International capital flows:

Structural reforms and experience with the OECD Code of Liberalisation of Capital Movements

Report from the OECD to the G20 Sub-Group on Capital Flow Management

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International capital flows: Structural reforms and experience with the OECD Code of Liberalisation of Capital Movements

The dramatic increase in international capital flows, despite a temporary contraction during the global crisis, has motivated policy discussions on the associated benefits and costs of capital mobility. While international capital movements can support long-term growth, they also pose short-term policy challenges, including those associated with undesirable consequences of exchange-rate appreciation, financial and asset-price cycles and sudden stops in capital flows.

Countries have dealt with such challenges through appropriate macroeconomic policies and, in some cases, sought to damp capital inflows by means of macro- and micro-prudential measures, tax instruments and direct capital controls. While some restrictive measures may be effective in the short run, they also entail risks, including those related to retaliatory measures by other countries and a progressive fragmentation of international capital markets.

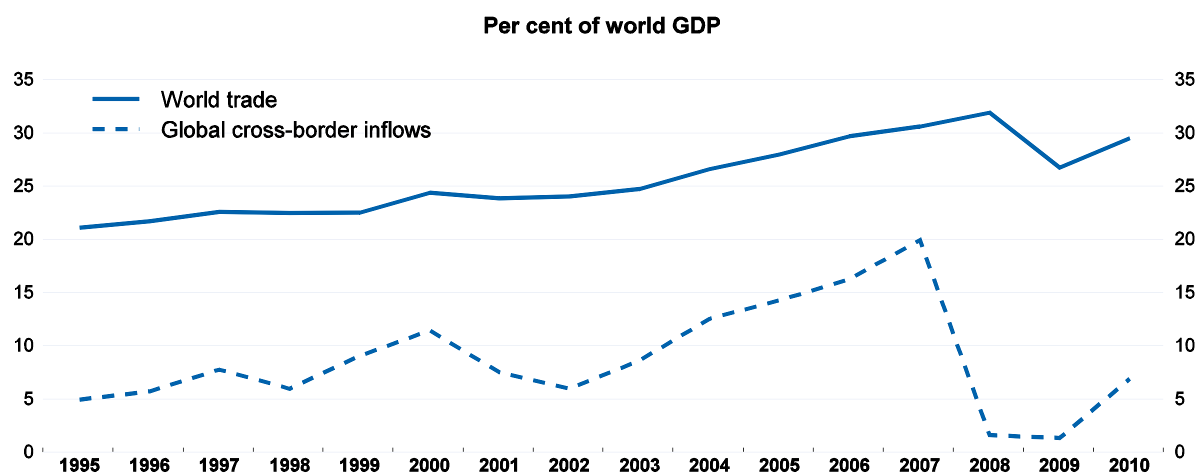
International cooperation is essential to avoid undesired collective outcomes as countries take unilateral action to manage international capital flows. In discussing the desirable features of a collective approach to capital flow management the OECD experience with the Code of Liberalisation of Capital Movements can be useful for G20 countries. Cooperation under the Code has fostered a continuous process of shared learning and has favoured convergence in policy settings.

This Report draws lessons from the experience of OECD countries with the Code. The Report reviews trends in international capital flows and discusses how structural reform can equip countries with the necessary tools to make the most of capital flows in support of long-term growth. The Report then summarises the main features of the Code and the dialogue and peer review processes that underpin it.

1. Trends in international capital flows

International capital flows have increased dramatically over time, despite a temporary contraction during the global crisis. Gross cross-border capital flows rose from about 5% of world GDP in the mid-1990s to about 20% in 2007, or about three times faster than world trade flows (Figure 1). Prior to the crisis, the dominant components were capital flows among advanced economies and notably cross-border banking flows. The crisis resulted in a sharp contraction in international capital flows, after reaching historical highs in mid-2007. The contraction affected mainly international banking flows among advanced economies and subsequently spread to other countries and asset classes. Capital flows have rebounded since the spring of 2009, driven by a bounce-back in portfolio investment from advanced to emerging-market economies and increasingly among emerging-market economies.

Figure 1. Financial and trade globalisation, 1995-2010



Note: 2010 global cross-border flows are estimated using available quarterly data.

Source: IMF (*Balance of Payments Statistics*), OECD (*Economic Outlook* 89 database), and OECD calculations.

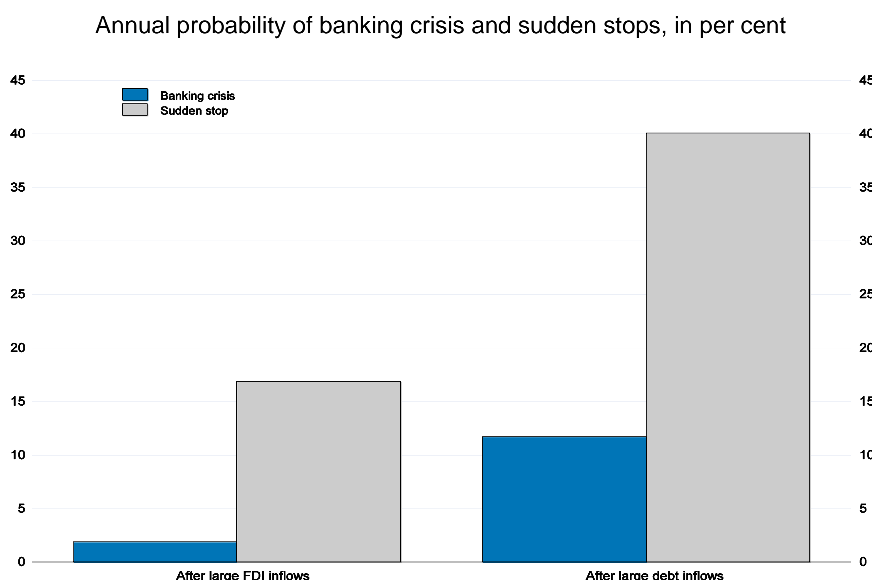
2. How can countries make the most of international capital flows?

