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Predicament of Capital Account Liberalization: Origin of Crises or Growth

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Abstract:** The collapse of the Bretton-Woods agreement and moving to the floating exchange regimes required the economies to remove the restrictions on the capital movement and facilitate free trade between the nations. There has been an extensive, controversial and still up in the air debate about the costs and benefits of Capital Account Liberalization (CAL). Detractors have blamed capital account liberalization as being the root cause of banking and currency crises experienced by emerging economies and argue that the deck is particularly stacked against the non-industrial countries, which has experienced few benefits but exposed themselves to considerable risks.

***Keywords:** Capital Account Liberalization, Banking Crises, Currency Crises, Growth*

***JEL Classification:** F2, F38, G01*

1. INTRODUCTION

"Those who cannot remember the past are condemned to repeat it," (George Santayana, (The Life of Reason, 1905)). Past four decades had seen the tremendous changes in the financial systems around the world. The collapse of the Bretton-Woods agreement and shift to floating exchange regimes required economies to remove restrictions on the capital movements, as it facilitate free trade between the nations. Capital flows around the globe had increased rapidly since 1990's. The developing nations are reforming and restructuring their domestic economic policies so as to integrate with the world economy. The IMF (International Monetary Fund) had always adopted the approach of promoting current account liberalization and capital account liberalization, so that nations may have unrestricted access to foreign exchange and trade in goods and services. But Report of the Managing Director to International Monetary and Financial Committee on Progress in Strengthening the Architecture of International Financial System and Reform the IMF states that Executive Board has emphasized on the sequencing of liberalization process to minimize the risk associated with international capital flows. Emerging Market Economies (EME's) started with the process of capital account openness in 1980's, most of which spell trouble without stronger domestic financial system. There has been an extensive, controversial and still up in the air debate about the costs and benefits of Capital Account Convertibility[1] (CAC) or Capital Account Liberalization (CAL).

Before we move on we need to understand two dimensions, related to why were controls imposed and what is the need to liberalize thereafter. For maintaining exchange rate regime and to shield sudden stop or surge of the capital flows, the industrialized nations sustained closed capital account accounts till the World War II or Bretton Woods Era to reduce the macroeconomic shock. Reasons for Moving to Liberalized Economy Framework are related to the movement of resources from the capital surplus-rich nations to capital deficit-developing nations, ultimately for the development of global economy as a whole. It's like achieving the equilibrium between inherent benefits and risk associated with opening the channels for international capital. The Capital Account Liberalization is much debated topic. There are different views expressed by the researchers, policy makers and various international organization of repute like International monetary fund. Each country wants to grow at higher rate which as per some policy maker is possible because of financial integration. Another view in the academia is that the opening up of economy without strong fundamentals both at macro and financial levels will leads the country into crises situation. In the light of the about the present paper is an attempt to explain what capital account Liberalization means.

The novelty of this paper is to understand in depth the view of International Monetary Fund on the Capital Account

[1]The Tarapore committee recommends a pragmatic working definition for Capital Account Convertibility i.e. "CAPITAL ACCOUNT CONVERTABILITY refers to the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. It is associated with the changes of ownership India foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can be, and is, co existent with restrictions other than on external payments. It also does not preclude the imposition of monetary and fiscal measures relating to foreign exchange transactions which are of a prudential nature".

Liberalization along with its benefits and risk. To talk about the short history of Capital Account Liberalization around the World. To deliberate whether CAL leads to banking crises and currency crises in BRICS and ASEAN 5 nations.

The objective of this paper is to understand the Capital Account liberalization in the light of IMF definition. Section 2 narrates literature review, section 3 talks about International Monetary Fund views on Capital Account Liberalization, section 4 narrates short history of Capital Account liberalization around the world, section 5 talk about Capital Account Liberalization in BRICS (Brazil, Russia, India, China and South Africa) and ASEAN-5 nations (Indonesia, Korea, Malaysia, Philippines and Thailand), finally in section 6 fixed currencies, monetary policy independence & Capital Account Liberalization: "the impossible trinity" to the "trilemma" is explained.

