

Policies for the Capital Account in Developing Countries

Benefits and Costs of International Financial Integration

- 21 Capital flows internationally with or without governmental controls over the capital account. Increasing numbers of countries have opted for full capital account convertibility and integration with global capital markets. This is a clear policy option for all developing countries today.
- 22 The principal gains from capital account liberalisation at the national level, and from global financial integration more generally, are those deriving from the increased efficiency of both national and global capital markets that they can create. By easing or removing constraints on private decision-making, governments permit private agents to make savings and investment decisions on a freer basis. The result should be a less “distorted” decision-making process both within individual liberalising nations and at the global level. Within the relatively capital-scarce developing countries (no less than elsewhere) this can be expected, in the best-case scenario, to include greater international portfolio diversification for their own investors; greater diversification of capital sources on the part of their public and private borrowers; greater competition and thereby increased efficiency for their financial services sectors; deeper financial markets and the increased efficiency of intermediation that it brings; and greater domestic savings and investment. These potential advantages are great enough to motivate open capital accounts in the OECD and to inspire most countries to declare capital account liberalisation to be an ultimate objective, whatever their current practices. But none of these potential gains are assured, and capital account liberalisation also involves risks and potential costs.
- 23 Firstly, capital account liberalisation would mean that domestic monetary authorities would have less room to pursue monetary policies independently of international interest rates.
- 24 Secondly, liberalisation of capital outflows would mean that domestic savings would no longer be available solely for the purpose of domestic investment. An older literature has long argued that the potential vulnerability of developing countries’ external payments positions or exchange rates to volatile private expectations should make capital account outflows the very last to be liberalised (e.g. Williamson, 1991).
- 25 Thirdly, there is by now plenty of evidence that developing countries can encounter severe macroeconomic management problems, even financial crises, as a consequence of surges of private capital flow which are presumably more likely to occur when capital flows are “freer”. According to much current wisdom, it is critically important for development that countries maintain a stable and appropriate real exchange rate, and thus a stable and sustainable current account, as well as a reasonably stable macro economy. Such stability is seen by many as more important for the achievement of an adequate level

and efficiency of investment than the details of incentive structures which purport to have micro-economic efficiency benefits. For this purpose, it may be desirable to moderate overall capital flows that are not driven by long-term economic fundamentals, and thus attempt to influence the composition, as well as the overall size, of capital flows so as to achieve more stable and more productive inflows. In the face of the limits to the efficacy, in terms of macroeconomic management objectives, of the available fiscal, monetary and exchange rate policy instruments, the monetary authorities of many developing countries have sought to deploy direct and indirect controls over private international capital flows as additional macroeconomic policy instruments. Such capital controls typically seek to alter the pace or composition of private capital flows. Further measures to restrain expansion of consumer expenditures which might otherwise be associated with capital inflows (and, in many cases, with import liberalisation) may also be considered appropriate, e.g., limits upon domestic consumer and mortgage credit, or compulsory private savings programmes (McKinnon and Pill, 1995). These may be able to reduce the prospect of credit-driven booms in private consumption of the recent Mexican type².

26 Fourthly, increased openness in the capital account may involve domestic banks and other financial institutions in increased risks, both because of increased deposit volatility and because of increased foreign exchange risk. Capital account liberalisation therefore is likely to require

prior strengthening of prudential supervision and information disclosure.

27 Capital account convertibility is obviously not a matter of all or nothing. Some types of transactions may be free while others are not; and the tightness of restrictions may vary in the same country over time. In this respect, as in trade policy and the analysis of the current account, "openness" can have a variety of interpretations. There is as yet no agreed way of measuring the degree of openness in the capital account (Montiel, 1994)³. For the present, there seems little alternative but to rely on descriptive accounts, such as the IMF offers in its Annual Reports on Exchange Restrictions, for data on the extent of capital account convertibility and changes therein.

