# OECD CODE OF LIBERALISATION OF CAPITAL MOVEMENTS

## PROMOTING ORDERLY CAPITAL FLOWS: THE APPROACH OF THE CODE

**The OECD Code of Liberalisation of Capital Movements (the Code) was born with the OECD in 1961 at a time when many OECD countries were in the process of economic recovery and development and when the international movement of capital faced many barriers.**

For over 50 years, the Code has provided a balanced framework for countries to progressively remove unnecessary barriers to the movement of capital, while providing flexibility to cope with situations of economic and financial instability. It is binding for the 34 OECD countries, including twelve G20 members. Since 2012, the Code are also open to non-OECD members.

The Code is based on several premises validated by evidence and experience:

- An open multilateral regime for international capital flows serves the global economy better than closed capital accounts. This is all the more true today as financial markets need to play their full role in allocating cross-border saving and investment efficiently in support of a sustainable global recovery.
- An adhering country should benefit from the liberalisation measures of other adhering countries regardless of its own degree of openness. Reciprocity is not in the spirit of the Code. OECD countries have unilaterally extended their measures to all members of the International Monetary Fund (IMF).
- Reintroducing capital flow restrictions can play a role in specific circumstances. Transparency and International co-operation are important. While restrictions can be justified from an individual country's viewpoint, a "beggar-thy-neighbour" approach to restrictions can lead to negative collective outcomes.

### A FORUM FOR INTERNATIONAL DIALOGUE AND CO-OPERATION

The Code has provided an established and tested process of international dialogue and co-operation. The process is managed and controlled by adhering countries through a forum at the OECD in which each country can explain its policies and raise questions about the policies of others. The International Monetary Fund (IMF) and other relevant international organisations are invited to this forum. The process is consensus driven and free of conditionality or links with emergency financing facilities. Over time, adherents have developed jurisprudence regarding implementation of the Code's rights and obligations and the conformity of individual country measures. Notification and examination of country measures enhance transparency and mutual understanding.

## TRANSPARENCY

Transparency under the Code means that information on the barriers to capital movements in adhering countries should be complete, up-to-date, comprehensible and accessible to everyone.

The Code requires adherents to:

- notify all measures which affect any of the transactions covered by the Code.
- notify modifications to any of these measures.
- reflect these measures as accurately as possible in a country reservation list, so that no restrictions exist except for those appearing in the reservation lists (this is called the "top-down" or "negative list" approach to defining commitments).

Updated versions of the Code, together with country positions, are made available on the OECD public website and as print publications.

## AN INSTRUMENT ADAPTED TO DIFFERENT LEVELS OF DEVELOPMENT

A country wishing to adhere to the Code is reviewed and assessed on its merits, in light of the specific circumstances of the country, including its level of economic and financial development and taking into account the provisions of the Code.

Countries can pursue liberalisation progressively over time, in line with their level of economic development. Emerging economies such as Chile, Korea and Mexico have adhered to the Code. Other countries, specifically Spain until 1962, Greece until 1977, and Turkey until 1986, availed themselves of a special dispensation from their obligations under the Code for countries in the process of development while still enjoying the same rights as other adhering countries.

## A LIVING INSTRUMENT

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 both these changing economic realities and new aspirations of adhering countries. Adhering countries regularly notify updates to their position under the Code.

## A FRAMEWORK FOR COPING WITH SHORT-TERM CAPITAL FLOW VOLATILITY

Capital flows are an integral component of international finance. They allow for savings to be channelled from surplus countries to deficit countries, where returns to investment are typically higher. However, these flows can also pose important challenges to open economies. Excessive inflows can lead the economy to overheat and fuel credit and asset price bubbles. Sharp reversals in capital inflows are disruptive. This has triggered renewed interest in the use of capital controls.