2. LITERATURE REVIEW

The standard Neoclassical model of CAL states that capital flows from the capital excess nations to the capital deficit nations or the ones which lack in domestic savings, thus reducing the cost of capital and providing higher returns on the investment. Both investors as well as stakeholders seek such investment opportunities which add maximum profits at manageable risk, therefore separating investment decisions from saving decisions, (Blanchard and Fischer 1989) which make them earn more than holding back the capital or investing in less profitable options. Also, integration leads to exchange of technology and knowledge, leading to important inventions. It also enhances the domestic financial markets by improving strength and liquidity of banking system and equity markets, due to competition in the international markets. (Dell'Ariccia et al., 2008) suggest that gains of CAL and market integration are observed more in advance industrialized economies than the emerging economies. There are threshold and prerequisites which are required to be accomplished before the liberalization of financial sector, as presence of weak financial and trade system may increase macroeconomic volatility. Therefore, policy makers of various emerging economies are facing controversies about the degree to which a nation should open capital account as it raises the risk of financial instability which can lead to different crisis. The risk is associated with international flows of capital because production and consumption patterns are not known to the investor, thus distortion leads to greater losses than gains expected.

The various researchers in their study on fuller convertibility of capital account concludes the number of pre requisites in relation to macroeconomic fundamentals and financial stability of a country. Economic theorists provide copious views on liberalization of capital account bringing different benefits and risks for a nation. Economist like (Krugman, 1997; Subbarao, 2013) suggest that countries who are still developing have higher risk of crises as repercussions of increasing CAL and financial integration. Macroeconomic imbalance, weak governance and premature capital account openness has more negative impact than positive upon economic growth and historical evidence shows that it can lead to high beta economy making them vulnerable to contagious effects of external cycles and fluctuation, exchange rate adjustments and asset price bubbles. Yet trade integration can boost economic growth.

2.1 The International Monetary Fund Views on the Capital Account Liberalization: Benefits and Risk

It was during the meeting of the Interim Committee of the IMF in 1997, when the major talk about the liberalization of the international capital movements was undertaken. During this meeting the focus was on the amendment of the Articles of Agreement, mainly pointing to recommendation over the definition of currency convertibility extending to capital account transaction. The important question among the policy makers was for the role of the fund in development of an approach towards the fuller CAC. During the period of 1980-1997, capital flows and number of financial transactions in developing world almost tripled. Developing nations removed restrictions on the transactions during this phase of opportunities to grow at a faster pace. The controls on capital account and various sub categories are stated in the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) by IMF under Article VIII. There exist a huge gap between the financial integration de jure and de facto i.e. even after controls are imposed there are routes of capital flows which make the situation during distress more difficult. The IMF AREAER is basically a measure of controls implemented on flows but do not measure the intensity and effectiveness of these controls.

Every new crisis makes it more difficult and an intense topic for debate among the policy makers. The large volatile capital flows before crises relate to increasing inflation, exchange rate appreciation and fluctuating asset prices. Even at IMF it is a controversy yet to be solved, few of the researchers argue that IMF in political pressure asked various member countries to liberalize their financial accounts. IMF through its Independent Evaluation Office prepared a surveillance report on IMF's institutional approach to Capital Account Liberalization in 2005 and updated report after a decade in 2015 (Independent Evaluation Office, 2015). (Gallagher, 2011) rightly mentioned that policies in emerging and developing nations should be such that, surges and sudden stop of international flows should not "jeopardize" the national development projects. The developing nations should focus more on the quantity-based measures of capital controls than their counter using the price-based measure. The flows both inflow and outflow are equally significant, therefore the Capital Account Regulations (CARs) may help to reduce the cost of reserve accrual. The CARs should be posted differently

for the residents and the non-residents & should have a dynamic mechanism so that investors and market adapt the regulations. In the IEO (Independent Evaluation Office, 2004) evaluation 2005, reports the IMFs ambiguity in the surveillance and inconsistence in policy advices to the countries with regard to liberalization of the financial account. Even after the evidences and experiences of various nations for the kind of turmoil they faced after liberalizing capital account, IMF is still deliberate to liberalize the economy as an end goal to be achieved. Little emphasis is paid on the type of flows in an economy and burden it faces. The nations should adopt an individualistic approach towards designing, monitoring and enforcing the CARs and policy for liberalization of capital account.

