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# CENTRAL BANK OF NIGERIA

# Economic and Financial Review

Volume 44 December 2006 Number 4

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*Branch Controller, Central Bank of Nigeria, Calabar*

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**Central Bank of Nigeria**
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# Welcome Address

*E. O. Alilonu*

The Governor, ably represented by,
Deputy Governor, Economic Policy, Dr. O. Mailafia
Departmental Directors,
Executives of the Bank,
Distinguished Ladies and Gentlemen

It is with great pleasure that I on behalf of the Management and Staff of the Central Bank of Nigeria, Calabar Branch, warmly welcome you all to the ancient city of Calabar, the capital of Cross River State for the 2006 Research and Statistics Department Executive Seminar. We are grateful to God Almighty for journey mercies granted all of you and wish you fruitful deliberations and peaceful stay in the Canaan City.

The choice of Calabar for this year's seminar is very appropriate. The ancient city is serene, clean and her people very hospitable. Since the seminar is a forum for exchange of ideas and brainstorming, Calabar is an ideal choice for this type of exercise. I am quite aware that your stay this time around is bound to be short. Nonetheless, you can still make out time to visit some places of interest. There are quite a number of interesting sites within Calabar and its environs. Tinapa, Africa's premier free trade resort is worthy of visit. It might also interest you to know that the National Museum which holds the relics of the historic African slave trade, information about the great kings of Old Calabar and the great arts and customs of the Efik people is a stone throw from here.

Please permit me at this juncture to mention the importance of the annual Executive Seminar which has become the bedrock for a number of socio-economic policies and reform agenda in the Central Bank of Nigeria and the nation. The theme of this year's seminar 'Capital Account Liberalization:

Issues, Problems and Prospects' is indeed very auspicious as it comes on the heels of the recapitalization of deposit money banks. The onus therefore falls upon this great gathering to discuss exhaustively and come up with adequate policy recommendations for management. I am convinced that this team of highly informed executives of the Bank is more than capable of handling this assignment.

I wish to commend the Management of the Bank for sustaining this seminar. My appreciation also goes to the Research & Statistics and Human Resources Departments for maintaining the executive policy in their respective annual calendar of events. It has always provided the highest conglomeration of executives in a single programme of the Bank. Once again, I want to thank the organizers on the choice of Calabar as the venue of this year's seminar.

I wish you all a fruitful deliberation and a very pleasant stay in Calabar.

Thank you and God bless.

## Special Remarks

*C.N.O. Mordi **

Deputy Governor, Economic Policy
Director, Human Resources Department
Branch Controllers
Distinguished Resource Persons and Participants
Ladies and Gentlemen

It is my honour and privilege to make this special remark at the opening ceremony of the 14th edition of the annual in-house Executive Seminar organized by the Research and Statistics Department, in collaboration with the Human Resources Department. This annual event was conceived as a forum to enhance the intellectual and professional competence of the staff in the executive cadre of the Research & Statistics Department and their colleagues from within and outside the Policy Directorate of the Bank. Indeed, the expectation was that, by so doing, they would be better placed to impact more positively on policy making process and content.

The theme of this year's seminar, '***Capital Account Liberalization: Issues, Problems and Prospects***' is particularly apt because the greatest challenge facing our country today is how to grow the economy and reduce poverty. Meeting this challenge is particularly difficult if we have to rely solely on domestic resources, given the low rate of savings and, hence, the attendant savings-investment gap. Against this background, it becomes crucial to try and attract foreign resources into the economy to fill the gap. The imperative for attracting and retaining external resources, either by external borrowing or investment inflows, is to formulate a consistent and an appropriate mix of financial, monetary, trade, fiscal and exchange rate policies, etc,. Given the country's recent experience with external debt burden, external borrowing has

** Mr. Mordi is the Ag. Director of Research and Statistics, Central Bank of Nigeria, Abuja*

become a 'hard-to-sell' option. It is within this context that the significance of the theme of this year's seminar can be situated. In other words, we recognize that if we are to meet the objectives of the Millennium Development Goals (MDGs), we must be part of the global competition for investment climate-sensitive capital inflows. Indeed, the prospects of attaining the MDGs can be boosted through the liberalization of our capital and financial transactions.

However, while capital account liberalization could make our economy more competitive in the global arena, it could also increase the country's susceptibility to external shocks in the event of any crisis. The cases of the financial crisis in Mexico and Asia in the mid-1990s are all too familiar. In our own peculiar context, the mono-cultural and import dependent nature of the economy calls for some measure of caution in pursuing a policy of full capital and financial account liberalization.

From the foregoing, and typical of all economic decisions, we are faced with a choice. But in view of the current trends around the globe, it is clear that we cannot continue to maintain restrictions on our capital transactions, more so, as we are now among the league of emerging economies. Therefore, our task in this seminar will include among others, how to appropriately sequence capital account liberalization so as not to unduly expose our economy to external shocks, and put in place strategies to deal with problems that may arise. Fundamental to this process are issues of macroeconomic stability, adequate prudential supervision and regulation of domestic financial markets and institutions, adequate disclosure practices, corporate governance, as well as avoidance of measures that encourage excessive and unsustainable capital inflows.

There are a number of posers that I charge this seminar to try and provide answers to. These include: is capital account liberalization a choice for a developing country like Nigeria? What is the roadmap to capital account liberalization? In particular, what are the necessary reforms, policies and preconditions for capital account liberalization? How do we sequence current and capital account liberalization? What are the conditions necessary for an orderly liberalization of the capital account? What fiscal, monetary,

stabilization, and exchange rate policies do we need to adopt? How do we handle issues relating to prudential and supervisory concerns? What is the nature of the relationship between capital account liberalization and economic crises? Do free capital flows lead to further long-term economic growth, which may compensate for the crises and the economic instability associated with capital account liberalization? Should a developing country like Nigeria opt for full capital account liberalization and does the composition of capital flows matter when considering capital account liberalization? And related to this, is whether some forms of capital controls are desirable. Answers to these posers are very important because capital account liberalization was once seen as an inevitable step along the path to economic development for poor countries, although theoretical analysis and empirical evidence have not corroborated this.