International capital movements can support long-term growth but are not without short-term risks. The long-term benefits arise from an efficient allocation of saving and investment between surplus and deficit countries. However, large capital inflows may challenge the absorptive capacity of host countries in the short run by making them vulnerable to external shocks, heightening the risks of economic overheating and abrupt reversals in capital inflows, and facilitating the emergence of credit and asset price boom-and-bust cycles. Empirical analysis carried out by the OECD for a large sample of mature and emerging-market economies shows that the probability of a banking crisis or sudden stop increases by a factor of 4 after large capital inflows.[1] Indeed, the probability of occurrence of a crisis or a sudden stop is particularly high after large debt capital inflows (Figure 2). Moreover, debt-driven episodes of large capital inflows tend to have a stronger impact on domestic credit than when inflows are driven primarily by FDI or equity portfolio investment.

[1] Overall about 60% of 268 episodes of large foreign capital inflows between 1970 and 2008 in both advanced and emerging market economies (identified by large deviations of the net capital inflows-to-GDP ratio from its historical trend) ended in a "sudden stop", and about one in ten episodes ended in either a banking or a currency crisis. Considering only OECD countries, about 40% of the 75 large capital inflow episodes ended in a sudden stop and about one in ten episodes in either a banking crisis or a currency crisis.

Figure 2. The likelihood of a crisis depends on the nature of capital flows

Annual probability of banking crisis and sudden stops, in per cent



Note: Based on regression results in Table 10 and 14 in Furceri *et al.* (2011c). Probabilities are evaluated at sample means for all other variables entering the equation.

Source: OECD calculations.

Structural policy reforms can maximise the long-term gains from international capital movements in support of stronger, more balanced and sustainable growth. Structural policy, including financial and product market regulation, have a large impact on net foreign capital positions. OECD analysis for a large sample of mature and emerging-market economies shows that countries with more open financial markets, better institutional quality and more competitive product and labour markets appear to be more able to attract and absorb foreign and domestic capital flows and on balance these countries have lower net foreign assets.[2]

Structural policy can also minimise the short-term risks associated with capital flows**.** On the one hand, improved structural policy settings are likely to increase the overall scale of capital flows, which may heighten short-term risks. On the other hand, better structural policies (more competition-friendly product market regulation, more adaptable labour markets, higher institutional quality and greater capital account openness) are associated with a composition of capital inflows -- principally more FDI and less debt -- which is more stable and less prone to risk. The net effect of capital flows on short-term risks will depend on the particular form of structural reforms enacted, but also on how they are buttressed by progress in financial reforms to strengthen the prudential and macro-prudential framework in both emerging and advanced economies.

Macroeconomic policies, particularly exchange rate and fiscal policies, also have an important role to play in reducing vulnerabilities associated with capital inflows. Exchange rate flexibility mitigates some of the effect of large capital inflows on domestic credit. In addition, countries that typically follow counter-cyclical fiscal policy have on average experienced more moderate credit booms during large inflow episodes, and especially during debt inflows episodes. These are, however, general findings and related

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2 See OECD (2011), *OECD Economic Outlook*, No. 89 (OECD, Paris) and Furceri *et al*. (2011a, 2011b and 2011c) for more information and empirical evidence.

policy recommendations have to take into account countries' individual conditions and institutional settings.

3. What moved OECD countries to adopt the Code?

In recognition of the benefits of international capital flows and the need to deal with the associated risks in a cooperative manner (Box 1), OECD countries adopted the Code of Liberalisation of Capital Movements in 1961.[3] Countries agreed on a framework for cooperation on issues concerning capital movements, which is reflected in the Code's disciplines and understandings.[4]

Box 1. Benefits of a cooperative framework for capital flow management

- A country receives international support and recognition for its openness.
- A country communicates that, as a cooperative member of the international community, it refrains from a "beggar-thy-neighbour" approach.
- A country enjoys the liberalisation measures of other participants, regardless of its own degree of openness.
- A country is protected against eventual unfair and discriminatory treatment of its investors established in other participating countries, and will be entitled to bring problems to the framework and seek remedy.
- A country has the right to transparency regarding the measures of the other participating countries.
- A country reassures market participants that it does not intend to maintain controls broader or longer than necessary.
- As a participant with equal rights and responsibilities, a country fully participates in shaping jurisprudence and improving the rules of the framework.

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3 In the aftermath of WWII, re-opening cross-border payments and financial transfers was key to rebuilding the European economies. It was this effort under the aegis of the Organisation for European Economic Co-operation – the predecessor of the OECD – that propelled the move towards free convertibly of European currencies and led to the development of the Codes of Liberalisation, adopted when the OECD was formed in 1961.The Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations –which covers current payments, cross-border services and establishment of foreign financial institutions– were adopted at the same time and share a common framework.

4 The European Union (EU) Treaty provisions have much in common with the Code but the membership is regional. They require free capital movements among EU countries and between EU countries and third countries. Many investment chapters of regional free trade agreements (FTAs) and bilateral investment treaties (BITs) use a broad definition of inward international investment. However, unlike the Code, they do not cover capital outflows by residents. In addition, while the Code provides for liberalisation of entry of new investments, most BITs protect only existing investments. The GATS includes some elements of capital movement liberalisation, but only insofar as a capital movement is needed for the effective delivery of a service. If, for instance, a foreign services provider wants to deliver a service by means of a commercial presence in a country, it should have the ability to move capital to establish a subsidiary or a branch in this country. But, unlike the OECD Code, the GATS is not a code of conduct for capital movements.

A legal framework

The Code established a consensus-driven process that is managed and controlled by the adhering countries. The Code has underpinned the right of countries to maintain capital flow measures, but also set basic principles regarding their use and encouraged progressive liberalisation. It has been developed with a view to maintain consistency with countries rights and obligations under other international agreements, including the IMF's Articles of Agreement.

