

International Experience of Capital Flows Liberalization

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In this research we concentrate on such instruments of regulatory policy as restrictions for capital flow and currency regulation. The study highlights the international experience of managing capital flows, considers the consequences of policies to manage capital flows and currency regulation in the world, and summarizes the recommendations of international financial institutions in this regard.

Given the globalization of economic processes and the high level of openness in the Ukrainian economy, a strategic goal of currency regulation reform in the country has to be the gradual liberalization of capital flows. This is particularly observed in the Association Agreement with the EU and other documents. In order to take full advantage of liberalization and minimize the risks associated with volatile capital flows, it is necessary to implement a series of measures aimed at improving institutional capacity to manage the effects of both the inflow and outflow of capital in the intermediate stages of liberalization.

The approach generally corresponds to the Comprehensive Program for Financial Sector Development in Ukraine Until 2020, the IMF, and the Memorandum of Association Agreement between Ukraine and the EU.

JEL: F2, F3, G18, G28

Key words: cross-border capital flows, currency regulation, liberalization, international experience.

1. Why the international liberalization experience is relevant for Ukraine?

The economic decline and capital outflows triggered by the deployment of military operations, combined with the political and economic crisis forced the NBU to resort to harsh currency regulation measures to calm the foreign exchange market in 2014-15. Implemented by the NBU, administrative measures of currency regulation helped stabilize the foreign exchange market and improve the balance of payments, but these measures coupled with an outdated configuration of currency regulation constrained the process of economic recovery. Therefore, currency regulation liberalization is a top priority in economic policy today.

For Ukraine it is even more important that throughout the period of independence, cross-border capital movement was limited, especially in residents' investment abroad and the existing legal framework remains from the early post-Soviet era.

On the one hand, relatively easy inflow of foreign currency loans during the global upward cycle in the mid-2000s turned to disastrous outflow with the global downturn in 2008-2009. This led to the rapid growth of companies' leverage and deteriorating asset quality of the banking system due to sharp hryvnia devaluation. Subsequently, a similar problem befell the state because the budget deficit and balance of payments was financed through external borrowing, and after the crisis of 2014-2015 the debt burden on the budget has soared. Hryvnia depreciation increased the value of debt denominated in foreign currency and is responsible for about two-thirds of the total increase in the ratio of public debt to GDP.

■ *The article is a translation of the original article in Ukrainian. In case of any discrepancies between the original article and its translation to English, the Ukrainian version of the article should prevail.*

On the other hand, since independence, Ukrainian economic agent-residents had almost no opportunity to invest in foreign assets and their investment were limited by offshore jurisdictions for the purpose of tax optimization and large business/HNWI investment. Even with quite limited access to the world's financial markets, there was close to zero development of the internal securities market and corporate governance.

A high-quality and wide financial services market (asset management, private pension funds, hedge funds, etc.) failed to develop. The hypothesis that may explain this situation (even though it requires a separate study) may be the lack of competition for investors' funds from foreign issuers with high standards of transparency, corporate governance, and proper protection of shareholders' and creditors' rights. The absence of an effective judicial system played a role to a fair extent. The main investment instruments are deposits in banks and (to the households) cash foreign currency.

At the same time, the banking supervision standards were relatively weak, which allowed owners of banks with Ukrainian capital to channel depositors' funds to related companies and/or to use banks as settlement centers for their businesses. Since 2014, the National Bank has expelled 64 insolvent banks out of the market and five banks are being managed by the temporary administration. Altogether, it is about 40% of the total number of banks operating in Ukraine before the 2014 crisis. It is noteworthy that none of liquidated banks were owned by foreign banking groups. At the end of 2015, among the 13 largest Ukrainian banks (about 80% of banking system assets), only five belonged to Ukrainian owners (the government owned three of them). Thus, we can say that the liberalization of the share capital in the post-Soviet era and, consequently, the appearance of foreign banking capital in Ukraine, from this point of view contributed to the stability of the banking system.

Given the globalization of economic processes and the high level of openness in the Ukrainian economy, a strategic goal of currency regulation reform in the country has to be the gradual liberalization of capital flows. This is particularly observed in the Association Agreement with the EU and other documents. In order to take full advantage of liberalization and minimize the risks associated with volatile capital flows, it is necessary to implement a series of measures aimed at improving institutional capacity to manage the effects of both the capital inflow and outflow at the intermediate stages of liberalization.

The liberalization of cross-border capital movements contributes to the acceleration of economic development, since foreign capital inflows allow structural financing of the current account deficit, arising from rapid growth in investment and consumer activity. In the long-term, capital inflow contributes to the financial sector development in recipient countries and expanding opportunities for investment in the country by facilitating the access of economic agents to financial resources, thereby stimulating economic growth.

According to the recommendations of the IMF (2013a), removal of restrictions on capital movement, which regulator imposed to combat the crisis, should be gradual and follow prudent steps because, in developing world, recipient countries bear the economic risks associated with the reduction of barriers to international capital flows. High pro-cyclicality of global capital flows for developing countries, leads to even more severe cyclical economic processes during periods of growth and decline. In Ukraine, we were able to observe this effect during 2008-2009 and 2014-2015 when the trend reversal of debt capital inflows predetermined a severe balance of payments crisis and led to the depreciation of the hryvnia after a long period of a de facto fixed rate (Figure 1).

Figure 1. Balance of payments and the official rate USD/UAH



Source: National Bank of Ukraine statistical data.

Therefore, during the process of financial liberalization many developing countries used to and still practice the use of capital control tools to mitigate the negative effects of a sharp inflow or outflow of capital for their economies (Kose, Prasad (2012), World Bank (2005)). The use of capital flows restrictions depends on causes and the extent of problems that arose in the economy.

In particular, accumulated international experience on the use of restrictions on capital flows, e.g., IMF (2013a), IMF (2013b), suggests that:

- use of administrative restrictions must be temporary anti-crisis measure;
- it is easier to control capital inflows than outflows;
- restrictions should be momentary and widespread;
- the effectiveness of restrictions on the capital movement is higher if the country's financial system has high standards of regulation and supervision, which reduces the risks of bypassing such restrictions; and
- the introduction of new restrictions entail high administrative costs.

