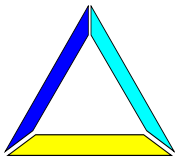
Institute for Economic Research and Policy Consulting in Ukraine
German Advisory Group on Economic Reform

Reytarska 8/5-A, 01034 Kyiv, Tel. (+38044) 278-6342, 278-6360, Fax 278-6336
E-mail: institute@ier.kiev.ua, http://www.ier.kiev.ua



V3

Managing Capital Flows: Ensuring Long-Term Benefits while Controlling for Short-Term Risks

Executive Summary

In 2005, the system of currency regulation has been significantly overhauled in Ukraine. On the one hand, several restrictions were relaxed or abolished. On the other hand, new temporary measures were introduced in September in an attempt to deter "hot money" from entering the country. We support the use of unremunerated reserve requirements (URR) on short-term foreign currency loans from non-resident sources, since this instrument is well-targeted, flexible and market-based. But we oppose the prohibition of local currency time deposits for non-residents, as it does not discriminate between maturities. Besides, this instrument has no flexibility and is not market-based. Consequently, we advice the National Bank of Ukraine (NBU) not to extend the use of this temporary prohibition beyond February 2006. Instead, the NBU should focus on short-term deposits only and apply a URR on them. Furthermore, we recommend abolishing the Pension Fund contribution of 1.3% levied for purchases of foreign currency, because of its negative effect on the foreign exchange market. In a long-term view, we present our considerations regarding the sequencing of future relaxations of foreign exchange regulations.

Contents

1. Introduction
2. Benefits and risks of foreign capital inflows
3. Instruments for regulating capital flows
4. Assessment of recently introduced temporary regulations
5. Capital account liberalization: a long-term view
6. Conclusions

1 Introduction

The rise of cross-border capital flows associated with increased financial integration can bring substantial benefits, but recent international experience also underscores possible risks. Policymakers must therefore carefully manage such flows in order to find the appropriate balance between benefits and risks.

Ukraine has been no exception in this context. While there has been a recent trend of abolishing existing regulations in order to reap the long-term benefits of foreign capital, other regulations have been recently introduced to target "hot money" inflows (i.e. portfolio and short-term debt inflows) of foreign capital. The latter is of obvious concern to policymakers, as it is of a speculative nature and therefore more prone to sudden shifts in investor sentiments. The purpose of this paper is accordingly twofold: to evaluate the usefulness of existing capital account regulations in Ukraine and to address the key issues of a longer-term strategy of capital account liberalization.

After a short overview of the general economic context of benefits and risks of inflows of foreign capital (Part 2) we analyse instruments that are frequently used to control capital account transactions (Part 3). The following section (Part 4) assesses the usefulness of recently introduced regulations in Ukraine and derives concrete policy recommendations. Next, we take a long-term view and ask how the capital account liberalization should be sequenced in order to ensure that the benefits outweigh the risks (Part 5). Finally, some concluding remarks are presented (Part 6).

2 Benefits and risks of foreign capital inflows

From the perspective of an emerging market country, abolishing controls on capital account transactions leads in general to an increase in capital inflows, as non-resident investors are trying to actively participate in the domestic markets. The following economic long-term **benefits** are associated with these inflows of foreign capital:

Financing of domestic investment

Foreign capital can stimulate domestic investment when domestic savings are in limited supply, a situation that is typical for emerging markets. This increase in investment through reduced costs of capital supports more rapid economic growth. The most relevant category of foreign capital for the development process is foreign direct investment (FDI). There is a considerable amount of evidence that further economic benefits, including spillovers of new technologies and the transfer of efficient business practices are associated with FDI. Furthermore, it tends to be more long-term oriented and more stable than mobile or "hot money" flows.

Development and strengthening of domestic financial markets

Capital account liberalization can play a crucial role in the development of domestic financial markets. The increase and widening of the investor base through foreign capital is expected to lead to a gradual deepening and broadening and an improved resilience in domestic financial markets. Transaction costs for all market participants are expected to decrease due to the dissemination of financial innovation originating from other countries. Thus, financial markets, or the financial intermediation process in general, will become more efficient, transparent and diversified. Furthermore, a highly developed and competitive system of financial intermediation creates also positive externalities like an increase in domestic savings.