The Code provides a balance of rights and obligations for adhering countries: they have the right to maintain measures and, under certain conditions, to introduce new ones; but they agree to subject such measures to disciplines (Box 2). The Code calls for measures to be transparent and non-discriminatory.

Through the Code countries commit to maintain their level of openness (standstill), progressively liberalise and to take a rigorous view of what is considered to be a restriction. The Code also recognises each country's policy space and contains safeguards, including for the re-introduction of restrictive measures to face a crisis situation. This balance of rights and obligations has allowed countries to advance on the liberalisation agenda at their own pace, while retaining their capacity to regulate and supervise financial markets, and to respond to emergency situations.

Adherents together and by consensus also continue to shape the obligations. Over time, adherents have developed jurisprudence regarding implementation of the Code's rights and obligations and how to consider individual country measures.

The OECD Council, the governing body of the Organisation, has decided to open the OECD Codes of Liberalisation of Capital Movements and Current Invisible Operations to adherence by non-OECD countries. The Council adopted the necessary amendments to the Codes at its session on 19 May 2011.

Box 2. Rights and obligations under the Code

General Undertakings.
Liberalise capital movements "to the extent necessary for effective economic co-operation"

Right to maintain measures.
Adherents have the right to maintain non-conforming measures (restrictions).

Stand-still and scope to re-introduce measures.
Countries engage to maintain the degree of openness attained (stand-still) for a list of operations (List A), subject to various safeguard and derogations procedures, which protect the policy space for national policies and ensure that there is scope to respond to crisis situations.

For a list of short-term and sensitive operations (List B) standstill does not apply (see Table 1 for details).

Transparency.
Countries notify any measures having a bearing upon the Code. Measures found to be restrictive are listed and made public; ensuring that information on barriers to capital movements in adhering countries is complete, up-to-date and accessible to all.

Right to seek redress and consent to be scrutinised by others.
Adherents are protected against eventual unfair or discriminatory treatment. They are also entitled to bring problems to the other adherents' attention and to seek remedy. Countries agree to have their measures reviewed and scrutinised by other adherents.

A high standard of openness.

A restriction is any measure which limits or restricts listed operations from taking place, including the granting of any prior approval, licensing or authorisation to conduct listed operations. While general taxation is not covered, the Code does consider as "equivalent measures" (i.e. restrictions) those taxes which specifically target listed operations.

Non-discrimination among adherents.
The Code calls for granting of equal treatment to all adhering countries and for efforts towards extending liberalisation benefits to non-adherents that are members of the IMF.

Right to benefit from others' openness.
A country enjoys the openness and further liberalisation measures of other adherents, regardless of its own degree of openness, and has the right to transparency regarding the measures of the other adhering countries. Reciprocity as a criterion to condition extension of liberalisation benefits to others is contrary to the Code. Special arrangements apply to customs unions such as the European Union.

Dialogue and peer review

Adherents agree that their measures will be examined by the other adherents; they also share responsibility for contributing to the policy dialogue based on the Code, including to act as examiners of others' measures.

Dialogue has led to further mutual understandings and shared learning about policy options which can help reduce the burden of restrictive measures in place. Countries have agreed that they will seek to ensure that restrictive measures cause minimum disruption of normal business operations and be least harmful to other adherents. Adherents also came to recognise the advantages of replacing bureaucratic, discretionary procedures with more transparent measures that minimise distortions and are subject to less uncertainty and/or arbitrariness in their application. Such steps brought benefits mostly in terms of reducing the burden –for the country concerned and its partners– of the maintenance of a given degree of restrictiveness.

The Code's dialogue process has encouraged countries to remove restrictions once the reason for their introduction had disappeared. This was the case with the measures introduced by the United States in 1968 to restrain foreign direct investment outflows and lending abroad by financial institutions. In their discussion pursuant to the Code's procedures, adherents found that, in light of the balance of payments situation, the United States was justified in taking temporary measures to restrain outflows. They also called upon the United States to periodically review such measures with a view to lifting of the restrictions.

4. How have adherents accommodated specific country circumstances and approaches?

Adherents to the Code agreed on the pursuit of open markets as a motor for economic growth, employment and development. Moreover, a balanced and comprehensive approach to liberalisation is needed to guarantee benefits to society as a whole in the long run. The approach adopted by the Code is to pursue liberalisation progressively over time and in line with each country's level of economic development. Thus gradual elimination of restrictions should be tailored to specific country circumstances and individual approaches. The Code fosters liberalisation not as an end in itself, nor as an exchange of reciprocal concessions among countries, but rather as a process undertaken by each country in the pursuit of its own interest.

Countries' reservation lists

The Code's system of reservation lists (Box 3) provides the flexibility needed to accommodate specific country circumstances and approaches. Each country lists all restrictive measures as "reservations".

Box 3. The Code's list of country reservations

Countries' measures that limit or restrict operations which are listed in the Code should be reflected in reservations. Such reservations are subject to the basic disciplines described in Box 2, thus there can be no reservations to cover discrimination among adherents or reciprocity requirements.

New adherents list their reservations at the time of adherence to the Code.

Reservations may be added to the list:

- at the time a new obligation is established, when the text of the Code is revised –as it has been on several occasions- or because new operations are developed as a result –for example- of financial innovation;
- at any time for short-term flows, real estate, and other sensitive operations (so called "List B" items).

Countries in the process of development

The Code includes a special dispensation for countries in the process of development and several countries have availed themselves of this special status which has allowed them to benefit from liberalisation benefits offered by other adherents and to participate in the process of dialogue.

The Code establishes that "[i]n order to reconcile the obligations of the Member concerned […] with the requirements of its economic development, the Organisation may grant that Member a special dispensation from those obligations."

The Code's approach to countries in the process of economic development finds support in the available empirical evidence. While the contribution of each factor is hard to identify, given the high correlation among various indicators for institutional and economic advancement, the empirical evidence does suggests that more advanced economies with deeper markets and stronger institutions may be in a better position to benefit from greater openness.