2.2 IMFs "New Institutional View" on Capital Account Liberalization

In year 2012 the IMF announced the new "institutional view" (Arora et al., 2012) on the liberalization and management of international financial flows, in the wake of great financial turmoil and contagion in 2007. There is a need of urgent change in macroeconomic policy to manage risk and economic variables for the steady growth of an economy. IMF now agrees that, free transfer of investments needs a lot of preparation beforehand i.e. it cannot rest upon the weaker economic or financial variables. The idea of free trade is far different from free finance, before liberalizing the capital account a nation needs to meet certain thresholds to prevent any kind of volatilities in the system. Liberalization of capital account can be profitable only if the other policies like fiscal policy, monetary policy, interest rates, policies for the foreign exchange reserves and macro-prudential policies are on the same line. Openness can be done only if the thresholds for these policies are met.

IMF reframed the "capital controls" (CC) as (Chensavasdijai et al., 2016) **"**Capital Flow Management Measures" (CFMs)**.** The CFMs are designed to control and manage capital flows and are divided into residency based measure and currency based & other measures. The residency based measures controls cross-border financial activity by differentiating the flows between residents and non-residents. The other measure controls the flows by implementing reserve requirements and laying down certain preconditions like registrations and holding period requirements. Also the shift in approach of IMF supports that the liberalization process should be gradual, sequenced, and pragmatic, different for the different economies, (Prasad & Rajan, 2008). The evaluation board recommended the IMF to provide its clarity on the issue of openness of capital account. IMF Executive Board in 2001 provided the "Integrated Approach" which is the part of the economic reforms required by the nations and which should be the part of their financial system and prudential regulation, based on sequential and detailed analysis of economic environment and risk levels in each country. The integrated approach focuses on the pragmatic and sequential approach towards liberalization of capital account. Also, great amount of attention needs to be made for the push-factors and supply side of foreign capital flows. Capital account liberalization process should be sequenced in the following pattern to avoid the risks associated with the volatility of capital flows. At first level of the liberalization, Foreign Direct Investment (FDI) Inflows should be allowed, At the next level of liberalization FDI Outflows should opened followed by long-term portfolio flows and finally, short-term portfolio flows and debt should be liberalized.

In their papers, (Dell'Ariccia et al., 2007; Kose, Prasad, Rogoff, & Wei, 2009) supported liberalization of capital account, but concluded that, impact over the growth can only be seen in long-run, through changes in macroeconomic and financial variables in the presence of strong institutional environment. Succeeding, to the global financial crises, IMF had been focusing on the supply side of capital flows and monetary policy. IMF will maintain both Bilateral Surveillance (modification of the balance of payment restrictions) and Multilateral Surveillance (impact of the change in the domestic policies) for the decisions over the capital account policies. The IMF provided framework specifying three criteria for implementation of the CFMs like Exchange rate overvaluation, Reserve adequacy and Economic overheating

The major questions regarding the liberalization of international flows still remained unanswered even after various policy discussions at IMF. The distortions related to the level of controls to be imposed and limits at which a nation can define the level of risk associated with capital flows is not yet defined. Even effectiveness of the capital controls to stabilize the economy and forms of control an economy should impose (price based or quantity based) on the capital flows is ambiguous. IMF still supports the liberalization of the capital account despite of lack of evidences supporting the same. Usage of the CFMs is not clear and the usage is limited. IMF fails to address the calculation of the under/overvaluation of the CFMs and "fiscal policy tightening subjects domestic policy to global finance"(Gallagher, 2011) in case of the capital inflows. The controls on the outflows are the part of counter-cyclical financial policy. The nations are not clear on the measures to deploy for avoiding the risk associated with the international financial flows. During G-20 meet policy makers defined "rules of the game" and recommended careful designing of macro prudential policy to mitigate the risk arising due to capital surges.

3. SHORT HISTORY OF CAPITAL ACCOUNT LIBERALIZATION AROUND THE WORLD

Capital Account Openness impact a nation's Monetary Policy as well as exchange rate regime as suggested by "Robert Mundell" (D. P. Quinn & Toyoda, 2008). Story of financial