Imposition of macroeconomic discipline

It is frequently argued that increased financial integration has worked as a disciplining market force on domestic policymakers, and has helped to improve the quality of macroeconomic management. High capital inflows thus signal that a country is willing to follow prudent macroeconomic policies, whereas unsustainable polices leading to external and fiscal imbalances or debt accumulation can trigger sudden outflows.

However, while many emerging markets have indeed benefited greatly from these external inflows, it is the reality that financial integration involves some well known trade-offs. Past

experience of numerous emerging markets has highlighted the fact that a couple of **risks** are associated with such a reform strategy of liberalization:

Misallocation of foreign capital

A major risk is that capital inflows are being intermediated in an inefficient way. Domestic financial markets have to be developed up to a point where they can allocate these inflows efficiently. In the presence of weak and inadequately supervised local financial institutions with limited capacity to assess, supervise, and manage risks such inflows could further lead to currency, maturity, and duration mismatches for both the banking and corporate sector.

Loss of macroeconomic stability

The rise in international capital flows has also certain macroeconomic risk implications. While capital inflows ease external financing constraints, they also pose significant dilemmas for the conduct of monetary policy. For instance, opening the capital account to inflows runs the risk of producing a sharp real appreciation and possible overshooting of the domestic currency. The usual policy response to such inflows under fixed exchange rates has been to conduct sterilized intervention. However, such intervention is generally of limited use since its effectiveness suffers within an open capital account context as substitutability of assets increases, and it has further financial implications for the central bank like quasi-fiscal costs (typically, higher-yielding domestic bonds are exchanged for lower-yielding foreign bonds).

Increase in volatility and "sudden stops" of capital flows

While an open capital account can help a country to weather the effects of domestic shocks, it increases at the same time the local vulnerability and exposure to external shocks. The most serious problems can occur when internationally mobile capital suddenly decides to leave the country, often leading to a subsequent banking and currency crisis. Such episodes of "sudden stops" or reversals of highly volatile and speculative "hot money" flows to emerging economies have been frequently observed in the past in a number of countries. The risk for the recipient country is therefore that during the process of capital account liberalization it may become gradually more exposed to contagion effects and the herding behaviour of international investors.

Conclusion 1: Foreign capital inflows can make a major contribution to economic development, but they also entail certain risks. Therefore, it is critical to conduct liberalization within a sound and sustainable economic policy framework to reap the benefits at a reasonable degree of risk.

3 Instruments for regulating capital flows

From a theoretical viewpoint, two main types of controls on international capital movements can be distinguished: controls on capital inflows and controls on capital outflows. However, in practice it is not always a straightforward task to determine whether a certain control impacts in- or outflows. Some controls on outflows (e.g. controls regulating the repatriation of foreign capital) can be established in order to discourage inflows, i.e. even though strictly a control on outflows, its intended purpose is to reduce inflows.

Controls on capital inflows

Proponents of controls on capital inflows share the view that massive inflows of foreign capital, mainly in the form of short-term portfolio flows and bank debt, behaved too erratic and unpredictable to be a major source of external finance for emerging markets. Consequently, countries should discourage excessive foreign exposures of domestic banks and corporations by adopting controls on short-term inflows. Chile, which is a widely-studied case on the effectiveness of capital inflow controls, had several goals in mind when it passed capital controls in 1991 (Annex 1 provides a brief assessment of Chile's experience with capital controls). First, to slow down the absolute volume of capital flows and to change the composition of flows towards longer maturities. Second, to reduce real exchange rate appreciation resulting from inflows. Third, to allow the central bank to conduct an independent monetary policy aimed at domestic targets. Fourth, it was the stated objective of the authorities to reduce the country's vulnerability to international financial crises.

Regarding the actual implementation of controls on inflows, two types of regulations can be distinguished: market-based controls (consisting of mandatory unremunerated reserve requirements [URR] on inflows) and administrative controls (minimum stay requirements and direct quantitative controls on inflows).

