate implementation.
3. Relevant IAS are currently being reviewed by the IAIS and IOSCO. The International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) are distinct from other standard-setting bodies in that they are private sector bodies.
Source: Financial Stability Forum. 2002. "Implementing international standards for stronger financial systems"

There appears to be general (and welcome) acceptance within ASEAN that such **international standards, amended to suit local risks and conditions, are appropriate and the authorities are moving – in general – to meet and apply the standards**. As that occurs, the risks from further liberalization of capital account flows will tend to diminish, though the risks will not be eliminated.

Given the potential benefits and risks, where do we stand? In our view, the prevailing global and Asian view is that capital account liberalization can produce net benefits and most countries see merit in attaining those benefits and managing the risks. But the risks cannot be ignored. Indeed, as the President of the ADB has said (*emphasis added*):

"It is important to note, however, that even when all the preconditions are in place, and capital account liberalization is pursued in a sensible and prudent manner, there can still be **surges in short-term capital flows that can be destabilizing**. In a world characterized by high and increasing capital mobility, this possibility is a very real one. If the surges in short-term capital flows are large enough, then countries might once again find themselves facing a crisis situation."

"In such a situation, there could be ***a case for imposing temporary capital controls on a selective basis****. These controls should be designed to stem the destabilizing flows of short-term capital driven by swings in investor sentiment. Apart from this, such capital controls could provide the breathing space for countries to introduce necessary financial and macroeconomic reforms to avert future crises. Countries using temporary capital controls must also be vigilant to* ***avoid a situation where such controls become a rigid policy****;* such a scenario can lead policy-makers and regulators to defer, or delay, the essential task of strengthening the domestic financial system, or restoring macroeconomic stability."

"The experience of **Malaysia** in using selective and mostly temporary capital controls provides a useful benchmark in this respect. Since the controls were introduced in September 1998, Malaysia has instituted a range of financial sector and macroeconomic reforms, making it more resilient to any future shocks. Malaysia has also reversed all controls imposed on portfolio capital."

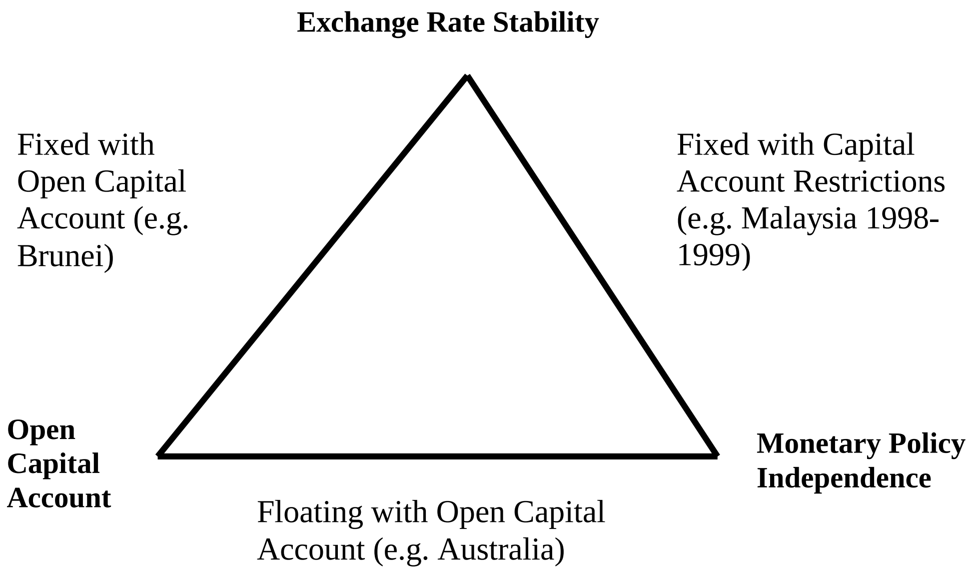
Tadao Chino, President, ADB, 10-12 Oct 2002, Beijing, China, ASEAN+3 Seminar on Management of Short-Term Capital Flows & Capital Account Liberalization.

Still more recent assessments, independent of this study, (Prasad 2003 and The Economist 2003) have also concluded, as we do, that **some selective capital controls are desirable** and the goal of compete liberalization of controls over capital flows is wise for only a few exceptionally well positioned economies.

The "Tri-lemma" and Capital Controls

It has become an **article of faith in economics** that a country cannot simultaneously target (1) an open capital account, (2) a fixed exchange rate, and (3) pursue an independent monetary policy (that is, a monetary policy aimed at a domestic price or activity target). **This constraint**, sometimes known as the "impossible trinity," or "tri-lemma" complicates efforts to implement stabilization policy. While it can be overstated, it highlights **an implied trade-off**, with one target often having to be sacrificed or given a lesser priority – see figure 2.

Figure 2. The "Tri-lemma"



For example, if, as a result of attractive returns, capital is flowing into a country and the central bank keeps the domestic interest rate high to dampen domestic demand, the currency will tend to appreciate, hurting exporters. If the central bank chooses to stabilize the exchange rate instead, it must purchase the foreign currency that is flowing in by "printing money" and allowing domestic interest rates to fall, which may lead to excessive domestic money creation and bank lending, an unsustainable boom in economic activity, a rise in inflation and an ultimate crash if the capital inflow suddenly reverses. With capital controls, a central bank can set both the interest rate and the exchange rate simultaneously, within reason, **at the cost** of foregoing capital inflows that could finance productive activity.

The international consensus has swung towards some tolerance, or even enthusiasm, for the use of controls on outflows or offshore trading of the domestic currency during periods of severe capital flow destabilization. The IMF in its published work (e.g., its WEO, October 2001) still often leans against controls, arguing that they are often a diversion from more important efforts to restore the foundations for macroeconomic and financial sector stability. But in discourse, (e.g., Mussa 2000) and in recent work (Prasad 2003), **controls on short-term capital flows are seen as instruments of some validity, at least temporarily**.

There are three situations in which **controls** over capital flows are generally considered to have proved to be **beneficial**:

1. Controls on inflows ahead of any crisis

What worked well, at least for a period of some years, in **Chile** was an **unremunerated reserve requirement (URR)** on inflows (i.e., reserves on inflows earned a zero interest rate). This repelled some inflows, which bought the authorities time to develop their economy and financial sector However, the controls do not provide a permanent solution, emphasizing the need to use the breathing space well.

As one commentator (Moreno 2001) recounts:

"In an effort to limit surging capital inflows, in June 1991 Chilean policymakers imposed an URR, first on foreign borrowing (except trade credit) and later on short-term portfolio inflows (foreign currency deposits in commercial banks and potentially speculative foreign direct investment). The reserve requirement rose from 20%, to 30%, but then fell to 0% when capital flows to Chile (and other emerging markets) dried up in 1998. A minimum stay requirement for direct and portfolio investment from abroad also was imposed (eliminated in May 2000), as were minimum regulatory requirements for corporate borrowing abroad. Banks also were required to report capital transactions."

While he questions their effectiveness, we consider that URR can be helpful, at least temporarily.

2. Controls on outflows during or after a crisis

What also appears to have been beneficial was the **Malaysian** set of measures implemented in September 1998. The key, according to our in-field consultations, was the imposition of the "12-month rule". This was a block on the repatriation of portfolio capital held by non-residents for 12 months, and capital outflows by residents were also restricted. Restrictions focused on short-term maturities and did not apply to international trade or long-term foreign investment transactions. In combination with some other measures (see 3., below), the controls allowed the ringgit exchange rate to be pegged, interest rates lowered, and commercial banks encouraged to lend.

Prominent economists (e.g., Dornbusch versus Krugman) have debated the extent to which the Malaysian controls were either necessary or indeed did work, see Moreno 2001. In the event, the controls provided a temporary breathing space, and the Malaysian authorities used this time well to restructure the financial and corporate sector and boost demand and activity in the economy. Nevertheless, there were costs borne by portfolio investors in particular, and Malaysia still confronts the "tri-lemma" of trying to maintain a fixed exchange rate, an independent monetary policy and, by now substantially liberalized capital flows.

3. Controls on lending to non-residents ("non-internationalization of the local currency" or "moves to limit offshore trading")

Singapore has been the longest-standing exponent of the non-internationalization policy, having put it in place early to foster development of a conservatively regulated domestic financial system and a more liberalized set of arrangements for international banking and financial activities. Over time, the non-internationalization policy in Singapore has been liberalized, but not abolished, as financial markets have developed.

Malaysia is the leading example of recent action. As part of the set of measures introduced in September 1998, in order to prevent speculation against the ringgit, access to local currency by non-residents was restricted, and rules were imposed that required all ringgit to be repatriated. This effectively closed the offshore market in ringgit. As observed above, the Malaysian controls are widely perceived to have "worked". The governor of Bank Negara Malaysia (BNM), then deputy governor, has argued that the ringgit funding that had built up in Singapore for speculators was a critical threat to the Malaysian recovery, and had to be terminated (Aziz 2000). **Thailand** had tried to achieve some of the same effect with a less comprehensive set of measures in May 1997, which did not "work" to the same extent. **Indonesia** has adopted a rule forbidding lending rupiah to non-residents in 2001, but its effectiveness remains somewhat untested.

We are aware of two quite comprehensive **analyses** made of capital controls that are intended to prevent the internationalization of local currencies, one by some Japanese researchers (Watanabe *et al*, 2002) for the EMEAP grouping of central banks and the other an IMF Working Paper (Ishii *et al*, 2001). The EMEAP paper summarizes:

"Regarding the effectiveness of these regulations, the evidence is mixed. Country experiences to date seem to indicate that there are **four factors which may influence the effectiveness of non-internationalization** (or capital controls more generally). These are (i) degree of macroeconomic distortion and market stress at the time of introduction of regulation, (ii) monitoring capacity of the authorities and incentive on the part of market participants to comply with regulations, (iii) comprehensiveness of regulations, and (iv) past history of capital account liberalization/regulation. It should also be noted that non-internationalization may reduce risk-hedging capacity among market participants and impose excessive regulatory costs on genuine investors. Balancing the benefits and costs of regulation will be one of the major challenges for policy makers in emerging markets." Watanabe 2002.

One frequent consequence of a policy of non-internationalization is the emergence of a **derivative offshore "non-deliverable forward" (NDF) market**. This facilitates hedging transactions which are not allowed under the controlled regime, and is driven by inefficiencies imposed by domestic and external regulations and the quality or sustainability of economic management (see Ishii, 2001 and Watanabe, 2002). Such a market is in effect working around the controls[*].

From these studies it would seem that the international consensus for developing countries is now that **full capital account liberalization is an inappropriate goal**:

1. Capital controls do have a role as part of prudential policy;

2. Short-term flows and/or non-residents' ability to borrow domestic currency in offshore markets should be liberalized last;

[*] Another apparent consequence of the regulations required to enforce a policy of non-internationalization of the local currency (essentially, the restriction on lending to non-residents) is that it becomes much more desirable for foreign banks to have full commercial banking presence in the country in question. This may be the rationale for cross-border presences in many of the ASEAN economies, the economies most obviously pursuing such a non-internationalization policy.

3. The least distortionary controls do not prohibit transactions but apply a tax or charge, e.g., including through unremunerated reserve requirements (URR), so that the market can still work with some efficiency;

4. Controls should be temporary as capital will find ways around controls in due course;

5. Temporary application of controls can be appropriate during a crisis, to “buy time” for reforms; but also that

6. Leaving in place controls for “too long”, as a shelter for the government and/or domestic financial sector to avoid making “overdue” improvements to the regulatory environment is a poor strategy, as it leads to actual and opportunity costs (shortfalls in performance that often are not easily observed).

Bearing in mind the caution on needing to avoid permanence, we remain **attracted to prudential controls such as URR** that deter to some extent the inflow of financial capital, **limit the internationalization of the local currency** and, in event of a crisis, **temporarily restrain outflows**. However, we recognize that such controls do entail costs. As economists know, “there is no such thing as a free lunch”.

The central objective for both the more advanced and the less advanced ASEAN countries must be to **quarantine the core of the financial sector** – the banks and the payments system – from the inevitable volatility of international capital flows. One of the critical issues in judging the appropriate extent of capital account liberalization in a country will be the resilience of the banking system and the strength of prudential supervision. If the banking system has the capacity to hold together in the face of volatile capital flows, then it is very likely that the rest of the economy can wear the shocks. So a central issue will be prudential controls on the banking system.

Another objective is to **create an institutional environment in which the foreign investors – and especially the foreign lenders – accept the risks of what they are doing**. For sovereign borrowings, this may be achieved by inclusion of **Collective Action Clauses** (CACs) in the terms of the borrowing, to prevent minorities of creditors blocking a restructuring that a large majority of creditors had been prepared to agree, apparently at little cost in terms of investor appetite and pricing. CACs are common in bonds issued in London under English law, but are coming to be used in the US market also. For private sector borrowings, an early statement from the authorities of the possible use of controls that will frustrate outflows in event of a crisis and ***‘bail the foreign investors in’*** (i.e., require private foreign investors to maintain their investments in the crisis country, and possibly even supplement their investment, rather than withdraw) is appropriate. The preparation of credible plans and procedures would also seem to be desirable, even though – or, more likely, because – it will tend to repel the more speculative inflows. (The downside is however the risk that investors will flee as the trigger for the determination that an event is indeed a crisis is approaching.)

Sequencing

Arising from a series of crises in emerging market economies involving dislocations in international liquidity and domestic banking (so-called “capital account crises”, rather than the previously more usual “current account crises”), policy scholars have been reassessing not only **the merits** of domestic financial and capital account liberalization, but also **the sequence** of measures that are appropriate.

Two schools but one outcome?

In the rapidly developing policy-oriented literature on Asian-country capital account liberalization and sequencing, there would appear to be **two apparently competing schools** of thought or general frameworks that have emerged since the Asian crisis. The first may be characterized as the **IMF** Integrated Approach, and the second the **ADBI** “Risk-based” Approach. Readers can see we consider the distinction overstated.

1. The IMF Integrated Approach

The IMF has published a most useful summary of lessons learned about capital account liberalization in Occasional Paper 211 “Capital Account Liberalization and Financial Sector Stability”, 2002. The authors, a Staff Team led by Shogo Ishii and Karl Habermeier, present the emerging consensus thinking on the requirements for risk-minimised capital account liberalisation, including general principles for sequencing and a suggested methodology for sequencing. It is based around several examples of individual country experiences (both successes and failures).

In summary, the IMF paper addresses the fundamental issue of how to reap the benefits from international capital market access while coping safely with the risks associated with capital flows. Country experiences indicate that the ability to avoid financial crisis in the context of more open capital accounts often depends upon the ability of financial and non-financial institutions as well as the government to manage financial risks in general. At the same time, legal, institutional, and prudential arrangements must be adequate to deal with complex risks associated with increasingly diverse types of capital flows.

The **general lessons, or principles, learned** emphasize:

1. The importance of macroeconomic stability and the choice of an appropriate exchange rate regime while giving priority to financial sector reforms that support macroeconomic stability;

2. The need to coordinate capital account liberalization with different financial sector policies, taking into account the initial condition of financial and non-financial entities and their capacity to manage the risks associated with capital flows;

3. The need to assess the effectiveness of existing capital controls;

4. The need to identify and implement urgent measures in connection with reforms that require a long lead time;

5. The need to ensure the sustainability of the reforms and the transparency of the liberalization process; and

6. The desirability, in most cases, of liberalizing long-term flows, especially foreign direct investment (FDI) flows, ahead of short-term flows and, at a minimum, accompanying any partial liberalization of short-term flows by adequate prudential measures.

The IMF paper provides a generic sequencing methodology, listing the items required for analysis, design and implementation. These will be pursued in this study. The IMF authors do, however, observe that there is no simple method for devising an operational plan for sequencing and coordinating capital account liberalization with other policies. This reflects the reality that capital account liberalization and financial sector development are often mutually reinforcing; therefore, removing controls on one type of flows affects other types of transactions, and hence the financial sector and the economy as a whole. Rapid liberalization in some circumstance may be safe, while gradual approaches to liberalization may not necessarily be orderly. It draws a firm conclusion that sequencing is only possible once the specifics of a country are analyzed.

2. The ADBI's "new" Risk-based Approach

The Asian Development Bank Institute (ADBI) and the Asian Policy Forum (APF), for their part, have developed a "new" risk-based approach to sequencing financial liberalization based around an assessment of two-dozen countries, focusing on an initial assessment of:

1. The core institutions that underpin the "quality" of financial and economic systems (the rule of law, creditors rights, shareholders rights, accounting standards, foreign bank presence, and state ownership of the banking sector). These are seen as proxies for systemic risks in financial systems (governance failures, excessive credit expansion, exploitation of minority shareholder rights, lax prudential oversight, abuse of bank monopoly power, chronic NPLs, etc.);

2. The effective degree of domestic financial liberalization (liberalization of deposit, lending and money market rates, over time);

3. The degree of capital account opening (the intensity of capital controls [from total bans, through quantitative and administrative controls, market-based instruments, to unrestricted freedom, over time); and

4. External financial parameters salient to gauging "maturity and currency mismatches".

ADBI observes that, in Asia, "the crux of the problem was weak core institutions relative to high capital account openness, and incomplete domestic financial liberalization juxtaposed onto capital account opening without systemic coherence". An ability to attract increasing short-term inflows as a result of economic successes masked the "trilemma" of fixed exchange rates, independent monetary policies and free flow of capital until fundamental imbalances became too acute.

The ADBI risk-based approach to sequencing of domestic financial liberalization and capital account opening aims to minimize systemic financial risk and therefore sees the building new core institutions as a pre-condition for either form of liberalization, and assigns priority to domestic financial liberalization over capital account opening, as it is less likely to lead to systemic risks. ADBI opines that within the capital flows which may be liberalized, the least risky (most permanent and least prone to reversal) are FDI and related trade credits and so should be liberalized first and that portfolio equity and other investment flows also involve less systemic risk (unless banks are heavily involved) and can be liberalized next. Furthermore, ADBI agrees that the last capital flows to be liberalized should be short-term international bank loans, non-trade credits and other financial instruments, and these “should be liberalized only after all other elements are in place (good prudential supervision, sound banks, ample FX reserves, functioning bond markets) and stress tested”. (See Asian Development Bank Institute and Asian Policy Forum Secretariat. 2002. “Policy Proposals for Sequencing the PRC’s Domestic and External Financial Liberalization.”)

As an example of application of the ADBI/APF approach, consider their recommendations on sequencing **Chinese financial and capital account liberalization**. They recommend (in synopsis) the following 7-step program and sequence of reforms for the PRC:

1. Restore banking sector solvency through prompt resolution of NPLs in the SOCBs, which in turn requires substantial restructuring of large SOEs;

2. Establish rational incentive structures through substantial ownership diversification and clearer property rights, in order to stop ever increasing NPLs under semi-autonomous management with state ownership and to promote market-based risk management;

3. To avoid monetizing the public debt, which will be greatly increased by recapitalizing the banks and establishing a minimum social safety net, give the central bank independence from state interference and guarantee the independence of financial supervisory agencies;

4. Manage excessive or new risk-taking behaviour by new institution-building, for instance by sequencing/carefully phasing domestic financial liberalization (e.g., of interest rates) to avoid inducing banks to take excessive risks;

5. Structure an entry strategy to encourage reputable foreign participation in the domestic financial sector, as a means of introducing better risk management skills and a credit culture;

6. Exercise great caution in opening the capital account, given the current status of core institutions. In particular, opening to short term, foreign currency denominated international capital movements should not be on the short-run policy agenda for the PRC and should be phased in according to progress made in institutional capacity building to avoid exacerbating the “double mismatches” (maturity and liquidity) and the “twin crises” (domestic banking crisis coupled with loss of access to international liquidity);

7. When freer capital flows are allowed, chose a midway exchange rate regime between a free float and a hard peg, supported by regional lender of last resort facilities in event of a capital account crisis.