Spain had this special status until 1962, Greece until 1977 and Turkey until 1986. Adherents since the 1990s have not availed themselves of these provisions; they introduced reservations to reflect those measures that they were not yet ready to lift at the time of accession to the OECD.[5]

[5] Since 1994, the following countries have adhered to the Code: Chile, Czech Republic, Estonia, Hungary, Israel, Korea, Mexico, Poland, Slovakia, and Slovenia.

What did recent adherents agree on when joining the Code?

Adhering countries have committed to:

- The core Code principles of non-discrimination, transparency and 'standstill'.
- Fair and transparent implementing practices and proportionality of the measures relative to the stated objective pursued.
- An open and transparent regime for FDI, liberalisation of other long-term capital movements, and prospects regarding the abolition of controls on short-term capital movements.
- Freedom for payments and transfers in connection with international current account transactions.

New adherents list reservations to reflect the restrictive measures they maintain at the time of accession. However, countries have to bring measures in line with the Code's disciplines. There are numerous instances of the lifting of reciprocity clauses and extension of benefits on a non-discriminatory basis by new adherents. A relevant example is the step undertaken by Mexico at the time of accession to the OECD to extend on a non-discriminatory basis to all adherents the benefits granted to North-American investors under NAFTA.

In general, since the 1990s, adherents have joined the Code with initial positions that reflect long-standing minimal restrictions on long-term operations and somewhat more restrictive positions regarding short-term flows and financial derivatives. The difference in treatment between both types of operations is more clearly marked among the 5 adherents that joined during the 1990s: the Czech Republic, Hungary, Korea, Mexico, Poland and Slovakia all introduced reservations on short-term flows or financial derivatives. In contrast, the scope of reservations was more limited for those which joined in 2010. Indeed, Chile, Estonia, Israel and Slovenia joined with reservations under the Code that are not unlike those maintained by other adherents.

The countries which joined the OECD during the 1990s did so shortly after undertaking substantial fundamental reforms, including financial deregulation and a move towards greater openness. The systematic reviews of measures undertaken at the time of accession gave these countries the opportunity to revise outdated regulations in the light of the new circumstances, resulting in additional steps to complete the reform of the framework regulating foreign exchange transactions. They would also all face pressures arising from stress and imbalances that developed after a period of rapid change and they all faced the need to build or adjust institutional and regulatory structures.

When Korea joined the OECD and adhered to the Code in 1996, it already had a long experience of allowing transfers of foreign funds to Korean banks. During Korea's accession process, the OECD drew attention to the need to modernise the banking system and, in particular, to upgrade the prudential supervisory framework. As part of Korea's new commitments under the Code, OECD countries recommended that Korea liberalise foreign direct investment and other long-term capital flows. Subsequent to the financial crisis that began in 1997, Korean authorities and academics found that adherence to the Code had not contributed to the financial crisis, in particular, as OECD had not requested liberalisation of foreign investment in money market securities and other short-term instruments. [6]

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[6] Dr. Soogil Young, Korea's second Ambassador to the OECD, in his speech at the 2nd Korea-OECD Conference on Korea's Five Years in the OECD, Seoul, in December 2001, notes that "the OECD did not request Korea to liberalise foreign investment in money market securities and other short-term instruments, including derivatives, and short-term financial credits from abroad. […] Nor did the OECD request that Korea to allow the transfer of foreign funds to Korean banks. This was permitted long before Korea's accession negotiations started. And as a matter of fact, at the time of Korea's accession, the OECD drew

5. Protection of policy space

Countries have agreed that measures intended to protect public order and security are outside the scope of their obligations under the Code. Likewise, the Code does not prevent adherents from taking measures to ensure the enforcement of national laws and regulations, including tax obligations. The Code also ensures ample scope for financial regulation and supervision.

The long and varied OECD experience suggests that greater financial openness increases the importance for stability of a coherent macro policy framework; properly sequenced domestic and external financial liberalisation; a stronger and well adapted institutional framework and regulatory oversight, both for the financial system and for the broader economy. This context, underlines the importance of the Code structures and processes that permit to reconcile the commitment to openness with flexibility to regulate.

The Code's provisions have built-in mechanisms to ensure that countries retain their capacity to regulate and supervise financial markets and institutions; this is achieved in various ways for different types of operations. Measures intended for macro-prudential purposes must conform with the disciplines of the Code; however, experience so far suggests that these disciples do provide sufficient scope for policies intended to attenuate risks arising from excessive risk taking and over-leverage.

Regarding securities operations, the Code reaffirms the preeminent role of regulations of the financial market concerned, to the extent that they do not discriminate vis-à-vis non-residents. Thus, countries are expected not to impose restrictions on what their residents can do abroad that go beyond the limits established in the securities market in which they are operating. For operations in local markets, liberalisation obligations are subject to "the regulations of the financial markets concerned" –to the extent they do not discriminate against non-residents. Thus, the liberalisation obligation under the Code calls for equal treatment of residents and non-residents. By way of example, this would mean that when a new operation is authorized on the domestic markets for residents, it would also be authorized for non-residents – unless the country at that time lodges a reservation. The approach ensures that countries can change rules for operations in its financial market place without being unduly constrained by Code obligations. Thus Germany has introduced rules of general application (for residents and non-residents alike) regarding short-selling, while still conforming with the Code's provisions.

Adherents to the Code have also developed jurisprudence and mutual understandings in the application of the Code's provisions which further protect the national authorities' policy space. Of particular relevance are understandings regarding prudential financial regulations and practices. Among these, is the explicit recognition that countries may request that payments and transfers take place through authorised resident agents. Furthermore, adherents have recognised countries' right to enforce, on their territory, rules regarding use of currencies for denomination and settlement of transactions. With regard to rules for operations by financial intermediaries, the Code calls for freedom to carry out authorised transactions with non-residents (or in securities issued by non-residents). Nevertheless, under existing understandings among adherents, rules on the foreign exchange risk exposure of domestic banks are considered to be in conformity with the Code (Box 4).

