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Management of Capital Flows:

Comparative experiences and implications for Africa

Introduction and Summary

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INTRODUCTION AND SUMMARY

The issue of management of capital flows has been brought into sharp focus by bouts of financial crises in the developing world and emerging market economies. Before the outbreak of the financial crisis in East and South-East Asia in 1997, the newly industrializing economies in the region were considered to be showcase models of development. Many researchers studied appropriate ways to replicate their performances in other regions. The UNCTAD secretariat also undertook intensive research on what were seen as successful development strategies in East Asia, and reported its analytical findings in the *Trade and Development Report (TDR) 1996*. However, as the crisis persisted and its contagion spread, both within and beyond the region, a heated debate emerged about the appropriateness of their development strategies in the context of the increasing international mobility of financial capital.

The UNCTAD secretariat has been closely following this debate; its analysis of the Asian experiences during and after the crisis were presented in *TDR 1998*, with the aim of drawing lessons to help contribute to the design of appropriate policies in other developing countries. Part two of that report, entitled *African Development in a Comparative Perspective*, sought to examine development strategies and growth performance in African countries in the light of the East Asian experience.

Increasing international mobility of private financial capital is a major aspect of the contemporary global economy, where the volume of international financial transactions far exceeds that necessary to finance trade and investment. Efforts to integrate the African region into the global

financial system, and to attract private flows through rapid liberalization of the capital account, have resulted not in increased inflows of such capital but in greater volatility, with attendant consequences for exchange rate instability and misalignments. A number of countries in the region experienced considerable financial instability and payments difficulties, but these were given little attention by the international community largely because, unlike the financial crises in the emerging markets of Latin America and East Asia, they did not pose a serious threat to the stability of the international financial markets.

Given this situation, the UNCTAD secretariat considered it useful to take stock of the financial policies and capital account regimes within the region of sub-Saharan Africa (SSA), and to draw appropriate lessons from the ways in which the capital account in other regions was managed. For this purpose, seven papers were commissioned by the secretariat and discussed at a workshop organized by UNCTAD and hosted by the Government of Egypt in Cairo on 20–21 March 2001. The workshop was attended by policy makers from a selected number of low- and middle-income African countries, many officials and experts from the public and private sectors in the host country, as well as representatives from some international organizations. The aim of the workshop was to enhance understanding of the complex relationship between external financing, capital account regimes, macroeconomic policies, and trade and development. Furthermore, it sought to promote dialogue between the researchers (both from developed and developing countries) and African policy makers and to help strengthen the policy relevance and analytical basis for the future work of the UNCTAD secretariat with regard to African growth and economic development.

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Three sets of issues emerged from the discussions at the workshop:

(i) The need for and role of foreign capital in developing countries;

(ii) How to manage the capital account so as to limit the potential damages caused by the instability of international capital flows without reducing the ability of developing countries to supplement their domestic resources with foreign capital; the latter, through access to international financial markets, necessary for faster accumulation, growth and development; and

(iii) The role of financial institutions, and the possible contribution of global standards and codes on governance, competition and transparency in promoting stability and growth.

While there was a convergence of views in a number of areas, considerable differences emerged regarding the contribution of domestic institutions and policies on the one hand, and external factors on the other, to accumulation, growth, financial instability and crises in emerging markets.

Two main reasons for reliance on foreign capital were suggested: for closing the resource gap and for transfer of technology. It was also pointed out that a reliance on transnational corporations might be necessary for establishing linkages with global production networks and access to financial markets. However, in all these respects, it was recognized that considerable differences existed among developing countries in their need for foreign capital as well as in the policy approaches pursued.

It was generally agreed that, while there was a need to fill the resource gap through capital inflows in Africa, and in other regions where income levels were too low to generate adequate domestic savings, this was not the case for a number of East Asian countries where savings rates were over 30 per cent of gross domestic product (GDP). Again, for many middle-income countries with per capita incomes of over $3,000, there was considerable scope to increase self-reliance by raising domestic savings. It was therefore counterproductive for such countries to pin their hopes on

foreign capital. Furthermore, successful growth and development often entailed reducing dependence on capital inflows. This was the case in East Asia, but not in Latin America and Africa, where savings rates remained low even when these regions were experiencing relatively high growth rates in the 1960s and 1970s.