Therefore, the implementation of financial liberalization must take into account the experience of countries that have their international capital flows liberalized and recommendations of international organizations that were involved in this process in different countries. This helps to minimize the risk of the crises and achieve maximum economic benefits from liberalization. Therefore, in this paper we focus on international experience coverage on the issue and the recommendations of international organizations, which must be considered in formulating future policy of capital flows management in Ukraine.

2. The benefits and risks of liberalized capital movements

Due to globalization and the development of financial tools and services, as well as the open nature of the Ukrainian economy, financial liberalization is an inevitable process that will speed up economic development, promote more efficient use of resources (both financial and material), help spread modern technology, and improve opportunities to diversify risks. This ultimately creates a foundation for sustainable and balanced economic development and public welfare.

The full liberalization of capital movements stimulates long-term capital inflows to the real economy and the realization of Ukraine's economic potential. The presence of free exit from investments in Ukrainian assets and simplified procedures for converting and transferring currency are crucial factors of new investments inflow and the development and strengthening of the liquidity of the domestic financial sector. This, in turn, will contribute to the development of currency risk hedging instruments and other financial instruments. As a result, real sector enterprises will have better financing conditions - both by expanding the number of instruments and due to the lower cost of capital. Households get better conditions for savings allocation, including pensions. The money market liquidity increase will boost the demand for hryvnia due to additional demand and supply from foreign players and will reduce the load on the Central Bank's reserves during periods of speculative fluctuations.

For Ukrainian companies and households, capital outflows liberalization will expand opportunities for diversification of assets. Facilitating the access of economic agents to foreign financial resources will contribute to smoothing fluctuations in consumption and investment in the event of external shocks in major export markets.

However, financial liberalization will promote deeper integration of Ukrainian economy into global economic processes that may cause greater volatility in exchange rates and require higher standards of risk management by both regulators and other market participants.

Table 1. Advantages and disadvantages of capital free movement for emerging economies

	<i>Free capital movement</i>	<i>Limited capital movement</i>
Advantages	Better access to international investment capital	Government deficit financing at below market rates
	Lower market rates the real sector funding	More autonomous monetary policy
	A wide range of financial instruments for domestic investors	The perspective of government preferences for certain market participants
	Developed internal financial sector	The possibility of lower volatility for the exchange rate or setting the fixed rate
	The development of pension funds which receive the opportunities to diversify	
	Higher fiscal discipline	
	Higher productivity of investments	
	Competitive environment	
Disadvantages / risks	The high volatility of capital flows	Real sector has limited access to the financial resources
	Budget deficit financing on market principles	Less competitive environment in the financial sector
	Greater volatility of exchange rate	Higher cost of funds
	The need for setting high standards of prudential supervision	Higher probability of unproductive investments
	Less autonomy and the need for more active monetary policy	High cost of conducting business
	Higher probability of entering crises	Low level of financial sector development
		Limited range of financial instruments for domestic investors
		Low level of risk management in the financial sector
		More likely market distortions (rent seeking, corruption)
	High administrative costs of capital restrictions	

Source: Economic Strategy Center.

Capital liberalization risks multiply if liberalization occurs in a country that hasn't reached a sufficient level of financial and institutional development (the first attempts to liberalize in Turkey and Israel provide an example), IMF (2013b). In the absence of an appropriate level of prudential regulation and supervision (which has constantly improved in light of the development of financial innovation), the financial openness of the economy could create incentives for financial institutions to take risks that are too high, which ultimately leads to the inflow of short-term volatile investments, especially in non-tradable sectors (for example, the real estate market). As a result, it may create a "price bubbles" in such markets. Sudden investment outflow could cause a liquidity crisis and banking difficulties, World Bank (2005). However, Hartwell's (2014) recent research showed that the probability of entering a crisis decreased with the deepening of the financial liberalization process subject to prudent macroeconomic policies and exchange rate flexibility.

From a regulatory point of view, free capital movement imposes restrictions on the monetary policy' autonomy for a small open economy like Ukraine, as the central bank faces a "classic trilemma," since one cannot control the cost of money in the country, the exchange rate, and capital flows simultaneously. Monetary policy in financially open developing economies can have a degree of autonomy, although there are restrictions on the objectives that it can achieve Obstfeld (2015). Obstfeld notes that countries with no fixed exchange rate are thought to have a certain degree of monetary autonomy, including the impact on short-term interest rates, but long-term interest rates show a high degree of correlation in various countries regardless of the exchange rate regime.

3. International experience

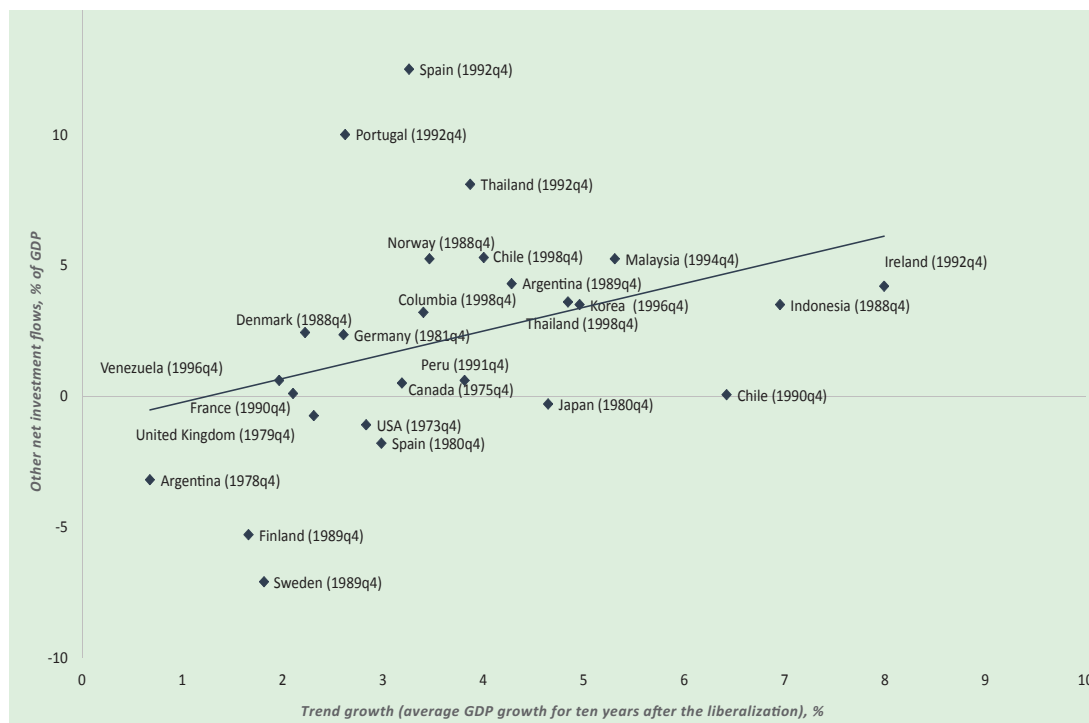
Given the overall globalization, the world generally tends to liberalize financial flows, including those among developing countries and countries with economies in transition. Changes in the index of capital restrictions (calculated based on the annual report of the IMF on foreign exchange regimes and restrictions on the capital movement (IMF, Annual Reports)), show that the number of economies classified as mainly financially open, from mid-1990 to 2010, increased from 78 to 93 from among 185 countries, Chinn, Ito (2015). However, the number of mostly financially closed economies only slightly decreased over the same period (65 to 62).