ADBI/APF see this as a "coherent policy nexus" for the PRC, consisting of a strong banking system, robust core institutions, a flexible midway exchange rate regime combined with regional lender of last resort facilities, as well as sustainable macroeconomic policies in a new era of domestic and external financial liberalization after the PRC's accession to the WTO.

Assessment of the Two Approaches

The ADBI describes the IMF approach as "an overly complex integrated approach, and its own approach (which it acknowledges as still needing to be fleshed out with country-specific microeconomic indicators) as a "risk-based" "pragmatic general framework".

We say "apparently competing" because the **objectives of the two schools are increasingly similar** (risk-minimised capital account opening), their risk assessments are increasingly similar (taking account of all relevant factors, including the macroeconomic policy mix, the domestic financial and institutional framework, the risk in various types of capital flows, the heavy emphasis on prudential regulation and supervision etc.) and the logical outcomes of either approach will therefore be very similar.

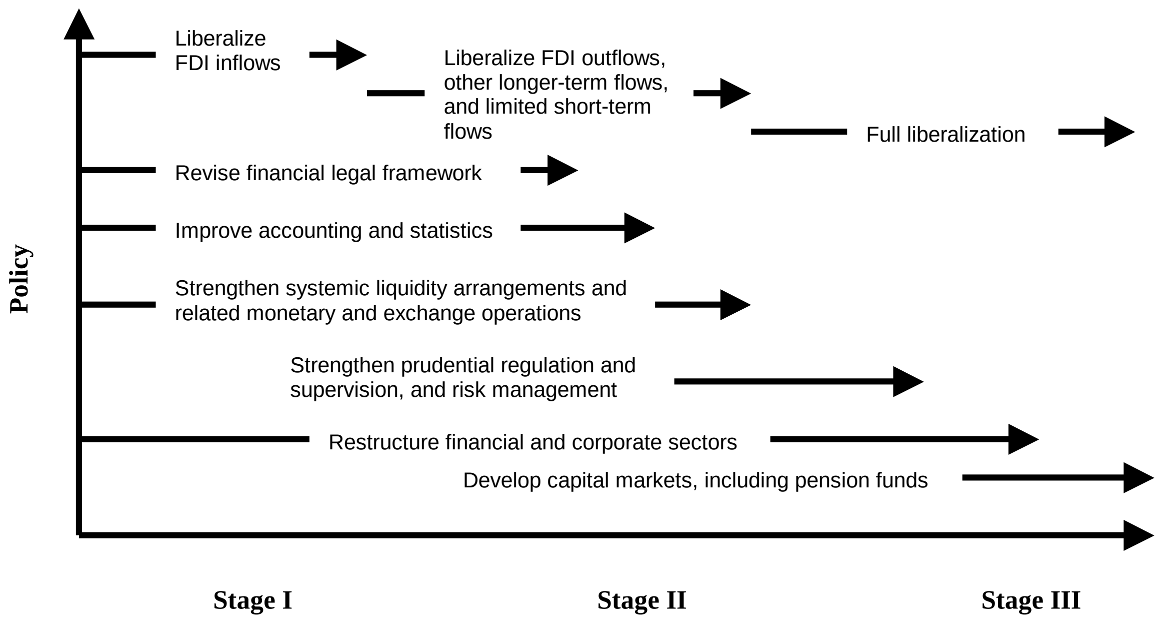
As policy-makers universally understand, "**the devil is in the details**". It seems to us that the derided complexity of the IMF approach will quickly assert itself in the ADBI approach once the latter is tested in a wide variety of circumstances (such as ASEAN countries). No matter which approach one takes at the start, in assessing a sensible sequence for capital account liberalization and financial system development for any individual country, the outcome will be both complex and all-encompassing, involving the full array of policy instruments and topics and institutional detail.

The conclusions of either approach are **in practice very similar**, as they both draw from the database of recent experience. The ADBI approach is fresher, focused on some relevant Asian countries, but untested against the world's complexities, while the IMF approach is world-weary, burdened by the weight of experience in every country, and very comprehensive. Both add value. However, **for the purposes of this study, the more comprehensive IMF approach provides an already developed set of templates for consideration of sequencing.**

Sequencing – the Generic Approach

The IMF approach may be illustrated with this generic diagram in figure 3.

Figure 3. A Stylized Representation of Sequencing



IMF. 2002. “Capital Account Liberalization and Financial Sector Stability.” Occasional Paper 211.

For ***every country***, the IMF staffers urge that **thorough research be undertaken**. Any policy study must commence from what is known about the economy, be it a well-developed economy with a deep financial sector and already well-integrated into the global economy or a transition economy only at the start of developing market-based instruments and institutions and still only partially integrated into global trade and financial flows, or some point in between.

Next, the baseline or starting point for capital account restrictions must be assessed. What controls and restrictions on capital flows are in place? A **summarized inventory** suggested by the IMF aids analysis – see table 7.

Table 7. Inventory of Capital Controls and Related Measures

Type of Control	Description
Current account proceeds	
Repatriation requirements[1]	
Surrender requirements[1]	
Foreign direct investment	
Inward	
Outward	
Liquidation by non-residents	
Capital and money market instruments	
Purchase locally by non-residents	
Sale and issue locally by non-residents	
Purchase abroad by residents	
Commercial banks and other financial instruments	
Borrowing by residents abroad	
Lending to non-residents	
Derivatives and related instruments	
Forwards and futures	
Other derivatives	

IMF. 2002. "Capital Account Liberalization and Financial Sector Stability." Occasional Paper 211.

Then, **conditions and vulnerabilities must be assessed** for macroeconomic policies and factors affecting financial sector stability, institutions and markets, and the prudential and governance infrastructure, to determine what liberalization may be contemplated (because it offers net benefits), and what precautionary measures are required before liberalization is likely to be safe enough to proceed. Table 8 sets out the IMF's suggested template. We use this template to identify, for every individual country, the expected benefits and costs of further capital account liberalization.

[1] Technically, these measures are not capital controls as they involve transactions among residents, but they limit the scope for residents to undertake capital transactions.

Table 8. Assessment of Conditions and Vulnerabilities

	Assessment of Conditions	**Financial Sector Vulnerabilities**
I. Macroeconomic Policies and Conditions Afflicting Financial Sector Stability		
Real economy		
Fiscal policy		
Monetary policy		
Exchange rate policy		
External sustainability, including debt and reserves management		
Capital flows		
Shocks		
II. Institutions and Markets – Development, Risk Profile, and Sensitivity to Shocks		
Banks		
Other financial institutions		
Non-financial institutions		
Monetary policy instruments		
Inter-bank money and foreign exchange markets		
Treasury bill and bond markets		
Equity markets and private bond markets		
Payments and settlements systems		
III. Prudential and Governance Infrastructure[1]		
Banks (Basel Core Principles)		
Insurance (IAIS Core Principles)		
Securities (IOSCO Core Principles)		
IMF standards (Fiscal Transparency, Monetary and Financial Policies, Statistics)		
Corporate governance		
Accounting (GAAP or IAS)		
Insolvency		
Arrangements for the resolution of systemic banking problems		
Financial safety nets		

IMF. 2002. "Capital Account Liberalization and Financial Sector Stability." Occasional Paper 211.

Finally, a **sequence of capital account and financial sector reforms and other policies** and issues needs to be determined, divided into various stages, including, where desirable, the use of capital controls for primarily prudential purposes – see table 9.

[1] Where appropriate, relevant standards and codes for assessment are included in parentheses.

Table 9. Sequencing Capital Account Liberalization with Other Policies

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows	Markets and systems	Macroeconomic policies and conditions
Capital outflows	Prudential policies and risk management	Legal framework
Special topics	Financial sector restructuring	Corporate restructuring
	Financial safety nets	Statistics and reporting
Stage II: Consolidating Reforms		
Inflows and outflows	Prudential policies and risk management	Macroeconomic policies and conditions
	Financial sector restructuring	Legal framework
	Transparency	
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization	Market and systems development	Macroeconomic policies and conditions
	Prudential policies and risk management	Legal framework
	Financial sector restructuring	

IMF. 2002. “Capital Account Liberalization and Financial Sector Stability.” Occasional Paper 211.

Practicalities

There are a wide variety of economies in the world, and in detail all are different. The countries in ASEAN reflect this diversity.

What we can learn from within this diversity and from history is that few countries liberalize their capital accounts in line with some optimum sequence, and the consequences for transgressing the optimal sequence can sometimes be very modest. We have seen examples of countries that got the sequence of capital account liberalization entirely back-to-front, yet they have prospered. We have seen others that conspicuously “did the right thing”, yet still ran into difficulties. Moreover, the achievement of policy reform is an intensely political exercise and requires dedication and commitment. The rewards often come late and are diffuse, while the opposition from entrenched interests before policy changes are made can be acute. To make progress, often doing what is possible is more important that getting the order exactly right. If nothing else, we do know that changes are dynamic and alter the anticipated future in ways that are unpredictable.

It does seem that the most important issues in risk-minimized capital account liberalization relate to the quality and depth of the financial sector, once macroeconomic parameters are under control.

There are always new lessons to be learned, from the experience of others or developments at home, to shift the balance of argument about timing and the specific measures to put in place. But the starting point is the current status quo, and recent developments that establish the context. So it is to the current situation in ASEAN that we now turn, in **Chapter 3**.

3. Current State-of-Play and Reforms in ASEAN Countries

Introduction

This Chapter reviews the **current status of capital account liberalization and other financial sector developments in individual ASEAN countries**. Its purpose is both informative and analytical: we need to understand the scope for progress. We draw on published material and analysis and our in-country fieldwork.

This review of current status is the basis for developing recommendations of measures and sequencing of reforms proposed for individual ASEAN countries in **Chapter 5**.

The accepted “bible” on the state of play with capital controls is the **IMF Annual Report on Exchange Arrangements and Exchange Restrictions (AREAR).** Our understanding has been supplemented by what has been learned from other reports and analysis and from fieldwork in the countries in question. Readers should be aware that some restrictions will have changed in recent months or are incompletely assessed.

While the topic of this research project is capital account liberalization, such liberalization cannot proceed in a vacuum. There is a clear interrelationship with **current account liberalization**, and the latter is an appropriate matter to consider in the sequencing of further capital account liberalization. The AREAR covers both sets of restrictions, together with other salient arrangements.

In compiling this Chapter and the accompanying country reports in **Volume 2**, there may still be some sensitivity over inevitably selective quotations from external reviews and from some cross-country comparisons. Without the resources for a full review of the state of the financial sector in each country, this study has had to draw on a limited number of assessments made in a national or regional context by national or international officials or researchers. The purpose has always and only been to understand what is possible and necessary in sequencing further capital account liberalization. Countries will benefit from **preparing their own assessments**.

The AREAR provides a very summary table of exchange arrangements and exchange restrictions for all member countries, in addition to all the fine detail. Table 10 extracts this **summary snapshot only for ASEAN countries**. We have added a numerical aggregate for all 10 ASEAN countries.

Table 10. Capital Account Liberalization: State of Play

Summary Features of Exchange Arrangements and Regulatory Frameworks for Current and Capital Transactions in ASEAN Member Countries	Brunei Darussalam	Cambodia	Indonesia	Lao People's Dem. Rep.	Malaysia	Myanmar	Philippines	Singapore	Thailand	Vietnam	**ASEAN-10**
Status under IMF Articles of Agreement											
Article VIII	●	●	●		●		●	●	●		**7**
Article XIV				●		●				●	**3**
Exchange rate arrangements											
Currency board arrangement	●										**1**
Conventional pegged arrangement					✙						**1**
Managed floating with no pre-announced path for the exchange rate		●	●	●		●		●	●	●	**7**
Independently floating							●				**1**
Exchange rate structure											
Dual exchange rates		●		●		●					**3**
Arrangements for payments and receipts											
Bilateral payments arrangements				●	●		●			●	**4**
Payments arrears				–		●				●	**2**
Controls on payments for invisible transactions and current transfers	●					●	●			●	**4**
Controls on proceeds from exports and/or invisible transactions											
Repatriation requirements		●		●	●	●			●	●	**6**
Surrender requirements		●		●	●	●			●	●	**6**
Capital transactions											
Controls on:											
Capital market securities		■	●	●	●	–	●	●	●	●	**7**
Money market instruments		■	●	●	●	–	●		●	●	**6**
Collective investment securities		■	●	●	●	–	●		●	●	**6**
Derivatives and other instruments		–	●	●	●	–	●		●	●	**6**
Commercial credits			●	–	●	●	●				**4**
Financial credits			●	–	●	●	●	●	●	●	**7**
Guaranties, sureties, and financial backup facilities			●	–	●	●	●		●	●	**6**
Direct investments	●	●	●	●	●	●	●		●	●	**9**
Liquidation of direct investments				●		●				–	**2**
Real estate transactions	●	●	●	●	●	●	●	●	●	●	**10**
Personal capital transactions	●			–	●	●	●		●	●	**6**
Provisions specific to:											
Commercial banks and other credit institutions	●	●	●	●	●	●	●	●	●	●	**10**
Institutional investors			●	–	●	–	●	●	●	–	**5**

● Indicates that the specific practice **is** a feature of the exchange system.
– Indicates that data were not available at time of publication.
■ Indicates that the specific practice **is not** regulated.
✙ Indicates that flexibility is limited to a single currency.
Position as of: Brunei Darussalam Dec 31, 2001; Cambodia Feb 28, 2002; Indonesia Mar 31, 2002; Lao People's Democratic Republic Dec 31, 2001; Malaysia Mar 31, 2002; Myanmar Mar 31, 2002; Philippines Jan 31, 2002; Singapore Apr 30, 2002; Thailand Jan 31, 2002; Vietnam Dec 31, 2001.
Source: IMF Annual Report on Exchange Arrangements and Exchange Restrictions 2002

Current Account Liberalization: State of Play

Most, but not all, ASEAN countries have sufficiently liberalized their current account transactions to be able to accept the obligations of **the IMF's Article VIII**, which is the international standard for members of the IMF. Article VIII imposes some discipline on individual country actions regarding the imposition of impediments on trade flows[*].

It also goes without saying that countries should move as soon as possible to remove any remaining constraints on current account transactions, if the full sustained benefits of free trade flows are to be achieved by individual countries and by the region.

The status of ASEAN countries with respect to Article VIII is set out in table 11:

Table 11. Status of ASEAN Countries with Respect to IMF Article VIII

Country	Effective Date of Acceptance
Brunei Darussalem	October 10, 1995
Cambodia	January 1, 2002
Indonesia	May 7, 1988
Lao PDR	*Not yet accepted*
Malaysia	November 11, 1968
Myanmar	*Not yet accepted*
Philippines	September 8, 1995
Singapore	November 9, 1968
Thailand	May 4, 1990
Vietnam	*Not yet accepted*

IMF. 2003. "International Financial Statistics." January.

[*] Regarding Article VIII, the IMF explains that:

> "Article VIII of the Fund's Articles imposes certain obligations on member countries of the Fund. In particular Article VIII, Sections 2 (a) and 3 prohibit members, except with the approval of the Fund, from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in multiple currency practices or discriminatory currency arrangements. Moreover, Article VIII, Section 4 requires Fund members, subject to certain conditions, to purchase balances of their currency from other Fund members, which represent that the balances have been recently acquired as a result of current international transactions or that the conversion is necessary for the purpose of making payments for current transactions.
>
> Article XIV, Section 2 of the Fund's Articles establishes a limited exception to Article VIII, Sections 2, 3, and 4. Thus, member countries that avail themselves of Article XIV, Section 2 may, without seeking Fund approval, maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on their date of membership in the Fund; however, if such restrictions are terminated and subsequently reintroduced or restrictions are introduced by these members after their date of membership, they are subject to Fund approval under Article VIII. Moreover, members availing themselves of Article XIV are required to consult annually with the Fund with respect to the retention of Article XIV measures.
>
> Members may accept the obligations of Article VIII, Sections 2, 3, and 4 at any time. When a member country accepts these obligations, it may no longer avail itself of the transitional arrangements of Article XIV, Section 2 and may not maintain any exchange measures inconsistent with Article VIII, Sections 2, 3, and 4."

Source: IMF. 2003. "International Financial Statistics." January.

Lao PDR, Myanmar and Vietnam, as members of the IMF, continue to avail themselves of Article XIV, Section 2. This allows them, without seeking Fund approval, to maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on their date of membership in the Fund. We are aware that Lao PDR is endeavouring to sign Article VIII, and also that Vietnam is in some dispute with the IMF over what in Vietnam's current arrangements prevent signature. Myanmar seems definitely precluded from Article VIII by the persistence of its dual exchange rate arrangements.

Capital Account Liberalization: State of Play

The summary table (table 10) **suggested that controls apply to most capital account flows.** However, the existence of a control may not mean that the flow in question is forbidden. **Controls can be graded**. For instance, a requirement for ex-post notification is a much lighter control than a requirement for prior approval; prior approval may be more or less onerous depending on the logistics to obtain such approval; a limit on the size of transaction will be less of a constraint if it is set at a comparatively high level; a transparent approval process is less onerous than one that is not clearly delineated; and so forth. Of course, if there is no control, then that particular flow can be deemed to be liberalized, though the freedom may be of little importance if, for instance, there is no marketplace for the flow (e.g., derivatives).

Unavoidably, this draws us into more of the **detail** of the controls for each country. The controls outlined in the AREAR are summarized below in tables 12 (ASEAN-5) and 13 (CLMV), for the main categories of controls important to our analysis. Note that for these tables only, **Brunei** has been omitted, to save space, because it has so very few capital controls.

A fuller description of the most relevant capital controls and related measures is included in more detail in ***Annex 2.*** A still fuller version of the arrangements and restrictions, also in a convenient form for cross-country comparisons, is presented in the **Addendum**, in A3-sized tables, provided separately. It must be noted that even at this level of detail they are not a substitute for the full reportage in the AREAR or from the countries themselves.

Table 12. Summary of Capital Controls and Related Measures – ASEAN-5

Control	Indonesia	Malaysia	Philippines	Singapore	Thailand
Controls on current account proceeds?					
Repatriation requirements [1]	No	Yes, in FX	No, except if from outward FDI sourced from the local banking system (LBS)	No	Yes, if over B500,000
Surrender requirements [1]	No	No, if retain FX within limit approved		No	Yes, but can retain FX in accounts
Controls on foreign direct investment (FDI)?					
Inward	Yes, sectors limited, some sell-downs required	Yes, foreign ownership & control limited, approval needed	Yes, must decide if to register (and access FX from LBS) or not	No	No, but must be banked
Outward	No	Yes, approval required for over RM10,000	Yes, tax return needed to buy FX from LBS (up to $6m pa) if no approval	No	Yes, approval required over $10 million (or equivalent) pa
Liquidation by non-residents	No unless tax relief received	No if from “external accounts” of non-residents	No, if registered. If not, no FX from LBS	No	No if supported by evidence
Controls on capital and money market instruments?					
Purchase locally by non-residents	No, few limits	No, after 15% withholding tax on bond interest	No, but registration if want FX from LBS	No	No, within 50% limit on equity holding
Sale and issue locally by non-residents	No, through Indonesian Depository Receipts (IDRs)	Yes, approval required	Yes, license required and no purchase of FX from LBS	No, but convert S$ to FX before use outside Singapore	Yes, several approvals required
Purchase abroad by residents	No, but not rupiah-denominated	No, after approval of purchases over RM10,000	No, unless if need over $6m FX from LBS pa	No	No, after approval (F.I.s limited)

[1] Technically, these measures are not capital controls as they involve transactions among residents, but they limit the scope for residents to undertake capital transactions.