On the type of capital inflows needed, there was a broad preference for greenfield investments, as opposed to either mergers and acquisitions of existing assets, or financial inflows of a speculative nature. It was noted that the motive pursued by foreign capital was profits, and not development, and that these objectives did not necessarily coincide. Hence there was the need to place policies on foreign direct investment (FDI) into a broad development strategy, and to retain policy autonomy in this respect. With regard to conditions that attract FDI, particularly in the traded-goods sector, it was broadly believed that, except for a few countries rich in natural resources, the SSA economies did not have the requisite human and physical infrastructure and institutions needed to attract FDI, and that foreign capital inflows to develop such conditions were unlikely.

It was argued that capital account liberalization was neither necessary nor sufficient to attract foreign capital. China was held as an example of a country that was receiving large amounts of greenfield FDI without pursuing an open capital account regime while many countries in SSA were receiving very little despite a rapid liberalization of their capital account. And some Asian countries, notably the Republic of Korea, drew on funds from international capital markets in the early stages of industrialization, while retaining strict controls over capital flows. On the other hand, while it was pointed out that liberalization of the capital account could bring some of the flight capital back to SSA by allowing it to re-exit, it was also noted that a considerable amount of flight capital had little to do with economic incentives. Further, capital account openness allowed leakages by the residents even in the absence of a serious distortion of incentives.

There was also general agreement that official financing should play a greater role in SSA. The Heavily Indebted Poor Countries (HIPCs) Initiative was seen as having fallen short of expectations. The process was tedious, burdened by excessive conditionality, requiring too much effort and time

on the part of debtor countries, and diverting a handful of skilled people to endless preparations and negotiations with little benefit at the end.

On the management of the capital account, there was broad agreement that developing countries needed strategic, as opposed to full, integration into the international financial system. The degree and pattern of integration would vary according to the level of economic and institutional development. The experiences of various countries in Asia, including China, India, Malaysia and the Republic of Korea, showed that successful management of the capital account required a policy approach that differentiated between:

- sources/types of capital (such as FDI, loans, and portfolio and equity flows);
- different maturities;
- different domestic uses;
- actors (residents versus non-residents; different types of borrowers such as banks and non-bank corporations); and
- inflows and outflows.

There was also agreement that in terms of its macroeconomic effects, dollarization (or use of foreign currencies in current and capital transactions among residents) was not very different from capital account liberalization.

A discussion on the role of sequencing in capital account liberalization noted that there are several approaches to the concept. One approach emphasizes sequencing of liberalization among different spheres of economic activity (e.g. trade, domestic financial sector, current account and capital account). In the sphere of finance, a distinction was made between different types of capital flows in the liberalization process (such as FDI, long-term borrowing and short-term flows). Another approach finds it necessary to sequence capital account liberalization.

The relationship between exchange rate policies and capital flows was also discussed. While it was agreed that the kind of exchange rate regime adopted has important implications for capital flows, it would be

difficult to address the question of what constitutes an appropriate exchange rate regime without reference to the underlying regime of the capital account. Attaining exchange rate stability under an open capital account regime by fixing or floating the currency against major reserve currencies is not easy. Again, it was emphasized that effective management of capital flows and the exchange rate also depends on fiscal discipline and the level of indebtedness of the public sector.

The question was raised as to whether some countries may have gone too far in capital account liberalization and whether it was possible to reverse this. While it was felt that restrictions and control in times of crisis may not work, paradoxically governments did not have the incentive to adopt such measures during good times.

The role of regional cooperation for greater financial and exchange rate stability was also taken up in the context of management of the capital account. The Chiang Mai Initiative in East Asia was seen as a small but important step towards greater cooperation. It was also noted that the experience of the European Union provided some important lessons in this respect.

Discussions around the role of institutions and global standards and codes drew significantly on the East Asian experience in the context of the financial crisis of 1997–1999. It was observed that there was a tendency to explain every crisis *ex post* by ad hoc arguments. The debt crisis of the 1980s was attributed to excessive government spending and borrowing. The orthodox view was that external debt and deficits associated with a private savings gap should not be a cause for concern. But this view had been quickly discredited by the Mexican crisis, which occurred against a background of budget surplus. The new explanation was that capital flows had been used for consumption rather than investment. But this view too had to be revised after the East Asian crisis, where much of the private borrowing went into investment. This had prompted suggestions that corruption and cronyism (attributed to government failure), led to unproductive investment. It had been argued that, although policies and institutions mattered, it often took a debtor and a creditor to create a bad debt and a financial crisis. Even developed countries with sound financial

institutions and policies, such as Sweden, had been seemingly hit by international speculators.