The liberalization of cross-border capital movements contributes to the acceleration of economic development, since foreign capital inflows allow structural financing of the current account deficit, arising from rapid growth in investment and consumer activity. Also, free international capital mobility allows diversifying investments. Empirical studies of Saadi and Sun (2012), on the impact of capital flows on economic development, point to the positive effects of foreign direct investment and other non-debts flows, especially to developing countries and countries with economies in transition, including through the positive effects of modern technology imports. In the long-term, capital inflow contributes to financial sector development in recipient countries and expanding opportunities for investment in the country, facilitating economic agents' access to financial resources and promoting economic development.

The experience of the countries that liberalized capital movements tended to show sustainable economic growth in the long run and not only by foreign direct investment, where the positive impact on the economic development of recipient countries is well documented in economic literature, but is also due to the influx of more volatile categories of investments, IMF (2013b). Figure 2 shows a positive correlation between the net inflow of foreign investments item "other investment flows"¹ after full financial liberalization, and the average economic growth for 10 years after that indirectly testifies in favor of liberalization in the long run, though it is not proof of one depending on the other since economic growth is determined by many different factors other than foreign investment.

¹ "Other investment flows" - investment category, which is characterized by high volatility, it does not include foreign direct and portfolio investments and derivative financial instruments. IMF (2007), Balance of Payments and International Investment Position Manual. 6th Edition, Chapter 6. <https://www.imf.org/external/pubs/ft/bop/2007/pdf/chap6.pdf>

Figure 2. Correlation between long-term economic growth and investment flow changes in the volume from abroad in the period, one year before the liberalization / one year after liberalization



* The growth trend is defined as the average real GDP growth for ten years after full liberalization.

Source: IMF (2013b).

On the negative side, the high pro-cyclicality of global capital movements leads to volatility of capital flows into and out of the country, and it also leads to more pronounced cyclical domestic economic processes - periods of growth and decline. Thus, for developing countries, if they are recipients of capital flows, it may exacerbate cyclical fluctuations and risks associated with them and will require appropriate and rapid correction of fiscal and monetary policy.

The countries' experiences that liberalized capital flows showed that, in the first years after opening the capital account, there was a massive capital inflow into the country, IMF (2012a), IMF (2013b), Hartwell (2014). This caused upward pressure on the recipient country currency, which was difficult to withstand with the help of sterilization operations via the central bank. As a result, the export competitiveness decreased causing further deterioration of the balance of trade, and the prices of non-trading sectors grew unreasonably fast (boom in the real estate markets), as well as domestic credit, consumption, and investment due to the inflow of funds from abroad, including short-term debt. This eventually led to the deterioration of macroeconomic indicators - the expansion of the current account deficit, increased inflationary pressures, a slowdown in the growth of GDP, and then reduced inflow or even outflow of foreign capital even in the absence of other negative factors.

With cyclical fluctuations in global markets, a sharp switch from capital inflows to outflows led to the downward pressure increased, prices fell in real estate markets, and the level of non-performing assets on the balance sheets of banks increased at an exorbitant pace. Depending on the scale of these processes, emerging countries saw temporary financial difficulties or entered a systemic crisis of balance of payments, banking sector crisis, and/or currency crisis. This required an adjustment of monetary and fiscal policy and often the need to re-impose the capital movement restrictions.

The accumulated experience of overcoming crisis consequences and the use of different tools makes it possible to draw conclusions about the efficiency of various capital control policy measures that let regulators to avoid or reduce the negative effects of volatile capital flows in developing countries.

3.1. The nature of the capital movement management

In the process of financial liberalization, many developing countries practiced and still practice use of capital controls to reduce the negative effects of sharp capital inflow or outflow for their economies, (IMF, Annual Reports).

Administrative and market-oriented capital flow management tools

The use of capital flows management instruments depends on the causes and extent of problems that arise in the economy. There are two broad categories of capital movement restrictions, Klein (2012), Table 2:

- 1) administrative constraints (permits, prohibitions on certain transactions);
- 2) market-oriented or price-based control measures (such as taxation, reserve requirements, etc.).