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the attention of the Korean authorities to the need to modernise the banking system and, in particular, to upgrade the prudential supervisory framework." Reproduced in Forty Years' Experience with the OECD Code of Liberalisation of Capital Movements, OECD (2002).

Box 4. How does the Code deal with prudential regulations?

The right of countries to regulate markets and operations is recognised and the liberty to conduct transactions is subject to such national regulations, as long as they do not introduce differences in treatment, in like circumstances, between residents and non-residents. The Code makes no distinction based on the intent of measures introduced. All measures are assessed against a standard of conformity whether they be intended to control capital movements, as micro or macro-prudential regulations.

Prudential measures are intended to protect users of financial services, ensure orderly markets, and maintain the integrity, safety and soundness of the financial system. Their fundamental role has been reaffirmed in the wake of the 2008 financial crisis.

The Code recognises the right of countries to set prudential measures. Whether such measures conform to the Code is based on a test of equivalent treatment. Prudential measures that do not meet the test must be notified and discussed. Countries can maintain prudential measures which are discriminatory if they are covered by "reservations". A number of countries have availed themselves of this possibility.

Commonly used prudential measures for inward direct investment in financial services pass the non-discrimination test. They include:

- "fit and proper" tests of general application;
- financial requirements for non-residents' branches equivalent to those required from domestic entities;
- review of investment, both foreign and domestic, at equity thresholds;
- rules on "widely-held" ownership;
- rules for consolidated supervision, including reporting requirements and other obligations of financial entities deriving from sharing of responsibilities between host and home country supervisors;
- the non-extension of emergency lending facilities to non-residents' branches.

Chile's authorities, at the time of adhering to the Code in 2010, examined the issue of how these obligations might constrain their margin for manoeuvre. The authorities expressed their satisfaction regarding the balance of rights and obligations set forth in the OECD Codes of Liberalisation as they provide adequate scope for handling disturbances to its economic and financial system including risks to currency stability, while preserving Chile's commitment to liberalisation"[7].

6. How have countries dealt with volatile capital flows and episodes of instability in the context of the Code?

While there may be efficiency gains from liberalisation of capital movements, there may also be a role for capital flow measures to reduce attendant risks, in particular to deal with the higher volatility of short-term capital flows. Furthermore, countries will face situations in which extraordinary measures will be required.

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[7] See Agreement on the Terms and Conditions of Accession of the Republic of Chile to the Convention of the OECD, 11 January 2010.

The Code provides flexibility in two ways regarding commitments to openness. First, for short-term and other sensitive operations (such as derivatives and foreign exchange transactions), the countries may reintroduce measures at any time. Secondly, countries may resort to derogation of obligations, which is a time-bound suspension of the liberalisation commitments made to others.

Special treatment of short-term capital flows.

It was not until 1992 that OECD countries as a group decided that the Code should cover almost all capital movements, including short-term capital operations. They made this decision in view of financial innovations which blurred traditional distinctions between short-term and long-term capital flows and the benefits for private and public actors to access wider sets of financial products.

The extension of obligations to cover short-term flows, derivatives and other sensitive operations was approached in a prudent manner, acknowledging risks associated with these operations. Adherents agreed to define short-term flows as those having a maturity of one year or less. They also decided that stand-still should not apply to these operations and that they should therefore be added to the Code under List B (Table 1). In addition, adherents decided that financial credits by non-residents to individuals as opposed to corporate entities should not be covered by the Code.

This approach has provided flexibility in taking steps to deal with potentially destabilising short-term flows. It has also provided a means for countries to experiment with fine tuning of measures or lifting of restrictions, without having to make an irreversible commitment.

Episodes of instability and the derogation clause

The derogation is a time bound suspension of the liberalisation commitments of the country, which allows it to introduce measures, unless there is consensus among adherents to disapprove them (Box 5). The derogation clause has been used 28 times since 1961 (Table 2). On three occasions it was used to request a general dispensation of the obligations on account of the country's economic development.

Commitments under the Code serve an adhering country as a means to communicate to its Code partners, and to market participants, that it is a co-operative member of the international community and, as such, it refrains from a "beggar-thy-neighbour" approach. The arrangement becomes all the more valuable at times of crisis, when authorities may have resort to emergency measures, and may wish to reassure market participants that it does not intend to maintain controls that are broader than necessary and that such controls will be removed when no longer needed. The dialogue process has also helped support countries' efforts to improve policy implementation by learning from the experience of others.

Experience of adherents: 1963-1993

The majority of cases of invocation of the Code's derogation clauses to re-introduce measures among initial adherents occurred during the period of tensions which lead to the eventual demise of the Bretton Woods system in the early 1970s. Introduction of measures to restrain outflows in various countries (Denmark, France, Italy, Sweden, the United Kingdom, and the United States) was followed by measures adopted between 1971 and 1973 to restrain inflows by another group of countries (Australia, Austria, Germany, Japan, and Switzerland). In the 1980s several European countries reintroduced measures following setbacks originating from tensions in intra-European exchange rate arrangements.