28 Direct regulation of international capital flows, both inward and outward, has evidently been common in developing countries. A summary of existing capital controls in 155 developing countries, based on IMF data, is shown in Table 4. Of the 155 developing countries surveyed by the IMF, 119 employ some form of control over international capital flows, although 75 have accepted Article VIII obligations in respect of the current account. (For further discussion of the IMF Articles, see Section 4(c).) The forms of these controls are numerous and the degree of their use varies greatly both across countries and over time. Some may be motivated more by the need to monitor than the desire to restrict. Table 4 shows that regulation of outward flows has been considerably more frequent than that of inward flows. Regulation of

2 Mexican private savings fell from 15.5 per cent to 7.7 per cent of GDP in the 1989+93 period (Schadler *et al.*, 1993).

3 There is no agreed method in the current or trade accounts either but there is a much more extensive empirical literature on the subject, including an important (and remarkably under-cited) one that finds little correlation among alternative such measures (Pritchett, 1991). There seems to be some consensus on the use of the percentage premium on the black market as against the principal official exchange rate as a measure (at least in an ordinal sense) of the strength of overall foreign exchange controls or official currency misalignment.

outward flows also has a longer history and remains fairly pervasive. Restrictions on residents' external investments and holdings of foreign currencies are frequent, at least in the form of upper limits, often based purely on prudential objectives, on the proportion of total assets that financial institutions may place abroad. Of inward flows, FDI is much more frequently regulated than purely financial flows. But there is evidently increasing interest in and resort to controls over the latter. In general, positive lists (in which only those transactions listed are "free") are more restrictive than negative lists (in which only those activities listed are restricted, regulated or prohibited).

detailed composition of such capital flows. Informed analysts conjecture that much of what is at present recorded as private "transfer" in some African countries is actually more appropriately categorised as private capital flow, quite probably quickly reflected in real investment (Kasekende, Kitabire and Martin, 1996). If the authorities do not know which flows are which, they will obviously face great difficulties in developing appropriate policies. Indeed, in some developing country circumstances, authorities are said to be inhibited in their attempts to collect more accurate information on private capital flows by their fear of frightening market participants, discouraging real investors and stimulating undesired outflows (ibid.).

Influencing the Composition of Inflows

29 There seems to be general agreement that some forms of external private capital inflow are more attractive to the recipient country than others. From the standpoint of future macroeconomic stability, longer-term and more stable inflows of capital are better. This would suggest a preference for longer-term investments – in long-term loans, equity and/or in the form of FDI⁴, particularly that which takes the form of physical flows of capital goods. Such flows are more likely to be based on long-term economic fundamentals and should be less susceptible to short-term volatility. (Some "reliable" development assistance may also carry these desirable attributes.)

30 Categorisation of portfolio capital flows, however, is often difficult. In some sub-Saharan African countries, for instance, the authorities have little idea about the

Short-Term versus Long-Term Flows

31 Short-term capital inflows (and outflows) have been an important element in the recent experience of many developing countries (including Thailand, Malaysia and several sub-Saharan African countries, where such flows have dominated). These include:

- ❖ short-term external borrowing (lending) by domestic commercial banks or other local firms;
- ❖ increased (decreased) non-resident holdings of domestic currency deposits in local banks;
- ❖ sales (purchases) of short-term money market instruments to (by) non-residents;
- ❖ reduced (increased) resident holdings of foreign currency deposits (where these are allowed); and

⁴ There may be significant differences within items which are categorised similarly. Under the heading of long-term loans, for instance, East Asian borrowers averaged bond maturities of nearly 12 years in 1995 whereas Latin American borrowers averaged only 3 years; and Latin American spreads over comparable government benchmark bonds were nearly three times as high as East Asia's (World Bank, 1996, p.11)