The Code has proven that it has the flexibility to cope with situations of economic and financial instability:

- Its system of reservations allows countries to maintain restrictions on operations they are not in a position to liberalise at the time of adherence to the Code.
- Restrictions on short-term capital operations can be introduced at any moment, even if no reservation had been initially lodged (the usual "standstill" rule does not apply).
- Restrictions can be re-imposed on other operations by invoking the Code's "derogation" clause in situations of severe balance-of-payments difficulties or financial disturbance. This clause has been used 30 times since 1961.
- The net foreign exchange positions of domestic financial institutions can be restricted.
- Financial credits and loans by non-residents to residents other than enterprises are not included in the list of operations covered by the Code.

In the event of recourse to new restrictions on capital movements, countries have agreed under the Code to well-tested guiding principles such as transparency, non-discrimination, proportionality and accountability:

- Capital flow restrictions are measures that could best be considered when alternative policy responses are insufficient to effectively achieve the objective pursued.
- Their implementation needs to be transparent. Measures should be subject to accountability, including open for international discussion.
- Measures should not discriminate among investors from different countries, and 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 and corresponding reservations may be maintained for as long as needed, but should be removed once non-restrictive means become available to address legitimate policy concerns.

## A HIGH STANDARD OF LIBERALISATION

The Code's Article 2 calls for adhering countries to "*grant any authorisation required for the conclusion and execution of transactions and for transfers*" specified in liberalisation lists. These liberalisation lists have been expanded over time to comprise practically all capital movements. Thus, any law, decree, regulation, policy and practice that may restrict the conclusion or execution of operations covered by the Code constitute a restriction. Adhering countries have also agreed to extend liberalisation commitments to include "*measures equivalent to restrictions*". These are measures that affect an operation, e.g. by raising its cost, although they do not prevent the operation from taking place.

It is the Investment Committee's responsibility to assess whether a particular measure or class of measures are "*equivalent to restrictions*". Members have agreed that compulsory deposit requirements, interest rate penalties or queuing arrangements for securities issues should be treated as restrictions. Taxes of a general nature, such as income taxes, and taxes levied in accordance with widely accepted principles of international tax law are not considered as equivalent to a restriction under the Code.

### Obligations for operations in foreign currency and use of foreign currency

The Code covers only operations between residents and non-residents. A key test is non-discrimination, but the Code also includes other specific liberalisation commitments. Under Art 2 "*[W]henever existing regulation or international agreements permit loans between different Members […] the repayment obligation may be expressed or guaranteed in the currency of either of the of the two members concerned*". Furthermore, under item XII of Liberalisation List B, Members –subject to reservation which they may have lodged- commit to permit their residents to freely buy and sell domestic currency for foreign currency and to exchange currencies, by means of spot or derivative transaction, when the operation takes place abroad.

The 1992 review of the Code's obligations lead to enlarged obligations on use of foreign currency in denomination and settlement. At that time, Members agreed on the following, as reported in Council document C(92)4:

*"{3. Use of foreign currency in denomination and settlement}*

*35. One of the innovations of the Revised Code is to provide that all the operations are to be liberalised regardless of the currency in which they are denominated or settled. This includes currency composite units of account such as the ECU and the SDR.*

*36. In the sense of the Code, the Committee took this to imply that non-residents in dealing with residents on the territory of residents should have access to the same facilities and can use the same foreign currencies that residents are permitted to use for domestic operations.*

*37. Similarly, residents should be permitted to use, in respect of operations abroad in another OECD Member country, any currency that may be used in the Member country concerned for the transactions in question.*

*38. Where operations have no natural domestic counterpart (e.g. Sections VIII to XII of the Revised Code), Members should be able to use any foreign currency for the denomination or settlement of those operations."*

## FOREIGN-CURRENCY RESTRICTIONS WITH A MACRO-PRUDENTIAL INTENT: AN ISSUE UNDER ACTIVE CONSIDERATION

Signs of a reversal in the trend towards greater financial openness following the 2008 crisis are visible from an increase in saving-investment correlations in OECD and BRICS countries (Figure 1).