While weaknesses in corporate governance and financial institutions may often lead to unproductive and excessive investment, whether an investment is good or bad also depends on the perceptions of markets and the macroeconomic environment. When overall economic conditions change, an investment that initially looked profitable to creditors and investors may cease to be viable. Financial bubbles, as occurred in the information technology (IT) sector of the United States in recent years, were often created as a result of such investment.

On the nature of discipline that financial markets exert over policy makers, it was argued that financial market pressures can have an adverse impact on stability and growth. Herd behaviour in these markets, and surges in capital inflows, can support unsustainable policies, leading eventually to currency appreciation and large external deficits. Financial markets can also put pressure on countries with sound fundamentals through contagion.

It was pointed out that there is no single set of institutions for the financial sector and for corporate governance that can be appropriate for all countries. Different models, such as the Japanese, German and Anglo-American systems of finance and corporate governance, may be appropriate under difference circumstances. Each has its positive aspects and its drawbacks, and the international community needs to be aware of the risks of promoting any single model through new sets of international codes and standards.

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This volume contains seven papers by researchers commissioned by the UNCTAD secretariat. The original papers were presented at the Cairo workshop, and were subsequently revised and updated by their authors following the workshop, in the light of the discussions held there. The major elements and general findings of these papers are presented below.

To place the present debate on financial policies and current account regimes in the wider development context, particularly that surrounding the need for improved management of increasingly globalizing trade and investment, the first paper covers a range of issues concerning corporate governance, competition, the new international financial architecture and large corporations in emerging markets. Of the remaining six papers, four examine the experiences of economies in East and South-East Asia and those of the Organisation of Economic Co-operation and Development (OECD). These experiences may provide useful lessons to policy makers in the SSA countries. Finally, two papers are concerned with an analysis of the situation in the SSA region, particularly with respect to internal management (i.e. macroeconomic policies related to public debt owed to the domestic and foreign sectors) and external management (i.e. wide-ranging financial policies related to external account issues).

In their paper entitled *Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in Emerging Markets*, **Singh, Singh** and **Weisse** examine, from the developing country perspective, important analytical and policy issues arising from two major trends: the current international discussions about corporate governance in relation to proposals for a new international financial architecture; and changes in the international competitive environment as a result of a spate of corporate mergers in advanced countries. The background to the current international discussions is the emergence of corporate governance as a key issue in the current G-7 proposals for a new international financial architecture. This emphasis by the G-7 can be traced back to the thesis that the "deeper" reasons for the Asian crisis lay in the microeconomic behaviour of corporations and businesses in the affected countries. Alleged failings in their corporate governance mechanisms and distortions of their competitive processes have been subject to particular scrutiny in such analyses.

The international competitive environment is changing rapidly, as large corporations in the industrialized countries are in the process of potentially "cartelizing" the world marketplace through numerous cross-border mergers and takeovers. This trend raises serious policy concerns for developing countries. The authors' main conclusions are the following. First of all, the thesis that the deeper causes of the Asian crisis were flawed systems of corporate governance and a poor competitive environment in the affected countries is not supported by evidence. Secondly, the Anglo-Saxon model of widely-held corporations with dispersed share ownership is the exception in developing countries and in much of continental Europe. Empirical evidence suggests that emerging markets, as well as European countries such as Germany, Italy or Sweden, have successful records of rapid, long-term growth with different governance systems to those of the Anglo-Saxon countries. Thirdly, empirical evidence does not support the view that the Asian crisis of 1997–1999 was caused by crony capitalism. Fourthly, corporate financing patterns in emerging markets in the 1990s were broadly similar to those observed in the 1980s. Unlike their counterparts in the industrialized countries, large, developing-country firms continued to rely overwhelmingly on external sources to finance their growth. Finally, challenging the widely held claim that developing country conglomerates are inefficient, financially precarious and necessarily create moral hazard, the authors argue that market competition in emerging market economies is no less intense than in the industrialized economies.

In their paper, *The OECD Experience with Capital Account Liberalization*, **Griffth-Jones, Gottschalk** and **Cirera** discuss the OECD Code of Liberalization of Capital Movements, which aims to promote capital account liberalization among the OECD member countries. Their analysis of the Code and, more generally, of the OECD experience with liberalization, leads the authors to identify three major historical trends. Initially, liberalization in the OECD area was very gradual, but speeded up in the 1980s and 1990s. During the first 25 years, the process was sequenced, with long-term capital flows being liberalized first and short-term flows only much later, in the 1980s. Acknowledging the diversity among the OECD member countries, the process initially allowed middle-income member countries to pursue liberalization more gradually than the industrialized countries. However, this changed later, with new members – all

from emerging market economies – facing requirements for much more rapid liberalization as a prerequisite for membership of the organization.