To this end, we have carefully selected seasoned professionals in the relevant fields to lead our discussions. I would urge participants to take full advantage of their expertise and participate very actively in this seminar. It is my hope that the outcome of our deliberations would serve as an input to producing a roadmap for capital account liberalization in Nigeria.

In conclusion, we wish to acknowledge the tremendous support of our Deputy Governor for not only honouring our invitation to grace this occasion, but also electing to lead our discussions. We also express our gratitude to the Human Resources Department for the collaboration in organizing this seminar series over the years.

The Special Guest of Honour, Distinguished Participants, Ladies and Gentlemen, I thank you for your attention and wish all of us a very fruitful deliberation.

## Keynote Address

*Obadiah Mailafia (Ph.D)**

Director of Research and Statistics
The Branch Controller, Calabar Branch
Executives of the Research and Statistics Department
All Executives present
Distinguished participants
Ladies and Gentlemen,

It gives me great pleasure to be here on this occasion of the 2006 Executive Seminar organized by the Research and Statistics Department in collaboration with the Human Resources Department. The theme of this year's seminar, "Capital Account Liberalization: Issues, Problems and Prospects" is very apt, in view of the developments in the global economy, and our policy reforms embedded in the National Economic Empowerment and Development Strategy (NEEDS), and the Millennium Development Goals (MDGs), which seek to further open-up the Nigerian economy.

Thus, this seminar presents an opportunity for participants to deliberate on questions such as: are restrictions or non-restrictions on the capital account beneficial for a developing economy undergoing economic reforms such as Nigeria? Should there be a big bang or gradualist approach to capital account liberalization? Should it be a complete liberalization? What are the available options?

These questions have assumed greater importance with the emergence of the World Trade Organization (WTO), the International Monetary Fund (IMF), the International Financial Architecture and the Basle Capital Accord as forces for trade and financial transactions in the World economy. Permit me to add

* *Dr Obadiah Mailafia is the Deputy Governor, (Economic Policy), Central Bank of Nigeria, Abuja*

that the answers to these questions that would emanate from your deliberations would provide the leeway for proactive policies by the Bank.

Perhaps, it is pertinent to recall at this stage that the Bank also refocused its research efforts with a view to preserving the external sector viability through the close monitoring of balance of payments developments. The capital account forms a central part of a country's balance of payment's account. This account, as you know, x-rays transactions between a domestic economy and the rest of the world. Thus, capital flows in the form of short and long term investments, which are usually recorded in the capital and financial account could be susceptible to external shocks. These shocks could be in the form of sudden reversals and/ or foreign ownership/control-related concerns. The apparent question becomes why a country would want to liberalize its capital account given this fact.

From a theoretical point of view, economists would generally point to the following benefits with regard to capital account liberalization; technology transfer, higher risk adjusted rates of returns, reduction in the savings investment gap, improved efficiency of capital allocation, risk and portfolio diversification, amongst others.

You will recall that the 1990s witnessed a series of financial crises which disrupted exchange rate and financial arrangements in a significant number of countries, particularly in Asia and Latin America. Most of these crises occurred in the wake of capital account liberalization. In the light of these experiences, most economies have become more careful to determine when and under what conditions liberalization of the capital account becomes desirable. In the context of the unrelenting forces of globalization and integration, it would not be wise to assume that capital mobility and investment flows as an economic development tool would not remain as a critical and integral part of economic policy for many years to come.

Net capital flows to developing economies are estimated to have tripled from $50 billion annually in 1987-1989 to more than $150 billion in 1995-1997 before most countries witnessed sharp reversals following the Asian crisis.

Nevertheless, a large number of IMF-member countries have removed restrictions on capital account transactions in the wake of globalization to take advantage of the potential and *ex-ante* benefits that arise from liberalizing the capital account. Over the years, the growth of international financial transactions *cum* capital flows has been attributed mainly to globalization, financial integration, technological developments, deregulation of domestic institutions in industrialized and developing economies, trade multilateralization as well as growth of financial derivative instruments.

For a developing economy such as Nigeria with the current policy efforts geared towards encouraging capital flows into the economy, achieving our key macroeconomic objectives requires addressing not only the questions posed above but also devising ways to minimize the shocks that may from time to time affect the domestic economy. This factor becomes even more prominent when it is realized that, although capital account liberalization shifts the risk burden to the private sector, the risks to macroeconomic management can become complicated.

Distinguished ladies and gentlemen, the most important considerations, in my view, relate to the imperative of designing a framework of macroeconomic stabilization and policy reforms that would put the economy on the path of sustainable growth and development with equity. Embarking and achieving most of the policy reforms and its objectives, as outlined in the NEEDS framework clearly requires a sizeable quantum of financial resources. The dilemma between attracting financial resources and undertaking reforms, without exposing the domestic economy to harmful external shocks becomes very apparent.

At this juncture, it is pertinent to clearly state the objective of any capital account liberalization, bearing in mind that liberalization can apply to inflow and/or outflow, and the type of capital to be liberalized. Is it debt or equity market liberalization?  Internal financial practices by market participants also need to be enhanced. These market participants range from banks, and companies to supervising authorities. Banks and non-bank financial intermediaries must engage in sound and prudent risk management. The supervising authorities need to engage in rigorous prudential regulations.

Countries such as Chile and Colombia have tried to discourage domestic corporations and banks from excessive foreign exposures by taxing all short term capital inflows; others have adopted more stringent measures. The need to develop in-house models that would manage risk cannot be overemphasized at this stage. Suffice to note that, the world over, negative conditions in the domestic financial system such as market indiscipline in the form of inadequate accounting, auditing, disclosure practices, implicit government guarantees that encourage excessive and unsustainable capital flows as well as inadequate prudential supervision/regulation of local financial institutions have to be addressed and reduced to the barest minimum before any credible program of capital accounts liberalization could be put in place.