Market-based controls like URRs work in principle in the following way: non-residents wishing to move funds into the country are required to make non-interest bearing deposits at the central bank. By forcing investors to deposit, at zero interest, a proportion of their funds in the central bank, the system of URR is equivalent to a tax on capital inflows and increases the costs of external finance. The associated costs depend on the proportion of the investment that has to be deposited, on the length of time the reserve must be held at the bank, and on the opportunity cost of these funds. The URR can be handled in a flexible manner: if the reserve requirements are set to zero, the restrictions on short-term indebtedness are eliminated in practice but the mechanism remains available for future use. Some countries differentiate reserve requirements for banks further according to both the residency and currency of denomination of deposits, while others differentiate only according to currency of denomination but not residency. Furthermore, normally foreign investors can waive this instrument by paying an up-front fixed fee which is related to the implied opportunity costs of the URR.

A far more restrictive class of controls on inflows are administrative measures. These measures can consist of minimum stay requirements (e.g. one year) on foreign capital inflows of several types (portfolio investment, bank flows, etc.). Again, the purpose of this measure is to effectively discourage short-term inflows. A more drastic measure is the imposition of direct quantitative controls on inflows, often in the form of outright prohibitions. These can take several forms, from restrictions concerning non-residents' investments in domestic securities markets (money, bond, and equity markets) to restrictions placed on external borrowings of residents and non-residents' access to local currency deposits in the domestic banking system.

It is difficult to assess the general effectiveness of inflow controls in reaching their stated objectives due to the widely differing economic conditions, policy frameworks, and international environment in which they were implemented. Some observers subscribe to the view that temporary inflow controls of the type Chile has implemented can be considered as prudential measures - as regulations designed to ensure the stability of the financial sector. However, these controls also have costs. The most important one is that they will increase the cost of capital significantly, especially for small- and medium-sized (SME) firms which find it difficult to evade controls[1]. In effect, a segmentation of the credit market results. A country considering the adoption of such inflow controls must therefore trade-off this higher cost of capital, especially for SMEs, with potential benefits like a reduced macroeconomic vulnerability to short-term inflows of capital.

Controls on capital outflows

Controls on capital outflows have been frequently proposed and implemented as a tool in financial and currency crises. Such controls can take a number of forms, including taxes on funds to be remitted abroad, separate exchange rates for current and capital account transactions, and outright prohibition of transfers of funds abroad. According to the timing of their imposition, two types of outflow controls can be distinguished (see EDWARDS [1999]): preventive controls (when a country is facing a balance of payments deficit, but has not yet devalued) and curative controls (for countries already facing a major crisis). The idea behind the former measures is that they will discourage speculation by restricting non-residents access to domestic currency and help to slow down the decrease of international reserves, giving the authorities the necessary time required to implement effective adjustment programs. The latter type would give a crisis-country additional time to restructure its financial sector in an orderly and undisturbed fashion. Once the economy is back on track, controls should be dismantled.

The empirical evidence – even though not fully conclusive- suggests that the implementation of outflow controls of various types has been largely ineffective. Such controls send negative

[1] As we will explain later on, firms frequently find ways to circumvent controls, thereby reducing the effectiveness of such measures.

signals to the market, and the private sector finds always ways of evading controls, rendering their purpose of slowing down capital flight as unsuccessful. At the same time, once controls are established, the authorities usually fail to restructure the domestic economies, or to implement credible economic reforms, justifying investors' fears. In many cases, the presence of such permanent outflow controls therefore heightened the risk of a currency and banking crisis.

Conclusion 2: While it can be useful to have market-based regulations on short-term inflows in the toolbox of economic policy instruments, their activation should be only temporary and strictly limited to times of crisis due to the costs associated with them. They should not be considered a substitute for sound economic and financial policies. Capital outflows should not be restricted.

4 Assessment of recently introduced temporary regulations

As became clear in the last section, there are sound economic arguments for regulating "hot money" inflows, as these flows follow a potentially volatile pattern and may endanger macroeconomic stability. If the overall aim of the Ukrainian authorities is the discouragement of such inflows[2], combined with a compositional shift of inflows towards more long-term flows, the existing regulations need to be thoroughly evaluated against this background. The key issue is whether current regulations in place can achieve this goal in a systematic, efficient and non-distortionary way. Furthermore, a certain amount of built-in flexibility is needed to ensure that controls are being activated only in times when "hot money" inflows negatively influence macroeconomic management and stability. In times when such inflows are not an important issue, or the macroeconomic risks lie more on the outflow side, they should be relaxed or suspended.