Although they do not ascribe a mechanistic causal link, the authors raise the concern that, of the six emerging market countries that joined the OECD in the 1990s, three had a large and costly currency crisis shortly after they joined. This should be seen as a warning of the risks of an internationally agreed framework on capital account liberalization, even if it is carefully designed, for the purpose of supporting orderly liberalization. If a divergence of interests exists among member countries, rather than guaranteeing orderly liberalization, such a framework may result in one group of countries imposing the objective of full capital account convertibility on a wide range of countries, most of which are still unprepared for undertaking such a step. The authors conclude that whilst there has not been significant progress towards creating a new international financial architecture that could help avert currency crises or make them less costly, the decision on the pace and timing of capital account liberalization should be left to individual countries.

In her paper on *Management of the Capital Account: A Study of India and Malaysia*, **Rajaraman** compares and contrasts the approaches of these countries to capital account management, which, although widely different historically, have arrived at a remarkable convergence following the East Asian crisis of 1997. The author seeks to demonstrate that there are advantages in not requiring a monotonic transition to capital convertibility. Though the paper does not recommend a reversal of convertibility for non-resident capital, which has damaging effects on a country's reputation, it does argue that retention of rights of sovereign control over resident capital is essential for macroeconomic control over the real sector. In countries with institutional weaknesses in the financial sector, it is damaging to focus on the gains of free capital flows without giving adequate attention to the institutional consolidation that would prevent a recurrence of episodes of volatility.

India and Malaysia are quite disparate in terms of long-term rates of growth and their degree of openness. Malaysia accepted Article VIII status under the IMF (current account convertibility) in November 1968, and the

Malaysian ringgit was floated along with major world currencies in 1973. India, by contrast, accepted Article VIII status only in August 1994, following a single floating rate for the rupee in March 1993. The Malaysian export/GDP ratio equals, or actually exceeds, 100 per cent. India on the other hand has an export/GDP ratio at the 11–12 per cent level. The Malaysian response to the currency crisis of 1997 backtracked on what had been one of the longest traditions of openness on current and capital accounts in the developing world. As the capital outflows from Malaysia reached crisis levels, the country famously imposed capital exit barriers, and a policy of lower interest rates that ran directly contrary to the policy proposed for other East Asian countries similarly afflicted. The Indian external liquidity crisis in mid-1991 on the other hand, when foreign reserves fell to an all-time low of $1 billion, led to the gradual opening up of the Indian capital account. In both countries today, non-resident capital inflows enjoy full freedom of repatriation. In Malaysia, a vestigial 10 per cent exit levy on portfolio capital gains repatriated within a year after entry was removed in May 2001. Capital outflows for corporate residents are permitted within prescribed limits, but all other outflows of capital by residents are banned.

There is a lesson in this policy convergence of the two countries with very disparate points of origin in terms of macroeconomic openness. Malaysian policy, whether during the 1993 capital surge, or after the 1997 capital outflow, has demonstrated the benefits of imposing temporary reversals of freedom of cross-border capital flows on residents. The paper examines in detail what has been done in both India and Malaysia, in terms of controlling the quantum and the composition of capital flows, in the context of the exchange rate regime in each country. The author concludes with a look at the likely future direction of policy towards the capital account.

In his paper entitled *China: Managing Financial Integration*, **Ge** explains that the Chinese economy exhibits many characteristics similar to those of the Asian countries that were affected by the financial crisis, particularly in terms of weaknesses in the financial and corporate sector. Despite this, China not only survived the worst external shock since its integration into the world economy – a process that began in 1979 – but actually achieved a very impressive rate of growth. The value of the Chinese

currency remained stable as did net capital inflows. How did China manage to accomplish this feat? Put more generally, given all the recognized structural and institutional weaknesses that characterize developing countries and economies in transition, how may a smoother process of economic integration and liberalization be facilitated, while minimizing the potential costs? The author explores this question in the context of the Chinese economy. His study is concerned mainly with the essential issues concerning financial sector reforms and capital account management.

Following a brief overview of China's economic transition since 1979, he examines the changing patterns of capital flows into China. He then goes on to discuss some of the critical elements and mechanisms that prevented China from being dragged into the Asian financial crisis, including restructuring of the financial sector, the exchange rate system and management, and the structure and operation of equity markets. Ge concludes with comments on some potential impacts on China following its entry into the World Trade Organization.