Distinguished participants, capital account liberalization is indeed inevitable for economies wanting to tap into the benefits that accrue from participating in the global economy. Do we go with the flow? Like anything in existence and as recent experiences have shown, liberalizing the capital account also has its risks. But the opportunities are stupendous. I urge participants in this very important seminar to explore the opportunities that would help put our economy at the next level even as we identify the risks and explore mechanisms for hedging against them. Ladies and gentlemen, there is no doubt that the research agenda described herein not only provides a deep intellectual challenge, but can also yield good returns in our common quest for sustainable capital flows.

I thank you for your kind attention and wish you fruitful deliberations.

# Capital Account Liberalization: Reflections On Theory And Policy

*Obadiah Mailafia**

## I. Introduction

Developing countries as well as other member countries of the International Monetary Fund (IMF) have always been encouraged to open up to foreign capital flows through the liberalization of their capital account transactions. The IMF conditionalities, World Trade Organization (WTO) rules and some regional trade arrangements have often spelt out capital account liberalization as a prerequisite for participating in trade and investment. Consequently, capital account liberalization is embedded in international standards and codes as best practice necessary for developing countries engaging in inter-governmental and non-governmental international relations. This is also in line with the provisions of the "Washington Consensus", which included interest rate liberalization, competitive exchange rate, trade liberalization, liberalization of inflows, privatization, and deregulation of economic activities.

The opening of world economies and greater integration, which started in the 1980s with the liberalization of the macro-economy of both emerging economies and other developing countries (especially those undergoing structural reforms), gave impetus for capital account liberalization. Globalization in the 1990s also opened many opportunities around the world for increased trade, foreign investment and new technologies. Current debate on the subject matter has been on the likely benefits of capital account liberalization to developing countries with fragile economies and underdeveloped financial systems, which are often prone to systemic distress. When the necessary macroeconomic fundamentals are lacking, banking

** Mailafia is the Deputy Governor, Economic Policy in the Central Bank of Nigeria. The views expressed herein do not represent the views of the institution to which he is affiliated.* *The author acknowledges the comments and suggestions of anonymous reviewers.*

systems are weak, and domestic distortions are pervasive, countries may experience capital flight rather than capital inflows (World Bank, 1997). Theoretically, there is a significant difference between capital account liberalization and financial integration. Capital account liberalization, in itself has resulted in the dismantling of capital controls in emerging economies and facilitated a high degree of financial integration. Controls in the form of outright prohibitions, licensing and approval procedures, and transaction taxes, have been noted as major hindrances to the rapid flow of capital across borders by international organizations like the IMF.

Capital account liberalization represents the systematic removal of administrative and legal controls on international capital transactions. The liberalization of these transactions is expected to improve a country's balance of payments, smoothen temporary shocks on income and consumption, reduce borrowing costs, and spur economic growth. A country may liberalize certain components of its capital account while maintaining controls on others. When countries eliminate controls, they usually experience stronger inflows, at least initially, as international investors and residents who had placed their capital abroad react to the improved investment environment. However, where unfavourable domestic social and macroeconomic factors precipitate reversal of capital flows (outflows), the effect can be severe and disruptive on the economy.

Developing countries are characterized by low level of domestic savings, and in order to attain the desirable level of investment, would need foreign savings to bridge the savings-investment gap. These savings come in the form of 'new money' or capital inflows which are expected to provide finance for economic activities. Sometimes, these inflows may come in the form of credit from either the parent company or affiliates to shore up the capitalization of the domestic company. An example is the current banking sector consolidation in Nigeria, which attracted about N6.7 billion worth of capital inflow in 2005. The new capital would enable Government to channel more resources in a more efficient and coordinated way into the social sectors through country-owned poverty reduction strategies. The experience of some countries in Asia notably, South Korea, Taiwan and Hong Kong in part-financing their economic

development with foreign capital, and recent developments in Central and Eastern Europe, have given credence to the importance of foreign capital in economic development of any nation. Effective use of capital inflows would transform the investment environment, generate multiplier effects and enhance the level of output and domestic savings. For instance in Egypt, savings increased by 6.0 per cent of gross domestic product (GDP) per annum after the country liberalized her capital account (Hussain, 1996). Empirical studies have attested to the fact that changes in the index of financial openness, as a proxy for capital account liberalization, have positive correlation with growth, and the opening of stock markets to foreign participation is directly associated with investment booms.

Liberalization improves financial depth and, in countries with sufficient financial repression, the benefits of greater financial depth dominate the costs of banking crises, resulting in a net positive growth impact. In addition, financial openness is supposed to provide external sector viability by gingering competitiveness and discipline as well as lowering inflation in economies that are more financially integrated. These would improve the investment climate and increase output in the economy in the medium-to-long-term. Controls in general, have adverse effect on trade and capital account transactions. For instance, empirical evidence in Nigeria revealed that when the economy was re-regulated in 1994, economic performance worsened, as reflected in the decline in the growth rate of real GDP from 2.3 per cent in 1993 to 1.3 per cent in 1994. Similarly, inflationary pressure increased with the rate of inflation at a peak of 57.0 per cent in December of that year.

In terms of the rate at which countries liberalize their capital account, Nigeria is among the countries tagged "Slow Trade Liberalizers" due to its inability to fully open up to trade in goods and services, which is current account liberalization as well as capital account transactions. The country practiced a protectionist policy for almost two and half decades after independence while the practice of liberalization has been experimented in fits and starts. Consequently, Nigeria has not fully acceded to the IMF Article VIII provisions and has more-or-less practiced guided liberalization characterized by series of documentation in the capital account transactions. Given the benefits of full

liberalization of capital account, Nigeria stands to gain in terms of increased investment if the right policy mix is adopted coupled with sustained macroeconomic stability. On the other hand, the country may be at risk, if capital account liberalization is not appropriately sequenced and coordinated with complementary policies and reforms.