We therefore concentrate our evaluation on two recently introduced regulatory measures: the prohibition of local currency time deposits for non-residents (NBU [2005b] Letter from 29 September 2005) and the obligatory reservation of funds for foreign currency transactions (NBU [2005a] Decree No. 291) . A further regulation, the Pension Fund duty levied on foreign currency purchases will be discussed subsequently. While it is a well-established feature of foreign exchange regulations in Ukraine, and therefore in a strict sense not new, its effect on capital inflows (including "hot money") needs to be clarified.

Prohibition of local currency time deposits for non-residents

In Ukraine, non-residents are generally not allowed to keep traditional time deposits with banks in local currency. As a measure to restrict short-term flows, this outright prohibition is clearly ineffective, as it does not discriminate between the maturities of inflows. Furthermore, this regulation has to be evaluated very critically from another point of view, as it in effect prohibits banks from funding long-term domestic currency assets (e.g. loans) with corresponding long-term time deposits supplied by non-residents, thereby lowering the currency and maturity mismatches of their balance sheets. We suggest therefore its abolition, and the concentration on the below-discussed reserve requirement to deal with negative implications of "hot money".

Obligatory reservation of funds for foreign currency transactions

This regulation is applied to residents' short-term foreign currency credits and loans (up to 180 days) from non-resident sources and amounts to 20% of the value of the transaction. It works in effect like a URR described previously, and as became clear in the last section, there is indeed a rationale for such measures to limit Ukraine's exposure to short-term external liabilities. It is potentially a well-targeted, market-based instrument, whose application can be furthermore handled in a flexible manner.

However, legal restrictions are frequently circumvented by the private sector. Some simple mechanisms make use of current account transactions to evade such restrictions on capital account transactions (by resort to leads and lags and over- and underinvoicing of exports and

[2] A practical problem may arise in the detection of the "hot money" component in short-term inflows which include also items like trade credits that should not fall under these regulations.

imports), or simply misstate the purpose of capital movements, or switch to other kinds of (not regulated) instruments that are close substitutes for regulated instruments. These developments erode the effectiveness of regulations over time, making it in turn necessary to extend the coverage of controls. Our suggestion is therefore, to consider the generalization of URR coverage to other (new) short-term debt inflows such as deposits. Regarding portfolio investments which can be potentially of a speculative nature, a further problem arises as these inflows do not have a fixed maturity from an ex-ante point of view. In this context, a possible solution would be to introduce a fixed duration of the URR (e.g. 3 or 6 month), irrespective of the actual maturity of the investment. This would allow a more broad-based and non-discriminatory treatment of all kinds of "hot money" inflows with respect to the assumed goal of limiting their impact on the domestic economy. In addition, and along with international practice, it should be considered to give foreign investors the option to pay an equivalent up-front fee[3] instead of deposition the funds at the NBU.

Regarding the concrete URR rate, it should be determined according to market conditions. Under current conditions, where risks related to short-term inflows are clearly not an issue, but rather relate to capital outflows, the reserve rate could be accordingly reduced (down to a minimum of 0%), to encourage foreign inflows that help to stabilize the foreign exchange market. In case that the risks shift over time (e.g. after a favourable outcome of the March 2006 elections according to foreign investors' opinions) more to the inflow side, it can be quickly increased to fulfil its described purpose. However, it has to be kept in mind that even a rate of 0% doesn't mean that the instrument is abolished completely; it rather shows that the instrument is available for further use.

Pension Fund duty on foreign currency purchases

As of 1 January 2006, this duty on all interbank foreign currency purchases has been reduced to from 1.5% to 1.3%, as specified in the 2006 state budget. Since the implicit costs of this duty are inversely related to the maturity of the foreign investment, this provides a disincentive for short-term flows.