Table 12. Summary of Capital Controls and Related Measures – ASEAN-5 cont./

Control	Indonesia	Malaysia	Philippines	Singapore	Thailand
Controls on commercial banks and other financial instruments?					
Borrowing by residents abroad	No	Yes, only supplier trade credit or limit of RM5m without approval	Yes, approval for public sector debts or if accessing FX purchased from LBS	No	No, if in FX and proceeds repatriated
Lending to non-residents	Yes, prohibited in rupiah and FX since Jan 2001	Yes, cannot lend more than RM10,000, with minor exceptions with approval, but can lend FX	Yes, requires prior approval and bank lending in pesos appears prohibited	Yes, not lend over S$5m to F.I.s for FX speculation, and must convert S$ to FX before use outside Singapore	Yes, cannot lend baht but can lend in FX
Controls on derivatives and related instruments?					
Forwards and futures	Yes, forward FX contracts offered to non-residents limited unless investment-related	Yes, imports limited to 12 months and exports 6 months. Other: prior approval, except to buy KLSE shares within limits	Yes, prior approval required, including for NDFs to sell FX to non-residents. Only authorized F.I.s allowed to deal in derivatives	Yes, consultation required for all banks transacting with non-residents in S$ financial derivatives; no controls for OTC interest rate derivatives or collateralized repos	Yes, forwards need to be related to underlying trade and financial transactions
Other derivatives	Yes, limits per customer and per bank. Derivatives other than FX and interest rates allowed on exception basis	Yes, approval required for some issue by non-residents and for residents' buying or issuing most derivatives abroad			Yes, without underlying activities in Thailand, baht derivatives obtained by non-resident from domestic F.I.s limited to B50m

Table format from IMF. 2002. "Capital Account Liberalization and Financial Sector Stability." Occasional Paper 211. Descriptions summarised from individual country sections compiled in Volume 2 of this report.

Table 13. Summary of Capital Controls and Related Measures – CLMV

Control	Cambodia	Lao PDR	Myanmar	Vietnam
Controls on current account proceeds?				
Repatriation requirements [1]	Yes, payments & receipts must use authorized banks	Yes	Yes, full repatriation required	Yes, immediate full repatriation required
Surrender requirements [1]	Yes, SOEs must surrender proceeds of invisibles exports	Yes, wood & wood products proceeds must be surrendered, after settling payments due to government	Yes, FX proceeds subject to 10% tax, unless waived. Invisibles FX deposited in approved accounts	Yes, resident enterprises must sell 30% of FX to banks; non-profit organizations must sell 100%
Controls on foreign direct investment (FDI)?				
Inward	No FX restrictions, but needs approval by Council for Development (CDC)	Yes, requires BOL approval and subject to Direct Investment Law	Yes, 35 – 100% allowed with tax incentives in a positive list of activities & sectors	Yes, sectors restricted under foreign investment laws. Projects must be licensed
Outward	No, only prior declaration if over $100,000	Yes, requires BOL approval and subject to Direct Investment Law	na	Yes, requires permit, account with bank, & schedule registered
Liquidation by non-residents	No, if accords with Investment Law and use authorized intermediaries, which report if over $100,000	No, but permitted after BOL scrutiny. Large sums in instalments with plan approved by BOL	Yes, repatriation of capital & profits through banks permitted after payment of taxes etc.	na
Controls on capital and money market instruments?				
Purchase locally by non-residents	No, no securities market, rules or regulations	Yes, requires approval, but limited market	na. No effective market	Yes, in total can hold up to 30% of issuer's shares (7% org. & 5% indiv.)
Sale and issue locally by non-residents	No, no securities market, rules or regulations	Yes, requires BOL authorization, but no market	na. No effective market	Yes, not allowed
Purchase abroad by residents	No, if use authorized intermediaries	Yes, requires BOL authorization	Yes, not apparently permitted	Yes, not allowed
Controls on commercial banks and other financial instruments?				
Borrowing by residents abroad	No, if use authorized F.I.s	Yes, requires BOL approval	Yes, state approval required	Yes, registration with SBV required
Lending to non-residents	Yes, not allowed in FX or rial, unless for local business	Yes, requires BOL authorization for both FX and kip	Yes, not apparently permitted for either FX or kyat	Yes, needs approval; outside normal policy
Controls on derivatives and related instruments?				
Forwards and futures	No, but no market	Yes, requires BOL authorization, but no market	na. No forward market	Yes, some allowed to 1- to 6-months. Others need SBV approval
Other derivatives				

Table format from IMF. 2002. "Capital Account Liberalization and Financial Sector Stability." Occasional Paper 211. Descriptions summarised from individual country sections compiled in Volume 2 of this report.

[1] Technically, these measures are not capital controls as they involve transactions among residents, but they limit the scope for residents to undertake capital transactions.

With so much detail, it is hard to see the wood for the trees. It is helpful, though more subjective, to classify the restrictions that are in place against the **perceived intentions** of the policy-makers. See table 14 below for our tentative post-fieldwork assessment.

Table 14. The Intention Behind the Capital Flow and Investment Restrictions

	Retain domestic savings in country	Social policy or national priorities for restricting inward FDI	Prudential		
			Restrain short-term inflows	Restrain capital flight by non-residents	Limit the internation-alization of the currency
Brunei	No	Yes	No	No	Yes
Cambodia	No	Limited	No	No	Hardly
Indonesia	No	Yes	No	Partly	Yes
Lao PDR	Yes	Yes	Partly	Partly	Partly
Malaysia	Yes	Yes	Partly	Partly	Yes
Myanmar	Yes	Yes	Partly	Partly	Yes
Philippines	Partly	Partly	Partly	Partly	Yes
Singapore	No	No	No	No	Yes
Thailand	Limited	No	No	Partly	Yes
Vietnam	Yes	Yes	Partly	Partly	Yes

Source: the author, from fieldwork

From the perspective of this study, which is to promote risk-minimized and benefit-maximized capital account liberalization, the rather prevalent restrictions aimed at retaining domestic savings in the home country or limiting inwards FDI for social policy or priority economic development reasons (including restrictions on ownership of particular assets by non-residents) are generally **appropriate to be liberalized**.

Regarding the desire to **keep domestic savings in-country** to fuel economic development (and to avoid capital flight), controls are unlikely to be effective in the long-term. Solutions are obvious: sustained sound economic management is required, so that investment opportunities at home are well advertised and capital flight (as opposed to sensible and productive diversification of risks) is never a rational response from the public. Controls aimed at **preventing capital flight** are likely to be circumvented in circumstances of well-founded reasons for panic, at least by the well-connected. (They may be useful, however, to impose during a crisis.)

The social and other policy reasons to limit foreign ownership, especially of sensitive sectors such as banks, or seeking to steer FDI into "priority" areas or "picking winners", can have a **perverse effect**. They serve to block what has been found to be the safest form of capital inflow, least prone – even in a crisis – to reverse. The merits of "picking winning sectors" for inward foreign investment must also be compared with the patchy record for such intervention in industry policy more generally. Social policy reasons for limiting foreign ownership have an equivalently debatable record in terms of creating appropriate incentives and actual outcomes (see Mohammad, 2002).

Regarding ownership of **banks**, we believe there are **good reasons for allowing foreign ownership** (and consequent obligatory support from the foreign parent) of such risky enterprises, that otherwise host governments feel have to be supported with public money when things go wrong. Furthermore, the stimulus to competition from the injection of foreign banks into the domestic banking marketplace is often a valuable catalyst for improvements of standards in the financial sector. The foreign-owned banks will still be subject to and have to obey local rules and regulations. And they rarely achieve the dominance of the local industry that is feared. However, we recognize that globally (including in Australia) there are strong political sensitivities involved with foreign ownership of a large component of the banking sector.

The better motivation for restrictions is prudential. Because controls that are in place for long periods can generally be worked around, the better controls are either temporary, or are aimed at limiting the extent of non-resident activity. This can usefully include restraining short-term inflows, most effectively through a tax such as an unremunerated reserve requirement rather than through an outright ban or approval process, or limiting the internationalization of the currency by a ban on lending the local currency to non-residents for speculative use. Either can be appropriate, depending on the institutional and legal arrangements in the country in question.

We would include as a good reason for a control the desire to "**keep it simple**". This would justify not being too ambitious, for instance with liberalizing the use of sophisticated derivatives instruments which may shift the risk to someone not particularly suited to bear it and – worse – hide the risk as if it has been eliminated.

Nevertheless, the **existence** of a control or regulation is only part of the story. The **intensity** of the regulation or requirement is also pertinent (*ex ante* or *ex post* reporting or notification versus *ex ante* approval versus limits and prohibition), as is its **enforcement and effectiveness**.

Many studies have tried to **rank the intensity of controls**, in order to assign a grading to the capital controls of an individual country. Thus, the ASEAN Secretariat's Final Report on Monitoring System for Short-Term Capital Flows prepared by UFJ Institute Ltd., Japan, April 2002, which is a detailed study focused on a very limited range of capital flows, produce two composite scales for ASEAN+3 countries for the controls over particular short-term capital inflows. For purely illustrative purposes, these can be combined into one grading (see table 15):

Table 15. Scoring on Regulations on Short-term Capital Inflows for ASEAN+3

Regulation on:	**Foreign Currency Loans**	**Portfolio Investment**	**Both Short-term Capital Flows [Illustrative]**
Scoring	0 (only *ex-post facto* reporting) – 6 (complete ban)	0 (completely free) – 9 (complete ban)	0 – 15 (additive)
From most liberalized to least liberalized			
Japan	0.0	0.5	0.5
Indonesia	1.0	0.0	1.0
Singapore	0.5	1.0	1.5
Malaysia	1.0	1.5	2.5
Korea	2.0	1.5	3.5
Thailand	2.0	3.0	5.0
Philippines	3.5	5.5	9.0
Vietnam	4.0	6.0	10.0
China	4.0	6.0	10.0
Cambodia	2.0	9.0	11.0
Myanmar	4.0	9.0	13.0
Lao PDR	4.5	9.0	13.5

Source: Derived from ASEAN Secretariat. 2002. "Final Report on Monitoring System for Short-Term Capital Flows." Chapter II.

The **problems with such scoring are obvious**: how to assign weights to the different forms of capital flow, how to judge the implementation of the regulation as opposed to its existence, etc.? Unavoidably, the act of summarisation requires fine judgement and takes away information required for the preparation of individual country sequences. We prefer the approach developed by Johnston, *et al*. 1997, in **spelling out the full set of regulations** in addition to summarizing the results into more manageable segments.

The market does find its way round some of the controls. One guide is the development and expansion of an unregulated derivative offshore "non-deliverable forward" (NDF) market for the currency. Its emergence reflects the cost of domestic regulations and exchange controls, limitations on ability to hedge risks, and yet also the interest that corporates, investors and speculators have in local currency exposures, (see table 16 below).

Table 16. Turnover in Foreign Exchange Markets (Daily Averages, US$ million)

Bank for International Settlements Survey Data for 2001					Dealer/Broker Estimates for Current Market
Currency	**Spot**	**Outright Forwards**	**Foreign Exchange Swaps**	**Total**	**Non-Deliverable Forwards (NDFs)**
CNY	39	55	0	94	150
HKD	5956	3055	18370	27381	0
INR	1213	428	1200	2841	50-100
IDR	250	103	198	551	50-100
KRW	5731	1671	2354	9756	1200
MYR					
PHP	201	73	228	502	50-100
SGD	2756	825	9305	12886	0
TWD	2246	603	319	3168	300-400
THB	530	231	1098	1859	very occasional

CNY Chinese yuan; HKD Hong Kong dollar; INR Indian rupee; IDR Indonesian rupiah; KRW Korean won; MYR Malaysian ringgit; PHP Philippine peso; SGD Singapore dollar; TWD Taiwan dollar; THB Thai baht. Source: the author

Financial Sector and Other Development: State of Play

Financial development has been a focus of ASEAN countries since economic development efforts began. As is well known to all, the countries are at different stages in their financial development, and evolution is continuing. Most financial sectors were severely weakened by the Asian financial crisis, and all are engaged in a process of what appears to be **continuous improvement** without end. The safety and efficiency of financial sectors and governance processes and standards have been the focus of continuing reform.

These are **complex issues that are inherently hard to objectively evaluate**. The effort made in this report (e.g., in **Volume 2: Country Reports**) is tentative at best.

The Linkage to Other Liberalization Programs

There are many commentaries that suggest that policy makers feel under pressure to liberalize capital accounts "before they are ready". Not only does some initial liberalization lead to demands/pressures for more liberalization, but other **developments in international affairs can lead to demands, or fears of demands, for more liberalization**. Below we assess the extent to which other ASEAN agreements, such as AFAS, or AIA, and other more global agreements such as WTO/GATS, "compel" countries to liberalize capital accounts.

In summary, we can find little evidence that the limited pressure for capital account liberalization from other international agreements needs to be overwhelming, so long as the pace and sequence of reform is considered, though care must be taken with the modes of access that are liberalized for trade in financial services. However, countries negotiating **bilateral trade arrangements** do need to consider negotiating strategies and commitments with their prudential regulator, rather than deliver a *fait accompli* that materially affects the path of financial reform.

1. The ASEAN Investment Area (AIA) involves countries liberalizing controls over inward FDI, from other ASEAN member countries. Inward FDI flows are the safest and most beneficial forms of capital flows, and therefore ought to be the easiest and the first capital account liberalization measures to be undertaken. AIA: Member states are committed under Article 4 to "Accommodate the free flow of capital …. from member states", unless abrogated from obligations under the AIA when confronted by certain prescribed circumstances. These include in the economic sectors under the temporary or sensitive lists (Article 7 (3)); to protect and safeguard the national security, public morals, laws and regulations and fiscal structures (Article 13); provisional emergency to safeguard measures taken to avert serious injury or threat (Article 14); and when confronted with serious balance of payments and external financial difficulties or threat thereof (Article 15) [Rajenthran 2002]. Several member states continue to restrict inward FDI by limiting the extent of foreign ownership of enterprises.

2. The AFAS under AFTA is rather more complicated to assess. We need to explore the conceptual difference between liberalization of barriers to trade in financial services and liberalization to capital inflows.

   Kono 1999 pertinently observes that many of the Asian countries that were worst-hit in the 1997 crisis had only liberalized trade in financial services relating to cross-border bank lending and borrowing (so-called "mode 1 trade", which involves cross-border supply), but not other trade in financial services. This liberalization exacerbated the risk of destabilizing capital flows, because it facilitated short-term cross-border flows, which could easily reverse.

   Other actions to liberalize trade in financial services (such as "mode 3 trade", permitting commercial presence, portfolio investments, unrestricted ownership of equity in branches or subsidiaries in the country in question, etc.) would have been more likely to promote stability in capital flows and to have contributed more to building and strengthening the financial services sector infrastructure and promoting efficiency gains. "Mode 3 trade" liberalization would have contributed to promoting financial stability by helping enable all financiers (not just domestic firms) to raise local currency liabilities and extend local currency assets. This could have reduced the emergence of the "double mismatches".

In addition, Kono argues persuasively that liberalization of trade in financial services and capital account liberalization are conceptually and practically separate, illustrating this claim with the following two matrices:

Matrix 1. Domestic versus International Capital Flows and Financial Service Provision: the Example of Lending by a Foreign Supplier Abroad (i.e., Mode 1)

	Loan provided by domestic supplier	**Loan provided by foreign supplier abroad**
Loan involves domestic capital only	I. Neither financial services trade nor international capital flow	II. Financial services trade only
Loan involves international capital only	III. International capital flow only	IV. Financial services trade and international capital flow

Matrix 2. Domestic versus International Capital Flows and Financial Service Provision: the Example of Lending by a Foreign Supplier Established in the Country (i.e., Mode 3)

	Loan provided by domestic supplier	**Loan provided by foreign supplier established in the country**
Loan involves domestic capital only	Ia. Neither financial services trade nor international capital flow	IIa. Financial services trade plus inward direct investment
Loan involves international capital only	IIIa. International capital flow only	IVa. Financial services trade plus inward direct investment and international capital flow related to the supply of the loan

Source: Kono, Masamichi and Ludger Schuknecht. 1999. "Financial Services Trade, Capital Flows, and Financial Stability." World Trade Organization, Geneva. Pp 5 & 6.

The lesson for policymakers to take away is that care must be taken to ensure that financial services liberalization is not confused with capital account liberalization, and that one does not preclude – or necessitate – the other. From the perspective of safe capital account liberalization, the most preferable form of liberalization of trade in financial services is "mode 3", direct commercial presence. In that case, countries can choose, through their prudential regulations, the activities that their financial sector is permitted to undertake. Of course, the regulatory structure and its implementation must be strong and effective.

Bilateral and global initiatives raise similar issues. Policymakers need to trace through the impact of policy commitments made in one area for other policies.

1. In terms of **bilateral agreements**, Singapore and Vietnam have agreed to admit US-owned banks and insurance companies within a timeframe, while Thailand and others have agreed to permit full foreign ownership of financial institutions as part of the conditions for bilateral economic support in the recovery from the 1997 crisis. It will be important for the host countries in question to carefully set out

what functions financial institutions (foreign or domestic) are permitted to undertake, to limit potentially destabilizing flows of capital. There is some suggestion that the *proforma* claim tabled by the US in its free trade agreement negotiations involves ceding the right to impose (or retain) capital controls, but these should be rejected (Bhagwati 2003 and The Economist 2003).

2. **Global initiatives**, such as the **GATS**, give substantial scope, on prudential grounds, for countries to not liberalize trade in financial services, until they wish.

   The **IMF** does not compel its members to liberalize restrictions over the capital account of the balance of payments, though it does have an obligation to encourage its members to liberalize restrictions over current account transactions. Its recent pronouncements suggest it is well aware of the risks involved in capital account liberalization and that it is intent on assisting countries minimize those risks.

3. But one international agreement with obvious relevance for future financial sector stability and development is the **new Basel Capital Accord**. Several studies (e.g., Reisen, 2002) suggest that the Basel Capital Accord II that is planned for 2007 paradoxically will **increase the pro-cyclicality of international capital flows**, destabilizing markets. Reisen, for instance, has highlighted how, for instance, the Basel Capital Accord II puts an undue emphasis on bank, corporate and sovereign credit ratings and the agencies that make the ratings judgments. Bank capital is to be linked, under some approaches, to published credit ratings, which are formed in a less than perfect manner. Herding, momentum trading and other destabilizing features of financial behaviour may therefore be accentuated.

   Some (e.g., Persaud, 2002) also warn of the risks of increased pro-cyclicality of capital flows as a result of **reduced diversity amongst the risk management practices of foreign (and domestic) banks, financial institutions and investors**. If many are managing the risks under the same risk management systems, then an event that triggers one to pull out will be the catalyst for all to pull out. In this regard, we need to also bear in mind the considerations on Highly Leveraged Institutions addressed in Chapter 6. Together, these concerns emphasize the importance of national authorities understanding the risks involved in institutional behaviour and prudential regulation.