Table 2. Examples of capital movement restrictions and examples of their use

<i>Restricting capital outflows</i>		<i>Restricting capital inflows</i>	
Administrative			
The prohibition of repatriating dividends	Ukraine (2014-2015), Malaysia (1998)	Limits to attract short-term capital by residents	Indonesia (2011)
Limitations (moratorium) on withdrawal of deposits and purchase of FX in cash	Ukraine (2014-2015), Argentina (1994, 2001)	A minimum holding period of domestic assets for resale on the balance sheet	India, Indonesia (2011)
Mandatory sale of export proceeds	Ukraine (1998, 2014), Thailand (1997)	Requirement to obtain permission or registration of international borrowing contracts	Korea (2010), Cyprus, Ukraine
Holding period on transfers to non-residents for proceeds from the sale of domestic assets	Iceland (2008)	Restrictions on the maturity of debt borrowings	India, Ukraine (2008)
Minimum lock-in period for foreign capital	Chile (1990s), India		
Delay on converting non-resident income from the sale of domestic assets (from 5 days to 12 months)	Ukraine (2008), Malaysia (1998)		
Prohibition on the conversion of assets denominated in local currency	Iceland (2008)		
Market oriented (price-based)			
Taxing the sale of securities by non-residents	Malaysia (1998)	Taxation of interest income and income from the sale of domestic securities by non-residents	Korea (2011), Thailand (2010)
Multiple exchange rates	Argentina (2002-2013), Venezuela (2003-2015)	Reservation of short-term capital inflows in separate accounts in the Central Bank	Chile (1990s), Slovenia (1995-99)
		Taxation of portfolio investments and inflow of debt capital	Brazil (2009)

Sources: IMF, NBU, Center for Economic Strategy.

Usually administrative restrictions are less transparent, more discretionary (they are given at the discretion of the official who makes decisions), and more distorting for activities of economic agents, while market-oriented restrictions call rather for non-stimulation of certain transactions, increasing their cost and not fully banning them, and they are transparent, clear, and binding rules of the game under which the market works.

The duration of capital controls application

Prolonged use of a capital control policy in most cases is considered as the one that has a negative impact on the economy, IMF (2012a), Klein (2012), Saborowski, Sanya, Weisfeld, Yopez (2014). In particular, it reduces the financial markets' discipline and control of public finances, narrows the scope for financing investment projects, and reduces the opportunities for residents to diversify their assets that negatively affects economic growth. There are also government costs related to monitoring and control of compliance with foreign exchange regulations and other restrictions. The existence of restrictions indirectly encourages economic agents towards rent-seeking behavior and corruption in order to be able to evade them. Thus, prolonged use of capital controls is counterproductive since they force the regulator to modify its rules constantly in order to keep the cross-border transactions under control that constantly increases costs for the state and economic agents.

A debatable exception in this regard is China, where the cross-border movement of capital was limited for a long time and that has not prevented its economy to grow. Capital controls in China were bypassed as described by Ma and McCauley (2007) thanks to the parallel existence of broad "offshore" and "onshore" currency markets, and from 2009 to 2014 the major problem was to control inflows rather than capital outflows, which reversed only in 2015. Current trends in the Chinese economy and stock market still need to be studied in terms of the effectiveness and appropriateness of capital control mechanisms that were applied by the government over time. But in any case, the China example for Ukraine is less relevant than the examples of smaller countries (Poland, Iceland, Asian countries) as it relates to small open economies.

As Krugman formulated (1998), for capital controls to become an effective tool in overcoming the crisis, and not become a cause of economic stagnation, structural deformation, lack of foreign investment flows, and more funds in the informal sector, their limitations should be:

- to be aimed to disrupt ordinary businesses as little as possible;
- to be regarded as temporary measures, designed to win breathing room for economic recovery, not as permanent practice;
- to not use them to protect overvalued currency, they should not evolve from a temporary defense against speculations into a permanent system of protectionism; and
- to serve as an aid to reform, not an alternative.

3.2. Prerequisites for the complete removal of capital flows restrictions

Given the lessons of the global financial crisis, the IMF currently does not recommend implementing measures to fully open capital accounts for countries that have not reached a certain level of domestic financial sector development and institutional capacity. International experience shows that liberalization of capital movements is more likely to be successful in the case of prudent fiscal, monetary, and exchange rate policy, IMF (2012a), Arvai (2005). Flexible exchange rates can help smooth out shocks from volatility in capital flows to the real economy, IMF (2012b).

According to the IMF recommendations that were developed based on member countries' experiences, IMF (2012a), IMF (2012b), which introduced measures liberalizing capital accounts, the prerequisites for the full and complete removal of capital movement restrictions are as follows:

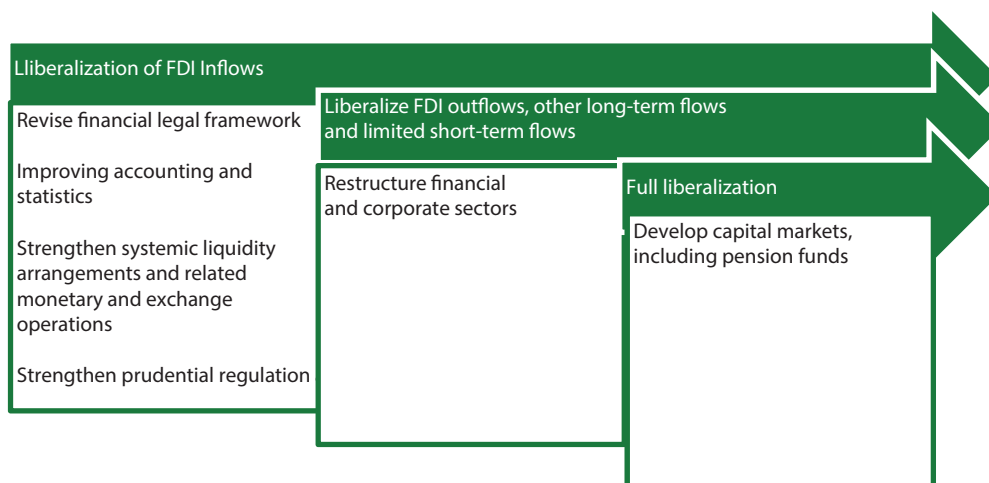
- sustainable economic growth;
- low inflation and high exchange rate flexibility;
- an adequate level of international reserves;
- a significant proportion of FDI and equity capital in the composition of capital inflows;
- an adequate level of financial sector development;
- high standards of prudential supervision and regulation;
- a positive perception by investors of the quality of governance and institutions in the country; and
- fully liberalized current account.