However, due to its universal appliance, a thorough evaluation of this instrument needs to take into account its overall impact on the foreign exchange market. In this respect, there are three points to note. First, since it concerns all foreign investors whishing to move out funds, it is a general obstacle for foreign investments in Ukraine and thus has a negative impact. Second, since it covers all foreign exchange transactions, also proprietary trading conducted by banks, it effectively punishes banks that try to provide liquidity to the market. A liquid and therefore more efficient foreign exchange market serves important economic functions in several respects (e.g. with regard to exporters and importers, investors, underlying for hedging instruments, etc.), which means that any measure that suppresses liquidity provision should be avoided. Third, since this duty is universally allied to foreign currency purchase in the interbank market, it covers also current account transactions like currency purchases for imported goods. Here again, there are drawbacks with this measure, as it penalizes e.g. the import of much needed capital goods. All arguments taken together, they make a strong point for the abolishment of this pension duty on foreign currency purchases.[4]

Conclusion 3: In order to discourage "hot money", the NBU should concentrate on a URR on a broad basis. The prohibition of local currency time deposit for non-residents and the Pension Fund duty on foreign currency purchases should be removed.

5 Capital account liberalization: a long-term view

The objective of a strategy of sequencing the necessary reform steps in opening up the capital account is to find an optimal adjustment path that maximizes Ukraine's economic welfare, given its initial structural constraints, especially in the financial sector. There are two basic

[3] This fee, which is equivalent to the interest cost of the URR would be determined by the product of a relevant foreign interest rate (e.g. LIBOR) and the fraction of funds to be deposited at the NBU.

[4] The abolishment of the pension duty will decrease the revenues of the highly deficitary Pension Fund. Consequently, an alternative source of finance has to be found. But this problem should not be considered as a reason to maintain an extremely distortionary instrument, which obstructs investment and economic growth.

approaches to capital account liberalization: the first is the big-bang approach, in which the capital account is opened rapidly; the second is a gradual approach in which liberalization is undertaken slowly over a period of time.

The big-bang (or shock) approach of immediately opening the capital account has been- with very mixed results- followed by a number of emerging markets in the early 1990s. Proponents of this strategy argued that a commonly observed lack of credibility of the reform process makes it necessary to act quickly, and is also needed to overcome resistance from different interest groups.

Current thinking, however, favours a more gradual strategy of sequencing capital account liberalization. The conventional view of sequencing shares the same ultimate goal of an open capital account, but differs in its recommendations on how to sequence reform steps optimally. While it is commonly agreed in the policy-oriented sequencing literature that real sector liberalization (including the current account), macroeconomic stabilization (both fiscal and monetary), as well as financial sector reform should precede capital account liberalization, special consideration is paid to country-specific characteristics. The impact of an open capital account on the conduct of monetary and exchange rate policy (Box 1) is a fundamental issue in this respect.

Box 1
Capital account liberalization and monetary and exchange rate policy

Theoretical considerations suggest that it is impossible for policymakers to simultaneously pursue a pegged exchange rate, an independent monetary policy and an open capital account (the "impossible trinity"). Once the decision to liberalise cross-border capital flows has been taken, the choice is to either fix the exchange rate or have an independent monetary policy, but not both at the same time.

If the government decides to liberalize the capital account, and capital is therefore freely mobile, a credible fixed nominal exchange rate leads to a loss in monetary policy independence, as capital flows tend to drive domestic interest rates towards the level of foreign rates. In the context of a pegged regime, it is therefore required that monetary policy is subordinated to the maintenance of the nominal anchor and domestic interest rates can adjust freely in response to capital flows. On the other hand, an independent monetary leaves under the restriction of an open capital account the exchange rate to be determined by market forces. With an increased openness to capital flows, the effectiveness of monetary policy depends therefore critically on the degree to which a flexible exchange rate is maintained.

The possibilities to assign monetary and exchange rate policy to achieve different macroeconomic targets at the same time become ultimately impossible with a liberalized capital account. An open capital account will therefore bring more sharply into focus any existing inconsistencies between monetary and exchange rate policies: if monetary policy is targeted at domestic inflation, the exchange rate cannot be targeted at the same time (e.g. to achieve certain current account objectives). This fundamental relationship is modified only in the case that countries maintain capital account restrictions, or domestic and foreign assets are not considered to be perfect substitutes. In both cases, central banks may retain some control over monetary policy even with a pegged exchange rate.

The authorities require another instrument to offset large capital inflows, namely fiscal policy. A tight fiscal policy lowers domestic absorption, thereby reducing pressure on the exchange rate. Fiscal consolidation can therefore be one possible way to achieve domestic stabilization objectives. However, it has to be kept in mind that fiscal policy instruments exhibit a limited short-run flexibility due to lengthy formulation and implementation issues, which constrain their usefulness in dealing with short-term capital inflows.