4. Roadmap for Capital Account Liberalization

A Roadmap for the Integration of ASEAN (RIA) on financial and monetary integration is currently being developed under the direction of the ASEAN Finance Ministers. It covers 4 areas: (i) development of ASEAN Capital Markets; (ii) liberalization of financial services; (iii) liberalization of capital account; and (iv) the establishment of an ASEAN Currency and Exchange Rate System.

The current draft ASEAN roadmap for cooperation on the issue of capital account liberalization and the goal of freer flow of capital by 2020 involves **sequencing**. See table 17 below:

Table 17. Detail of Existing ASEAN Roadmap for Capital Account Liberalization

Critical Success Factors	Steps	Time Frame	Problems/ Obstacles	Recommendations
Strong political will and commitment to efficiently implement necessary reforms of the financial systems. Prudential supervision and regulation measures to ensure adequate management of risks, effective internal governance and market discipline.	1. Remove all types of administrative (i.e., outright prohibitions or approval procedures, quantitative limits) and market-based controls (i.e., explicit or implicit taxation, reserve requirement, dual or multiple exchange rate systems) on **Foreign Direct Investment**. 2. Remove all controls and restrictions on **Portfolio Investment**. 3. Remove all controls and restrictions on **Long-term Borrowing**. 4. Remove all controls and restrictions on **Short-term Borrowing**. 5. Strengthen supervisory and regulatory regime through the implementation of **financial, legal and structural reforms** that are required for the liberalization of capital flows in steps 1 to 4. [*emphasis added*]	**2005** **2008** **2012** **2015** **2003 – 2015**	Inadequate financial infrastructure, accounting, auditing and disclosure practices, prudential regulation and supervision measures, that limit the ability of the domestic banking system to fully and efficiently intermediate capital flows in the economy. Lack of institutional capacity to engage in a wide range of capital account transactions and to assess and manage risks associated with large capital flows. Tendency to adopt protectionist and populist measures in response to political pressures from certain interest groups.	Identify and establish preconditions for successful external liberalization, including the implementation of key financial sector reforms and policies and institutional capacity, as well as development of necessary institutions, markets and instruments for dealing with massive capital flows. Gradually remove restrictions on capital movement in accordance with the progress in financial reforms. In line with the above approach, develop a work program for capital account liberalization detailing each subsequent step and timeframe until all restrictions are eliminated, preferably by 2020 at the latest. Monitor and discuss the progress of liberalization against the benchmarks in the work program annually as part of the review of the implementation of the Finance Work program. Given the varying level of economic and financial developments in ASEAN, member countries with limited capacity to implement reforms should be assisted through capacity-building program.

Source: ASEAN Secretariat. 2002. "Roadmap for Integration: Financial & Monetary Integration." Information Paper, ADFM, Yangon. October 22.

Considerations

The sequence is risk-minimized in that the safest capital flows are envisaged to be liberalized first, and the riskiest capital flows last: FDI first, followed by portfolio flows, then long-term borrowing and finally short-term borrowing. And there is to be continuous improvement in legal and regulatory structures, as is very appropriate.

However, the draft roadmap raises **several issues**:

1. As we saw in Chapter 2, the international consensus now is **not so clearly in favour of the end-point**, of full capital account liberalization. Indeed, controls which restrict the internationalization of local currencies, and periodic resort to temporary controls when inflows are too buoyant or outflows too rapid, have become the norm where financial systems are not sufficiently robust to cope with the volatility that may arise from freer capital flows (see Prasad 2003 and The Economist 2003).

2. **The timetable** for a country to open its capital account to particular flows has to be determined by the national officials and policy-makers, having assessed when they are ready. Many of the ASEAN-6 today have still severely weakened financial systems and infrastructure that needs building. The CLMV countries have still greater needs to develop some strong domestic financial institutions and practices before major capital flows intrude. Progressing de-dollarization (if that is the decision taken in CLV countries) and exchange rate unification in Myanmar are policy changes that will be all-consuming and of completely uncertain duration. For these economies, capital account liberalization may well come late.

3. The draft roadmap proposals appear to relate essentially to **easing restrictions on *inflows*** of capital, whether it be from ASEAN countries alone or also from the rest of the world ex-ASEAN. As such, it is consistent with the traditional **"fish-trap approach"** to Asian economic and financial development, in which inflows are good, and outflows are bad [Sheng 2002]. However, much of the longer-term gain to ASEAN economies from liberalization will come from liberalizing controls and restrictions over **outflows of capital, not just inflows**. Countries might like to consider a similar range of steps and timeframe for easing restrictions on outflows, subject to some limits on lending to non-residents in local currency when the borrowing is to be used to speculate against the exchange rate. Conceptually, opening up ASEAN countries first to capital inflows and only later as a destination for outflows implies an **"anyone-but-ASEAN" preference**, which is surely not intended.

4. In many countries virtually all the **critical success factors are still absent** and the problems and obstacles appear – for now – deep-seated, intractable and overriding. To attempt to coordinate an ASEAN-wide program of capital account liberalization without effectively resolving the issues would lead to substantial disappointment.

Above all, a roadmap for ASEAN on capital account liberalization must be tailored to the needs and capabilities of the individual member economies. Each has developed its financial system, including its set of exchange restrictions and capital controls, to be unique, and uniquely designed to address local issues and achieve balance. Generic sequencing plans therefore can only be a guide.

Liberalization of capital flows only within ASEAN or between ASEAN and the world?

One important issue that has been skirted around in the roadmap is whether the **benefits of capital flow mobility can be maximized**, and risks minimized, by giving other ASEAN countries either **preference or exclusivity**. For instance, is opening up to capital flows from other ASEAN members a "softer, gentler" form of liberalization, or does it incur significant costs without extending many benefits?

Our "big picture" economic view is that the benefits of capital account liberalization would **not** be fully achieved if the only permitted flows were between ASEAN member countries. It is the rest of the world that has the capital that ASEAN countries are most motivated to attract, and presents the investment diversification opportunities that many ASEAN-based investors would most benefit from. An ASEAN preference in capital account restrictions would add a layer of **complexity** to an already complex set of rules. And, in addition, existing controls would be **more easily circumvented** if loopholes were created to allow flows to and from other ASEAN countries.

Nevertheless, even without an ASEAN preference, it is likely that businesses in ASEAN will be disproportionately represented amongst foreign investors in any other ASEAN country. Through close proximity and business dealings, they are likely to know more about business opportunities in other ASEAN countries (the information asymmetry is lesser) and can take up those opportunities more easily.

Thoughts for revisions to the roadmap:

1. Explicit provision should be made in the roadmap for the adoption or maintenance of prudentially-motivated controls on capital flows.

2. The timetable for liberalization laid down in the roadmap should be ambitious (with due regard for the need for propitious critical success factors) but not overly prescriptive, and with no penalties for not meeting the timetable.

3. Excepting for CLMV countries which may usefully seek to limit outflows while they develop a domestic savings culture, the roadmap should focus on easing restrictions on both inflows and outflows in tandem.

4. The roadmap, as it applies to individual member countries, must be tailored to the needs and capabilities of those individual members.

5. The roadmap for capital account liberalization in ASEAN should not give preference for capital flows to and from ASEAN countries, but to liberalization of controls over flows to and from all countries.

A Recommended Program and Sequence of Reforms for ASEAN Countries: The Generic Roadmap

The revised draft roadmap is put forward in table 18 to stimulate discussion on the way ahead. It reflects the thinking outlined in preceding sections of this report. Further elaboration is provided after the revised draft roadmap is presented.

Table 18. Recommended Revised ASEAN Roadmap for Capital Account Liberalization

Sequence of Measures to Liberalize Capital Account Restrictions	**Type of Risk**	**Primary Policy Measures to Limit Risk from Liberalization of Specific Capital Flows**	**Further Precautionary and/or Facilitative Measures**
1. Current account proceeds Ease (i) repatriation and surrender requirements[1] and (ii) unify any remaining dual exchange rates, so that countries can accept the obligations of IMF Article VIII.	Moves to reduce distortions brought about by dual exchange rates and/or trade barriers designed to restrict imports or subsidize exports or measures that affect the timing of payments and receipts may worsen the trade balance, disadvantage some industry and labour and/or upset the government's fiscal balance.	• Develop macro-and micro-economic policies that are conducive to productivity growth and facilitate flexibility in the deployment of capital and labour resources. • Diversify government fiscal exposures by broadening tax base and limiting expenditures and ensuring that government business enterprises face market-based prices and hurdles on return of capital. • Improve tax regime so that there is no tax advantage in not repatriating export receipts.	• Consider Asean technical and fiscal assistance where serious transitional impact would be incurred.
2. Foreign direct investment (FDI) (and, probably later, real estate investment) Ease controls and/or other restrictions on inward and outward investment flows, and on liquidation of investments by non-residents, to implement commitments under the AIA.	Despite being the safest form of capital flows, outward and inward foreign direct investment or real estate investment is often financed by financial institutions, and can give rise to credit risk that may be compounded by various other risks, including in particular foreign exchange risk. Moreover, real estate has proven to be susceptible to price bubbles. Sudden or panicky rushes of outward investment may also be destabilizing.	• Adequate risk management practices by financial institutions, reinforced by prudential regulation and supervision, are needed to mitigate these risks. • Strengthen accounting practices to ensure appropriate valuation, especially for collateral. • Improve insolvency regime. • Guard against misallocation of investment and against price bubbles and substantial currency depreciation by maintaining sustainable prospects for low inflation.	• Maintain policies that create confidence in the sustainable growth and development of the domestic economy.
	Unsound ventures or fraudulent activities.	• Increase transparency and market discipline through strong accounting and disclosure rules.	

[1] Technically, these measures are not capital controls as they involve transactions among residents, but they limit the scope for residents to undertake capital transactions.

Table 18. Recommended Revised ASEAN Roadmap for Capital Account Liberalization cont./

Sequence of Measures to Liberalize Capital Account Restrictions	**Type of Risk**	**Primary Policy Measures to Limit Risk from Liberalization of Specific Capital Flows**	**Further Precautionary and/or Facilitative Measures that may be Appropriate**
3. Capital and money market instruments (e.g., tradeable securities including equities, bonds, and money market instruments) Ease controls that limit (i) purchases locally by non-residents or (ii) sale and issue locally by non-residents and (iii) purchases abroad by residents.	Sales and purchases by non-residents can result in sudden or large-scale reversals in capital flows, with a boom-bust pattern in asset prices that can spill over to domestic demand and the exchange rate, and entail the risk of an external or financial crisis if market access is curtailed	• Develop deep and liquid domestic markets in these instruments, with efficient payments and settlements systems, well integrated with monetary operations. • Diversify funding sources and improve maturity structure of liabilities. • Develop efficient insolvency procedures to facilitate foreclosure and debt restructuring. • Closely monitor non-resident investors' demand for domestic financial assets, including bank deposits on an *ex post* basis. • Establish appropriate lender-of-last-resort facilities to maintain market liquidity.	• Where appropriate, to limit the risk of volatile capital flows, impose or maintain Chilean-type inflow taxes and/or keep in reserve a Malaysian-style rule delaying outflows. • To gain most from liberalization and yet limit the risk of volatile capital flows, liberalize controls on inflows and outflows of equity portfolio investment before controls on debt portfolio investment. • Delay liberalization of controls over flows involving short-term debt until the end of the liberalization program.
	Sales and purchases by residents involve exposure to market risk (foreign exchange, interest rate, and price), credit risk (except for equity), and liquidity risk.	• Establish prudential safeguards, including limits on shareholdings of domestic banks and other financial institutions, and limits on lending against shares. • Ensure that financial institutions appropriately value these instruments (for example, by marking to market). • Enhance financial institutions' capacity to monitor and manage their direct and indirect (through their clients and counterparties) exposure to these instruments.	
	Mispricing of securities owing to inadequate information. Fraud	• Improve accounting, transparency, and disclosure standards. • Strengthen law enforcement.	

Table 18. Recommended Revised ASEAN Roadmap for Capital Account Liberalization cont./

Sequence of Measures to Liberalize Capital Account Restrictions	Type of Risk	Primary Policy Measures to Limit Risk from Liberalization of Specific Capital Flows	Further Precautionary and/or Facilitative Measures that may be Appropriate
4. Commercial banks and other financial instruments Ease restrictions on (i) borrowing by residents abroad and (ii) lending to non-residents.	Liquidity or solvency risk related to borrowing by residents.	• Diversify funding sources and improve maturity structure and debt-equity mix. • Improve financial institutions' liquidity management and disclosure.	• Where appropriate, to limit risk of volatile capital flows, impose or maintain constraints on lending to non-residents to limit the internationalization of the domestic currency. Also, if appropriate, impose or maintain Chilean-type inflow taxes and/or keep in reserve a Malaysian-style rule delaying outflows. • Delay liberalization of controls over flows involving short-term debt until the end of the liberalization program.
	Credit risk related to lending to non-residents, which may be compounded by foreign exchange risk.	• Limit financial institutions' exposure to a single borrower or a country. • Implement internationally recognized supervisory practices for capital adequacy, asset classification, and provisioning. • Implement sound practices for credit risk assessment and management. • Develop securitized markets for credits.	
	Mismanagement and fraud.	• Increase transparency and market discipline through strong accounting and disclosure rules.	
	Slow resolution of creditors' claims undermines credit culture and reduces market access.	• Strengthen insolvency procedures that allow rapid foreclosure of assets.	

Table 18. Recommended Revised ASEAN Roadmap for Capital Account Liberalization cont./

<table>
<tr><th>Sequence of Measures to Liberalize Capital Account Restrictions</th><th>Type of Risk</th><th>Primary Policy Measures to Limit Risk from Liberalization of Specific Capital Flows</th><th>Further Precautionary and/or Facilitative Measures that may be Appropriate</th></tr>
<tr><td rowspan="2">5. Derivatives and related instruments

Ease controls over transactions involving (i) forwards and futures and (ii) other derivatives.</td><td>Counterparty credit risk, which can change substantially with market conditions for underlying shares.</td><td>• Strengthen supervision capacity, including oversight to limit excessive exposures, to assess the risks associated with derivatives.</td><td rowspan="2">• Where appropriate, to limit risk of volatile capital flows, impose or maintain constraints on derivatives and related instruments to ensure that restrictions on internationalization of the domestic currency or on short-term capital flows are not undermined.</td></tr>
<tr><td>Counterparty credit risk, which can change substantially with market conditions for underlying shares.</td><td>• Develop deep and liquid markets for the underlying assets and liabilities.
• Develop risk management capacity in financial institutions, including through hiring and training skilled personnel.
• Strengthen accounting rules to properly measure the risks.
• Strengthen reporting by financial institutions on derivatives risks, and disclosure of counterparty exposures.</td></tr>
<tr><td>6. Additional Regional and/or Individual Country Measures to Minimize Risks of Excessively Volatile Capital Flows</td><td colspan="3">• Undertake thorough research, including preparing an inventory of capital controls, assessing conditions and vulnerabilities, and determining a sequence for capital account liberalization and other policies appropriate for the individual countries.
• Establish Collective Action Clauses to include in the term sheets for sovereign borrowings and establish and announce the “rules of the game” that will “bail private foreign investors in”, in event of a subsequent crisis.
• Continue to improve and implement comprehensive data-gathering, monitoring and surveillance of short-term and long-term capital flows.
• Organize a schedule of ASEAN countries as volunteers for the joint IMF/World Bank Reviews of Observance of Standards and Codes (ROSC) and Financial Sector Assessment Programs (FSAP).
• Monitor and discuss the progress of liberalization against benchmarks in work programs annually. Take care to ensure that the risk of destabilizing capital flows is limited in moves to liberalize trade in financial services.
• Given varying levels of development, consider assisting member countries that have limited capacity to assess and manage risks associated with capital flows and to implement reforms with capacity-building programs.
• Assist all countries select exchange rate regimes that minimize the risk of damage from capital flow volatility in a more liberal capital flow environment. When appropriate, address issues of practicalities of any proposed transition to a single ASEAN currency and develop appropriate convergence criteria that minimize risk of destabilizing capital flows in the transition period.</td></tr>
</table>

When considering revisions to the draft roadmap, it seemed advisable to establish a timeframe and program that identifies “quick wins” and medium- and longer-term reforms. Responsibilities for action lie with individual countries and the ASEAN Secretariat Bureau of Finance and Surveillance (BFS) Suggested BFS responsibilities are identified below.

The Recommended Roadmap for the Short-term:

1. Liberalize any remaining restrictions impeding current account transactions (especially the IMF Article XIV countries (see (3.) below) to gain full benefit from trade flows.

2. Commence the move to a unitary exchange rate system, where a dual system persists (i.e., Myanmar), with budgetary support from within ASEAN if necessary to assist the adjustment process, to improve resource allocation.

3. Accept IMF Article VIII (i.e., Lao PDR, Myanmar and Vietnam) to “lock-in” access to the benefits of unimpeded trade flows.

4. Liberalize any remaining exchange control restrictions on inflows and outflows of foreign direct investment (FDI). These are the safest and most obviously beneficial capital flows. Restrictions on FDI motivated by social policy or other national priorities should be implemented outside of the exchange control arrangements.

5. Liberalize exchange control restrictions on inflows and outflows of portfolio equity investments. Controls motivated by social or other priorities should be implemented outside the exchange control arrangements.

6. Continue to improve and implement comprehensive data-gathering, monitoring and surveillance of short-term and long-term capital flows, both for each country and for the ASEAN group of countries. 5 countries are already involved in an ASEAN Secretariat project to improve capacity to monitor short-term capital flows – Cambodia, Indonesia, Lao PDR, Philippines and Vietnam. One means of improving monitoring would be to require all flows to be transacted through authorized intermediaries with commercial presence. The role of the BFS in coordinating surveillance and information-sharing is important and may most usefully focus on early identification of emerging threats of capital flow instability.

7. Where they are not already in place, consider for prudential reasons the introduction of Chilean-type inflow taxes (unremunerated reserve requirements (URR) on specified types of capital inflows) and/or constraints on internationalization of the domestic currency (restrictions on lending domestic currency to non-residents that may be used to speculate against the exchange rate).

8. Establish, through discussion in an ASEAN framework (organized by BFS?), the most appropriate Collective Action Clauses to include in the term sheets for sovereign borrowings, to facilitate interruption to debt service in event of a crisis.

9. Establish, through discussion in an ASEAN framework (organized by BFS?), the most appropriate “rules of the game” to “bail private foreign investors in” in event of a new crisis, to be announced at a time of further capital account liberalization.

1. The Recommended Roadmap for the Medium- and Longer-term:

1. Strengthen the supervisory and regulatory regime through the implementation of financial, legal and structural reforms that are required for the liberalization of capital flows and other liberalization programs. Regular BFS coordination of surveillance and peer review will help drive individual country action.

2. Comprehensively address the dollarisation issue in Cambodia, Lao PDR and Vietnam (and Myanmar?), of course having regard to plans, if any emerge, for the introduction of a single ASEAN currency. There may usefully be a role for BFS to contribute to identifying capacity building needs and facilitating delivery of assistance in the countries.

3. Build or improve the effectiveness of institutional investors and security markets and risk management capacities, to reduce reliance on and the dominance of banks and the banking system. Several ASEAN-area initiatives are driving progress in this area: BFS may contribute by initiating periodic regional reviews.