The main objective of this paper, therefore, is to reflect on the theoretical issues and related policy of capital account liberalization globally and, in particular, the case for Nigeria. The rest of the paper is structured as follows: section two provides a review of the theoretical framework while section three presents country experiences. Section four presents the current status of Nigeria's liberalization efforts while policy issues are discussed in section five. The summary and concluding part of the paper are contained in section six.

## II. Theoretical Issues

The capital account in a country's balance of payments covers a variety of financial flows mainly foreign direct investment, portfolio flows (including equities) and bank borrowing, which is the acquisition of assets in one country by residents of another country. In theory, capital account liberalization is expected to allow the flow from capital-surplus industrial countries to capital-deficit countries especially emerging economies and other developing countries. There have been theoretical conflicts on the issue of liberalizing capital across borders with different schools viewing the international mobility of capital differently. These thoughts are tailored mainly along the orthodox, dependency and neoclassical counter revolution frameworks.

### II.1 The Orthodox School

Mainstream economists would see the liberalization of capital account from the view point of solving a global problem, which is definable in terms of global resources, wants, production, exchange and growth. This model, which is the centerpiece of the neo-liberal school, see capital mobility as adding new resources, technology, management and competition to capital deficit economies in a way that improves efficiency and stimulates change in a

positive direction. Currently, the example of the Asian Tigers is used to drive home the growth driven force of capital mobility when FDI flows are encouraged with the liberalization of the capital account transactions. This submission transcends the classical, neo-classical, keynesians, and monetarists standpoint.

Neo-classical theory suggests that free flows of external capital should equilibrate and smoothen a country's consumption or production paths. In the real world, this theory seems not to hold, being at variance with actual outcomes. Liberalization of the short term capital account has been associated with serious economic and financial crises in Asia and Latin America in the 1990s which has necessitated the caution in the 21st Century to fully liberalize the capital account transactions. The free short term capital flows are highly volatile and prone to reversals than the long term capital flows, particularly FDI. Long-term flows are regarded as much more stable and there is the suggestion that developing countries may wish to liberalize only long-term flows while still controlling, partially or wholly short-term flows. These view points have been contentious within the framework of a global village and the pressure for full integration of world financial markets.

Macroeconomic stability, stable political environment, minimal regulation, developed financial market (capital and money markets) as well as sound fiscal policy are pre-conditions for capital account liberalization. In addition, it requires strong prudential guidelines and adequate supervisory framework that would checkmate excessive financial market risks. Specifically, FDI flows will also depend on good infrastructural facilities, low production cost, attractive or stable interest yield and credit worthiness. These are critical conditions for attraction and retention of foreign capital necessary for economic transformation. Thus, large fiscal deficits, structural rigidities, inappropriate monetary policy, high degree of volatility in exchange and interest rates as well as high levels of inflation constitute serious threats to financial resource inflows.

Grilli and Milesi-Ferretti (1995); Dooley (1996); Quinn (1997); Henry (1997); and Demirguc-Kunt and Detragiache (1998) in their works confirmed that

capital account liberalization is a necessary strategy to attract private capital flows to substitute declining aids in developing countries. Capital account liberalization in these studies, correlated with growth as well as the deepening of the financial sector. It is imperative to note that current account liberalization is a precondition for capital account liberalization, since the former provides complementary requirements for the latter. Thus, current account and capital account liberalization is a continuous process. When financial markets are working as they should, capital account liberalization would in principle give rise to a more efficient allocation of resources as well as facilitate economic growth especially in the less developed economies.

Fischer (1997 and 1999) suggested that the benefits of liberalizing the capital account outweigh the potential costs. He noted that capital account liberalization would lead to global economic efficiency and facilitate the allocation of world savings to those who are able to use them most productively, and thereby increase social welfare. Citizens of countries with free capital movements would be able to diversify their portfolios thereby increasing their risk-adjusted rates of return. Such development would also enable corporations in these countries to raise capital in the international markets at a lower cost. Financial deepening associated with capital account liberalization would enhance productivity in the real economy. Fischer believes that capital movements are mostly appropriate and that capital markets serve as an important discipline on government macro-economic policy by rewarding good policies and penalizing bad ones.

Although, capital account liberalization has been widely encouraged to enhance trade and investment, some degree of control has been recently advocated. For instance, the Bank for International Settlements (1995) Annual Report stated that it is "….now widely agreed that prudence in liberalizing capital inflows implies that short-term operations should not be free until the soundness of the domestic financial system is assured." In the same vein, the IMF (1995) and the World Bank (1997) explicitly recognize that some regulation by recipient countries of excessive surges of capital can be a desirable policy. Applying country-based evidence, the IMF study admitted that controlling both the inflows and outflows of capital has, to varying

degrees, helped countries to protect themselves from the damaging effect of financial crisis.

Orthodox economists recognize that there are risks associated with capital account liberalization given market conditions. Markets sometimes overreact or react late or react too fast. If market risks are not properly managed they could lead to economic instability, and financial crisis in emerging market economies. The fundamental theoretical reasons why capital account liberalization may lead to economic instability were attributed to the volatility of short-term capital flows, increased competition among banks following liberalization and the changes in the global financial system. The volatility of the private capital flows to developing countries is a well confirmed feature of international capital movements during the last two decades.

### II.2 The Dependency School

This school of thought is tailored along the neo-Marxist analysis developed from Marxism. Though un-popular as a result of the collapse of communism in the 1980s and the subsequent embrace of the market doctrine by the former Eastern bloc, it helps historically to examine the diverging view point of development economists.