Table 1. Operations covered by the Code

LIST A "Standstill" applies to these operations (derogation is needed to reintroduce restrictions)	LIST B No "standstill" applies to these operations
I. Direct investment	
II. Liquidation of direct investment	
III. Real estate - Sale	**III. Real estate - Purchase**
IV. Operations in securities on capital markets (shares and bonds of over 1 year maturity)	**V. Operations on money markets**
VII. Collective investment securities	**VI. Negotiable instruments and non-securitised claims**
VIII. Credits directly linked with international commercial transactions or rendering of international services In cases where a resident participates in the underlying commercial or service transaction	**VIII. Credits directly linked with international commercial transactions or rendering of international services** In cases where no resident participates in the underlying commercial or service transaction
IX. Financial credits and loans	
X. Sureties, guarantees and financial back-up facilities (see List B)	**X. Financial back-up facilities** in cases not directly related to international trade, international current invisible operations or international capital movement operations, or where no resident participates in the underlying international operation concerned
XI. Operation of deposit accounts by non-residents of accounts with resident institutions	**XI. Operation of deposit accounts** by residents of accounts with non-resident institutions
XIII. Life assurance	**XII. Operations in foreign exchange**
XIV. Personal capital movements Except Gaming	**XIV. Personal capital movements** Gaming
XV. Physical movement of capital assets	
XVI. Disposal of non-resident-owned blocked funds	

Box 5. The Code's derogation clause

Causes of Derogation:

"a) If its economic and financial situations justifies such a course […]

b) If any measures of liberalisation taken or maintained […] result in serious economic and financial disturbance […]

c) If the overall balance of payments […] develops adversely at a rate and in circumstances […] which it considers serious […]"

Measures introduced making use of the derogation clause must abide by standards of:

- **Transparency and accountability.** Measures should be notified and subject to scrutiny, including open for international discussion. An adherent invoking the derogation clause must justify the course of action undertaken; it must provide information to other adherents and subject its measures and policies to examination by the Code's Forum.

- **Non-discrimination among adherents.** All adherents have the same right to benefit from liberalisation measures of others. Measures should not discriminate among investors from different countries.

- **Proportionality**
  - Restrictions on capital movements are measures of last resort, when other policy responses are insufficient to effectively achieve the objective pursued,
  - and should avoid unnecessary damage, especially when they have a bearing on the interests of another country.
  - The severity of restrictions should be proportional to the problem at hand, with measures disrupting business as little as possible and in particular minimising adverse impacts on operations such as FDI and commercial credits.
  - Restrictions on capital movements should be conceived as temporary, accompanied by indications on the conditions and expected timing for their phasing out.

The United States' invocation of the derogation clause in 1968 serves as a useful example of the dialogue process under the Code. At issue was the unequal application of the measures to different countries, leading to debate among adherents on whether this could be reconciled with the principle of non-discrimination. In fact, the United States' measures exerted greater restraint upon outflows destined to advanced economies with stronger balance of payments positions. While some adherents considered such differentiation to be contrary to the principle of non-discrimination, the United States argued that differentiation was needed in light of the principle that the measures should avoid, in the language of the Code, "unnecessary damage with bears especially on the financial or economic interests of other Members". Differentiation would protect vulnerable economies when their economic and financial stability was linked to capital flows from the United States. Adherents have repeatedly asserted the pre-eminence of the principle of non-discrimination. However, when a country invokes the derogation clause, the Code asks other adherents not to disapprove of the measures introduced by the invoking country. While there was no consensus to disapprove the United States' measures, the process did allow affected countries to voice their concerns on their discriminatory nature.

Table 2. Invocation of derogation to the Code

Australia	09/1972	06/1978
Austria	11/1972	08/1980
Denmark	02/1979	03/1983
Finland	06/1985	01/1991
Germany	06/1972 02/1973	01/1974 11/1980
Greece	09/1967[2]	06/1980
Iceland	1961[2] 11/1992 10/2008	12/1990 31/1993
Italy	04/1969	01/1978
Japan	01/1972 03/1978	11/1973 02/1979
Norway	11/1984 08/1986	12/1989 12/1989
Portugal	1968[2] 1977 1983 07/1991	1981 1981 1987 11/1992
Spain	1959[2] 07/1982	1962 06/1985
Sweden	09/1969	06/1986
Switzerland	03/1964 07/1972 02/1978	10/1966 02/1974 01/1979
Turkey	1962[2]	1985
United Kingdom	05/1966	03/1971
United States	01/1968	04/1974

1. The date of the entry into force, or the maintenance, of the restrictive measures which called for an invocation of the derogation clauses by the country concerned are indicated, and not the date when the council of the OECD formally endorsed the invocation in question.
2. General dispensation from the liberalisation provisions of the Codes.

Experience of adherents during the 1990s with surges in capital inflows

The countries that joined the Code in the 1990s all came under pressure shortly after joining. The Central and Eastern European members came under pressure at the time of the Russian crisis and both Korea and Mexico were prey to banking and currency crises. All of the new adherents had gone through a period of rapid financial innovation, increased capital mobility and integration to global financial markets.

The crisis-struck countries did not resort to suspension (derogation) of their obligations under the Code, as the older members had when faced by crisis in the 1970s and 1980s. Countries may have shunned the re-introduction of restrictions in view of the potential cost of a further loss of market confidence (including by domestic investors).

The response of recent members was generally to maintain previous commitments to openness, however in several countries adjustments in regulations followed. Poland, faced with speculative pressures on the zloty, postponed the liberalisation measures for short-term operations that it had planned and announced to its partners at the time of adherence to the Code. Korea issued a new Foreign Exchange Transaction Act in the wake of the crisis which simplified regulations and eliminated restrictions on some short-term flows, while introducing new requirements for qualification for non-bank borrowers to raise

short-term funds abroad. These changes in legislation led to adjustments in Korea's reservations under List B.

Mexico, in the course of the 1995 crisis, reaffirmed its longstanding commitment to open capital markets and free convertibility. In the view of authorities, the introduction of measures to stem outflows would have done little to redress the situation in the short-term and would have severely damaged the country's credibility and prospects for re-gaining access to international capital markets. In the course of the 1997 review of Mexico's position under the Code, the Mexican authorities noted that the massive capital inflows experienced in the early 1990s and ensuing financial market instability could not be regarded as a direct consequence of the freedom of capital movements, which is a long standing policy. Furthermore, in the view of the authorities, the 1995 crisis provided further evidence that it is essential in a context of free capital movements to maintain a stable macroeconomic environment and to enhance the flexibility of the overall economy through continued financial and other structural reforms.