democracy largely measures the story of conflict between politics and economics. Period from the last decade of 18th century, there was probably the great harmony between economic theory and economic fact than at any later time. Industrialization during these years was spreading widely and was connected historically with the movement toward laissez-faire (i.e. freer enterprise and freedom of trade and exchange with no government intervention) and this was the era of economic expansion that served for the most part of industrial and commercial expansions. During 1925-29, there were some who saw the strains and stresses were gathering beneath the economic surface which would sooner or later upset the economic balance. Cumulative effect of these economic strains resulted in stock market crash in the United States in, October 1929 followed by the Industrial depression. This depression was the result of failure of developing countries to meet obligations arising from international capital flows. Collapse came as the great shock to the business world and the world was in the midst of a "Great Depression" which was to leave a lasting impact on economic and political developments. In the late 1930's stringent regulations were passed to control the foreign trade and foreign exchange due to the difficult economic situations in the Britain and the Western world. The movement toward greater public (government) control of economic activities gained strength and became dominant note for both, economic thinking and economic policies. Consequently, capital transfers were largely left to official sources for several years.

At Bretton Woods in 1947 at International Monetary Conference, one of the major economic reform emerged which was adoption of fixed but adjustable exchange rates, by assigning central parity against American dollar with + one percentage on either side. During this era the major financial transactions and exchange of capital flows were limited to industrial economies (Obstfeld and Taylor, 2002; Pilbeam, 2006). But 20 years down the line the system started trembling as US monetary reserves started depleting and liquid liabilities were higher and adjustment mechanism was inefficient (Bordo and Eichengreen, eds. 1993; Eichengreen, 1996).

(Williamson & Mahar, 1998) in his speech at the Second Annual Indian Derivatives Conference mentioned that "The modern economic analysis" of financial policy in developing countries started with the seminal works of McKinnon (1973) and Shaw (1973). They explained "financial repression" in developing countries as where government majorly controls interest rates, borrowing and lending abroad, regulating and controlling financial institution and implement barriers for new entrants into financial sector. The McKinnon and Shaw & all other authors who favored capital account liberalization state that, the above dimensions would tend to repress savings and therefore the opportunity to invest. Economic growth would suffer as the savings will not be channelized in the best ventures available thus would not have optimal return. Whereas critics say that liberalization of financial sector would not only lead to loss of monetary policy control but also foster financial crisis. During the liberalization of the financial sector a relationship has to be developed between the savings and investment in terms of risk and return. Liberalization provides opportunity for getting the best return on your investment but the risk involved can be very high. The liberalized systems are indeed more prone to banking crises and currency depreciation or contagion effect of financial and balance of payment crises (Reinhart and Kaminsky 1996, Demirguc-Kunt and Detriarche 1997, Williamson and Mahar 1998). These crises occur due to the default in the financial structure, poorly regulated financial sector, and high rate of corruption in a nutshell lack of financial stability.

The Chiles experience with capital controls is generally viewed as a positive factor i.e. the Chilean Encage is also recommended by IMF to other nations facing difficult situation due to international capital flows (Forbes, 2006, 2007). Authors have conflicting views on whether lifting the capital controls leads to growth or it has no impact on growth. The experience of Latin American Nations and Chile shows that financial integration and open markets leads to economic disorders and disturbs institutional environment as well (Diaz-Alejandro, 1985).

The popular proverb "Prevention is better than cure" also applies to the financial system. When we talk about the East Asian Financial flu of 1997-98, the nations like India, China, Sri Lanka and Bangladesh were least impacted than the nations like Korea, Thailand, Philippine, Malaysia and Indonesia and the major reason was a systematic difference between the two groups, with respect to whether or not they had liberalized their capital accounts. Also the restrictions on capital flows played major role for saving these economies. In the following section we study the liberalization of the financial account in the BRICS and the ASEAN 5 nations.

4. CAPITAL ACCOUNT LIBERALIZATION IN BRICS AND ASEAN 5 NATIONS

The picture of the perfect financial world i.e. the free capital flows between the emerging and the advance economies is regarded as a source of great investments and growth opportunities. The standard binary indicator for the Capital Account Openness (CAO) or Capital Account Liberalization (CAL) is based on the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)[2]and provides the dejure information i.e. the government control

[2]*AREAER is the database maintained by IMF that keeps the record of exchange and trade agreements for 187 IMF member countries. "The database provides information on different types of capital controls used by countries, restrictions on current international payments and transfers, arrangements for payments and receipts, procedures for resident and nonresident accounts, exchange rate arrangements, and the operation of foreign exchange markets. It also includes measures implemented in the financial sector, including prudential measures"(International Monetary Fund, 2014).*

over the capital transaction which may differ from the actual scenario. The actual scenario is basically recorded by the capital flows in and out of the nation. The capital controls across the BRICS (Brazil, Russia, India, China and South Africa) and the ASEAN-5(Malaysia, Indonesia, Philippines, Korea and Thailand) are compared in Table 1 and 2 below. All the nations have imposed some kind of controls on capital account transactions i.e. restrictions on international capital flows and the degree of control vary from nation to nation.