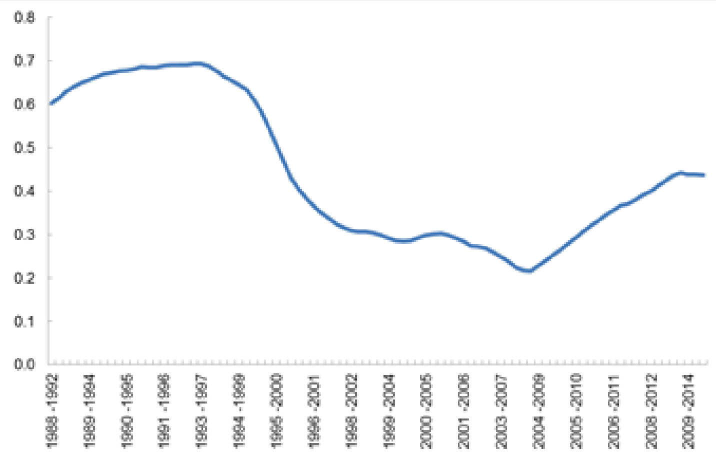
While this reversal may reflect cyclical factors and subsequent retrenchment of banks' international operations, the introduction of certain macro-prudential measures overlapping with capital flow management measures may also be playing a role. In particular, recent OECD research (De Crescenzio et al., 2015) shows more frequent use of restrictions on banks' foreign-currency operations by 7 G20 non-OECD countries and 14 OECD Members in 2013.

These measures, which discriminate on the basis of the currency of an operation rather than on the basis of the residency of the parties to the transaction, comprise, among others, limits on use of foreign exchange derivatives, levies on foreign currency liabilities, and differentiated reserve requirements on foreign-currency liabilities.

These currency-based measures can play a role in mitigating financial sector risks associated with certain types of capital flows. While not all these currency-based measures have a bearing on the Code, countries are currently reviewing the level of transparency and accountability which certain types of foreign-currency measures should be subjected to under the Code, with the view to assisting adherents in finding least restrictive solutions at national level and ensuring that the collective interest in avoiding negative spill-overs is protected. All non-OECD G20 members, the IMF and other partners have been invited to take active part in the work on updating the Code.

**Figure 1. A reversal in financial openness following the crisis**

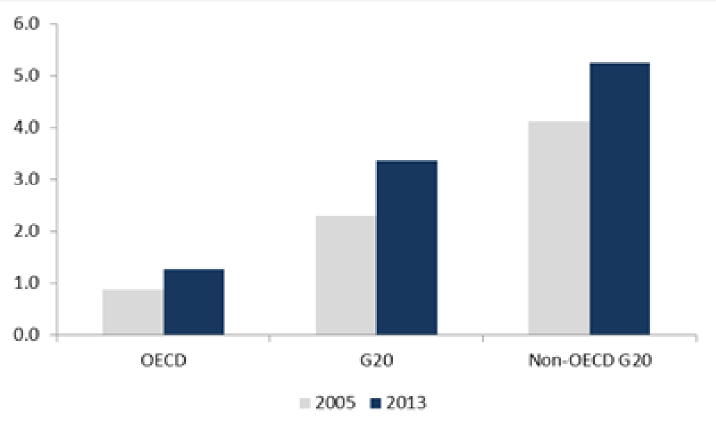
Five-year rolling correlation of saving and investment in BRICS and OECD countries




*Note:* Saving and investment correlations can be used as indicators of financial openness. Low saving and investment correlations are found in open economies, since global markets can absorb excess supply of savings or demand for investment.

*Source:* OECD calculations.

**Figure 2. Average number of foreign currency measures by country has increased in all groups over 2005-2013**




*Source*: OECD calculations, adapted from De Crescenzio et al. (2015)

## EXPERIENCE WITH SEQUENCING LIBERALISATION

Many but not all adherents have followed a gradual approach to lifting capital controls. The process typically begins with less volatile transactions and those more directly necessary to normal business activities. Hence, direct investment is usually authorised earlier than portfolio investment and commercial credits are liberalised before financial loans. Equity operations are liberalised before those in debt securities – and when these have been liberalised, adherents begin with long-term bonds, thus keeping control over money-market instruments for a longer period.