The dependence model is a combination and reformulation of the Structuralist model based on the centre-periphery framework analysis. This could be summarized as dependence on capital-surplus developed economies by the capital-deficit developing economies. The dependence according to the model, tends to cause underdevelopment and worsen the conditions of developing countries. Thus, the penetration of capital from developed countries into developing nations through FDI flows and short-term capital cannot produce beneficial results in the host countries. The thinking is that there exists a symbiotic relationship between the metropolis (developed) countries and the underdevelopment of the satellite (developing) countries and that capital mobility to the satellite is mainly to benefit the metropolis.

Andre Gunder Frank (1975) who popularized this model, analyzed the structuralists import-substituting capitalist industrialization strategy in Latin America, in which the "foreign monopoly capital" was taking over the import substitution process. Frank further noted that the strategy was unprogressive and that the peripheral formations became more underdeveloped with their incorporation into the world capitalist system. The theorists recommended the need to severe link with the exploitative international capitalism as the recipe to developing the economies of the periphery. Revolutionary as this may sound, it is unattainable in a world that is almost becoming a big village. Consequently, a modification of this thought has been formulated drawing from the experiences of the newly industrializing economies (NIEs) of Latin America and South East Asia. In these economies, foreign investors were attracted through the provision of enabling environment, while their entry and operational modalities were negotiated. The modification of the dependency model thus presupposes that through a strategy of autonomous and self-reliant macroeconomic policy objectives and implementation programmes, developing countries can still use external stimuli, particularly FDI to achieve their developmental aspirations (Aremu, 2005).

## II.3 The Neo-classical Counterrevolution Framework

With the relevance of the radical dependency perspective being questioned, at the end of the 1970s, a "neoclassical counterrevolution" was launched in the West with a re-affirmation of the dictates of the market and the importance of "getting the prices right" (Mailafia 1997). This formed the theoretical underpinnings for the structural adjustment programmes of the 1980s. The counterrevolution, led by among others, Ian Little, Bela Balassa, Anne Krueger and Deepak Lal, argued that the policy-induced distortions of developing countries are largely responsible for their poor development performance, and proposed that the problems of economic development can only be solved by an economic system with freely operating markets and a minimalist government (Ohiorhenuan, 2003). The World Bank publication, Accelerated Development in Sub-Saharan Africa: An Agenda for Action (World Bank, 1981) emphasized the importance of correct pricing policies and reduced government intervention in economic activities as the two main keys

to a revival in African growth rates. Thus, the IMF conditions for access to her facilities included not only control of the money supply, but removal of price distortions including price controls, subsidies, tariffs, foreign exchange, freeing of markets from public sector intervention and elimination of restrictions against foreign direct investments. An outcome of the protest against the harsh conditions of the IMF policy prescriptions was the emergence of the "Washington Consensus" emanating from the IMF, World Bank and the group of seven leading industrial countries, particularly the United States. It represented the mainstream development practice throughout the 1980s into the 1990s. The consensus advocated a focus on balanced budget, exchange rate correction, liberalization of trade and financial flows, privatization and domestic market deregulation.

## III Country Experiences

Many emerging market economies have relaxed and removed statutory restrictions on capital account transactions and liberalized domestic financial markets to avail themselves of the benefits of capital inflows. Also, the decline in official flows in the 1980s and 1990s resulted in a sharp growth in private capital flows especially short-term flows. The favoured destinations were East Asia and Pacific, Latin America and Caribbean and Central Asia. However, in a number of cases, unprecedented capital flows have precipitated financial crises. The volatility began in Mexico and infected Latin America in 1994/95, and two years after it was the attack on the Thai Bhat, which sent the economies of the Philippines, Indonesia, Malaysia and South Korea into a financial crisis that jeopardized the gains of over thirty years. Following this, was the Russian and later Brazilian crises. Though these were currency and banking crises but were precipitated by the more liberalized capital accounts.

The post-crisis performances of the East Asian countries have triggered more concerns on the responses to any adverse impact of capital account liberalization. For instance, Korea and Malaysia adopted two extreme stances to the contagion effect of the surge in the flow of capital. Korea pursued further liberalization while Malaysia imposed more stringent controls; however, both countries successfully implemented their reforms. The country experiences of

Japan, Korea, Malaysia and South Africa are presented below.

**Japan**

Japan is a true case of an economy that started the liberalization of her capital account transactions from the 1970s. In the 1970s-80s, the economy witnessed the lifting of the ban on overseas listing of domestic securities, opening of domestic market to non-residents, the first issue of Euro yen bond by a non-resident, establishment of foreign exchange banks and the promulgation of new foreign exchange and foreign trade control laws that liberalized major current and capital account transactions. From 1981-1990, the economy was further deregulated, allowing securities firms to sell foreign certificate of deposits and commercial papers in the domestic market. Interest rate deregulation started to encourage capital flows while taxes on domestic bond transactions were reduced. In the 1990s, far-reaching measures aimed at easing external financial transactions included: market valuation of foreign bonds, removal of laws regulating foreign currency assets; also the regulations on foreign exchange positions were relaxed to promote investments in foreign currency-denominated bonds. It is important to note that while the Japanese economy maintained a very high degree of openness arising from the export or outward - oriented policy, they were not all that open on the import side. They maintained formally or informally, selective import controls for a long period of their industrialization.

**Korea**

From the early 1960's through 1997, Korea's macroeconomic performance was impressive. The net private capital flows in the 1990s to Korea was 2.3 per cent of GDP. Capital account liberalization proceeded more slowly than financial sector liberalization. The process of the capital account liberalization was largely influenced by current account developments. When the current account started to deteriorate, the authorities put in place measures to promote capital inflows and gradually liberalized capital outflows. Non-residents were given greater investment opportunities in the country's stock market, and the types of securities that could be issued abroad by residents were expanded.