The capital controls are the regulation that controls inward and outward flow of the capital from the nation. According to IMF AREAER "controls on capital transactions include prohibitions; need for prior approval, authorization, and notification; dual and multiple exchange rates; discriminatory taxes; and reserve requirements or interest penalties imposed by the authorities that regulate the conclusion or execution of transactions or transfers and the holding of assets at home by non-residents and abroad by residents" (International Monetary Fund, 2014). Repatriation means the conversion of foreign currency into the local currency, which is exposed to foreign exchange risk. So there are controls imposed by the nations on repatriation of financial assets.

TABLE 1: Contemporary Position of Capital Controls in BRICS Countries

Measure/Countries	BRAZIL	RUSSIA	INDIA	CHINA	SOUTH AFRICA
Controls on capital transactions	Yes	Yes	Yes	Yes	Yes
Repatriation requirements	Yes	No	Yes	Yes	Yes
Controls on capital and money market instruments	Yes	Yes	Yes	Yes	Yes
Controls on derivatives and other instruments	Yes	No	Yes	Yes	Yes
Controls on credit operations	Yes	No	Yes	Yes	Yes
Controls on direct investment	Yes	Yes	Yes	Yes	Yes
Controls on liquidation of direct investment	No	No	Yes	Yes	No
Controls on real estate transactions	Yes	No	Yes	Yes	Yes
Controls on personal capital transactions	No	No	Yes	Yes	Yes

Source: https://www.elibrary-areaer.imf.org

TABLE 2: Contemporary Position of Capital Controls in ASEAN-5 Countries.

Measure/ Countries	INDONESIA	KOREA	MALAYSIA	PHILIPPINES	THAILAND
Controls on capital transactions	Yes	Yes	Yes	Yes	Yes
Repatriation requirements	Yes	Yes	No	No	Yes
Controls on capital and money market instruments	Yes	Yes	Yes	Yes	Yes
Controls on derivatives and other instruments	Yes	Yes	Yes	Yes	Yes
Controls on credit operations	Yes	No	Yes	Yes	Yes
Controls on direct investment	Yes	Yes	Yes	Yes	Yes
Controls on liquidation of direct investment	No	No	No	No	No
Controls on real estate transactions	Yes	No	Yes	Yes	Yes
Controls on personal capital transactions	No	No	Yes	Yes	Yes

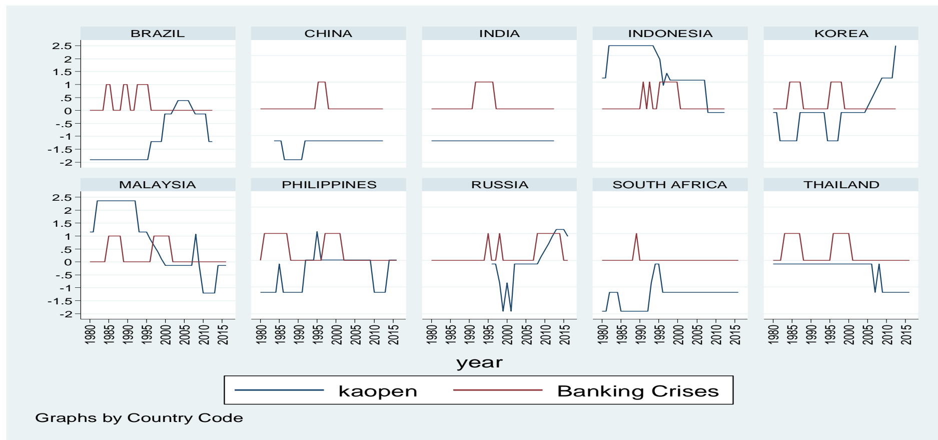
Source: https://www.elibrary-areaer.imf.org

In table 1 and 2 we study the current status of the capital controls in the nations under the study, where; yes indicates that the country had maintained the control on the transaction falling under the category and no means that restrictions are not imposed on the transaction (following this code various authors have developed the binary index for the capital account, (Abiad, Detragiache, & Tressel, 2008; Chinn & Ito, 2007; Fernández, Klein, Rebucci, Schindler, & Uribe, 2015; D. Quinn, 1997; D. Quinn, Schindler, & Toyoda, 2011). In table 1 we discern that amid the BRICS countries only Russia had lifted various controls and among the ASEAN5 countries Korea is most liberalized. All the South East Asian nations have lifted most of its controls from the direct investments.