As financial market integration accelerated in the 1980s, countries found limits to the merits of further fine-tuning sequencing of liberalization. In Turkey, outward direct investment and portfolio investment were liberalised at the same time. Sweden liberalised operations in Treasury bills and longer-term government bonds together, in 1989; Italy and Ireland liberalised operations in equities and bonds in tandem rather than in sequence.

Several countries, such as France and Norway, maintained restrictions on lending to non-residents in local currency until the latest stage of liberalisation, for fear of facilitating speculation against the currency.

### CAPITAL FLOW RESTRICTIONS, FINANCIAL STABILITY AND GROWTH: WHAT NEW OECD EVIDENCE TELLS US

In some specific country experiences, capital flow restrictions have played a positive role to advert the build-up of financial sector vulnerabilities as a result of surges in capital inflows. But generalisation is difficult and evidence is mixed. An IMF staff study frequently cited by proponents of capital controls (Ostry et al., (2010), *Capital Inflows: The Role of Controls*) presents some evidence that can be interpreted in the sense that countries that had capital flow measures in place before the 2008 global financial crisis avoided the worst outcomes. However, a re-examination of the empirical evidence regarding the post-crisis growth performance of countries maintaining measures suggests otherwise. A more recent OECD study (Blundell-Wignall and Roulet, 2013) shows that the results of Ostry et al. (2010) are not robust to the removal of one country, Latvia, from the sample, or the inclusion of other countries in the category of worst performers in the post-crisis period (Russia). Furthermore, expanding the empirical estimates to examine pre and post crisis growth performance, the OECD study suggests that countries with controls did better in the pre-crisis period and worse in the post-crisis period than countries without controls.

A subsequent OECD study published in 2014 by the same authors, using a panel regression based on data for 4780 MSCI publicly-traded companies from 55 countries and 9 sectors over 2004-2012, shows that in the period since 2008 the increased presence of capital controls is associated with highly-significant negative effects on business investment in MSCI listed companies.

In general, the last operations to be liberalised were those concerning deposit accounts with non-resident institutions abroad; and this mainly for tax control reasons.

Overall, today OECD countries have reached high-levels of financial openness, compared with non-OECD economies including large G20 countries such China and India. These countries are embarked in gradual capital movement liberalisation and can benefit from country experiences under the Code.

## PRUDENTIAL SAFEGUARDS APPLY FOR THE ESTABLISHMENT AND OPERATIONS OF FOREIGN FINANCIAL INSTITUTIONS

Prudential measures are 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 crisis.

The Code recognises the right of countries to set prudential measures to regulate foreign financial institutions' establishment and operations on and from their territories.

Whether such measures conform to the Code is based on a test of equivalence of treatment (non-discrimination) between domestic and foreign institutions.

Measures motivated by prudential objectives that do not meet the test are notified and discussed. Countries can maintain measures which are discriminatory if they are covered by “reservations”. A number of countries have availed themselves of this possibility, notably regarding the establishment of branches by non-resident financial institutions.

All generally accepted prudential measures for inward direct investment in financial services pass the test of equivalent treatment, including:

- "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
- the non-extension of emergency lending facilities to non-residents' branches
- reporting requirements and other obligations of financial entities deriving from sharing of responsibilities between host country and home country supervisors.
- A host country can require home country standards for supervision to be comparable to its standards and information sharing and similar cooperation arrangements with the home country authorities as a condition for authorising establishment, provided that equal opportunities are offered by the host country to interested home countries to demonstrate they meet the required standards and to enter into such co-operation arrangements.

In view of the unique benchmark provided by the Code for international rules of fair treatment of foreign financial institutions, the FSB has been looking forward to receiving an OECD report by end-2015 on the consistency of national requirements for foreign financial institutions' establishment and operations with the Code.

## GOVERNANCE OF THE CODE

The Code is governed by the OECD Investment Committee which considers all matters concerning the operation of the Code. The Committee acts as a forum for discussion and exchange of information, considers questions of interpretation of their legal provisions, reviews country measures and assesses their conformity with the Code obligations.