Therefore, the limits hitherto imposed on FDI inflows was gradually removed, and later other capital account transactions were opened to foreign investors. In 1997, the country suffered both banking and currency crises, brought about by structural weaknesses in the corporate and financial sectors. Consequently, a number of measures were taken in steps to reform the financial system. Although the financial liberalization helped to strengthen competition and allowed market forces to play a greater role, distortions in the economy left the banks vulnerable to adverse shocks. These distortions stemmed from government interference, relaxed prudential regulations, fragmented supervision, and inappropriate sequencing of domestic financial reforms. The Korean experience showed that a weak credit culture and lack of commercial orientation adversely affected the financial sector in dealing with the additional risks arising from capital account liberalization. The liberalization process which was not properly sequenced affected short-term capital flows but favored FDI and other longer-term flows.

**Malaysia**

The Malaysian economy recorded unprecedented levels of capital account surpluses in 1990-1993 for both short-term and long-term capital inflows. Short-term inflows were boosted by relatively high interest rate differentials in favor of the country while strong underlying economic fundamentals contributed to long-term inflows. Given the persistence of inflows and concerns about a loss of control over monetary aggregates and inflation, and instability in the financial markets, the authorities introduced a number of direct and regulatory capital control measures in early 1994 to stem short-term foreign bank borrowing. The Malaysian experience reveals the importance of adopting consistent and appropriate monetary and exchange rate policy mix that could prevent excessive and destabilizing capital inflows and enhance prudential regulations.

**South Africa**

South Africa has experienced large swings in its capital account over the last 20 years. The country recorded large net private capital inflows in the period

1980-84, followed by significant net outflows in the period 1985-94 and large net inflows in 1995-99. The deterioration in the capital account in the mid-1980s reflected difficulties in rolling over external loans following the debt standstill and the imposition of international sanctions. The 1990s were characterized by macroeconomic stability, financial consolidation and gradual external liberalization. In 1995, virtually all capital controls on non-residents were removed by eliminating the dual exchange rate system. This approach was facilitated by a well-developed financial infrastructure that included sound domestic banks and strong prudential standards and practices in the financial and corporate sectors. South Africa's experience shows that with sound macroeconomic policies, a strong banking system can withstand large volatility in capital flows and market prices. The country adopted a cautious approach to capital liberalization. A well-developed financial infrastructure, a robust banking system and sound prudential practices in the financial sector allowed South Africa to lift capital controls on non-residents without adverse consequences. It is crucial to remark that the authorities gradually liberalized the capital account for residents as a measure to preserve the central bank's reserve position.

## IV. Current Status of Capital Account Liberalization in Nigeria

### Capital Account Transactions

- Any person whether resident in or outside Nigeria or a citizen of Nigeria or not, may invest in any enterprise except those specified in Section 13 of Nigerian Investment Promotion Commission Act of 1995. However, a foreign national who wishes to establish an enterprise in Nigeria shall first of all, comply with the provision of the Companies and Allied Matters Act of 1990, i.e be incorporated by the Corporate Affairs Commission. In addition, an Authorized Dealer shall issue a Certificate of Capital Importation (CCI) to the investor within 24 hours of the receipt of the capital.

- Capital account transfer restrictions have been removed following the enhanced liberalization policy of the government.

- Foreigners are allowed to invest in all sectors of the economy except in the production of arms, ammunitions, narcotic drugs and military apparels. The law guarantees unconditional transferability of funds in respect of profits and dividends, loan servicing and repatriation of capital, the remittance of proceeds (net of all taxes etc.).

- A foreign investor may buy the shares of any Nigerian quoted enterprise. Such purchases of shares shall be completed through any of the Stock Exchanges in Nigeria.

- A foreign national or entity may invest in Nigeria by way of purchases of money market instruments such as commercial papers, negotiable certificates of deposits, bankers' acceptances, treasury bills, etc.

- Request for foreign loans by companies incorporated in Nigeria from corporate bodies/institutions offshore shall be processed through Authorized Dealers supported with some specified documents.

## V. Policy Issues

The issue of capital account liberalization is not only of academic interest but is also of serious policy concern for developing countries. The challenges to policy include its potential for overheating the macroeconomy, arising from the excessive expansion of aggregate demand from the huge inflows, vulnerability from the sudden and large capital reversals and the long term implications of capital account liberalization for the conduct of macroeconomic policy. The focus should, therefore, be in the area of sound macroeconomic policy, sound prudential regulation and supervision, risk management and policy sequencing.

### Sound Macroeconomic Policy

The major challenges for the macro-economy are overheating and vulnerability. Overheating is manifested by high inflation, appreciation of the real exchange rate, and widening of the current account deficit; vulnerability is

reflected in the instability of major prices. Sound macroeconomic policies are important for successful capital account liberalization. They help to strengthen and ward off imbalances in financial markets, as well as offset the damaging effects of financial crises. Prudent fiscal policy that prevents the ballooning of large deficits will avoid the temptation to rely on foreign loans that might create debt management problems, reduce creditworthiness, or weaken an economy's ability to manage external shocks. This implies that government should ensure a reduction of the fiscal deficit and its financing should be non-inflationary; while the exchange rate regimes should be deregulated and market based. The inflation objective for instance, can be aided by the creation of a strong, independent central bank that is relatively insulated from pressures emanating from the political process. It is also important for the central bank to have funds to intervene in the market to promote stability and reduce volatility, thereby providing psychological reassurance to foreign investors.

**Financial Sector Reforms**

Financial sector reform, prudential norms and effective regulatory supervision are veritable conditions for a successful transition to capital account liberalization. This is because weaknesses in the financial system can cause serious macroeconomic instability and crises, while a healthy financial system would certainly reduce the incidence and extent of the crisis. Key aspects of this reform programme should include liberalizing interest rate, the dismantling of entry barriers to new banks, restricting the direct role of the government in allocating financial resources, greater use of open market operations in monetary policy, widening and deepening of financial markets and strengthening bank supervision.