4.1 Capital Account Liberalization and Crises in BRICS and ASEAN 5 Nations

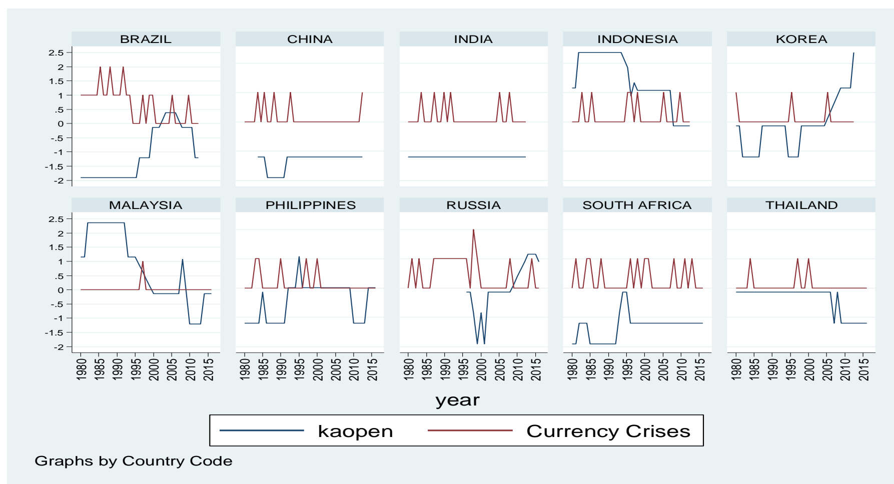
In the graphs 1 and 2 we study the nexus between the capital account liberalization and Banking and Currency Crises respectively for the BRICS and ASEAN 5 Nations. The definition and data for banking crises and currency crises was obtained from (Reinhart & Rogoff, 2009). The Banking crises episodes are defined evaluating the two broad events; first can be when there are major closures or mergers and amalgamation of one or two more financial institutions in the public sector (Government owned and controlled) and second when the banks are not restructured but government provides large-scale funds to multiple financial institutions. Currency crises episodes mark to the depreciation of domestic currency against pegged currency more than 15% or value of metallic currency reduces by 5% or a new currency replaces old depreciated currency. The presence of aforementioned episodes is than binary coded where, one means presence of crises and 0 means Absence of Crisis.

The definition and data for capital account openness has been adopted from (Chinn & Ito, 2008), who developed the index using principal component analysis for k1t (multiple exchange rate), k2t (transactions in current account), SHAREk3 (transactions in capital account), k4t (surrender of export proceeds0. The index is developed using binary codes; where 0 represents restrictive capital account transactions and 1 represents non-restrictive capital account transactions. This index takes the higher values as the economy gets more open to the cross-border capital transactions.



Graph 1: Capital Account Liberalization and Banking Crises

Source: The Data has been retrieved from http://www.carmenreinhart.com/data/ and (Chinn & Ito, 2008)



Graph 2: Capital Account Liberalization and Currency Crises

Source: The Data has been retrieved from http://www.carmenreinhart.com/data/ and (Chinn & Ito, 2008)