3.3. The sequence of steps to liberalize the capital account

Economic thought is unequivocal about the falsity of the idea of an instantaneous liberalization of capital flows, even with the implementation of the above prerequisites.

Based on different countries' experiences, the IMF recommends following a certain sequence in removing restrictions on capital movement to reduce the negative effects of the high volatility of international capital, IMF (2012b), Figure 3.

Figure 3. A generalized diagram of measures to liberalize capital



Source: IMF (2012b). <http://www.imf.org/external/np/pp/eng/2012/031312.pdf>.

3.4. Selecting the pace of capital account liberalization

The capital flows liberalization pace slowed in recent decades through repeated commencement of crises in different countries. Many countries have introduced new or returned to previously used measures limiting cross-border capital movement in crisis episodes to reduce the negative effects of the high volatility of capital flows on their economies (Israel, Latin America, Iceland).

Experience, such as the immediate liberalization in Israel in 1977, shows that the shock therapy without proper macro-stability and developed financial markets can greatly deepen the crisis. IMF (2013b).

Israeli's two attempts of financial liberalization

First attempt of liberalization, 1977, also called the "Big Bang"

- Sudden onset and rapid progress
- Instability of policies that worsened macroeconomic conditions
- Financial markets were controlled by the regulator, there were no developed capital markets and money markets
- Led to inflation growth and capital flight along with rapid devaluation
- Recognized as failed and dismantled in 1979

The second attempt of liberalization in 1987

- Gradually, slowly implemented
- Relatively stable, improved macroeconomic conditions
- Implemented against the background of macroeconomic reforms, disinflation, gradual liberalization of the exchange rate and deregulation of the capital markets

Completed in 2005.

Source: IMF (2013b).

Now economists agree that liberalization must be conducted with no reference to dates and terms, but to the occurrence of certain events or stages of economic development, IMF (2013a), IMF (2012a), IMF (2012b).

International experience shows that the liberalization of capital movements is a lengthy process because it requires complex reforms and development of the market infrastructure. The time required for the necessary reforms in the country to create the conditions for safely opening the capital account depends on each country's specifics, but even in industrialized countries this process was sometimes quite lengthy (for instance, liberalization of capital movements lasted 16 years in Japan), IMF (2013b).

Among developing countries over the past decade, there are many examples of rapid financial liberalization, after which crises happened. Relatively painless (within 7-10 years) capital flows liberalization was conducted in Central and Eastern European countries, Arvai (2005), probably due to their success with the European integration process and the support from the European Union. As to the opening of capital accounts, countries such as Poland, Hungary, Czech Republic, and Slovenia already had well developed financial sectors and institutions and were recipients of large amounts of FDI. Among Central and Eastern Europe countries, the liberalization process took course relatively quickly in the Czech Republic: the main measures were implemented during 1993-1995 and the final opening of the capital account ended in 2001, Arvai (2005). During this period, the Czech Republic has endured one crisis episode, it was the currency crisis of 1997, which provoked the departure from a fixed exchange rate policy. The pace of financial liberalization in Poland was longer and more gradual than in neighboring countries (lasted 16 years), but the country managed to avoid crisis episodes and did not have to re-impose restrictions that had been taken earlier, Arvai (2005) Kokoszcyński (2001) (see the **Polish Experience** section).

In Iceland, capital liberalization movements in the absence of appropriate prudential regulation and capital inflows restrictions exceeded the absorptive capacity of the economy and this led to a deep crisis, which triggered by a global crisis in 2008, Ostaszewski (2013), IMF (2015). Resorting to capital restrictions practice in Iceland was a necessary step on the part of authorities to gain control and manage the macro-financial stability. (See the **Iceland Experience** section).

Examples of successful and unsuccessful processes of liberalizing capital flows and the use of restrictions during the Asian crisis are Malaysia and Thailand, respectively. An integrated approach has helped Malaysia to confront the global financial crisis with fewer losses than in Thailand (see the **Thailand and Malaysia Experience** section).

The process of capital account liberalization in Korea in the last decade is consistent with the generally recognized integrated approach when lifting restrictions has been accompanied by prudent macroeconomic policies, IMF (2012).

Polish Experience

Background

Public policy: the public policy was shaped in the 1990s, after the collapse of the Soviet Union when Poland was going through a period of transformation from a planned to a market economy. At the beginning of transformation, the country suffered from hyperinflation. Part of the stabilization program after a major devaluation was linking the fixed exchange rate to the dollar, Kokoszcyński (2001). In 1991, with a growing proportion of developed economies in its foreign trade structure, Poland abandoned the fixed exchange rate by switching to a crawling peg regime based on a basket of currencies. In 1994, due to improved balance of trade and capital inflows associated with privatization, partial convertibility of the Polish zloty became possible, first in the currency band regime (crawling band) and then a move to a flexible exchange rate. This led to the country's foreign exchange market development, along with it came the stock market as a result of privatization. All important indicators (interest rates, exchange rates, credit limit) were rigidly controlled, Kattel, Kregel and Tonveronachi (ed.) (2016).

Financial Sector: The rehabilitation of the financial system held together with tectonic transformation processes in the economy. In the early 1990s, the financial sector consisted mainly of banks; besides them, there was only one state insurance company. Thus, Poland had to build its financial system from scratch.

Economic growth: In 1990, the first post-Soviet Polish government introduced the "Program of economic transformation," designed to stabilize the economy and implement structural reforms as the first steps on the way from a planned to a market economy.

The transformation process

First stage. Reconstruction of the financial system and its regulation. The large-scale financial system transformation in Poland began in 1989 and lasted until the late 1990s. Parliament passed the Banking Act and the Act of the National Bank of Poland, thus forming a two-tier financial system, and commercial banks appeared. Removal of restrictions on the foreign banks' activities also refers to the earlier transformation time and licensing conditions for new banks were simple. In 1991 the country already had 72 commercial banks. Many of them were European and actively participated in the privatization process, thus establishing an economic ties with the EU even without formal entry into the Union.