- ❖ swap transactions – sales (purchases) of foreign currency simultaneously unwound by forward market contracts.
- 32 Some of these flows may be directly related to real international trade in goods and services. A high proportion, however, may be unrelated to any real transactions, whether international or domestic. If so, they may be highly volatile. In Zambia in the late 1980s, for instance, there were sharp reversals in the direction of such flows involving year-on-year changes amounting to 6-8 per cent of GNP (Kasekende *et al.*, 1996).
- 33 Unfortunately, it is often difficult to distinguish flows that are related to real transactions from purely financial ones, or short-term from long-term flows. Korea has consciously tried to treat capital account transactions related to real investments differently from (more liberally than) purely financial transactions but this is inherently very difficult. Over many years, it has proven difficult even to distinguish current from capital transactions.
- 34 Long maturity external obligations may seem, in principle, less vulnerable to volatility than short maturity ones; but if there are active secondary markets, long maturities may be highly liquid. Longer maturity instruments are thus not necessarily less volatile in their short-term behaviour than nominally short-term ones (Claessens *et al.*, 1995). According to the IMF, “financial asset flows have become increasingly fungible ... [making it] more difficult for ... countries ... to maintain the effectiveness of their controls” (IMF, 1995d, p. 18). Indeed OECD and EU codes on capital flows have abandoned efforts to distinguish short-term capital flows from others and this indicates that others may eventually be forced along the same route (IMF, 1995d, p. 9). Monetary authorities in Chile, among other countries, have nonetheless found it possible to encourage longer-term bank deposits and longer-term credits via carefully structured bank reserve requirements and “minimum stay” regulations respectively (LeFort and Budnevich, 1996).
- ### *FDI versus Portfolio Capital*
- 35 FDI is generally believed to be motivated differently, to behave differently, and to create different macroeconomic (and developmental) effects from portfolio capital flows. Foreign direct investors are presumed to base their decisions on longer-term economic and political fundamentals and thus to be less volatile in their short-term behaviour. FDI also often takes the form of real flows of capital equipment and brings technology and/or managerial and marketing skills along with capital.
- 36 FDI flows can also be volatile. Transnational corporations (TNCs) manage liquid funds as well as flows of real goods and services, and they usually do so very effectively. Foreign direct investors can also, when appropriate, borrow from foreign or domestic financial institutions in pursuit of their international financial flow objectives. FDI can therefore be associated with higher, rather than lower, variability in capital flow, reflecting TNCs’ capacities for managing international intra-firm financial transactions to respond quickly to changing national circumstances (Dooley *et al.*, 1995).
- 37 The regimes for FDI in developing countries are usually quite different from those for portfolio capital, and they are not typically primarily motivated by short-term macroeconomic management considerations. In many ways, FDI inflows are treated more liberally than foreign

portfolio capital because of the recognised advantages brought by its longer-term motivation, and the potential managerial, technological and export market-opening attributes associated with it. On the other hand, there are often selective prohibitions, controls and approval procedures – designed to protect strategic sectors or to ensure national benefits of various kinds – that are more stringent for FDI than for “arms-length” portfolio capital (IMF, 1995d). Although controls over inward foreign direct investment are not usually primarily directed at reducing the volatility of capital flows, they can be. Chile has instituted “minimum stay” regulations for direct investors to complement its reserve requirements for portfolio investors, in pursuit of its macroeconomic stabilisation objectives.

Debt versus Equity

38 External portfolio investment in domestic equities clearly involves fewer risks to the borrowing country than debt. External debt requires servicing regardless of domestic economic circumstances and the rollover of its principal can never be assured. Foreign owners of equity can, of course, choose to exit at any time, but when they do so as a group they must first find domestic buyers and, when they do so, they may be forced to take capital losses that ease the blow to the capital-losing country. There is therefore a risk management rationale for developing countries to favour portfolio equity inflows over debt-creating ones (although they may, on average, be more expensive). It can be argued that the shift towards equity borrowing in the 1990s has already imparted an important stabilising influence on developing country borrowers, relative to their variable-interest bank borrowing in the 1970s (Williamson, 1996b).

Efficacy of Controls

- 39 According to a number of analysts, direct controls (and, for that matter, sterilisation) can only be effective in the short-run: “... given the worldwide integration of financial markets and the sophistication of financial intermediaries, such policies do not seem to work in the long run”. (Corbo and Hernandez, 1996, p. 84).
- 40 It is well-known that controls over capital outflows are difficult to enforce and that considerable capital flight will occur, when market participants deem it warranted, even in the tightest of control regimes – via misinvoicing of trade transactions, leads and lags in external payments, alterations in trade credit terms, etc. The effects of expectations, as always, can also generate unexpected results. The tightening of controls may constitute a signal to investors, generating greater net outflows than before; similarly, liberalisation of outflows may trigger more inflows.
- 41 But it would be inappropriate to conclude that controls are always ineffective, provided they are used sparingly and are not intended to mask fundamental imbalances. The issue is usually whether the actual social benefits of such controls warrant their administrative and other (including efficiency) costs; and, more fundamentally, whether domestic macroeconomic management is, or is about to become, sound.
- 42 Controls over capital outflows are not universally associated, as some seem to imply, with payments crises or preludes to currency devaluation and payments liberalisation. Many developing countries have maintained such controls over outflows over very long periods of time, and varied them in response to their external payments positions (e.g. IMF, 1995d, p. 21).