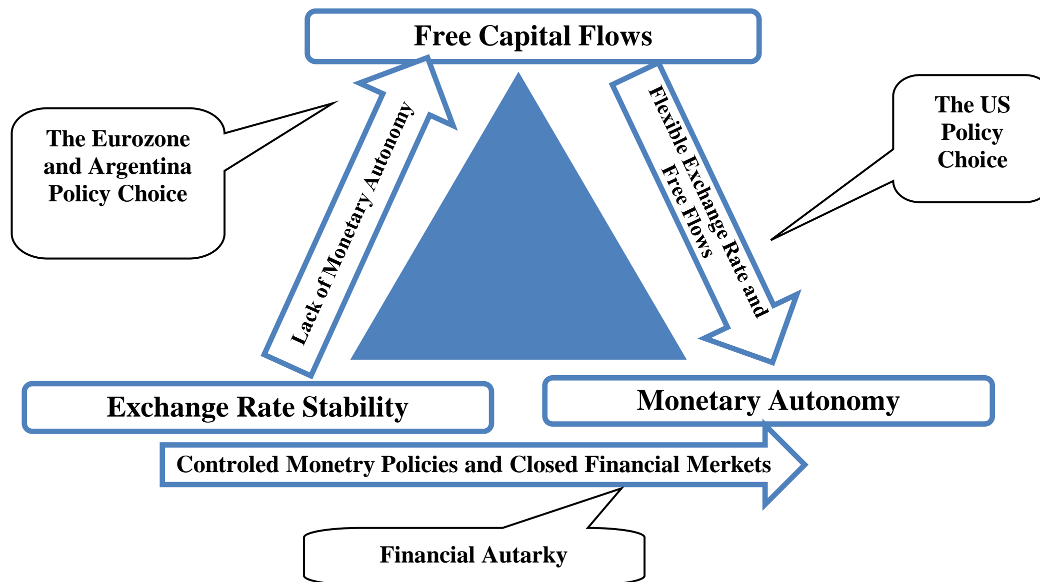
Graphically evaluating the relationship between CAL and Banking Crises we observed that with the increase in liberalization the episodes of banking crises have dropped. It can be seen that among the BRICS nations post crises reregulation of financial sector is undertaken, but the crises events still occurred, therefore nations partially liberalized the capital account. After year 1995-2000 banking crises among the BRICS nations are not evident as they followed sequential pragmatic approach towards liberalization (Prasad & Rajan, 2008). But the scenario is different in ASEAN-5 nations, which witnessed banking crises episodes immediately after liberalizing the capital account. Multiple episodes of crisis can be seen in graph 1 during the period between late 1980's and early 2000's. Except Korea the other four nations reregulated international capital movements. Among the ten nations Korea and Russia are majorly liberalized economies.

In case of the Currency crises among the BRICS nations in graph 2 we can observe that there are multiple episodes of currency crises, but in the recent time china had least episodes of currency crises, whereas Brazil, India and South Africa had witnessed many episodes of currency crises during the period from 2005-2015. Among the ASEAN-5 countries Malaysia had the least episodes of currency crisis followed by Korea, Thailand and Philippines. Indonesia had maximum events of currency crisis and off lately suffered 2 episodes during 2005-2015. The graphic representation shows no correlation between liberalization of capital account and currency crisis.

5. FIXED CURRENCIES, MONETARY POLICY INDEPENDENCE & CAPITAL ACCOUNT

LIBERALIZATION: "THE IMPOSSIBLE TRINITY" TO THE "TRILEMMA"

The Mundell-Fleming model is a shift of traditional IS-LM model of closed to open economy, studying the relationship between the nominal exchange rate system and the output produced in an economy in a short-run. The model is used to argue that the three pillars of the trinity can't uphold in a chorus. The 'Trilemma' is the assertion that a nation can simultaneously choose only two out of the below mentioned three policies in figure 2. The putative tenet by the policy makers is that the combination of the open economy, monetary autonomy and a fixed exchange rate regime can't be held together (failure of the Bretton wood System), but combination of two is possible (Mohan & Kapur, 2009). To have a stable economic growth and smooth financial system nations should achieve price stability, financial stability and the economic stability. The international capital flows impacts the economic situation and the financial condition of the nation. The basic purpose is to keep the economic growth on the track, which gets boosted by international capital flows, cross border trade and independent polices but (Minsky, 1993) raised the question of financial instability, that may increase with the new innovated financial products made available in the market. Basically the nation's economic, financial and monetary policy (Mohan & Kapur, 2009) should be such that it can dampen the instability in system. The different polices of the Mundell's Impossible trinity are Free Capital Mobility, Exchange Rate Stability and Monetary Autonomy.



Source: (Aizenman, 2013) and Authors Presentation

FIG. 1. The Impossible Trinity

The Nations in past had tried to achieve the combination of at least two out of the three policy goals, to recover and prevention from crisis and the economic events, forming the different systems like, The Bretton Wood System- focusing on the monetary autonomy and the exchange rate stability and The Gold Standard System- Free capital mobility and exchange rate stability.