Second stage. Formal integration. Poland's formal integration with the European Union and the country's implementation of the changes to the regulation of financial markets demanded by the OECD included the creation of an entirely new regulation package that Poland simply adapted over time using existing EU regulations. In 1997, amendments were made to basic legislation and regulation of the financial sector in Poland, fully consistent with EU guidelines. Small differences that remained were eliminated in 2004. The new Foreign Exchange Act of 2002 lifted the most restrictions on the capital movement with EU countries and the OECD member countries. Polish residents were free to invest in the capital markets of these countries, hold accounts in foreign banks, and invest funds in such accounts. This had not led to economic disaster. The temporary capital outflows on portfolio transactions in equities, which was observed in 2001-2003 (-0.2% to -0.4% of GDP), changed to inflows in 2004-2005 in the amount of 0.4%-0.7% of GDP, and the capitalization of the domestic stock market almost tripled from 13.7% of GDP in 2001 to 30.9% of GDP in 2005.

The third stage. Continued liberalization. Since 2007, Poland mostly continued its adjustment to EU standards, particularly by liberalizing investment funds' operations and debt regulation. Restrictions on foreign exchange settlements between residents in the country had not been withdrawn. In 2010, Poland implemented investors' protection legislation (requirements of the European Directive Markets in Financial Instruments Directive), particularly in terms of the detail and quality of information on the tools and terms of financial services, evaluation of the consumer's understanding of the product, and verification of the risks related to investor's skills and product knowledge.

Conclusions

With legislation being gradually brought in line with European directives and liberalization of capital movements, Poland managed to integrate into the global financial system, avoiding significant crises related to capital outflows. Even during the crisis of 2008, no financial institution went bankrupt, and NPLs remained at more or less controlled level. The main reasons for the success of such a policy were strong prudential regulation and supervision of the financial services market, and the regulator's flexible response to internal and external challenges (changing the capitalization requirements, making the act of state guarantees in the recapitalization of financial institutions, many formal recommendations for the management of credit and currency the risk of work with derivatives, etc.).

Sources: IMF (2013b), Kokoszcyński (2001), Kattel, Kregel and Tonveronachi (ed.) (2016).

Iceland Experience

Background

Public policy: Since 1980, the Icelandic government took a course on liberalization, deregulation, and reduction of intervention in the state's economy. During the 1990s, the central bank moved to inflation targeting, fully implemented in 2001, and a floating exchange rate. At the same time, Iceland joined the European Economic Area and legally declared free capital movement.

Financial Sector: In 2003, privatization of the country's three largest banks was completed and the government began to provide its guarantees for mortgage loans. This led to a credit boom. At the same time, interest rates higher than the average European level made appealing investments to the Icelandic currency and derivative instruments for non-residents. Given the fully liberalized movement of capital, banks had virtually uncontrolled access to foreign borrowings and channeled them to both the domestic market and high-yield foreign assets. Rapid development of the credit market was inconsistent with the level of economic development, and Icelandic banks, using leverage, increased their total assets to as much as 1000% of GDP as of 2007.

Economic growth: The Icelandic economy grew (cumulatively +25% during 2003-2007) due to a carry-trade currency speculation scheme, high interest rates of the Central Bank, and strengthening of the national currency against the background of prevailing capital inflows. This led to an accumulation of excessive private sector debt (corporate sector debt as of 2008 accounted for 308% of GDP) and a significant dependence on foreign financing.

Crisis

First stage. The crisis development. With the Lehman Brothers bankruptcy and the collapse of world stock markets, rapid capital outflow began. The domestic price of financial assets and real estate collapsed and the opportunity to refinance debt disappeared. As a result, Icelandic banks lost liquidity and banking sector collapsed. This caused panic in the financial markets and a new significant capital outflow resulted in a balance of payments deficit and the depreciation of the Icelandic krona.

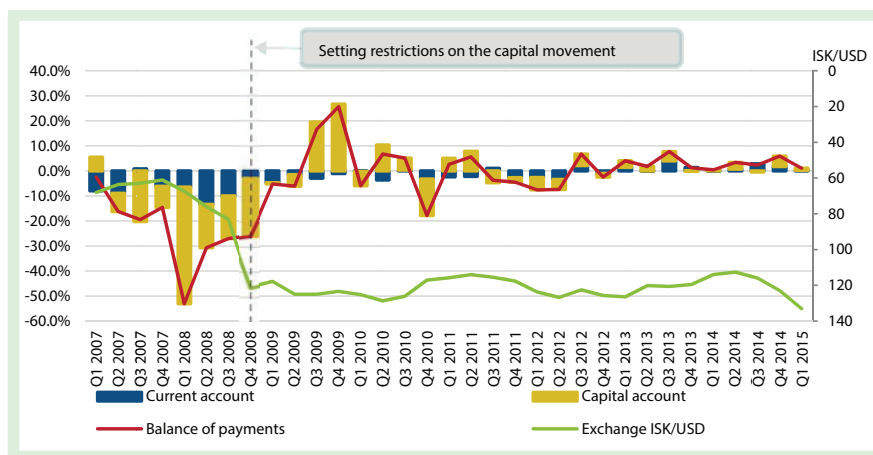
Second stage. Soft regulation. In an attempt to resolve the situation, the government was forced to nationalize the three largest banks. But since Iceland declared free capital movement by law, the central bank did not have sufficient powers to resolve the situation. The central bank raised interest rates to 18%, but it did not help and capital flight continued. The government signed an agreement with the IMF for the period of 2008-2011.

The third stage. Administrative restrictions. To introduce additional restrictions on capital movement Iceland had to legally empower the Central Bank to manage the capital flows. The first restrictions on capital flows imposed by the Central Bank in November 2008 prohibited or significantly limited any cross-border movement of capital not related to international trade. The restrictions had immediate effect; in the same quarter (in IV quarter 2008), the capital outflow almost completely stopped and the exchange rate stabilized (Figure 4).

The fourth stage. "Crackdown". Since economic agents eventually found opportunities to bypass restrictions, the regulator had to review them in 2009 and 2011, mainly in the direction of strengthening regulation. Partial exceptions were made for public institutions or companies, and those companies where the state had a significant stake. Nevertheless, during the time when capital flows restrictions were in force, up to one third of the failed banks' assets flew out of the country via various channels.