The key point to recognize in the sequencing of capital account liberalization is the danger of removing existing restrictions on cross-border transactions before major problems in the domestic financial system have been tackled. Countries in which such problems are severe should not take the risk of incurring a serious financial crisis by too rapidly opening their capital account. A gradual and integrated approach that allows for the building-up of a certain threshold of domestic financial markets, institutions, and instruments could help to allocate external capital more efficiently.

Regarding Ukraine, the process of the liberalization of the capital account and the development of Ukraine's financial system must be combined in order to reduce the risk involved. Prerequisites for moving towards an open capital account consist of strengthening the domestic financial system by improving the regulatory and supervisory framework and prudential controls, especially when substantial inflows are intermediated through the banking

system. In more detail, this would concern areas like risk-management practices, bankruptcy and insolvency laws, adequate capital requirements and transparent auditing and accounting systems.

Other policy implications can be derived from the sequencing debate with respect to the order of liberalization of the individual components of the capital account. Capital inflows should be permitted on as broad a front as current conditions allow, beginning with long-term flows before short-term flows and low-risk foreign direct investment flows ahead of more risky portfolio and bank-debt flows. While foreign direct investment might help to smooth real sector reforms like industry restructuring and export orientation, portfolio and debt flows play an important role for further banking and securities market liberalization and development.

The extent to which capital account liberalization is conducted asymmetrically-more open to inflows than outflows or vice versa, can be exploited temporary and within certain limits by domestic authorities. If it is necessary to dampen the negative effects of short-term portfolio or debt inflows, an asymmetric relaxation of existing controls on outflows can take some pressure from the exchange rate. However, a substantial degree of asymmetry in the openness of the capital account can lead to serious misalignments in the exchange rate as compared to its long-term equilibrium. Thus, in the process of capital account liberalization existing asymmetries should be gradually removed to facilitate an orderly correction of any potential misalignments.

Conclusion 4: The liberalization of the capital account should be sequenced in a gradual manner that closely complements financial sector reform in Ukraine. Financial stability requires the development of a well-regulated and supervised financial sector. Furthermore, due to its linkages, capital account liberalization needs to be coordinated with appropriate monetary, exchange rate, as well as fiscal policies.

6 Conclusions

As has been demonstrated above, international capital flows bring many benefits, but they also entail certain risks. It is therefore the task of the authorities to develop a toolbox of foreign exchange regulations that ensure an optimal balance of benefits and risks. In this paper, we identified the risks mainly associated with short-term speculative inflows of foreign capital, so-called “hot money”. Consequently, the NBU needs market-based and flexible instruments that target these inflows. The URR currently in place is such an instrument that we consider an adequate reply to such inflows if applied on a broad basis, and its temporary use is subject to market conditions. Other instruments, like the Pension Fund duty on foreign currency purchases and the prohibition of local currency time deposits for non-residents are regulations that are either not market-based, lack flexibility, or do not target specifically “hot money” flows and should therefore be removed.

Following a long-term view, there is indeed a strong rationale for Ukraine to open up its capital account, moving towards the ultimate objective of full liberalization. Almost all developed economies have open capital accounts, a fact that suggests that capital account liberalization is an inevitable and unavoidable step on the path of economic development. At the same time, it is an integral part of conventional wisdom that capital account liberalization has important prerequisites and should be viewed as an important component in a broad scheme of reforms. Liberalization of the capital account can be counterproductive, if it takes place before severe domestic distortions have been removed and before domestic financial markets, institutions, and the capacities of the prudential authorities have developed and foreign funds can be subsequently channelled in productive activities. In order to deal with these risks, a solid macroeconomic framework and a healthy financial system with an effective system of prudential regulation and supervision are required.

Kyiv/Berlin, February 2006

Authors: Robert Kirchner and Ricardo Giucci
Lector: Veronika Movchan

Bibliography

BIS [2005]. Globalization and monetary policy in emerging markets, *BIS Papers No. 23*, Bank for International Settlements, Basle.

DUTTAGUPTA, RUPA, GILDA FERNANDEZ AND CEM KARACADAG [2004]. From Fixed to Float: Operational Aspects of Moving Toward Exchange Rate Flexibility, *IMF Working Paper 04/126*, International Monetary Fund, Washington.