43 Controls over capital inflows are generally easier to implement than those over outflows. Dooley's recent survey (1995) of the academic literature on capital controls (which has mainly been addressed to attempts at control of unwanted outflows) concludes that they have often successfully driven wedges between domestic and international interest rates, thereby generating government revenue and reducing the costs of public domestic debt servicing (pp.29-32); but in developing countries, contrary to the evidence for developed countries, they have not succeeded in influencing the volume or composition of capital flows, or exchange rate levels (pp.34-35). This study is also sceptical, in view of the distortions they create, of their overall benefit+cost ratio. (See also Mathieson and Rojas-Suarez, 1993.)

44 However, other analyses of recent developing country experience suggest more optimistic conclusions regarding the efficacy (to be distinguished from efficiency) of capital controls, particularly those relating to inflows (LeFort and Budnevich, 1996; Park and Song, 1996). Many developing country macroeconomic managers evidently believe it is possible to influence not only the pace but also the composition of external private capital inflows.

Recent Policy Response to Capital Surges

45 As has been seen, many developing countries have encountered large surges of capital inflow in the 1990s, which have significantly complicated the tasks of macroeconomic management. In sub-Saharan African countries such as Tanzania, Uganda and Zambia, macroeconomic policy response has consisted primarily in letting the exchange rate reflect the increased capital flows; and this has not yielded results

with which policy-makers can be fully content. In East Asian countries like Indonesia, Korea, Malaysia and Thailand, on the other hand, strenuous efforts were made by macro-economic policy-makers to preserve incentives for their tradable goods sectors by preventing too much real currency appreciation. Inevitably this involved the use of activist policies in currency and financial markets, and pragmatic resort to direct and indirect capital controls that varied in their intensity in response to changing external circumstances. In Chile and Colombia, too, policy-makers sought to moderate the exchange rate effects of the new capital inflows by "managing" exchange rates, monetary sterilisation and judicious resort to capital controls, principally in the form of indirect taxes (via reserve requirements).

46 Recent experience suggests that the vigorous use of market-friendly policy instruments – particularly official participation in financial markets – has helped many developing countries in their pursuit of traditional macroeconomic objectives in the context of volatile international flows of private capital. The most important instruments used have been:

- ❖ flexible central bank intervention in the foreign exchange market, with varying limits and "bands", and without overly rigid adherence to nominal exchange rate targets;
- ❖ flexible intervention by the monetary authorities in domestic financial markets and/or provision to them of new financial instruments for purposes of monetary sterilisation;
- ❖ maintenance of fiscal discipline; and
- ❖ use of reserve requirements (deposits in foreign currency in the Central Bank) on

domestic bank deposits of non-residents, domestic foreign currency deposits, and all external borrowing, bond issues or lines of credit. (These deposits have sometimes included a minimum time period, sometimes varied with the maturity, and have typically been designed to discourage shorter-term flows.)

47 The managers of capital surges in East Asia and Latin America have also often combined their more “market-friendly” instruments with selective and temporary direct regulations.

- ❖ Regulation of inward flows of portfolio capital has involved:
- ❖ overall quantitative restrictions or even prohibitions on some types of flows (e.g. some short-term flows in Malaysia in early 1994);
- ❖ regulation or restrictions on borrowing or issuance of securities abroad by residents;
- ❖ restrictions on access by foreigners to domestic stock and financial markets, or limits on foreign ownership shares of domestic corporations (which often vary with the sector of activity); and
- ❖ certain requirements for foreign direct investment, such as minimum length of stay (e.g. in Chile, one year).