The aftermath of the 2008 crisis

Iceland introduced in October 2008 exchange controls and measures restricting capital movements in response to a severe banking and balance of payments crisis. In its examination of Iceland's invocation of the derogation clause, adherents found these measures to be justified. The authorities have been developing a plan for the eventual lifting of the measures, which they consider necessary but temporary in nature. Adherents will continue to work with Iceland towards the elimination of the measures, some of which Iceland has already relaxed.

7. Changes in countries' positions under the Codes

Over time Code adherents have converged on a fairly liberal position under the Code. They have all renounced recourse to exchange controls as a viable permanent feature of the policy framework. Common trends also emerge from the examination of countries' motivation for maintaining measures; however adherents have followed a variety of approaches regarding order and speed of liberalisation. The Code, not being prescriptive on such issues, has accompanied countries as they strive to adjust a changing reality and their evolving aspirations.

Motivation for restrictions

By the early 1960s, at the time when the OECD was established and the Code adopted, the position under the Code of most adhering countries was much more restrictive than that of countries with a tradition of liberal policies in this field such as the US, Canada or Switzerland. In Europe, under the Treaty of Rome the treatment of the movement of capital was not as free as that of goods, services or persons[8]. In Japan, at the time of its adhesion to the Code in 1964, exchange controls were still in force.

One common theme that emerges from a survey of the rationale provided for the maintenance of restrictions on capital flows is concern over reconciliation of free capital movements, exchange rate targeting and an independent monetary policy[9]. The move towards greater exchange rate flexibility among currencies -and greater monetary integration within Europe- has reduced the tensions in reconciling

[8] As already noted several European countries, at the time of their adherence to the Code, maintained full derogations under the Code making use of the special dispensation that may be accorded to countries in the process of economic development.

[9] See OECD (2002) p.p. 68-69, which uses the information provided by countries regarding the motivations for maintaining restrictions in the context of reviews of countries' positions under the Code.

external (exchange rate) and domestic monetary policy objectives, opening the way for greater freedom for capital movements.

In several countries, the move towards more market based instruments of monetary control has also been a factor conducive to further liberalisation. Among the last Code reservations to be relinquished by Mexico were measures limiting the use of the peso abroad. These restrictions were intended to insure the effectiveness of credit control measures by closing potential loopholes if financial intermediation in the domestic currency were to move off-shore and beyond the scope of regulatory authorities. In general, the motivation for maintaining such measures was diminished following the move towards reliance on interest rate instruments, rather than direct credit controls, for implementation of monetary policy.

The loss of effectiveness of measures appears as another important motivation for liberalising. The broader drive towards financial deregulation played a role as greater sophistication in domestic markets opened the scope for investors to elude restrictions. Moreover, measures lacked effectiveness when the incentives to evade them were strong, namely at times of unrest when their use appeared to be most justifiable. The lesson emerged from the examination of country experiences with the use of measures to restrain speculation against currencies at time of stress, such as France's extreme tightening of controls in the early 1980s, which did not prevent the eventual devaluation of the Franc. Of some interest is the outcome of the deliberations by adherents regarding the United States' measures to restrain capital outflows in the late 1960s: they were ineffectual in terms of their overall impact on the balance of payments as they merely changed the composition of outflows. Likewise, the liberalisation measures undertaken by Australia in 1983 and by New Zealand in 1984 followed episodes of massive capital flight which made evident the ineffectiveness of measures in place.

Sequencing

The greater concern regarding short-term operations has been reflected in countries' reservations. As countries liberalised, they have generally first removed restrictions on longer term flows (hence for example FDI before money-market operations) and on operations linked to business operations before purely financial ones (hence commercial credits before financial loans) (Table 3). This was not the case however for the followers of a big-bang approach (the United Kingdom and Turkey). Nor has it been the case of more recent experiences in the context of more sophisticated financial practices, as the lines of demarcation between short and long term operations have become blurred by the existing array of derivatives.

Table 3. Operations restricted by pre-1990 adherents from 1961 to the early 1990s

	Foreign exchange outflows		Capital inflows (other than direct investment and real estate operations)
	Capital transactions	Travel allowances	
Australia	until 1983		
Austria	until late ‘80s		early '70s to mid-'80s
Belgium/Luxembourg	channelled through separate markets from 1955 to 1990		
Canada	until 1951		
Denmark	LT. securities until l978 ST. financial credits until 1988		LT: securities until 1971 ST. op. until 1988
Finland	until mid-80s	until 1985	Securities until 1979 credits until 1986
France	until 1986	until 1958 1968-1970 1983-1984	credits from 1971 to 1974 other op. until 1986
Germany	until 1958	until mid-'50s	until 1958; 1972-1975
Greece	LT. op. until 1992 ST. op. until 1994	until 1992	credits until 1987 ST. op. until 1994
Iceland	LT. securities until 1993 other LT. op. until 1990 ST. op. until 1994		credits until-1992 ST. op. until 1994
Ireland	LT. op. until 1988 ST. op. until end-1992		until end- 1992
Italy	LT. Securities 1973-87 credits until 1988 ST. op. until 1990	1973-1984	credits until 1988 ST. op. until 1990
Japan	until 1980	until 1964	1970-1973 1977-1978
Netherlands	credits until 1986 other op. until 1960		credits until 1983 other op. until 1960
New Zealand	until 1984	until 1971	credits until 1984
Norway	until late 1980s ST. op. until 1990	until 1984	credits until early 1980s LT. securities until 1989 ST. op. until 1990
Portugal	LT. Securities & trade credits until late 1980s other op. until end-1992	until 1990	LT. securities & trade credits until late 1987 other op. until end-1992
Spain	ST. credits until 1991 and in October 1992 other op. until 1989-90	until 1979	ST. credits until Feb. 1992 other op. until 1986-87
Sweden	until 1989	until the 1950s	until late 1980s
Switzerland			Securities from 1972 to 1980
Turkey	until 1989 trade credits until 1983	until 1983	until 1989 trade credits until 1983
United Kingdom	until 1979	until 1977	
United States	1963-1973		

Legend: LT. = long-term;
ST. = short-term;
op. = operations.