4. Assist countries select the appropriate exchange rate regime that minimizes the risk of damage to the country and the region from capital flow volatility. The majority of ASEAN members have prudently adopted exchange rate regimes with some flexibility in-built, which is the international best practice for emerging markets seeking to implement independent monetary policies and maintain an open capital account. The Brunei currency board arrangement with Singapore, as a “hard-fix”, also conforms to this international best practice. Malaysia’s “soft-fix” against the US, in conjunction with an increasingly open capital account and an independent monetary policy, runs against the conventional “trilemma” wisdom, and may eventually attract destabilizing speculation. The BFS may usefully initiate this discussion in the context of minimizing risks of capital flow instability for the region.

5. Organize a schedule of ASEAN countries as “volunteers” for the joint IMF/World Bank Financial Sector Assessment Programs (FSAP) and Reviews of Observance of Standards and Codes (ROSC), with capacity-building assistance (from more advanced ASEAN member countries?) where that is requested by a member preparing for an FSAP. FSAPs have already been undertaken for the Philippines in 2002 and Singapore in 2002/2003. Malaysia has considered the opportunity; but at this stage has not taken it up. In fieldwork, other countries did not say whether they were interested in participating or why they had not yet participated, though the explanation is likely to be that the FSAP is relatively new, and its global capacity is still developing. The following suggested order/timing for other ASEAN countries is put forward to initiate discussion: Thailand 2004, Indonesia 2005, Malaysia 2006, Vietnam 2007, Brunei 2008, Cambodia 2009, Lao PDR 2011 and Myanmar 2013. FSAPs are not intended to replace national evaluations or policy reform processes in any way, but are intended to assess the financial sector as it is changing and give some insight from external experts. The prioritization we have suggested takes broad account of the anticipated level of financial sector and other development and the consequence for the region of financial instability in the countries in question.

The list of suggested items is hardly comprehensive, yet it gives an indication of the scope and duration of reform efforts that lie ahead.

5. Consideration of Individual Country Programs

From the Generic to the Specific

Our analysis, in the context of learning the lessons from other countries' experience and applying these lessons to suggesting revisions of the generic roadmap, leads to the following general conclusions:

1. Flexibility is required in programs and sequencing
2. Urgent capacity building is needed in less advanced countries
3. Determining the exchange rate regime and the prudential framework cannot be rushed
4. Learning by doing often beats waiting
5. Country differences imply a two-speed ASEAN, if not multi-speed
6. Transition economies should concentrate on developing banking systems
7. Some more advanced economies also need to strengthen financial systems
8. Take a cautious approach to internationalizing local currencies
9. All ASEAN countries should take up offers of "free" FSAP & ROSC reviews

It is worth restating these conclusions in full as we consider how the generic roadmap may frame the programs for individual countries.

1. Flexibility is required in programs and sequencing

One key feature of the revised approach to sequencing is the recognition that flexibility is required in applying the proposed general sequence to the evolving and very individual circumstances of a country. In consequence, for instance, the tasks ahead for ASEAN countries that are in transition to more market-based economies are dramatically different to the tasks ahead for the more advanced ASEAN countries, which have much more experience with capital flows. A further implication is that the sequences of measures recommended in this study for the individual countries in ASEAN are no more than a first cut, that will have to be re-assessed and altered as reforms and development proceed. Periodic reviews of progress and issues arising are highly desirable, both at an ASEAN level (with BFS assistance) and by individual countries.

2. Urgent capacity building assistance is needed in less advanced countries

The resources required for the full analysis and assessment of the financial sector and the scope for capital account liberalization are very large, and often exceed existing capacity in individual countries, let alone the scope of this study. Urgent capacity building in the less advanced ASEAN countries is warranted, supported locally and from the region and other agencies – the issues are going to have to be addressed by each country, ready or not, as the pressures from globalization proceed. It is a paradox that the more advanced countries that have substantially liberalized their capital accounts generally have less to benefit from such access to foreign capital, whereas it is the transition economies of ASEAN which face a shortfall in domestic savings, and therefore have much the most to benefit in terms of increased investment from improved access to foreign capital. However, they also face the greatest challenges in safely opening up. In most of the advanced ASEAN countries (arguably with the exception of the Philippines), domestic savings are a very high proportion of GDP and quite adequate to finance a strong program of domestic investment. The ASEAN Secretariat BFS could usefully play a focused role in identifying and assessing capacity building needs and facilitating assistance to the less advanced ASEAN member countries.

3. Determining the exchange rate regime and the prudential framework cannot be rushed

Some really big issues cannot be resolved quickly, especially the macro issues in CLMV transition countries – the exchange rate (dollarize, de-dollarize, currency board, "hard fix", managed floating or free floating etc.?) – and the complex prudential and other micro issues in addressing market imperfections of asymmetric information and inconsistent knowledge and standards across jurisdictions. Reforming the exchange rate is a significant task that requires very clear analysis. Establishing sound banking systems and new codes of conduct and standards of governance cannot be achieved *by fiat* or overnight.

4. Learning by doing often beats waiting

"*Waiting*" is a popular prescription for some who propose carefully sequenced reforms. Certainly, few countries visited in fieldwork gave an impression of having prepared for more capital account liberalization, sequenced or not. However, we believe that "*waiting*" is often not the answer. Some things cannot be learned from a text-book or grafted onto a country's existing processes. They have to be *learned by doing*. A key example is introducing a "credit culture" into a banking system where credit has previously been directed by the authorities. The only way to start the learning process is by making the reforms. This re-emphasizes the need for early and sustained reforms, but it also confirms the desirability of keeping the pace of development of capital account liberalization in rough balance with institutional growth.

5. Country differences imply a two-speed ASEAN, if not a ten-speed ASEAN

The majority of ASEAN members already have substantially liberalized their capital accounts, and we recommend that most of them devote their major efforts to ensuring that net benefit is obtained from the liberalized capital flows and that the risk of volatility is minimized at reasonable cost. Others have not liberalized their capital accounts to any great extent (or even achieved full liberalization of their current accounts), and they have further to travel to gain the net benefits on offer from a safe liberalization of their capital accounts. While individual country programs can be seen as a subset of the suggested ASEAN roadmap, there is considerable danger in trying to force countries into a timing and sequence that does not suit their individual circumstances. Programs need to be individually tailored.

6. Transition economies should concentrate on developing banking systems

We cannot be sure that the countries still at the early stages of their transformation to market economies and the development of better banking systems will actually be ready before 2020 to liberalize most of, let alone all of, their capital accounts.

However, their starting point and the immediate steps ahead are reasonably clear. The program or sequencing for these countries concentrates on the early years.

7. Some more advanced economies also need to strengthen financial systems

Equally, some of the more developed ASEAN countries appear to us to have "gone too far" in their liberalization of their capital accounts, in comparison to their need for sounder and more supportive financial systems. The demands from the liberalized state of their capital accounts are a considerable distraction from the urgent tasks of rebuilding sound banking institutions and building the capacity of the authorities to prudentially supervise and regulate the banking sector. Thus, on occasion, we recommend consideration of some re-imposition or tightening of controls/restrictions (e.g., on lending to non-residents), at least until the domestic financial systems are on a sounder footing. Sometimes one has to step backwards to ultimately move forward.

8. Take a cautious approach to internationalizing local currencies

Overall, excepting Singapore, which appears well-advanced in developing its own very sophisticated capacity, we are not in favour of other ASEAN countries facilitating the internationalization of their currencies. We do favour encouraging foreigners to invest in local currency assets, including especially in FDI projects and in local equities, both for the transfer of real resources and technology and for the incentive given to improve market structures and operations and the conduct of policies. And we also favour residents being able to access foreign funds and hedge currency exposures. But we do not see any advantage in facilitating the exit of foreign investors from their local currency exposures in volatile times, so we do not propose reforms that will unnecessarily facilitate speculation against the local currency. In our view, there is no reason to allow foreign investors to borrow local currency [except for some local costs of FDI projects], and foreign banks that enter the domestic banking market must meet the same prudential limits on currency exposures as do domestic banks.

9. All ASEAN countries should take up offers of "free" FSAP & ROSC reviews

The IMF/World Bank Financial Sector Assessment Program (FSAP) can provide a useful and thorough review of financial sector capacity for liberalization by external experts (from multilateral and national agencies, possibly including from Bank Negara Malaysia and the Monetary Authority of Singapore). The FSAP program builds on the conventional IMF Article IV annual review program. The Philippines and Singapore have recently participated in an FSAP. From our vantage, we see considerable benefit to all other ASEAN countries to individually invite the IMF to assemble a FSAP team to undertake such reviews. (BNM has considered participating, but has declined to do so, citing the work that went into the development of its Financial Sector Master Plan.) The Philippines has also recently completed a slightly different IMF external review, of compliance with standards and codes (ROSC), targeting fiscal transparency. The ROSC reviews are also likely to be very useful to ASEAN member countries as their governance, legal and other standards develop. There is no such thing as a free lunch, however: the FSAP and ROSC require lots of preparation, staff time and follow-up.

Recommended Program and Sequence of Reforms for Individual ASEAN Countries:

Below we summarize the programs and sequence of reforms that our analysis suggests for individual ASEAN countries. The analysis is presented in more detail in tabular form for each country in **Annex 3**. In addition, **Volume 2: Country Reports** sets out some of the background and considerations for each country. What is presented is only a 'first-cut' and all countries are urged to undertake their own analysis and assessment.

1. **Brunei Darussalam** already has a very liberalized capital account (with some minor limits on inward FDI) and there is no significant set of measures or sequence to liberalize Brunei's capital account to be recommended. The exchange arrangements are also very appropriate, with a currency board that pegs the Brunei ringgit to the Singapore dollar at par. Brunei does not attempt to pursue an independent monetary policy, but "imports" Singapore's monetary policy. Brunei is extremely dependent, therefore, on the quality of financial and economic management in Singapore and any changes in the policy of non-internationalization of the Singapore dollar that were to lead to greater volatility in financial markets in Singapore would be of major consequence. However, Brunei does have a significant task ahead in reforming its financial system. Banks dominate Brunei's small financial system and it would be desirable to see other institutions and instruments develop in order to reduce the risk of periodic financial instability. Prudential regulations and prudential capacity need to be improved, especially if the Brunei International Financial Centre succeeds in intermediating funds, not least to contain and manage the destabilizing consequences of leakage of international funds into the domestic Brunei market. Brunei seems unlikely to need to make any sovereign bond issue, so no Collective Action Clause is required, but a warning that private investors will be "bailed in" would still be appropriate. Brunei might usefully volunteer to participate in an IMF/World Bank FSAP and ROSC once already-planned prudential reforms have been implemented.

2. **Cambodia** has a relatively loose set of restrictions on capital account flows. Our recommended sequence of measures for a safe move to fuller capital account liberalization involves initial imposition of some new restrictions and many financial sector reforms, before capital account liberalization can be safely resumed and advanced. Cambodia is very highly dollarized, with the US dollar and the Thai baht circulating freely. The riel floats. Deposits in the banking system are almost entirely denominated in foreign currencies, as are assets. This dollarization, and the very limited state of development of the financial system, has allowed an open capital account to prevail. Financial intermediation remains very limited, in part because there has been considerable financial sector volatility in the past, so bank liquidity reserve requirements have been set at a high level (80% is required); but the resultant high cost of intermediation has meant that banks do not lend, and would-be borrowers look elsewhere. Reserve requirements need to be reduced as other supervisory means of ensuring bank safety develop. Until the improvements in economic and financial sector management (which have both been significant in recent years) give confidence to the population to hold and transact in riels rather than dollars, the open capital account should be retained. But once de-dollarization commences in earnest (e.g., with the issue of riel-denominated bonds), some limitations on capital flows will be appropriate to contain short-term inflows and

avoid internationalization of the riel. This will help support economic recovery and pursuit of an appropriate monetary and exchange rate policy. During this transition, it will probably be appropriate to limit outflows until the domestic savings rate has increased. A Collective Action Clause should be considered for any sovereign issue, along with other means to “bail-in” private foreign investors. Participation in an IMF/World Bank FSAP and ROSC should be scheduled for later, after substantial progress has been made with financial sector development.

3. **Indonesia** has had an open capital account for a long period and a prudent sequence of measures to achieve further liberalization of capital flows must concentrate on financial sector and governance reforms rather than renewed capital account liberalization *per se*. Indonesia has a floating exchange rate, but is likely to accord a high priority to exchange rate stability (and other aspects of financial sector stability) for the foreseeable future, supported by a move to inflation-targeting for monetary policy. Measures that help avoid capital flow instability are therefore very desirable until the inflation-targeting regime is robustly established. A very appropriate “non-internationalization” restriction was applied from January 2001, preventing banks from lending rupiah to non-residents. The banking sector remains dominant, but is still burdened by NPLs and a lack of creditworthy borrowers. The process of intermediation (beyond consumer lending) has not revived since the crisis, with the major banks, recapitalized by the state, now channelling bank deposits mostly into bonds. The way forward lies with accelerated and effective restructuring of the corporate sector and the banking sector. This will require enormous political will, including a determination to make the legal system work, and effective enforcement of regulations. As local interest rates are likely to remain above global rates, and so attract capital inflows, it may be desirable to impose some tax via an unremunerated reserve requirement on short-term inflows. A Collective Action Clause should be considered for sovereign issues, along with other means to “bail-in” private foreign investors. Indonesia should volunteer for participation in an IMF/World Bank FSAP and ROSC once further early progress has been made with financial sector strengthening.

4. **Lao PDR** has a very regulated capital account and could benefit greatly from well-deployed capital inflows. It pursues a managed float for the kip exchange rate, which has depreciated substantially, at least until recently. There is little evidence of strong international investor appetite. The economy is substantially dollarized (less than Cambodia, but more than Vietnam). There is a small financial sector, which is bank-dominated, unconducive to economic development. The priority issue is development of a sound, broad and effective financial system, based on strengthening of current institutions. A first desirable step may be to make the changes required to be able to accept the obligations of IMF Article VIII. De-dollarization is an on-going goal, though still must rank secondary to strengthening the financial sector. Confidence in holding and using kip will be promoted by improvements in the prudential infrastructure (underway with ADB support) and continued better economic management. Controls over inward FDI should be relaxed first, as the economy progresses. If a securities market is to develop later on, some reform in capital controls will be useful, easing the approvals process to improve access for foreign portfolio investors. For risk minimization, this may also require consideration of a market-based limitation, such as an unremunerated reserve requirement. In addition, the de-dollarization process is likely to require a careful sequence of steps to limit volatility in the early stages, implying a need for controls on lending kip to non-residents. Liberalization of restrictions on outflows

might best be delayed until the domestic savings rate has increased. A Collective Action Clause should be considered for any sovereign issue, along with other means to "bail-in" private foreign investors. Participation in an IMF/World Bank FSAP and ROSC should be scheduled for later, after substantial progress has been made with financial sector development.

5. **Malaysia** has had a very open capital account since the 1970s, but made clever and well-timed use of selective capital controls in the 1990s, limiting the actual emergence of financial instability. Malaysia has done more than most to ensure that foreign investors are aware that they may be "bailed-in" were a crisis to develop. Nevertheless, risks of instability do persist: of all of ASEAN, Malaysia is the only one to now peg its domestic currency, the ringgit, against the US dollar, utilizing a "soft fix". Nevertheless it has managed, thus far, to retain monetary policy independence despite substantially easing the selective capital controls applied in September 1998. The financial sector is bank-dominated, and the banks are engaged in domestic restructuring, but the financial system is increasingly broad and deep, with healthy progress in bond and equity market development. Prudential supervision is moving to a market-risk basis. Despite having opened its capital account substantially in the 1970s, Malaysia has built a track-record of use of temporary controls over capital flows (on outflows in 1998 and on inflows in 1994) to facilitate the maintenance or restoration of financial stability. The move in 1998 to apply measures to limit the internationalization of the ringgit was especially decisive and successful. The measures have been substantially softened now that conditions have improved. A sequence of measures to liberalize remaining restrictions over capital flows (both in and out of Malaysia) is appropriate, tied to the progress scheduled for strengthening of the financial sector and the development of capital markets. As international investor risk appetite returns, Malaysia may find renewed problems with the maintenance of a fixed exchange rate. An unremunerated reserve requirement may help in temporarily restraining some of the potentially unstable inflows. However, as the ringgit peg is not a "hard-fix" of the currency board variety, it is likely to be more sustainable and less risky to aim for continued independence in monetary policy by moving to a more flexible exchange rate. An alternative risk-minimized strategy would be yet more stringent restrictions on capital inflows and a vigorous encouragement of outflows. Potential leakage of international flows through Labuan International Financial Centre into the domestic banking system may also be a pressure point for exchange controls and prudential supervision. A Collective Action Clause should be considered for any sovereign issue. Malaysia could be an early – and well-prepared – volunteer for participation in an IMF/World Bank FSAP and ROSC.

6. **Myanmar** has a very regulated capital account and could benefit greatly from well-deployed capital inflows. A risk-minimized sequence of measures to liberalize controls over capital flows however has to start with some very fundamental reform. Myanmar is the only ASEAN country with a dual exchange rate, having an official rate fixed against the SDR for a small number of official transactions and a parallel or market rate that has depreciated sharply in recent years and applies to the majority of transactions. The financial system is dominated by banks, but intermediation is not vigorous and remains unconducive to economic development. Development of the financial sector must be a priority to catalyze economic development, and easier access for foreign investors would be a stimulant as Myanmar re-engages with the international community. Moving to a unified, and flexible, exchange rate is the first necessary step, and would facilitate

acceptance of the obligations of IMF Article VIII. However, a unified exchange rate will impose significant transition costs on the budget, and may warrant ASEAN support through the transition. A second step is reform of the prudential infrastructure to supervise the risks in a more market-driven financial system. Over time, replacing the "everything is controlled" set of exchange controls with more market-sensitive measures would be appropriate. Risks could be minimized by imposition of an unremunerated reserve requirement and delays on portfolio outflows, and by specifying that banks may not lend kyat to non-residents. Liberalization of restrictions on outflows might be delayed until the domestic savings rate has increased. A Collective Action Clause should be considered for any sovereign issue, along with other means to "bail-in" private foreign investors. Participation in an IMF/World Bank FSAP and ROSC should be scheduled for later, after substantial progress has been made with financial sector development.

7. The **Philippines** has had a quite open capital account for a long period, which has been progressively liberalized over recent years. A prudent sequence of measures to achieve further liberalization of capital flows must concentrate in a balanced way on financial sector and governance reforms, as well as capital account liberalization *per se*. The Philippines has a floating exchange rate for the peso and has moved to an inflation-targeting regime. Following the external debt crisis in the early 1980s, its exchange control arrangements focus on limiting access to the banking system for foreign exchange obligations. The financial system is bank-dominated, with banks and others having both domestic operations and Foreign Currency Deposit Units (FCDUs). Prudential supervision (and governance generally) is impeded by a weak legal framework, and needs urgent improvement. Many desirable improvements to financial sector arrangements are likely to have been reviewed by the recent IMF/World Bank FSAP and ROSC. The "non-internationalization of the peso" aspects of capital control might usefully be amplified, making explicit that bank lending of pesos to non-residents is forbidden. An unremunerated reserve requirement may usefully tax short-term inflows, if they are strong as a result of interest rates higher than world norms while inflation is brought down to sustained low levels. Over time, the capital flow approval process might be put on a more market-driven basis, depending less on official judgement. A Collective Action Clause might be considered for sovereign issues, and other means to "bail-in" private foreign investors.