**Sound Prudential Regulation and Supervision**

Policy should be directed at reinforcing the accounting, auditing and disclosure standard and procedures which will contribute to market transparency and discipline and, in turn, facilitate prudential supervision. Good accounting and auditing practices are needed to determine whether a financial institution is solvent and also help guide decision-making by

financial institutions themselves, including internal controls. Disclosure of key indicators by financial institutions including their capitalization, provisioning, earnings, liquidity and extent of non-performing assets are essential for maintaining adequate market discipline, achieving financial sector stability and preventing systemic failure.

**Risk Management**

Capital account liberalization may induce banks to expand risky activities at rates that far exceed their capacity to manage them prudently. These may involve risky lending and a resort to expensive and potentially volatile funding. Other observable risks that needed to be tackled include transfer and settlement risks, country risk, market risk, foreign exchange risk, interest risk and liquidity risk. The question of whether financial institutions are prepared to handle the risk associated with international capital transactions depend largely on how well they are equipped to manage financial risks.

**Policy Sequencing**

A proper sequencing of capital account liberalization process is also required. Thus, the re-capitalization of the banking industry and the subsequent emergence of sound financial institutions are in consonance with the policy sequencing. Furthermore, the current account should be liberalized before the capital account. The ability of the financial sector to absorb huge inflows should be put into consideration. Therefore, until the required level of efficiency is achieved in the banking sector, liberalization of more volatile short term capital inflows should be implemented with great caution.

## VI. Summary And Conclusion

The extensive debates in recent years and feedbacks at the national level indicate that the international financial architecture must guarantee the consistency of national macroeconomic policies, with the stability of global economic growth as the central objective; and appropriate transparency and regulation of international financial loan and capital markets. The goal of

capital account liberalization for all countries is a major issue in the proposals by G7 countries for the New International Financial Architecture (NIFA), the European Union and Japan. The new proposal will focus more on FDI flows while excluding the more volatile short-term capital. For capital account liberalization to be clearly beneficial for developing countries, so as to promote growth and development, it is necessary that an international financial and development architecture exists that would prevent currency and banking crises, and support the provision of sufficient net private and public flows to developing countries. The "Monterrey Consensus" of the International Conference on Financing for Development of the United Nations, held in March 2002 provided, for the first time, an agreed comprehensive and balanced international agenda, that should be used to guide and evaluate reform efforts. The Basel accord on international banking regulation has also concentrated much effort for enhanced macroeconomic surveillance of developing country policies. The IMF has been reviewing its access policy in the context of capital account crises, to "establish a stronger framework for crises resolution", which defines criteria that could pose constraints on exceptional access, and risks slowing down the granting of such loans.

As regards crisis prevention, the area where most emphasis has been placed and much activity undertaken is the development and implementation of codes and standards for macroeconomic policy and financial sector regulation in developing countries. Clearly their aims are worthy, and desirable, such as strengthening domestic financial systems. One important concern is whether implementing existing codes and standards would always be meaningful in helping to prevent crises.

In general, the liberalization of capital account in developing countries has more benefits than cost. However, the critical issue is how best to maximize these benefits to the advantage of the developing countries as the inherent risks of capital account liberalization could be disastrous to the economies of recipient countries.

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# Globalization and Capital Account Liberalization

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## I. Introduction

Mainstream literature generally encourages developing countries to take advantage of the opportunities offered by the process of globalization to enhance the rapid and sustainable growth of their economies. Since the globalization process involves general liberalization of a range of economic policies as a means of harvesting the dividends of these opportunities, there exists considerable research and policy interest in seeking a fuller understanding of the links between the process of globalization and capital account liberalization. This is not an easy task. The globalization process manifests itself in many different ways and while these may bring opportunities, it is generally recognized that an economy's exposure to the process is not without significant risks. In addition and in spite of years of concerted analytical and empirical analysis, capital account liberalization remains an area in which there is little professional consensus (IEO, 2005).

This paper reviews some aspects of the debate on the linkages between globalization and capital account liberalization. In doing this, the paper starts with an analysis of globalization and the associated capital flows in section II; and then discusses the impact of the capital flows on the financial and real sectors of the economy. Capital flows create their own unique policy challenges. Hence, section III of this paper addresses issues relating to the management of capital flows by identifying and discussing a menu of policy options. Capital account liberalization also has an important role in the management of capital flows, but the process of capital account liberalization

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itself requires to be managed. Section IV is therefore devoted to an analysis of these two aspects. The paper's concluding comments are offered in section V.

## II. Globalization, Capital Flows and their Impact

Globalization, as a process, is a complex and multi-dimensional phenomenon, but some of its most visible and influential elements are economic in nature (ECLA, 2002). In its economic dimension, this process is characterized by increasing flows of trade in goods and services among countries and as a share of their gross domestic products, as well as similar flows in the factors of production, particularly capital and technology. In other words, globalization could involve trade booms, huge capital flows, and mass migrations (Richardson, 1995).

In essence, therefore, the globalization process generally involves the deepening and widening of cross-border flows of trade, capital, labour and technology which are facilitated by rapid communication mechanisms. In effect, innovations in communications and information technology combined with the liberalization and deregulation of the markets and economies of many countries have played the key role of fostering global economic integration by boosting trade and investment flows. The belief that the resulting freer flows of trade and investment in the global context will produce the best outcome for economic growth and human welfare is increasingly pressurizing governments of developing countries to further liberalize their economic policies and regulatory regimes so as to align them more closely with those prevailing in the more industrialized high-income countries.

There is clear evidence that the globalization process has been under way for sometime. Since the 1970s, for instance, international trade, investment and technology flows have been large and rising. In particular, the ratio of trade to output has risen markedly virtually world-wide; global trade has grown twelve-fold, foreign direct investment (FDI) flows have increased approximately 32-fold, and the linkages between trade and capital flows are strengthening as more and more FDI flows are geared to serving global rather than domestic markets and are increasingly attracted into rapidly growing and

export-oriented economies. More recent estimates show that net private capital flows to developing countries grew from less than $100 billion in 1990 to well over $200 billion in 1995 (IEO, 2005). But subsequent years saw an equally large reversal of these flows so that the volume remained subdued through the 2000-2005 period.