Lee, in his paper on *Post-Crisis Financial Reforms in the Republic of Korea*, examines the changes in policy measures aimed at applying global standards to Korean financial restructuring efforts after the financial crisis. He points out that existing global standards do not cover all areas, and, where applicable, they are not applied uniformly. Furthermore, the paper stresses that the various ramifications resulting from adjustment should be taken into consideration in the implementation of financial sector reforms. The author draws several important lessons, including cautioning against a heavy reliance on the external sector as a source of funding for carrying out the needed restructuring of the domestic financial sector.

Public Debt and Macroeconomic Management in Sub-Saharan Africa by **Rwegasira** and **Mwega** focuses on external debt and its servicing, which pose a major problem in SSA, causing a negative impact on investment and growth. The region's external debt almost doubled between the mid-1980s and late 1990s. Its external debt as a proportion of GNP and exports was nearly twice the average for all developing countries, although the external debt service ratio was lower due to the concessional terms of much of its borrowing. Some SSA countries have also accumulated substantial

domestic debt since the mid-1980s (e.g. Cameroon and Côte d'Ivoire), which has further aggravated their external balance.

The authors suggest that there is a correlation between the fiscal position of SSA Governments and the evolution of the external debt ratio. They point out that there are clear limitations and trade-offs with respect to the various fiscal deficit financing methods. Empirical studies, for example, show seignorage revenue to be relatively modest, while domestic borrowing through the sale of securities is constrained by weak capital and money markets (with a few exceptions such as those of Côte d'Ivoire, Kenya, Nigeria and Zimbabwe). Deficits have also been financed, in part, by proceeds from the sale of assets (e.g. privatization proceeds) and through payments arrears (i.e. delayed payments for goods and services).

The authors argue that public debt has specific implications for macroeconomic management and monetary policy. Large fiscal deficits, for example, undermine the two competing objectives of exchange rate policy: control of inflation and improvement in external competitiveness. This is compounded by feedback effects on the budget deficit from changes in the exchange rate. Since the late 1980s, many SSA countries have also liberalized their financial systems. However, these reforms have been undertaken in the context of pervasive macroeconomic instability, contrary to the consensus on the appropriate sequencing of such reforms. Between the 1970s and 1990s there has been an increase in the volatility of international capital flows and in the terms and conditions on which external finance has been available. The causes range from changes in donor sentiments to disagreements on policy conditionalities. In addition, swings in private capital flows may have significant implications on key macroeconomic variables, notably the exchange rate and interest rate. The authors conclude that an opening up of the capital account is likely to render the SSA economies even more vulnerable to these adverse external developments.

In his paper on *Capital Flows, Capital Account Regimes and Foreign Exchange Regimes in Africa*, **Ndikumana** first examines capital account regimes in African countries over the past two decades. Evidence shows that official lending to Africa has declined. At the same time, the volume

of private capital flows remains low, and significantly below the levels observed in other developing regions. The author argues that since private capital inflows to Africa are limited, due to factors such as weakness of the macroeconomic environment, underdeveloped financial systems, high country risk, and exchange rate misalignments, policy reforms for overcoming the shortage of development finance must be focused on alleviating these constraints.

The author discusses motivations for capital account restrictions in Africa and highlights recent reforms in capital account regimes there. While many African countries have pursued reforms aimed at liberalizing their capital account and exchange rate regimes, such liberalization has not always resulted in income growth, price stability and trade performance. He argues that African countries need to give serious attention to the scope, speed and sequencing of capital account liberalization to minimize the potential adverse effects of openness. It is desirable for countries to maintain selective discretionary control over capital movements and foreign exchange markets in order to hedge against adverse shocks to the economy and maintain macroeconomic and financial stability. To attract foreign capital, any move towards capital account openness and exchange rate liberalization must be supported by reforms aimed at improving the credibility of macroeconomic policy and establishing an investment-friendly environment. These reforms will not only attract foreign capital, but also encourage domestic investment.

An important aspect of capital movements in Africa is the high level of capital flight. There is an urgent need for policies to stem further capital outflows from Africa and induce the repatriation of private capital held abroad. This will require not only improvement in the macroeconomic conditions to ameliorate incentives for domestic investment, but also reform of the political and legal systems to improve accountability and credibility of economic policy. Exploring the implications of recent exchange rate regime transitions for capital mobility and economic performance, the author discusses motivations, advantages, and disadvantages of dollarization or "euroization" in the context of increasing financial integration. ■