8. **Singapore** is in an enviable position having substantially liberalized its capital account flows, and there is hardly a sequence of liberalization measures to propose. The monetary authority uses the Singapore dollar exchange rate, which floats, as its guide for monetary policy. The exchange control regime has been in place since the 1970s, and has focused on the non-internationalization of the Singapore dollar, together with the promotion of Singapore as a competitive international financial centre. It has high credibility. Initially focused on banking development, prudential and exchange controls split banking books into Domestic Banking Units (DBUs), regulated closely and conservatively, and Asian Banking Units (ACUs), which faced much lesser costs. To help encourage the development of Singapore's capital markets for international issuers, aspects of the restrictions have been eased, and the non-internationalization policy now extends only to not lending Singapore dollars to non-resident financial entities for use in speculative purposes and a requirement for conversion of Singapore dollars raised in Singapore by non-residents into foreign exchange before their use overseas. Over time, as prudential standards and capacity in the industry continue to increase,

there will be advantages in further easing these limited restrictions, to reduce any remaining costs of the approval/transacting process. Some improvements to financial sector arrangements are likely to have been suggested by the recent IMF/World Bank FSAP. Singapore will of course be aware of the desirability of avoiding financial sector instability from capital flows in its increasingly sophisticated financial sector, not only because of the consequences for Singapore's welfare but also because any instability will flow through directly to Brunei's more fragile markets.

9. **Thailand** has had an open capital account for a long period, though some prudential restrictions on internationalization of the currency have now been imposed. A new sequence of measures to gain net benefits from further liberalization of capital flows must also concentrate on financial sector and governance reforms. Thailand manages the float of the baht exchange rate and has moved to inflation-targeting. Since just before the crisis in June 1997, the authorities have put in place a set of exchange restrictions on the supply of baht to non-residents, thus moving to limit the scope for non-residents to speculate against the exchange rate. Previously, the capital control regime was very open. Measures that created an official offshore market were reversed in 1998. The financial system is bank-dominated, but is broadening, with gradual development of other institutions and capital markets. Prudential supervision is moving to be more risk-based and focused on governance standards. Before significant further capital account liberalization is appropriate, the improvement in train in the financial sector needs to be effected, which may be accelerated by some increased foreign entry. The authorities face a dilemma. On the one hand, maintenance of stability and avoidance of risk would be facilitated if a tax, such as an unremunerated reserve requirement, were available to limit the risk of excessively strong inflows when economic momentum and inflation pick up and interest rates rise. On the other hand, in order to promote development of the securities and derivatives markets, the approvals process for non-residents seeking to issue securities in Thailand might best be eased, and risk management through derivatives also facilitated. A Collective Action Clause might be considered for sovereign issues, and other means to "bail-in" private foreign investors. Thailand should volunteer for participation in an IMF/World Bank FSAP and ROSC after further early progress has been made with financial sector strengthening.

10. **Vietnam** has extensive controls over capital flows, which are being gradually liberalized. The economy could benefit greatly from access to well-deployed capital inflows and, later, from access to opportunities obtained from capital outflows, provided risks of instability can be minimized. Of all the new ASEAN members, Vietnam most closely reflects the original members and is attempting to grow through the same strategies earlier deployed. However, Vietnam has adopted a managed float for the dong exchange rate, with the flexibility acting as a safety valve. The IMF has not yet accepted that Vietnam complies with the obligations of Article VIII on current account convertibility. Resolution of the underlying issues is desirable. The financial reform agenda is substantial and also needs early progress. The financial system is bank-dominated and saddled with a heavy burden of NPLs from SOEs, though there has been some progress with the commencement of operations of a stock market, bond tenders and insurance sector development. Prudential and legal standards are being worked on, together with improvements to operational efficacy in the major banks. Risk minimized capital account liberalization depends substantially on further financial sector

strengthening. With a development plan that depends on substantial access to international capital, an early easing of restrictions on inflows (especially over FDI and other means for non-residents to take local currency risk) is appropriate. A Collective Action Clause should be considered for any impending sovereign issues, and other means to "bail-in" private foreign investors. Liberalization of restrictions on outflows might be delayed until the domestic savings rate has increased. Vietnam should volunteer for participation in an IMF/World Bank FSAP and ROSC after further progress has been made with financial sector strengthening.

These country recommendations need to be validated by analysis by the individual countries, possibly with assistance from the Bureau of Finance and Surveillance in appropriate cases.

6. Analysis of the Financial Stability Forum (FSF) Consideration of Highly Leveraged Institutions (HLIs) and Short-Term Capital Flows and Global Actions

Summary

Little action has been seen from the global leaders as (i) the issues have been overtaken by events; (ii) the HLIs have been in retreat from big macro-positioning (though there are reports of some return of macro funds recently); and (iii) the strategic approach, to control through existing supervision/regulation channels (largely on banks), may be working and is the logical approach if we believe that the new Basel capital adequacy approach is appropriate.

However, the HLIs and other institutional investors and banks are prone to herd-like and destabilizing behaviour, which will continue in future. This makes more appropriate some actions by ASEAN countries to do some of the following:

1. Limit short-term capital inflows prior to any crisis through imposing unremunerated reserve requirements (URR).

2. Keep to a minimum the offshore trading of local currencies through actions to avoid supplying the offshore market with local currency (so-called "non-internationalization" controls).

3. Build defenses through reserves accumulation (though this is expensive, as we have seen in Chapter 2).

4. Develop currency swap agreements as under the Chiang Mai Initiative (though this presumes the funding under the agreements is accessible and is an effective addition to the defense provided by in-country foreign reserves).

5. Pre-announce the rules under which the private sector will be "bailed in", in the event of a crisis, which may include a Malaysian-style "12-month rule" on repatriation of profits/proceeds of sale of local securities.

6. Develop a prudential and regulatory framework that will give adequate protection to ASEAN-based retail investors participating in hedge funds.

Assessment of Progress

HLIs remain largely, but not entirely, unregulated. Furthermore, FSF assessments have not recommended regulation, (See FSF, 2002, March)[*]. However, this remains under review in many jurisdictions, including the US.

[*] "The FSF Recommendations and Concerns Raised by Highly Leveraged Institutions (HLIs): An Assessment." March 11 says an initial FSF report in March 2000 *did **not** recommend direct regulation of currently unregulated HLIs but indicated that this would be reconsidered if, upon review in March*

The 2000 Report had focused on three main concerns over HLIs:

1. The systemic risks arising from the accumulation of high levels of leverage in financial markets;

2. The potential market and economic impact of a sudden and disorderly collapse of an unregulated HLI; and

3. The potential market dynamic issues relating to HLI activities in small and medium-sized open economies, including the possibility that large and concentrated positions could amplify market pressures and that aggressive trading practices could compromise market integrity.

To address these concerns, a package of responses considered to be "consistent, complementary and commensurate" to the problems was recommended in the 2000 Report in the following areas:

1. Counterparty risk management and regulatory oversight

2. Hedge fund risk management practices

3. Hedge fund disclosures

4. Public sector initiatives to enhance hedge fund disclosures

5. Infrastructure improvements, including documentation

6. National surveillance of financial market activity and functioning

The recommendations made fell a long way short of the strict controls that some ASEAN leaders have thought should be applied to constrain HLI actions. There has been substantial criticism of the FSF 2000 Report/Recommendations, especially because it did not discuss proposals for substantial improvements in transparency regarding operations in currency markets widely considered to have contributed to recent episodes of instability (see Cornford, 2000).

In noting progress on all fronts, some adequate and some limited, the FSF 2002 Assessment has also raised some fresh concerns over:

1. The marketing of hedge funds to retail investors

2. Capital guaranteed hedge fund products

3. In-house hedge funds

4. Terrorism financing and money laundering

2002, the implementation of the report's recommendations had not proven effective in addressing the concerns identified." [*emphasis added*]

It has concluded that: “On balance, concerns that HLIs could pose a systemic risk to the international financial system are less than before. Funds are smaller and are generally perceived to employ less leverage.”

It did however recommend that the FSF consider a number of comparative minor actions that would be useful in improving information and limiting risk of instability:

1. Bank supervisors and securities regulators should continue oversight of regulated firms’ relationships with large counterparties (including HLIs) and consider repeating at some stage the BCBS/IOSCO joint review of counterparty risk management practices.

2. A desire has been expressed for supervisory and regulatory authorities whose financial institutions have active relationships with hedge funds to share with supervisory colleagues in other jurisdictions more regularly their assessment of developments with regard to counterparty risk management practices in the HLI industry.

3. The FSF could reiterate its support for broad implementation of the Multidisciplinary Working Group on Enhanced Disclosure (MWGED)’s recommended disclosures and continue to encourage the hedge fund industry and regulated institutions to adopt the MWGED recommendations. The FSF should welcome the Joint Forum evaluation of the degree to which regulated financial intermediaries and unregulated hedge funds have complied with the four major recommendations contained in the MWGED report and to examine the need for further follow-up on disclosure of financial risk.

4. Although industry developments may have reduced the urgency in considering the appropriateness of introducing mandatory public disclosure by hedge funds on systemic grounds, these developments could reverse. National authorities should continue to be vigilant of prevailing market practices, to which the above-mentioned Joint Forum evaluation should contribute, and of new material developments.

5. National authorities and international bodies should continue their monitoring of potential threats to market functioning posed by HLIs.

6. National authorities should encourage foreign exchange market associations in their jurisdictions that have not already done so to adopt the good practices guidelines for foreign exchange trading.

7. The FSF should encourage the Global Documentation Steering Committee (GDSC) to progress its work to strengthen and harmonize documentation, where appropriate. It should also encourage relevant authorities to strengthen the legal certainty of contracts.

8. It is recommended that IOSCO be encouraged to study the investor protection concerns that may arise in connection with hedge-fund products and retail investors and consider possible actions as necessary.

9. Relevant authorities are encouraged to investigate how banks offering principal guaranteed hedge fund-related products measure and manage their exposures.

In our view, actions along these lines will no doubt proceed, if rather gradually, since the issues are slipping from the top of the agenda for those concerned with financial system stability.

Hedge funds are for ASEAN investors too, not just foreign investors

In the context of continued ASEAN concern over HLIs, it is interesting to note that one ASEAN member, Singapore, has recently established on the rules under which hedge funds can market their services in their jurisdiction and one other, Hong Kong, has begun to consult interested parties on the issue. For instance, the FSF 2002 Assessment records that “In response to interest expressed by the financial industry, the Monetary Authority of Singapore issued guidelines in June 2001 that will allow hedge funds to be sold to the public subject to a minimum initial subscription of S$100,000 per investor, minimum manager expertise requirements and disclosure guidelines, and other requirements. In October 2001, the Hong Kong Securities and Futures Commission issued a consultative paper on offering hedge funds in Hong Kong, which discusses the issues involved and proposes a set of criteria for authorisation of such funds.”

From the perspective of preparing an ASEAN-wide position on HLIs and the appropriate regulations to be placed by other countries on HLIs’ investment behaviour and reporting, the actions of Singapore and Hong Kong will be instructive. It would appear that the regulations over investment behaviour and reporting of hedge funds raising subscriptions from investors in Singapore and elsewhere in ASEAN do not go beyond international norms. This somewhat undermines the case for additional regulation of HLIs being advanced in an ASEAN context.

Hedge funds will continue to raise concerns but have some desirable attributes

We expect that concerns over HLI investment behaviour, and the investment behaviour of institutional investors and banks more generally, will continue to be a concern to those charged with the maintenance of financial sector stability. Macro hedge funds are enjoying renewed inflows, according to anecdotal reports in late 2002 and early 2003. Momentum-investing practices and herd-like behaviour will remain a challenge for countries that attract inward portfolio investment from these institutions. This is especially the case as, it would appear, the global financial system architecture has no firm grip yet on the maintenance of adequate international financial system liquidity. Indeed, it may get worse. Persaud, 2002, and others worry that the new Basel Accord risks creating the very volatility and disruptions to financial stability that it is intended to reduce, because the rules will induce pro-cyclical behaviour.

Persaud says: “Modern financial regulation since the early 1990s has been about the spread of market-sensitive risk-management systems for banks, the spill-over of this approach to other financial institutions and, in general, the retreat of regulatory ambition. There is growing evidence that these trends are leading to a more fragile financial system, more prone to concentration, crisis and ‘liquidity black holes’. This problem has not been sufficiently addressed because, although it is born of the regulation of financial institutions in developed countries, its most glaring effects are felt in the pro-cyclicality and volatility of capital flows to emerging markets.”

“The root of the problem is that the liquidity of financial markets requires diversity, but all these trends are serving to reduce the diversity of behaviour of market participants. Regulators should have a more global perspective on the implications of their local regulation. In order to encourage, and perhaps impose, greater diversity in the financial system as a whole, regulators need to place less reliance on internal ratings-based approaches to bank risk management, must encourage the adoption of alternative, contra-cyclical risk management systems by long-term investors and, within limits, should temper their discouragement of off-shore, leveraged, institutions." Persaud 2002.

We see these are pertinent concerns, which need to be addressed in the appropriate international fora.

In our view, diversity is important (see **Box 2**.), but hard to achieve. When policymakers consider which foreign financial institutions to let in, opting for diversity would be beneficial. Concentrating the risk by not diversifying the source and type of foreign financial institutions, for instance, by allowing in only ASEAN banks (a shock to one country in ASEAN will then ripple through all of ASEAN), or only European/Japanese banks (a shock within Europe/Japan would be disproportionately felt in ASEAN), or only FDI (multinationals may come to behave to a global norm), or only equity but not debt investors, raises risk. The risk lies in an undiversified pool of investors – " the electronic herd".

Box 2. Why Hedge Funds Are Useful

Hedge funds supply a useful range of products, provide risk diversification services to investors, can boost liquidity and can act as "rational or stabilizing" speculators, rather than "irrational or destabilizing" speculators. Regulation may be able to encourage hedge funds to fulfill this useful function, or at least avoid promoting pro-cyclical instability.

For instance, Persaud, 2002, suggests:

"Regulators need to … limit the losses of retail investors for fear that they will be abused for their relative lack of information, and to encourage them to save for their future. Financial instruments used by retail investors should be strictly regulated – as they are – and losses limited through short-term risk systems. Financial instruments used by professional investors, however, should be lightly regulated and their ability to be buck-the-trend should be facilitated."

"This framework provides a different perspective on hedge funds, investment vehicles designed for investment professionals with wealth to lose. Hedge funds will sometimes lose money, sometimes blow up and sometimes be part of the herd, but they are also best suited to the role of the unregulated investor, who can buy when everyone else is selling and in the process make the financial market liquid. The cost of making it hard for them to do this through regulation of their leverage and their credit is a reduction in market liquidity. Regulation of hedge funds and their requirements of disclosure to their counter-parties should therefore be governed by tough questions such as: would a fund with this amount of leverage endanger the financial system? This would catch an LTCM without leading the others to withdraw from providing the necessary liquidity."

7. Scope for ASEAN Actions

The study has built a case for concerted action by ASEAN countries to **liberalize restrictions over capital flows in a sequenced manner**.

However, Robbie Burns, the renowned Scottish poet, wrote that "*the best laid plans o' mice and men oft gang astray*". The fact is that liberalization of the capital accounts in individual ASEAN countries, safe or otherwise, will **not occur without strong political commitment and drive**.

Given the difficulties involved in any such complex task, the theoretical optimum – or ideal sequence – of measures may prove politically impractical. History records that most countries (including, individually, the ASEAN-6) have proceeded by doing what has proven politically possible, even if the sequencing was back-to-front, then "learning by doing", fixing problems as they emerge, sometimes soon enough, some other times only after a crisis.

The important issue in practice is to ensure that the **country's capacity to address the problems** is developed *pari passu* with the policy changes, so that the issues can be addressed successfully when they arise, as they inevitably will. Commencing a move to open capital accounts, for instance by allowing inward FDI, inexorably leads to pressure for further opening, because the foreign investors will legitimately seek the means for hedging etc. In such a case, central banks need to develop appropriate risk management and supervision skills if new riskier products are to be permitted.

History also bears out that progress in such difficult matters needs inspired leadership "from the front" and is not dictated by the slowest constituent.

"The ASEAN Way" is consciously very different to "the European Way", but there are **some lessons from the European Union** on capital account liberalization and handling crises that are relevant to ASEAN.

From a self-styled "Eurocentric" perspective, one researcher pertinently claims: "the experience of the EMS [crisis in the early 1990s] demonstrates that **codes of conduct** accepted on a sovereign basis by participating states receptive to peer pressure will **both reduce the danger of crises and expedite their resolution**. … The European Union's experience has shown that sovereign nations will benefit from regional co-ordination between monetary and fiscal authorities to the extent that they subject themselves to **peer pressure**." See de Macedo, 2000.

The implication is that the more that ASEAN can do to establish amongst its members some common goals and ways of thinking about issues and provide a forum for peer pressure, the greater the prospect that capital account liberalization can be pursued with risks minimized. The BFS of the ASEAN Secretariat can serve a valuable focus for surveillance, coordination, reviews of progress and facilitation of assistance.

"Having to cope" with and make decisions about the degree of openness of the capital account, has become an inevitable feature of economic development. Technological progress is a driver that cannot be wished away.

The BFS in particular may serve a role in facilitating assistance provided by the more developed ASEAN countries to newer and less developed member countries, particularly in achieving convergence towards a common set of rules or standards for governance (e.g., for sharemarket listings, corporate law etc., in addition to codes of conduct regarding FDI etc.).

This is in addition to the BFS's current responsibilities to assist in the monitoring and surveillance of capital flows, with the information swapped between ASEAN authorities.

The BFS could also take a leadership role in developing an ASEAN-area common approach to Collective Action Clauses and to "bailing in" private foreign investors, supporting the rules for access to the Chiang Mai Initiative ASEAN+3 currency swap arrangements.

Also, while it may not be feasible to develop regional (or ASEAN) codes and standards, it might be possible for the BFS to assist in developing regional responses to the international standards, and achieve some regional uniformity in implementing them.

But perhaps the most beneficial contribution that the ASEAN-6, and the BFS, might make to the advancement of financial and economic development of the more recent ASEAN members would be to **continue to develop sound financial systems less prone to volatility**. There is a **spillover** from one country to all in the region as it puts its financial system on a sounder path.

Annex 1. Abridged Terms of Reference RP02/007, 20/8/2002

AADCP Regional Economic Policy Support Facility
TERMS OF REFERENCE
Research Project 02/007

I. Title

Liberalizing Capital Movements in the ASEAN Region

II. Background and Significance

Structuring an orderly capital account liberalization is an important activity under the ASEAN Finance Process, to sustain economic growth while maintaining macroeconomic and financial stability. The ASEAN Vision is to create a freer flow of capital in the region by year 2020. Free movement of capital is generally considered to contribute to economic efficiency, promote growth, and increase welfare. Yet, at the same time, the risks associated with liberalization can be substantial, particularly if the domestic market lacks the ability to allocate and manage finance efficiently, and the contracting environment is too weak to force agents to live with the consequences of their investment decisions. It has been suggested therefore that opening one's economy to international (or regional) financial transactions would be welfare and efficiency enhancing only when prudential supervision is first upgraded, corporate governance and creditor rights are strengthened, and transparent auditing and accounting standards and equitable bankruptcy and insolvency procedures are adopted.