Source: OECD, Exchange Control Policy, CCEET (1993).

Gradualism vs. "Big bang"

Among pre-1990 adherents, gradualism was the prevalent approach in the post war period. It took more than a decade for most European countries to return to full current account convertibility after the war.[10] Liberalisation of capital movements was also gradually introduced over a period of over a decade in Denmark and the Netherlands following initial steps in the 1970s. Austria, starting somewhat later, in the 1980s, also adopted a gradual approach. France dismantled its system of direct credit controls before moving on to full capital account liberalisation, which was concluded in the late 1980s. Japan also followed a gradual approach over a 16 year period in lifting capital account restrictions after adhesion to the OECD Code in 1964.

There are also a significant number of OECD countries on the other opposite end of the spectrum. Canada dismantled capital flow measures in a single stroke in December 1951, while Germany attained current account convertibility and capital account liberalisation simultaneously in 1958. Of particular interest is the big-bang approach of the United Kingdom's in 1979, which saw the removal of all controls in less than 6 months after a period in which an extensive set of measures in conjunction with extensive regulation of domestic financial intermediation. Australia and New Zealand followed in the early 1980s. Turkey in the late 1980s also rapidly established full current account convertibility and capital account liberalisation.

As financial market integration accelerated in the 1980s, countries found limits to the merits of further fine-tuning of liberalisation. In Turkey, outward direct investment and portfolio investment were liberalised at the same time. The path followed by various Scandinavian countries in the mid-1980s was also gradual, although the process was completed in a shorter time span than in previous gradual liberalisation processes. Sweden liberalised operations in Treasury bills and longer-term government bonds together, in 1989. The timeframe of Italian liberalisation was somewhat more compressed, as exchange controls were maintained until shortly before the adoption of the EU Directive on capital movements in June 1988, which brought removal of remaining restrictions. Italy and Ireland liberalised operations in equities and bonds in tandem rather than in sequence.

The more recent OECD members of Central and Eastern Europe (CEE), faced with the challenge of a system shift, provide another example of rapid liberalisation. All four CEE countries which adhered to the OECD by the year 2000 (Czech Republic, Poland, Hungary and Slovakia) attained current account convertibility and liberalisation for capital movements in less than a decade.

8. How has the Code responded to a changing reality and new aspirations of adherents?

When the Code was first established in 1961, its coverage was rather limited. Since then, national economies have become more integrated, financial market regulation more harmonised and financing techniques more sophisticated. Over this time the Code has been revised to reflect these changing economic realities, as well as the new aspirations of the adhering countries.

The new financial landscape that emerged in the 1980s as the result of financial innovation and integration confronted policy makers with major challenges in the regulatory framework, to improve prudential oversight and the framework for cooperation among regulators. Rather than attempting to stop or reverse the impact on their countries of global trends, policy makers in OECD countries have striven to mould the process.

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[10] Portugal and Spain achieved Article VIII status under the IMF's Articles of Agreement in the late 1980s, while Greece did so in 1990 and Turkey in 1992.

Dealing with new issues and practices, including macro-prudential regulations

Adherents have reviewed and compared their policies in areas as diverse as admission of foreign securities on domestic financial markets, FDI in telecommunications, outward portfolio investments by institutional investors, and real estate. In most cases, these reviews were initiated as the result of the examination of a particular measure maintained by a country and to discussion on the conformity of measures of a particular type. Countries' positions have been adjusted, ensuring equal treatment for all countries, in light of the interpretation of the obligations that was reached by the adherents. This was the case regarding European Union rules for custodial services performed for collective investment instruments, which were determined to be non-conforming and required the listing of a reservation by all adhering European Union countries.

Recent developments have draw attention once again to the treatment of prudential measures under the Code, as they have implications for foreign direct investment and for other capital flows. For each of these types of operations there are important differences both in the motivation and in the nature of prudential measures maintained. This diversity among prudential measures reflects the different concerns for each type of operation. While monetary and other macroeconomic policy considerations are central to macro-prudential measures for capital flows, systemic stability is a core consideration for the treatment of FDI in financial services.

Adherents' work on the way in which prudential measures for inward direct investment in financial services are treated under the Code takes place in a broader context where the crisis has underlined the need to preserve flexibility for governments to take financial sector stability measures. The scope for taking prudential measures under international instruments, such as the Codes, acquires added relevance in the context of the design of longer-term reforms of the financial system. At the same time, countries have expressed concerns that certain categories of financial sector measures may have the effect of restricting or distorting international capital flows to the detriment of other countries.

Several countries have relied on macro-prudential instruments and other tools to deal with large capital inflows. Macro-prudential measures provide a defence against the short-term risks arising from large capital inflows and contribute to an effective intermediation of domestic credit, in addition to limiting excessive risk-taking and a build-up of leverage. Macro- and micro-prudential tools can also address risks in particular sectors or asset classes. Renewed interest in capital controls reflects their potential usefulness to tackle external adjustment challenges that some countries, notably emerging-market economies, are facing at present. While controls may be effective in the short run, they also entail risks. These include spiralling counter-measures by other countries and a progressive fragmentation of international capital markets, making international cooperation essential to avoid undesired collective outcomes as countries move to deal with global imbalances.

Recent macro-prudential measures taken by Korea and other adherents to the Code are being actively discussed at the OECD. By notifying capital flow measures and subjecting them to the peer review process of the Code, adherents act as co-operative members of the international community, find solutions to similar problems, and participate in shaping jurisprudence and improving international rules. This discussion will advance mutual understanding on least-restrictive solutions to problems associated with surges in capital inflows. The OECD is ready to report on the results of this discussion to G20 in due course.

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