48 Governments have often varied their capital account regulations so as to pursue their macroeconomic objectives as external circumstances changed. Korea systematically tightened or eased restrictions on both capital inflows and outflows in response to developments in the current account of its international payments. To counter excessive inflows, some governments have at times eased regulations only on outflows (e.g. Thailand). They have also varied their reserve requirements on foreign borrowing.

49 Many East Asian and Latin American countries thus appeared remarkably successful in responding to surges of private capital inflows in the 1990s through a judicious combination of exchange market intervention (to moderate real currency appreciation), monetary sterilisation, fiscal discipline, and the careful and changing use of direct controls on both inward and outward flows to dampen volatile short-term movements.

50 It is always difficult to assess the effects of policy in the absence of clarity as to the relevant counterfactual. Those with faith in the perfectibility of markets may argue that the provision of greater information is always more socially efficient than governmental interventions. Still, government interventions, including direct controls, did frequently seem to be effective in terms of their own declared (and limited) macroeconomic objectives. It is important to recognise that the purpose of controls in the more “successful” cases was generally not to maintain a fundamentally unsustainable exchange rate, but to assist in real exchange rate stabilisation. In some cases, there may also have been a longer-run concern to prevent undue real currency appreciation and its detrimental effects for the tradables sector. The policy objective was always a stable and appropriate overall incentive structure, and thus effective macro-economic management for development.

51 On the other hand, if capital controls are used to support weak macroeconomic policy, they can be distinctly harmful. Nor are they without difficulties or costs. In Dornbusch’s words, however, “while a near-perfect system of managing capital flows would be desirable, something that falls even far short may still do the job much better than doing nothing” (1995).

52 Policy makers should draw pragmatic conclusions from these recent experiences, like those of a recent literature survey of the same subject: "In view of the multiplicity of factors that should in principle influence the response of macroeconomic policies, no single combination of policies is likely to be optimal in all cases". (Fernandez-Arias and Montiel, 1995, p.76).

New Policy Instrument: A Cross-Border Transactions Tax?

53 There are strong theoretical and practical grounds for relying on taxes on international transactions rather than direct controls. Such taxes (often known as a "Tobin tax") are likely to interfere less with the allocative efficiency of the relevant capital markets, and to be administratively no more (and maybe even less) demanding. They overcome the difficult administrative task of distinguishing long-term from short-term flows by leaving market agents to decide what types of flows will be altered. They also have the important side-benefit of raising fiscal revenues (some of which can be used to fund their own administrative costs). Some developing countries have levied taxes on international financial transactions, most notably Brazil from 1994 onwards; and their experience deserves more study. Obstfeld is among those who have argued that: "A coherent case can be made for a Tobin tax in the context of stabilising developing countries, which need to manage exchange rates and have relatively shallow financial markets, and where the cost of failed stabilisation is extremely high" (Obstfeld, 1995, p. 188).

Such taxes have also been advocated for OECD countries (Eichengreen, Tobin and Wyplosz, 1995) and active professional debate continues over the merits and feasibility of a worldwide Tobin tax (e.g. Felix, 1995; Kenen, 1995; Frankel, 1995; Spahn, 1995; ul Haq *et al.*, 1996).

54 Dornbusch argues for a (small) tax, levied by individual countries, which could be varied over time, on all international (cross-border) transactions so as to discourage short-term capital flows and lengthen investor horizons. Such a tax, he argues, is superior to administrative controls in that "a maximum of market choice and discipline is maintained and a minimum of bureaucratic control intrudes" (1995).

55 He suggests that most of the relevant problems of tax evasion could readily be overcome by imposing the tax on all transactions in foreign exchange, whether for trade in goods or services, or for international capital movement. Since the tax applies to all cross-border flows rather than only to financial transactions, and since its object is to moderate instability in cross-border flows and not financial asset markets, the arguments concerning the ineffectiveness of financial transactions taxes, he argues, are irrelevant. There could be some negative effects on international trade but, at the tax rates contemplated, they would be minimal. Rather, he argues, the tax could be a useful transitory device in the context of stabilisation and the opening of the capital account and would serve to smoothen the process of national integration into the world economy.