Recognizing the differences in economic structures and financial systems adopted by Member Countries, ASEAN follows a flexible approach towards capital account liberalization. While it is generally agreed that the capital account liberalization should be properly sequenced to avoid the significantly adverse impact of reversal of capital flows that led to the 1997-1998 financial crisis, Member Countries are free to design their own programs towards more open capital account arrangements. While this flexible approach towards capital account liberalization is expected to continue, a study that critically reviews approaches and environments in which open capital account regimes contribute to sustained growth and better welfare, including measures that need to be put in place to mitigate the possible adverse impacts of capital (out)flows, can play a catalytic role in facilitating liberalization efforts in each Member Country.

III. Research Objectives/Research Problems

To provide guidance for Member Countries in properly sequencing their capital account opening, the consultant is expected to:

1. Review and assess past and on-going experiences and approaches on capital account liberalization in both developed and developing countries, with an aim towards drawing relevant lessons that could be applied to ensure orderly liberalization of capital account.

2. In each ASEAN country, review the status of capital account liberalization including current restrictions and controls on both capital inflows and outflows, monitoring systems, supervisory regimes and relevant legal infrastructure, and objectively analyze positive as well as negative impacts of further capital account liberalization measures.

3. Formulate a program of capital account liberalization appropriate for each ASEAN country to gradually remove the restrictions on its capital account by the year 2020, including the proper sequencing of regulatory and institutional reforms and necessary measures to maximize the benefits and minimize the risks associated with opening the capital account.

4. Review the work and recommendations of the Financial Stability Forum (FSF) and the role of Highly Leveraged Institutions (HLIs) with respect to short term capital flows, and identify the measures to be taken at the international level in ensuring that the risks associated with short-term capital flows are minimized.

IV. Scope of Study

Within the above objectives, the following items are expected:

1. A comprehensive review of country experiences of capital account liberalization, highlighting specific policy measures, approaches adopted, and other relevant success factors that are applicable to ASEAN.

2. A comprehensive analysis of the current status of capital account liberalization in each ASEAN country, including types and forms of restrictions and controls on capital transactions, comparison with and linkages to other liberalization efforts in the region, such as trade, investment and financial services, and the expected effects of further liberalization.

3. On the basis of (1) and (2), a program of capital account liberalization for each ASEAN country, including step by step removal of capital account restrictions and controls and the design and sequencing of regulatory and institutional reforms/measures needed for successful liberalization, towards full capital convertibility by 2020.

4. A comprehensive review of the work of the FSF and role of HLIs, including recommendations on measures to be taken at the international level in ensuring that the risks associated with short term capital flows are minimized.

V. Outputs

The consultant will be expected to produce the following outputs:

1. An abstract and an executive summary

2. A full report (no page limit). While reflecting high quality analytical standards, the report should be in a plain style which avoids the excessive use of technical language and jargon. This criterion does not preclude the necessity for providing adequate and appropriate technical details, explanations and methodologies in connection with the project report; such technical detail as may be required should be contained in separate technical annexes to main reports. The full report must contain a section or chapter thoroughly discussing the policy implications and recommendations.

VI. Documentation and Views to be Considered

Critical inputs to the study include but are not limited to the following documents:

- ASEC Study on Monitoring Capital Flows (March 2002)
- The FSF Recommendations and Concerns Raised by Highly Leveraged Institutions (HLIs): An Assessment (March 2002) and other related FSF reports

Consultant must confer with the Director of Bureau of Finance and Surveillance (BFS) and other BFS officers in the ASEAN Secretariat.

VII. Tasks and Required Activities

1. Prepare and present an inception report to the ASEAN Secretariat (ASEC), including an outline of the approach to the research.
2. Conduct the study.
3. Present the outcome of the study (draft report) to ASEC.
4. Finalize the study based on comments and recommendations from participants and reviewers.

The Consultant is expected to complete the study in 5 months.

Annex 2. Capital Account Regulations in ASEAN Countries

Table 1. Inventory of Capital Controls and Related Measures – ASEAN-5

<table>
<tr><th>Control</th><th>Indonesia</th><th>Malaysia</th><th>Philippines</th><th>Singapore</th><th>Thailand</th></tr>
<tr><td colspan="6">Current account proceeds</td></tr>
<tr><td>Repatriation requirements [1]</td><td>None.</td><td>Required as contracted but no later than 6 months after export. Proceeds must be in FX.</td><td rowspan="2">Only for remittances due from outward FDI, which, if it exceeds US$6 m pa sourced from the local banking system (LBS), must be approved and registered, and an undertaking given to remit and sell within 15-18 days the FX proceeds from the investments. Peso use for trade not allowed except with ASEAN countries.</td><td>None.</td><td>Export proceeds over B500,000 must be repatriated immediately on receipt and within 120 days from date of export.</td></tr>
<tr><td>Surrender requirements [1]</td><td>None.</td><td>Exporters allowed to retain proceeds in FX accounts with designated banks; approval needed if O/N limit over $1-10 million, depending on business characteristics.</td><td>None.</td><td>Proceeds must be surrendered to authorized banks or retained in foreign currency accounts with authorized banks in Thailand within 7 days of receipt.</td></tr>
</table>

[1] Technically, these measures are not capital controls as they involve transactions among residents, but they limit the scope for residents to undertake capital transactions.

Table 1. Inventory of Capital Controls and Related Measures – ASEAN-5 cont./

Control	Indonesia	Malaysia	Philippines	Singapore	Thailand
Foreign direct investment					
Inward	Several sectors face controls, and sell-down of some shares to Indonesians is required within 11-15 years	Prior approval required for acquisition of substantial fixed assets; when ownership or control pass to foreigners; acquisition or increases in paid up capital to achieve 15% (total 30% or more) voting power; control via JV, merger or takeover; or exceed RM5 million. % permitted depends on exports, high-tech purchases or priority production. 100% allowed for mining and Multimedia Super Corridor companies.	Need not be registered with BSP. But only BSP-registered foreign loans and investments may be serviced or repaid with FX from the LBS.	No restrictions.	No restrictions, but proceeds must be surrendered to authorized banks or deposited in FX accounts with authorized banks in Thailand within 7 days of receipt.
Outward	No restrictions.	Investments exceeding RM10,000 in any form require approval.	Income tax return needed to support application to purchase FX from LBS (less than $6 million a year) without prior BSP approval.	No restrictions.	Over $10 million (or equivalent) pa requires BOT approval.
Liquidation by non-residents	No restrictions unless investment benefits from tax relief are being received.	No restrictions if from external accounts (i.e., accounts opened by non-residents); reporting required over RM 10,000.	No restrictions for BSP-registered foreign investments. Otherwise, cannot access FX from the LBS.	No restrictions.	No restrictions if supported by documentary evidence.

Table 1. Inventory of Capital Controls and Related Measures – ASEAN-5 cont./

Control	Indonesia	Malaysia	Philippines	Singapore	Thailand
Capital and money market instruments					
Purchase locally by non-residents	Permitted without limit, except for shares of finance companies and mutual funds.	Permitted, with issuer deducting 15% withholding tax on bond interest paid to non-resident.	Permitted, but registration required if FX for repatriation or remittance is to be purchased from LBS.	Permitted without limits.	Permitted, subject to 50% limit on a non-resident's equity holding.
Sale and issue locally by non-residents	Permitted, if foreign companies issue Indonesian Depository Receipts (IDRs).	Permitted after approval, and proceeds can be repatriated any time. Non-resident sellers of local equities may repatriate profits free of levy only more than 12 months after realization.	Permitted after obtaining license and provided payment for sale or issue does not involve purchase of FX from LBS.	Permitted, but non-resident financial entities must convert S$ proceeds into FX before using them to finance activities outside Singapore.	Permitted, but debt instruments require MOF, BoT and SEC approval.
Purchase abroad by residents	Permitted, except that resident banks are prohibited from purchasing securities denominated in rupiah issued by non-residents.	Permitted, but prior approval is required for purchases exceeding RM10,000.	Permitted, but prior approval and subsequent registration with BSP are required unless either 1) withdrawn from FCDU accounts; or 2) funds not required to be sold for pesos; or 3) less than $6 million from LBS p.a. per investor. All outward investments by domestic banks must be registered.	Permitted.	Permitted, but purchases require approval of BoT. Mutual funds and provident funds are prohibited investing abroad, and insurance companies are limited in their investments.

Table 1. Inventory of Capital Controls and Related Measures – ASEAN-5 cont./

Control	Indonesia	Malaysia	Philippines	Singapore	Thailand
Commercial banks and other financial instruments					
Borrowing by residents abroad	Permitted.	Supplier trade credit permitted. Credit terms for capital goods for periods over 12 months are considered as FX credit facilities. Approval required for over the equivalent of RM5 million. Residents are not allowed to obtain ringgit loans from non-residents. Guarantees etc are limited to an aggregate of RM 5 million. No limit on financial guarantees from offshore banks in Labuan. Payments related to guarantees to be in FX; or approval is required.	BSP regulates FX loans. All publicly guaranteed obligations from foreign creditors (incl. offshore banking units and FCDUs) are subject to prior approval. Private sector loans also require prior approval if they are to be serviced using FX purchased from LBS, as are FX borrowings from FDCUs with maturity over 1 year. For short-term FCDU loans (incl. those by private sector), no prior BSP approval is required if borrower qualifies for foreign financing. BSP-registered loans may be serviced with FX bought from LBS. Unregistered loans may be serviced with FX from outside LBS.	Permitted.	Permitted, but obligation to pay must be in FX and the proceeds of credit must be repatriated.

Table 1. Inventory of Capital Controls and Related Measures – ASEAN-5 cont./

Control	Indonesia	Malaysia	Philippines	Singapore	Thailand
Commercial banks and other financial instruments cont./					
Lending to non-residents	Prohibited in either rupiah or FX since Jan 12, 2001.	Permitted if lend in FX, or if lend less than RM10,000, except that margin financing is allowed for KLSE shares (within KLSE rules), and limits apply to insurance companies' ringgit policy loans, financial institutions' ringgit loans for local immovable property and for other purposes and banks' lending to non-resident stock brokers & custodians. Ringgit loans to non-residents above limits or for other purposes require prior approval.	Requires BSP prior approval. [Domestic bank lending to non-residents in pesos appears to be forestalled by a prohibition on export of peso bank notes, but lending to non-residents in FX is permitted.] Usual controls on outward remittances and registration apply. Subsidiaries or affiliates of financial intermediaries may not sell FX to non-residents and are subject to same rules as banks for trading.	Banks may not extend S$ credit facilities exceeding S$5 million to any non-resident financial entity for speculative activities in the FX market. Non-resident financial entities must convert S$ proceeds from loans, equity listings, bond issuance into FX before using them to finance activities outside Singapore.	Banks are permitted to lend to non-residents in FX, but not in baht.

Table 1. Inventory of Capital Controls and Related Measures – ASEAN-5 cont./

Control	Indonesia	Malaysia	Philippines	Singapore	Thailand
Derivatives and related instruments					
Forwards and futures	Forward FX contracts offered by domestic banks to non-residents are limited in amount except for investment-related transactions.	Imports are allowed 12 months forward cover and exports 6 months. Prior approval is required for other transactions, excepting for payments or commitments to buy KLSE shares within 3 days.	Prior BSP approval is required, including for forwards to sell FX to non-residents with no full delivery of principal. Only banks, quasi-banking NBFIs and their authorized affiliates or subsidiaries are allowed to deal in derivatives.	MAS consultation requirement for all banks transacting with non-residents in S$ financial derivatives; no controls for OTC interest rate derivatives or collateralized repos.	Forward transactions need to be related to the underlying trade and financial transactions.
Other derivatives	Limits set on amounts per customer and per bank. Derivatives for other than FX and interest rates are prohibited by BI, except on an exception basis.	Approval required for issuance locally by non-residents of certain non-exchange traded derivatives; for residents' purchasing abroad spot or forward contracts or interest rate futures not transacted at a futures exchange in Malaysia; and for sale or issue of derivatives abroad by residents.			Without underlying trade and investment activities in Thailand, baht credit facilities, including swap and forward exchange contracts obtained by a non-resident from all domestic financial institutions combined, are limited to a maximum outstanding of B 50 million.

Table format from IMF. 2002. "Capital Account Liberalization and Financial Sector Stability." Occasional Paper 211. Descriptions summarised from individual draft country reports compiled for this research project.

Table 2. Inventory of Capital Controls and Related Measures – ASEAN-4

Control	Cambodia	Lao PDR	Myanmar	Vietnam
Current account proceeds				
Repatriation requirements [1]	Payments/receipts must be made through authorized domiciled banks.	Yes.	Full repatriation of export proceeds is required.	All receipts from current account transactions by residents must be repatriated immediately.
Surrender requirements [1]	SOEs must surrender proceeds of invisibles exports.	Proceeds from wood & wood products must be surrendered to SOBs, after settling payments due to government.	Export proceeds in FX are subject to a 10% tax, unless waived. Proceeds of invisibles, if in FX, must be deposited in approved foreign currency accounts.	Resident enterprises must sell 30% of FX earning to banks; non-profit organizations must sell 100%.
Foreign direct investment				
Inward	No foreign exchange restrictions, but inward FDI is subject to approval by Council for Development of Cambodia (CDC).	All capital transactions require BOL approval. Subject to Direct Investment Promotion and Management Law.	35 – 100% permitted by Myanmar Investment Commission (MIC) with tax and other incentives in a positive list of activities & sectors.	Sectors restricted under foreign investment laws. MPI licenses projects over $1m; provincial governments under $1m.
Outward	No specific laws regarding approval, and outward FDI is not restricted, but transfers over $100,000 need prior declaration to NBC.	Requires BOL approval. Subject to Direct Investment Promotion and Management Law.	na.	Requires MPI permit, an account with authorized bank, & the schedule registered with SBV (+ approved if SOE is the investor).
Liquidation by non-residents	Proceeds can be transferred freely if in accordance with Investment Law. Must transfer through authorized intermediaries, which must report if transactions exceed $100,000.	Permitted after BOL scrutiny. Transfers of large sums may be made in instalments according to a plan approved by BOL.	Repatriation of capital & profits through banks permitted, after payment of taxes etc. Government has committed that enterprises formed under permit will not be nationalized.	na.

[1] Technically, these measures are not capital controls as they involve transactions among residents, but they limit the scope for residents to undertake capital transactions.

Table 2. Inventory of Capital Controls and Related Measures – ASEAN-4 cont./

Control	Cambodia	Lao PDR	Myanmar	Vietnam
Capital and money market instruments				
Purchase locally by non-residents	No securities market, rules or regulations.	All capital transactions require BOL approval.	na. No effective market.	Foreign investors are allowed in total to hold up to 30% [from 27/3/03] of issuer's current shares (maximum for an organization is 7%; for an individual 5%).
Sale and issue locally by non-residents	No securities market, rules or regulations.	Requires BOL authorization.	na. No effective market.	Not allowed.
Purchase abroad by residents	No rules or regulations, provided payments are through authorized intermediaries.	Requires BOL authorization.	Not apparently permitted.	Not allowed.
Commercial banks and other financial instruments				
Borrowing by residents abroad	Freely permitted, provided payments are through authorized intermediaries.	Requires BOL approval.	State approval required.	Registration with SBV is required.
Lending to non-residents	Freely permitted, in FX and rial, to non-residents doing local business only.	Requires BOL authorization for both FX and kip.	Not apparently permitted for either FX or kyat.	Lending in FX or dong not expressly forbidden, but subject to SBV approval, and regulations on lending to qualified residents suggest that lending to non-residents is outside normal policy.
Derivatives and related instruments				
Forwards and futures	No rules or restrictions. No forwards and futures market.	Requires BOL authorization. No forwards, futures or derivatives markets	na. No forwards, futures or derivatives markets.	Banks and others are allowed to enter into forwards and swaps with maturities of 1- to 6-months. Sale or issue locally by non-residents and purchase abroad by residents requires SBV approval.
Other derivatives	No rules or restrictions. No derivatives market.			

Table format from IMF. 2002. "Capital Account Liberalization and Financial Sector Stability." Occasional Paper 211. Descriptions summarised from individual draft country reports compiled for this research project.

Annex 3. Recommended Sequence for ASEAN Countries

Extracted from **Volume 2: Country Reports**

Table 1. Brunei Darussalam – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: beneficial to deregulate “social/priority sector” controls on inward FDI; otherwise capital account is already liberalized	**Markets and systems:** desirable to develop some institutional investor capacity (the pension fund) and, later, an equity market as an alternative to the banking system	**Macroeconomic policies and conditions:** continue to keep fiscal policy firm
Capital outflows: already completely liberalized	**Prudential policies and risk management:** Financial Institutions Division of MoF to increase skills/capacity in market-based and on-site supervision	**Legal framework:** adequate but must develop with international financial centre and Islamic activity
Special topic: currency board arrangement with Singapore: maintain, and collaborate to keep non-internationalization of B$	**Financial sector restructuring:** work to get NPLs down	**Corporate restructuring:** priority is to develop alternatives to oil and government sector employment
Special topic: Islamic international financial centre and international financial centre: rigorous development of prudential standards and supervision capacity required	**Financial safety nets:** repeatedly clarify that bank deposits are not guaranteed, or develop explicit deposit insurance	**Statistics and reporting:** need to improve on many fronts, especially Nat A/C, BoP and capital flow statistics
Stage II: Consolidating Reforms		
Inflows and outflows: no further liberalization possible or necessary	**Prudential policies and risk management:** further move to risk-based supervision	**Macroeconomic policies and conditions:** continue focus on fiscal control
Special topic: currency board arrangement with Singapore: maintain, and collaborate to keep non-internationalization of B$	**Financial sector restructuring:** ensure no leakage from IFC to domestic commercial banking	**Legal framework:** na
	Transparency: consider inviting IMF ROSC/FSAP	
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: done	**Market and systems development:** improve as Singapore improves	**Macroeconomic policies and conditions:** maintain fiscal firmness
Special topic: currency board arrangement with Singapore: maintain, or change if ASEAN is moving to common currency	**Prudential policies and risk management:** improve as financial sector activity deepens and broadens	**Legal framework:** improve as necesary
	Financial sector restructuring: na	

Table 2. Cambodia – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: little to liberalize (attract FDI as priority); maintain requirement to use authorized intermediaries; consider URR	**Markets and systems:** build banks first	**Macroeconomic policies and conditions:** sustain recent improvements
Capital outflows: little to liberalize; consider limit on lending riel to non-residents	**Prudential policies and risk management:** reduce liquidity reserve requirement when safe	**Legal framework:** improve, commence across-the-board land titling
Special topic: reserves: accumulate 3 – 4 months of imports equivalent	**Financial sector restructuring:** progress	**Corporate restructuring:** na
Special topic: dollarization: provides some safety at present	**Financial safety nets:** na	**Statistics and reporting:** improve, especially Nat A/Cs and capital flows
Stage II: Consolidating Reforms		
Inflows and outflows: as above, implement measures to limit internationalization of the riel if de-dollarize	**Prudential policies and risk management:** extend beyond bank regulations	**Macroeconomic policies and conditions:** sustain fiscal and monetary conservatism
Special topic: dollarization: provides some safety but **de-dollarization** better in medium-term	**Financial sector restructuring:** build non-bank institutions	**Legal framework:** improve
Special topic: "bailing in foreign investors": consider Collective Action Clauses and action to "bail-in" private foreign investors with lack of recourse to government	**Transparency:** improve, invite ROSC and FSAP	**Accounting framework:** improve
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: with non-internationalization in place	**Market and systems development:** strengthen as flows/activity increase	**Macroeconomic policies and conditions:** sustain
Special topic: de-dollarization or move to adopt ASEAN common currency, if it is progressing	**Prudential policies and risk management:** strengthen, especially if de-dollarize	**Legal framework etc:** improve
Special topic: FSAP: invite	**Financial sector restructuring:** build security markets	