The OECD Council has decided to enlarge the Investment Committee to include participation of countries adherents to the Code, but which are not OECD members, with equal rights and responsibilities. The enlarged Investment Committee has been given the authority to take all final decisions concerning the Code.

Should the existing text of the Code need to be amended, the amendment decision would need to be agreed both in the enlarged Investment Committee and in Council. This "double consensus rule" also applies to the decision to invite an additional country to adhere to the Code. Accordingly, decisions regarding the Code cannot be made without the consent of adherents that are not members of the OECD.

## The Code brings significant benefits to adherents

A country receives international support and recognition for its openness.

A country communicates that, as a co-operative member of the international community, it refrains from a “beggar-thy-neighbour” approach.

A country enjoys the liberalisation measures of other adherents, regardless of its own degree of openness.

A country has the right to transparency regarding the measures of the other adhering countries.

A country is protected against unfair and discriminatory treatment of its investors established in other adhering countries or of its enterprises seeking to raise capital abroad, and will be entitled to bring problems to the Code’s dialogue and seek remedy.

A country reassures market participants that it does not intend to maintain restrictions broader or longer than necessary.

As an adherent with equal rights and responsibilities, a country fully participates in reviewing and influencing other adherents’ policies, shaping jurisprudence and improving rules under the Code.

## Operations covered by the Code

| **LIST A**<br>**"Standstill" applies to these operations (ie. derogation needed to reintroduce restrictions)** | **LIST B**<br>**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** | **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**<br>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**<br>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**<br>(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** | |

## National security provisions

Article 3 of the Code lists the safeguard provisions relating to public order and essential security interests. They allow adhering countries to introduce, reintroduce or maintain restrictions not covered by the reservations to the Code and, at the same time, exempt these restrictions from the principle of progressive liberalisation.

However, adherents have been encouraged to lodge reservations when they introduce restrictions for national security concerns, rather than keeping these restrictions outside the disciplines of the Code. This enhances transparency and information for users of the Code. This also constitutes a first step towards eventual liberalisation, especially when national security is not the predominant motive for restrictions.

The 2009 OECD Guidelines for Recipient Country Policies relating to National Security provide complementary practical guidance to help adherents to design and implement these policies so that they achieve their national security goals with the minimum impact possible on investment flows.

## Obligations under other international agreements

The Code has been designed to ensure consistency with other international obligations of adhering countries, including the IMF Articles of Agreement. The IMF has jurisdiction over current payments, but not capital flows. It nevertheless engages its members in policy dialogue on capital flow issues and can require its members to impose capital controls as a condition for their use of the Fund's resources.

The 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.

## The articles of the Code



## A WEALTH OF KNOWLEDGE AND EXPERIENCE

The Capital Movements Code online
www.oecd.org/daf/investment/flows

OECD Code of Liberalisation of Capital Movements

OECD Code of Liberalisation of Current Invisible Operations

OECD Codes of Liberalisation of Capital Movements and Current Invisible Operations: Users' Guide

De Crescenzio, Ott, Palerm, Currency-based measures targeting banks: a delicate balance between national regulation of risk and financial openness (2015, forthcoming)

Blundell-Wignall and Roulet, Capital controls on inflows, the global financial crisis and economic growth: evidence for emerging economies (2014)

Blundell-Wignall and Roulet, Problems in the international financial system (2014)

OECD (2012) International capital mobility: Which structural policies reduce financial fragility?

OECD countries improve their investment commitments under the Codes of Liberalisation (2009)

Foreign Direct Investment for Development: Maximising benefits – Minimising costs, OECD (2002)

Forty Years' Experience with the OECD Code of Liberalisation of Capital Movements, OECD (2002)

The Experience of the OECD with the Code of Liberalisation of Capital Movements; Current Developments in Monetary and Financial Law, Vol. 1, IMF (1999)

The New OECD Members and Liberalisation, OECD Observer No.205 (1997)

Exchange Control Policy, OECD (1993)

Liberalisation of Capital Movements and Financial Services in the OECD Area, OECD (1990)

www.oecd.org/daf/investment/flows