EDWARDS, SEBASTIAN [1999]. How Effective are Capital Controls?, *Journal of Economic Perspectives*, Vol. 13, No. 4, pp 65-84.

HANG LUO, ROBIN AND CHUN JIANG [2005]. Currency Convertibility, Cost of Capital Control and Capital Account Liberalization in China, *Journal of Chinese Political Science*, Vol. 10, No. 1, pp 65-79.

JOHNSTON, R. BARRY [1998]. Sequencing Capital Account Liberalization and Financial Sector Reform, *IMF Paper on Policy Analysis and Assessment PPAA/98/8*, International Monetary Fund, Washington.

LE FORT, GUILLERMO [2005]. Capital Account Liberalization and the Real Exchange Rate in Chile, *IMF Working Paper 05/132*, International Monetary Fund, Washington.

NBU [2005a]. On introduction of obligatory reservation of funds for foreign currency transactions related to attraction of foreign currency loans by residents from non-residents, National Bank of Ukraine, Decree No. 291 (12.08.2005), Kiev.

NBU [2005b]. On Foreign Investments into Ukraine, National Bank of Ukraine, Letter (28.09.2005), Kiev.

PRASAD, ESWAR, THOMAS RUMBAUGH AND QING WANG [2005]. Putting the Cart Before the Horse? Capital Account Liberalization and Exchange Rate Flexibility, *IMF Policy Discussion Paper PDP/05/1*, International Monetary Fund, Washington.

Annex 1

Country experience with temporary controls on capital inflows: the case of Chile 1991-1998

When 1991 a surge in capital inflows intruded with macroeconomic policy and put the domestic currency under real appreciation pressure, Chile implemented capital inflow regulations, with an unremunerated reserve requirement (URR) being the most relevant instrument (other, less important regulations included a minimum withholding period applied to foreign direct investment, and limitations to issue securities in foreign markets). The URR consisted of a compulsory and non-remunerated deposit in foreign exchange that had to be kept at the central bank, which was designed to discourage short-term borrowing without affecting long-term foreign investments.

Several measures had to be taken over time to close loopholes and improve the effectiveness of the URR. When it was introduced, it amounted to 20%, and the term of the URR deposit was equal to the maturity of the foreign funds. Soon, it was raised to 30% (and the term of the URR deposit was unified to one year irrespective of the maturity of the funds) and kept at that level until 1998 when it was first reduced to 10% and then to zero, after the sharp reduction in capital inflows to emerging markets in the aftermath of the Asian crisis (the instrument was formally removed in 2001). In the process of generalization of URR coverage, it was extended to cover most forms of foreign financing except foreign direct investment. In reality, this meant that loans, fixed-income securities, and most equity investments were subject to the URR, and only FDI and American Depositary Receipt (ADR[5]) primary issuance were exempted from it. The URR coverage[6] of gross capital inflows in that period fluctuated between a minimum of 30% (1994) and a maximum of 60% (1992).

Although coverage of the URR was extended over time, circumvention reduced its effectiveness. Examples of such legal avoidance strategies by economic agents included ADR and bond issuance abroad, the use of suppliers' credit and direct trade financing. In addition to the legal circumvention, the avoidance of the URR could have also taken the form of illegal evasion by way of capital flight.

Despite these limitations, the URR has been widely acclaimed as effective in fulfilling its goals. This refers not so much to a containment of the size of capital inflows (which was not intended) but rather to an improvement in the composition of external financing towards more long-term flows. The instrument reduced the share of portfolio and other short-term capital flows in total inflows, while increasing the respective share of foreign direct investment and other long-term flows, leaving the overall volume of capital inflows roughly unchanged. Furthermore, it gave additional room of manoeuvre for monetary policy and signalled the authorities' commitment to ensure financial stability.

Sources: EDWARDS [1999], LE FORT [2005], BIS [2005].

[5] ADR's are certificates issued by a US bank representing a specific number of foreign shares that trade on a US stock exchange. ADR's allow US investors to easily invest in foreign stocks without having to buy the stocks on a non-US exchange.

[6] The URR coverage sets the amount of gross inflows to which the URR is applied into relation to total gross inflows.