The fifth stage. Stagnation. The above restrictions on capital movement, established in November-December 2008, are still in force today. According to Iceland's Ministry of Finance, maintenance of restrictions on the capital movement costs the Icelandic economy 2-3% of annual GDP growth. In September 2009, the first program for financial liberalization was presented, but it did not receive adequate support and was not implemented, so another program was presented in March 2011.

Figure 4. Payments dynamics and the capital movement restrictions in Iceland



Source: according to the Iceland Central Bank.

The sixth stage. The liberalization. Thus, most of restrictions existed until 2015. During this time, the balance of payments has stabilized, the country started with a surplus for the third consecutive year (in 2014 the surplus was US\$ 1.45 billion), and GDP started to grow in 2011. In 2015, a liberalization program was adopted. The total amount of funds that would be withdrawn, in case of simultaneous restrictions lifting, according to the Iceland Ministry of Finance is more than 1.7 trillion euros (~US\$ 12 billion, 70% of GDP), IMF (2012a). Assets on US\$ 9 billion (52% of GDP) could be withdrawn from the country immediately in the case of full financial liberalization and thereby disrupt the macroeconomic stability, triggering a panic on the currency market. Because of this risk, the Ministry of Finance decided to define the following groups of assets:

- money for depositors of failed banks denominated in krona – (~US\$ 3.5 billion, 20% of GDP);
- money for resident depositors of failed banks denominated in FX - (~US\$ 2.8 billion, 16.5% of GDP);
- money for financial instruments of non-residents denominated in krona - (US\$ ~2.1 billion, 12.4% of GDP).

For each of these groups, its own liberalization strategy was developed, designed to smooth the maximum impact on the macroeconomic situation. Of course, the future financial flows are not limited to the groups mentioned above and therefore, with increased financial freedom in Iceland, the Central Bank will have to modify prudential supervision and authorize investments in order to avoid repeating of the crisis.

Conclusions

Against the background of capital account liberalization with inadequate levels of prudential supervision and institutional constraints of the regulator (superimposed by signed international agreements), Iceland faced considerable economic difficulties, the effects of which the country has yet to break. After 7 years, severe restrictions on capital movement remain in place concerning almost all aspects of international capital flows. Now, the Icelandic government has created a roadmap for the gradual lifting of restrictions on capital movement, clearly defining key asset groups and individual policies for each of them. In the plans of the government and the central bank, strengthening prudential supervision in order to prevent similar situations in the future holds a special place.

Sources: Ostaszewski (2013), IMF (2015), Capital Account Liberalization Strategy. (2015), Central Bank of Iceland (2011).

The Thailand and Malaysia experience

Background

Economic growth: The Thai economy rapidly evolved over 1980-90, with an average growth rate of 7.6% per year. In total, from 1980 to 1996, the GDP of Thailand increased 3.9 times. Due to low labor costs, the country's exports had a significant competitive advantage and was rapidly growing. The main factors that determined the inflow of foreign investment were the recession in the US and the low US Federal Reserve interest rates, which caused investment flows from the United States abroad. Thailand at this time was attractive for investments because of the central bank's high interest rates (13% in 1995), the currency pegged to the dollar, and liberalized capital movements.

Public policy: Since 1993 the Thailand Bank decided to develop the Thai financial system as a regional financial center. A key role in this process was to be played by a system of offshore banks institutions (Bangkok International Banking Facilities, or BIBFs). In 1994, exchange controls were loosened and transfers abroad eased (investments and loans). Interest rates remained high and the currency was pegged to the dollar.

Financial sector: The basic scheme of a licensed BIBF was to attract foreign funds for lending to residents (out-in operation) and non-residents (out-out transactions). The lack of business transparency, weak bank supervision, too low capital requirements, and inadequate bankruptcy procedures encouraged unscrupulous practices by banks. Combined with low-cost loans, it led to buying into the low-quality assets and to speculations, especially in real estate sector, where investments were protected by the government.

Crisis

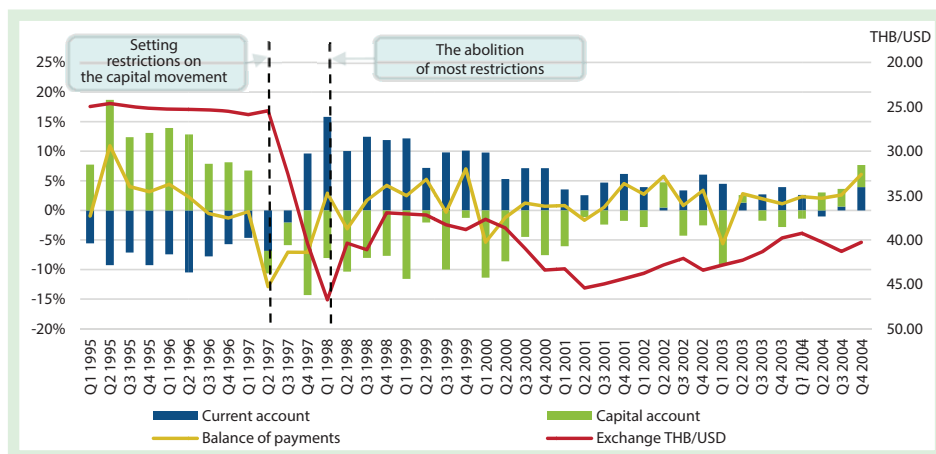
First stage. The crisis development. When the US Federal Reserve interest rates began rising with the subsequent strengthening of the dollar, the capital flows reversed (from South-East Asia to the US). For Asian currencies linked to the dollar, the higher value of the dollar meant reducing export competitiveness in global markets and balance of payments problems.

Second stage. Soft regulation, market practices. Since December 1996, increased pressure on the national currency forced the central bank to raise interest rates from 5% to 9%; it partly prevented a capital flight and the BoT has started its foreign exchange interventions to keep the baht's fixed rate still.