Table 3. Indonesia – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: liberalize remaining ‘social’ restrictions on FDI; consider an unremunerated reserve requirement (URR) for FX deposits	**Markets and systems:** continue to improve operational efficiency of securities markets	**Macroeconomic policies and conditions:** inflation-targeting needs support from fiscal tightening and flexible, but not excessively volatile, exchange rate
Capital outflows: continue to ban lending rupiah to non-residents; possibly allow lending in FX	**Prudential policies and risk management:** significant improvements in credit risk capacity required; move forward carefully in reform of regulatory responsibility	**Legal framework:** vital efforts required to improve the effectiveness of the legal framework and its operations – central to all improvements in financial system/economy
Special topic: non-internationalization of the rupiah: maintain effectiveness, adjust policy measures if loopholes emerge	**Financial sector restructuring:** privatization of originally-private banks, and improved governance for originally-government banks	**Corporate restructuring:** urgent need for further progress
Special topic: “bailing in foreign investors”: consider Collective Action Clauses and action to “bail-in” private foreign investors with lack of recourse to government	**Financial safety nets:** introduce deposit insurance in place of government blanket guarantee, but ensure regulator can act as systemic lender-of-last-resort	**Statistics and reporting:** reporting complies with SDDS, but scope for improvements **Special topic: monitoring and surveillance of capital flows:** implement system assisted by ASEAN
Stage II: Consolidating Reforms		
Inflows and outflows: refine restrictions to ensure policy of non-internationalization of the rupiah remains effective; possibly require capital flows to be through authorized intermediaries	**Prudential policies and risk management:** reduce regulatory forebearance further	**Macroeconomic policies and conditions:** persist with inflation-targeting and flexible exchange rate
	Financial sector restructuring: ensure banks do effective intermediation and build effective institutional investor sector	**Legal framework:** meet need for on-going improvements
	Transparency: invite ROSC and FSAP, participate strongly in regional surveillance activities	
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: gradually ease the most costly measures promoting the non-internationalization of the rupiah, improve access to hedging instruments	**Market and systems development:** accelerate development of securities market as alternative to by-now strengthened banking sector	**Macroeconomic policies and conditions:** sustain low inflation and low interest rates (conditions that support a stable – yet flexible – rupiah)
Special topic: prepare for any move to ASEAN common currency	**Prudential policies and risk management:** strengthen	**Legal framework:** meet need for improvements
	Financial sector restructuring: ditto	

Table 4. Lao PDR – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: liberalize access for FDI without tax incentives; consider requirement to use authorized intermediaries; consider URR	**Markets and systems:** focus on core state-owned banks	**Macroeconomic policies and conditions:** sustain fiscal tightening; move towards more market-driven monetary instruments
Capital outflows: liberalize once confidence in economy rebuilt; consider limit on lending kip to non-residents	**Prudential policies and risk management:** strengthen	**Legal framework:** improve capacity, complete land titling
Special topic: dollarization: provides some safety at present	**Financial sector restructuring:** focus on operational improvements of SOCBs	**Corporate restructuring:** focus on SOEs
Special topic: "bailing in foreign investors": consider Collective Action Clauses and action to "bail-in" private foreign investors with lack of recourse to government	**Financial safety nets:** maintain Fund adequacy in face of market-related risks	**Statistics and reporting:** improve
	Special topic: Article IV: sign before end-2004	**Special topic: reserves:** accumulate 3 – 4 months of imports equivalent
Stage II: Consolidating Reforms		
Inflows and outflows: as above, implement measures to limit internationalization of the kip if de-dollarize	**Prudential policies and risk management:** more market-related; extend beyond bank regulations	**Macroeconomic policies and conditions:** retain exchange rate flexibility, tighter fiscal /looser monetary policy
Special topic: dollarization: provides some safety but **de-dollarization** better in medium-term	**Financial sector restructuring:** build non-bank institutions	**Legal framework:** improve
Special topic: equity and bond markets: develop, with inflows from abroad (consider "12-month rule")	**Transparency:** improve, invite ROSC	**Accounting framework:** improve
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: with non-internationalization in place	**Market and systems development:** strengthen as flows/activity increase	**Macroeconomic policies and conditions:** sustain
Special topic: de-dollarization or move to adopt ASEAN common currency, if it is progressing	**Prudential policies and risk management:** strengthen, especially if de-dollarize	**Legal framework etc:** improve
Special topic: FSAP: invite	**Financial sector restructuring:** build security markets	

Table 5. Malaysia – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: gradually move to ease 'social' and 'priority' restrictions on FDI	**Markets and systems:** proceed with FSMP and CMMP	**Macroeconomic policies and conditions:** maintain firm fiscal plicy while liberalizing capital flows
Capital outflows: gradually liberalize restrictions on outflows (e.g., raise the RM10,000 approval threshold)	**Prudential policies and risk management:** increase monitoring and FX risk management ability as liberalize capital flows	**Legal framework:** continue sustained improvement compatible with FSMP and CMMP
Special topic: non-internationalization policy: ensure that the easing in limits on outflows does not materially jeopardize policy	**Financial sector restructuring:** bank and other financial sector strengthening to progress; less direction of EPF investments	**Corporate restructuring:** continue
Special topic: risk management capacity: if eventually there is a move to a more flexible exchange rate, need to develop deeper markets for managing risk	**Financial safety nets:** introduce credible deposit insurance scheme for smaller bank deposits, in place of government blanket guarantee	**Statistics and reporting:** publish full IMF Article IV assessments
Stage II: Consolidating Reforms		
Inflows and outflows: gradually liberalize all controls except lending to non-residents for speculative purposes (as in singapore now)	**Prudential policies and risk management:** further step up monitoring of capital flows and risk management skills and capacity	**Macroeconomic policies and conditions:** retain tight fiscal policy to build most conducive financial conditions for eventual move to a flexible exchange rate
Special topic: non-internationalization policy: decide whether policy is sustainable in conjunction with goal of deeper markets	**Financial sector restructuring:** accelerate introduction of real new foreign competitive entry	**Legal framework:** develop as appropriate
	Transparency: invite both a ROSC and a FSAP	
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: complete liberalization of all controls over capital flows except Singapore-style lending for speculation	**Market and systems development:** continue, as under FSAP and CMMP, with open access for foreign competition	**Macroeconomic policies and conditions:** move to flexible exchange rate (unless there is a transition to any single ASEAN currency)
Special topic: prepare for any move to ASEAN common currency	**Prudential policies and risk management:** reach international standards on derivatives etc appropriate for flexible exchange rate	**Legal framework:** continue improvement
	Financial sector restructuring: remove all restraints on competition	

Table 6. Myanmar – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: focus on liberalization to attract FDI without tax incentives	**Markets and systems:** build banks first	**Macroeconomic policies and conditions:** focus on low inflation; fiscal tightening
Capital outflows: impose formal policy of non-internationalization of the kyat, with limit on lending riel to non-residents	**Prudential policies and risk management:** move to strengthen regulations and enforcement capacity	**Legal framework:** improve
Special topic: exchange rate unification: implement, with international fiscal support; adopt flexible exchange rate policy	**Financial sector restructuring:** progress	**Corporate restructuring:** na
Special topic: Article IV: move to accept after unification of exchange rate/end of trade taxes	**Financial safety nets:** na	**Statistics and reporting:** improve, especially Nat A/Cs and capital flows
Special topic: reserves: accumulate 3 –4 months of imports equivalent		
Stage II: Consolidating Reforms		
Inflows and outflows: as above, implement measures to limit internationalization of the kyat if unify rate and de-dollarize	**Prudential policies and risk management:** extend beyond bank regulations	**Macroeconomic policies and conditions:** retain exchange rate flexibility, tighter fiscal /looser monetary policy
Special topic: dollarization: may provide some safety but **de-dollarization** better in medium-term	**Financial sector restructuring:** build non-bank institutions	**Legal framework:** improve
Special topic: "bailing in foreign investors": consider Collective Action Clauses and action to "bail-in" private foreign investors with lack of recourse to government	**Transparency:** improve, invite ROSC	**Accounting framework:** improve
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: with non-internationalization in place	**Market and systems development:** strengthen as flows/activity increase	**Macroeconomic policies and conditions:** sustain fiscal and monetary conservatism
Special topic: de-dollarization or move to adopt ASEAN common currency, if it is progressing	**Prudential policies and risk management:** strengthen, especially if de-dollarize	**Legal framework:** improve
Special topic: FSAP: invite	**Financial sector restructuring:** build security markets	**Accounting framework:** improve

Table 7. Philippines – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: liberalize borrowing for external trade purposes from FCDUs and all foreign sources as planned; shift burden of 'social' controls over FDI from BSP	**Markets and systems:** implement recommendations of FSAP	**Macroeconomic policies and conditions:** maintain exchange rate flexibility, strengthen fiscal framework and pursue inflation-targeting
Capital outflows: clarify ban on peso loans to non-residents	**Prudential policies and risk management:** pursue Central Bank Act and other recommendations of FSAP	**Legal framework:** significant strengthening in effectiveness required
Special topic: non-internationalization policy for the peso: simplify approvals but maintain policy effectiveness by clarifying ban on peso loans to non-residents (and guard against erosion via FCDUs)	**Financial sector restructuring:** reinforce moves against build-up in NPLs, effectively implement SPAVs without public funds	**Corporate restructuring:** make conglomerate structures transparent
Special topic: "bailing in foreign investors": consider Collective Action Clauses and action to "bail-in" private foreign investors with lack of recourse to government	**Financial safety nets:** legal certainty of BSP actions needs improvement	**Statistics and reporting:** Need improvement in many areas **Special topic: monitoring and surveillance of capital flows:** implement system assisted by ASEAN
Stage II: Consolidating Reforms		
Inflows and outflows: further streamline approval process or move to more market-based system	**Prudential policies and risk management:** improve in line with increased potential volatility (market-based)	**Macroeconomic policies and conditions:** reinforce fiscal/monetary policy, with flexible FX as safety valve
Special topic: non-internationalization policy for the peso: adapt as financial sector deepens, on Singapore/Malaysian path	**Financial sector restructuring:** encourage sale of restructured NPLs at market value, banking sector consolidation	**Legal framework:** significant strenthening in effectiveness required
	Transparency: implement improvements to recognized shortfalls (ROSC and FSAP)	
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: retaining non-internationalization policy unless risks have diminished	**Market and systems development:** improve as required	**Macroeconomic policies and conditions:** make every effort to have inflation and interest rates at global levels
	Prudential policies and risk management: adapt as financial sector deepens	**Legal framework:** continue required significant strenthening in effectiveness
Special topic: prepare for any move to ASEAN common currency	**Financial sector restructuring:** further ease foreign potential entry	

Table 8. Singapore – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: no actions required	**Markets and systems:** continue to increase efficiency of securities market and range of instruments for risk management	**Macroeconomic policies and conditions:** persist with sound economic management that makes the ever-looser non-internationalization policy effective
Capital outflows: continual refinement of non-internationalization policies to keep Singapore's markets competitive	**Prudential policies and risk management:** implement improvements recommended by FSAP	**Legal framework:** sound, adapt as required
	Financial sector restructuring: market-driven	**Corporate restructuring:** improve competitiveness, reduce government linkages
	Financial safety nets: be clear not to shelter domestic banks from mistakes	**Statistics and reporting:** publish ROSC and FSAP
Stage II: Consolidating Reforms		
Inflows and outflows: continual refinement of non-internationalization policies to keep Singapore's markets competitive	**Prudential policies and risk management:** as above	**Macroeconomic policies and conditions:** as above
	Financial sector restructuring: as above	**Legal framework:** continue to adapt as necessary
	Transparency: publish more	
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: may have to adapt to requirements of a common ASEAN currency	**Market and systems development:** continued improvement	**Macroeconomic policies and conditions:** as above
Special topic: Brunei's currency peg: if Singapore's markets are destabilized, the destablization will be felt in Brunei, which has less thorough prudential standards	**Prudential policies and risk management:** as above	**Legal framework:** as above
Special topic: prepare for any move to ASEAN common currency	**Financial sector restructuring:** as above	

Table 9. Thailand – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: ensure approvals process works smoothly	**Markets and systems:** continue to strengthen and make more effective both the banking system and capital markets	**Macroeconomic policies and conditions:** inflation-targeting is an improvement, even if interest rate and exchange rate volatility results in transition period
Capital outflows: ensure approvals process works smoothly	**Prudential policies and risk management:** continue improvements and move to market-based system	**Legal framework:** improve, especially in bankruptcy and rehabilitation
Special topic: non-internationalization of the baht: maintain effectiveness, adjust policy measures if loopholes emerge; however, liberalize repatriation & surrender requirements	**Financial sector restructuring:** sustain the banking sector restructuring that is in progress	**Corporate restructuring:** sustain and accelerate
Special topic: “bailing in foreign investors”: consider Collective Action Clauses and action to “bail-in” private foreign investors with lack of recourse to government	**Financial safety nets:** introduce limited deposit insurance in place of the government blanket guarantee, on planned phased basis	**Statistics and reporting:** continue improvements
Stage II: Consolidating Reforms		
Inflows and outflows: refine restrictions to ensure policy of non-internationalization of the baht remains effective at a reasonable cost (e.g., ensure cost of risk management is not excessive)	**Prudential policies and risk management:** further move to market-based supervision, and encouragement of active risk-management	**Macroeconomic policies and conditions:** persist with inflation-targeting and flexible exchange rate
	Financial sector restructuring: ensure banks do effective intermediation and build effective institutional investor sector	**Legal framework:** meet need for on-going improvements
Transparency: invite ROSC and FSAP, participate strongly in regional surveillance activities		
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: refine restrictions to ensure policy of non-internationalization of the baht remains effective at a reasonable cost (e.g., ensure cost of risk management is not excessive)	**Market and systems development:** further strengthen	**Macroeconomic policies and conditions:** sustain low inflation and low interest rates (conditions that support a stable – yet flexible – rupiah)
	Prudential policies and risk management: further strengthen	**Legal framework:** meet need for improvements
Special topic: prepare for any move to ASEAN common currency	**Financial sector restructuring:** further strengthen	

Table 10. Vietnam – Recommended Programs and Sequence

Capital Account Liberalization	Financial Sector Reforms	Other Policies and Issues
Stage I: Laying the Foundation for Liberalization		
Capital inflows: further liberalize and streamline FDI approvals process; consider requirement to use authorized intermediaries; consider URR	**Markets and systems:** focus on improvements in core state-owned banks, but also improve ops of (infant) securities market & institutional investors	**Macroeconomic policies and conditions:** sustain improvements, including for SMEs
Capital outflows: liberalize as confidence in economy is strengthened; maintain (and formalize) ban on lending dong to non-residents; prefer formal policy of dong non-internationalization	**Prudential policies and risk management:** strengthen in line with ever-wider risks	**Legal framework:** improve capacity, certainty over use of collateral
Special topic: dollarization: provides some safety at present, but is detrimental in the long-term	**Financial sector restructuring:** focus on operational improvements of SOCBs	**Corporate restructuring:** focus on SOEs and corporatization and equitization
Special topic: “bailing in foreign investors”: consider Collective Action Clauses and action to “bail-in” private foreign investors with lack of recourse to government	**Financial safety nets:** ensure adequacy of new deposit insurance scheme in face of market-related risks	**Statistics and reporting:** improve
Special topic: reserves: ensure adequacy (3 – 4 months of imports equivalent)	**Special topic: Article IV:** make necessary changes and accept obligations	
Stage II: Consolidating Reforms		
Inflows and outflows: as above, implement and improve formal measures to limit internationalization of the dong	**Prudential policies and risk management:** ever more market-related; extend beyond bank regulations	**Macroeconomic policies and conditions:** retain exchange rate flexibility, focus on low inflation, tighter fiscal /looser monetary mix
Special topic: de-dollarization: progress further: require use of dong domestically	**Financial sector restructuring:** build non-bank institutions	**Legal framework:** improve
Special topic: equity and bond markets: develop dong instruments, with inflows from abroad (consider “12-month rule” for all securities)	**Transparency:** improve, invite ROSC and FSAP	**Accounting framework:** improve
Stage III: Completing and Reassessing Liberalization and Reforms		
Complete liberalization: with non-internationalization in place	**Market and systems development:** strengthen	**Macroeconomic policies and conditions:** sustain
Special topic: ASEAN common currency: prepare to move from de-dollarization, if it is progressing	**Prudential policies and risk management:** strengthen	**Legal framework etc:** improve
	Financial sector restructuring: build deeper security markets	

Annex 4. Record of International Consultations

1. Inception Meeting, December 2002

ASEAN Secretariat, Jakarta

2. Fieldwork Meetings in early 2003[*]

Thailand — Monday 3 February to Wednesday 5 February

Ministry of Finance

Bank of Thailand

Securities and Exchange Commission

Thailand Development Research Institute

World Bank

Cambodia – Thursday 6 February to Friday 7 February

National Bank of Cambodia

Ministry of Economy and Finance

Ministry of Commerce

Cambodian Development Research Institute

Mekong Project Development Facility

International Monetary Fund

Lao PDR – Monday 10 February to Tuesday 11 February

Bank of Lao

Ministry of Finance

Asian Development Bank

International Monetary Fund

[*] Officials and research institutes. Excluding commercial banks.

Vietnam – Wednesday 12 February to Friday 14 February

State Bank of Vietnam

Ministry of Finance

Central Institute for Economic Management

World Bank

International Monetary Fund

Myanmar – Monday 17 February to Tuesday 18 February

Central Bank of Myanmar

Singapore – Monday 3 March to Tuesday 4 March

Monetary Authority of Singapore

Institute of Southeast Asian Studies

Indonesia – Wednesday 5 March to Friday 7 March

Bank Indonesia

Ministry of Finance

Securities Commission (BAPEPAM)

Tax Office

Ministry of Finance, Monitoring and Governance Unit

International Monetary Fund

World Bank

ASEAN SeEcretariat

Brunei Darussalam – Monday 10 March to Tuesday 11 March

Ministry of Finance, Financial Institutions Division and International Division

Brunei Currency Board

Brunei International Finance Centre

Philippines – Wednesday 12 March to Friday 14 March

Banko Sentral ng Pilipinas

Philippine Institute for Development Studies

Department of Industry and Trade

Asian Development Bank

Malaysia – Monday 17 March

Bank Negara Malaysia

Securities Commission (Suruhanjaya Sekuriti)

Ministry of Finance

3. ASEAN Workshop, 31 March – 2 April 2003

Thailand

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Annex 6. Erskinomics Consulting & the Author

Erskinomics Consulting Pty Limited is an economics consultancy based in Sydney, Australia.

Erskinomics was incorporated in August 1999 to provide analysis, advice and training, specializing in economic and financial policy for accelerated development in Asia and Australia. It has undertaken several international and domestic projects for clients including AusAID and its various sub-contractors and program managers, the Australian Stock Exchange, the Australian Innovation Association, the Australian Institute for Commercialisation, BIS Shrapnel and the Securities Institute.

Its *modus operandi* has been to assemble and provide the specific expertise for individual projects on a case-by-case basis, through a network of consultants, taking compete responsibility for management and meeting project goals. Main projects to date have been in Thailand, other ASEAN countries and Australia.

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