The Bretton wood system got failed when the countries moved to floating exchange rate from fixed exchange rate system. But in the post-Bretton Woods era developed world on one hand moved to the floating exchange rate to manage the open economy and independent monetary policy and the other economies adopted the hard peg for exchange rate management (one of the major reasons for the 1997-98 Asian Currency Crises). Keeping this trilemma into focus, international policy makers have mentioned the transformation from Impossible Trinity (Fixed Exchange Rate, Free capital Flows and Independent Monetary Policy) to Holy Trinity (Price Stability, Sovereign Debt Sustainability and Financial Stability).

The policies of the holy trinity triangle are supportive to each other at normal times and behave differently at the time of crisis and works for sustainable economic growth. But in the short-term to achieve a complete harmony between three policies is difficult. To maintain the economic growth, financial system needs to be sound with the controlled inflation and market forces at place. Perplexingly the policies of holy trinity work in their own way during the different economic situations. The price stability and financial stability interaction works with the sound monetary policy, sustainable and steady economic growth and low inflation over the period. But during the previous crises these policies didn't complimented each other. The reverse interaction involves the easing of the monetary policy, but ended in the increase in inflation and jeopardizing policies in the future. The next interaction moves between financial stability and sovereign debt sustainability. In the difficult times for a nation the revenues are falling, leading to sovereign indebtedness, and failures of institutions resulting to larger financial gap which forces the government to borrow. The ways the private sector helps in funding the government, to bring the sovereign debt at the sustainable levels. It further takes into consideration the Long-Term refinancing Operation which in turns brings arbitrage opportunity. But if value of the bonds declines the banks need to bring the additional capital, therefore shaking financial stability. The next connection is midst the Sovereign Debt sustainability and price stability, which involves Open Market Operations (OMOs) bringing in autonomous Monetary and expansionary Policies. They are quasi fiscal measures which may shake price stability. The reverse relation between the price stability and government debt sustainability is about the level of inflation and rising interest rate, raising the cost of debt for government. So the policy makers need to balance these policy linkages for maintain the growth and avoid crises.

6. CONCLUSION

In the paper we had studied the phenomena of the capital account liberalization, risks and benefits associated with the same. The present restrictions maintained by BRICS and ASEAN 5 nations on the capital Account Transactions using IMF's Annual Report on Exchange Arrangements and Exchange Restrictions was evaluated. Overall all the 10 nations under the study have maintained the controls upon the capital movements. Among the BRICS and the ASEAN 5 nations the Repatriation Requirements are restrictive except Russia, Malaysia and Philippines. The controls on Money Market and Capital Market Instruments are imposed by all the ten economies. Except Russia, all the other nations have maintained controls on the Derivatives and the other instruments. The controls on Credit Operations are maintained by 8 nations and Russia and Korea have liberalized these controls. The Direct Investments are restrictive in all the 10 nations. Except India and China all the other eight nations have liberalized the controls on the Liquidation of Direct Investment. The controls on Real Estate Transactions are lifted by Russia and Korea, where as the other nations have restrictive real estate transactions. Brazil, Russia, Indonesia and Korea have liberalized the controls on the Personal Capital transactions. Thus among the BRICS and ASEAN 5 nations, Russia and Korea are more liberalized than the other economies in the sample.

The collapse of the BrettonWoods agreement and moving to the floating exchange regimes required the economies to remove the restrictions on the capital movement and facilitate free trade between the nations. The capital flows around the globe had increased rapidly since 1990. The BRICS and ASEAN nations are reforming their domestic economic policies so as to integrate with the world economy. Detractors have blamed capital account liberalization as being the root cause of financial crises. As per them it is difficult to find persuasive evidence that financial integration boosts growth. Sound macroeconomic policies, and quality of corporate governance if controlled effectively, than the CAO lead to growth. The international capital flows are highly sensitive to the macroeconomic policies of the nation and the benefits are associated with the soundness of the monetary, fiscal and the political developments. There is no strong evidence that higher and free capital mobility fuels economic growth in the emerging economies. Even with the larger exposure to crises, the evidence suggests that the net effects of financial globalization are still positive, at least in the long run. The main challenge for policy makers is to manage the integration process as to take full advantage of the opportunities, while minimizing its risks.

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