The third stage. Administrative restrictions. But in May 1997, in the face of speculative attacks on the currency, the Bank of Thailand introduced restrictions on most of direct cross-border currency transactions, except for international trade and investments. A two-tier foreign exchange market was created, with the fixed rate used for trading and the remaining transactions carried out at the market rate. This did not stop capital flight, but sharply reduced the liquidity of the financial system. The pressure on the national currency was not reduced, so the central bank continued to intervene, and, in 1996-1997, Thailand's international reserves declined from USD 38.6 billion to USD 26.8 billion, or 34% to 25% of external debt.

The fourth stage. Liberalization of the exchange rate. After 2 June 1997, Thailand's central bank introduced a floating exchange rate of the Thai baht, which led to a significant depreciation, further increasing pressure and deepening the debt crisis. Low confidence, uncertainty and panic because of capital movement restrictions only increased outflows, despite the fact that short-term interest rates were risen to over 20%. The collapse of one of the largest financial corporations in the country, Finance One, caused more panic among investors. The banking sector, especially BIBFs, boosted the amplitude of the financial crisis. Commercial banks recorded a net capital outflow of USD 4.7 billion in 1997 and USD 4.3 billion in 1998, at the same time, USD 1.7 billion were withdrawn through BIBFs in 1997 and USD 9.6 billion in 1998 (Figure 5).

Figure 5. Payments dynamics and restrictions on capital movement in Thailand



Source: according to the Bank of Thailand.

The fifth stage. Elimination of restrictions. The Bank of Thailand, entering into USD 3.9 billion IMF stand-by program signed 20 August 1997, abolished the dual exchange rate regime practice and the rest of its limitations in early 1998. Subsequently, the central bank increased reserve requirements and strengthened regulations on assets' classification, then required banks to reserve at least 20% of lending value for each reporting period and fully maintain this level of reserves until 2000. It created a favorable foundation for further growth and the competitive positions of exports strengthened due to the depreciation.

Conclusions

Unlike other countries in the region, Thailand failed to prevent a crisis. According to some Thai officials, restrictions introduced on capital movement only deepened the problem. Scientists agree that the restrictions on capital flows were introduced too late and were quite complex, so, rather than producing the desired effect, they caused panic and accelerated the withdrawal of capital.

It is widely recognized that weak supervision of banks and financial corporations and excessive leverage were key reasons for the economy's rapid collapse after the introduction of the floating exchange rate regime.

The Thailand experience is frequently contrasted with Malaysia's practice. These countries are similar in terms of economic development, structure of their economies and financial sectors, they faced similar external problems (generated by unfavorable economic conditions), and internal problems. But, unlike Thailand, Malaysia's anti-crisis policy was much more efficient and appeared able to prevent the outflow of capital and a significant economic downturn. The Malaysian system of restrictions on capital flows leveled any potential gains from speculation in the national currency. The Central bank regained control of capital outflows through early responses to potential threats and floating the currency (rynnhita) that left no significant benefit for currency speculators, as was the case in Thailand where the central bank was trying to maintain the rate. Malaysia was more fortunate during the moment of crisis; it started later than Thailand and its exit out of the crisis coincided with the economic recovery in other countries of the region.

The main objectives of the capital controls system, implemented by the Malaysia Government, were:

- to negate any potential benefits of speculation in the national currency;

- to eliminate the offshore rynnhit market and dual exchange rates:
- to increase monetary autonomy policy; and
- to insulate the economy from the effects of further deterioration of global financial conditions.

To achieve the goal of completely blocking all cross-border financial transactions, except for trade, Malaysia implemented mandatory sale requirement of foreign currency. Foreign exchange transactions could have taken place only with the permission of the government, for which it was necessary to establish the nature of the trading transaction or that the funds were direct investments.

The main difference between the results of capital controls policy in Thailand and Malaysia were:

- Thailand suffered because of speculative attacks and imposed restrictions on capital movement as a defense mechanism to support the currency. Malaysia, instead, didn't suffer from the extraordinary speculative pressures because, at that time, the exchange rate had not been fixed;
- Restrictions on the capital movement in Malaysia were very broad and intended to destroy all loopholes for the withdrawal of currency. Instead, the restrictions imposed by Thailand, at least in retrospect, were not broad-based. In particular, significant opportunities remained to withdraw currency through BIBFs, there was no adjustment to properly control fictitious foreign transactions, the possibility to withdraw capital through securities and the stock market was not offset; and
- Thailand used restrictions in the midst of the crisis, while the government of Malaysia had introduced it on early stage when financial markets had just begun to decline. The important point here is the last fact. This difference between the moments of restrictions' imposition could be the key factor in explaining the negative results of control policy of the Thai capital movement.

Source: Bank of Thailand (2009); Lauridsen (1998), Jongwanich, Socorro Gochoco-Bautista, Lee (2011), Watanabe, Akama, Mifune (2002), Hali, Edison, Reinhart (2000).

4. Conclusions

International experience shows that long-term use of capital control policies have negative consequences for the economy by distorting market conditions and changing the incentives of market participants. Moreover, maintaining such a policy increases government's administrative costs.

Ukraine, whose economy needs major investment resources for development, has the potential to benefit from full financial liberalization. Given the current level of Ukraine's integration into the global economic system and the need to attract large amounts of investment for structural modernization, full liberalization of capital flows is a welcome result of market reforms leading to fully realizing the country's economic potential. In addition, liberalization of capital movement is consistent with the Ukraine's strategic goal of integrating into the EU.

The full liberalization can be reached at different pace depending on the necessary prerequisites. The experience of other countries that liberalized capital movements and IMF precautions should be taken into account. In particular, liberalization is more likely to be successful if it is carried out with closely-coordinated fiscal, monetary, and exchange rate policies while carrying out reforms that enhance the capacity of markets and institutions. It is also important to promote prudential supervision and risk management in the banking system.

International experience also shows that the liberalization policy should be carried out carefully, making it possible for the economic agents to adapt and to implement market reforms. Thus, it is recommended to gradually open access to various capital flows, classifying them as more or less risky for the economy. This liberalization can be quite a lengthy process. Thus, even in Europe full liberalization took place for over 10 years from the beginning of changes.

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