Capital flows differ quite markedly, particularly in terms of volatility. Because certain forms of these flows (e.g. portfolio investment) are volatile, they can constitute a significant source of macro-economic disturbance. The possibility exists that such forms of capital inflows could abruptly slow down or even be reversed and thus force the recipient country to make sudden, costly and painful macro-economic and financial adjustments. Hence, there are two fundamental concerns about rising foreign capital inflows; one relates to the effective utilization of the resources they provide and the other relates to the appropriate management of the problems associated with the recipient economy's vulnerability to volatile capital flows.

Foreign capital inflows can have both financial (monetary) and real effects in the economy of the recipient country. Starting with the former, the literature suggests that an important trigger for capital inflows is the rate-of-return differential between the recipient country and the rest of the world. The differential attracts foreign investors who are looking for more attractive returns. The resulting foreign-induced demand for domestic stocks leads to a sharp rise in stock prices. The intermediation of this process through the banking system generates an increase in the domestic liabilities of banks; while the higher transactions demand associated with the process also leads to additional bank deposits. The increased bank liabilities will, in turn, stimulate increased bank lending which should put a downward pressure on interest rates. In summary, therefore, economic theory postulates that capital inflows will generate an increase in stock prices, an increase in monetary aggregates and domestic liquidity, and a reduction in domestic interest rates.

While there appears to be broad consensus regarding the impact of capital inflows on key monetary and financial variables, there is a wider range of opinion with respect to their impact on the real sector (Oyejide, 2005). One

general view is that foreign capital inflows provide an opportunity to utilize international resources to supplement limited domestic resources to enhance the growth of the economies of developing countries (Gavin et al, 1997). In this context, foreign capital inflows put to good use can finance investment and stimulate economic growth of the recipient country (Reinhart, 2005). Against this is an opposite view which is derived from empirical analysis; this view shows that capital flows have no significant impact on economic performance once the impact of key variables such as the level of education, initial level of income, and the quality of institutions are controlled for (Rodrik, 1998). An attempt to reconcile these two views is based on the "absorptive capacity" perspective; it suggests that real sector effects of foreign investment on the economy of a recipient country is contingent on key characteristics such as initial income, education and level of financial development. When these characteristics are below certain threshold levels, capital inflows tend to have an ambiguous or even negative effect on growth (Durham, 2000).

Analytical and empirical research provides further insights into the real sector effects of capital flows. For instance, it is well established that capital inflows lead to real exchange rate appreciation because the increased domestic absorption generated by the inflows puts pressure on the non-traded goods sector, and increases its price relative to that of the traded goods sector. The real exchange rate appreciation can, in turn, have positive effects on consumption and investment through at least three channels: increase in the domestic purchasing power of consumers, reduction in the cost of imported capital goods, and fall in the domestic value of debts denominated in foreign currency (Ibarra, 2004). In addition, the real exchange rate appreciation induced by capital inflows is typically associated with a stronger import boom and a relatively weak (if not negative) effect on exports (Celasum et al, 1999).

Capital inflows are usually associated with sharp declines in private domestic savings for at least three reasons. First, the wealth effects of the booming equity and real estate markets induced by capital inflows tend to reduce domestic savings; second, the expansion of bank credit associated with capital inflows relaxes financing constraints of firms and tends to reduce savings; and third, the often excessively optimistic view by domestic consumers of

prospects for the future, induced by capital inflows, results in savings decline.

By comparison, capital inflows may increase investment, to the extent that private investment growth responds positively to the increase in stock prices instigated by the inflows. In summary, therefore, capital inflows tend to be associated with a fall in domestic savings, an increase in private investment and a rise in consumption; a consumption boom which is often heavily driven by rising imports of durable goods. However, the impact of capital flows on the real sector of a low-income country's economy tends to be sensitive to the level of development of its stock market and the banking sector (Durham, 2000).

Beyond this caveat is the much larger issue of the effects of capital flow instability. Significant asymmetries exist with respect to the impact and effectiveness of capital inflows and outflows. In particular, the reduction in total investment and output generated by a given capital outflow tends to be larger than the increase in investment and output induced by capital inflow of the same magnitude. Similarly, while the real exchange rate rises on the inflow of capital, it does not necessarily fall proportionately following an equal capital outflow. In addition, capital inflows and subsequent outflows may shift relative prices in ways which distort resource allocation decisions, and generate abrupt fluctuations in aggregate demand which may raise the level of country risk, depress investment and make government borrowing from abroad more difficult.

Sharp fluctuations in capital inflows can pose significant challenges for economic management by interfering with the effectiveness of government policies and their objectives. In particular, endemic capital flow fluctuations can frustrate attainment of price stability and aggregate demand management in the short-run, as well as constrain economic growth and structural transformation in the medium and long-term. These problems suggest the need for sophisticated management of capital flows and the economy's degree of vulnerability and exposure to capital flow fluctuations.

## III. Managing Capital Flows: A Menu of Options

In the 1990s, the search by international investors for more attractive returns on their investments and the economic reforms pursued by a number of emerging market economies combined to produce a surge in capital flows to these countries. As they experienced large capital flows and the associated macroeconomic management challenges, economic research and analysis began to focus increasingly on the question of how to manage these flows not only to maximize their advantages but also to minimize their costs. This effort has given birth to a large and growing literature which generally identifies and discusses policy measures that are aimed at preventing and/or managing capital inflows and their volatility. These policy measures can, obviously, be categorized into two groups. In one group are the policy measures which can be used to prevent instability in capital flows or reduce the economy's vulnerability to capital flow fluctuations. Such policy measures include tax and regulatory policies which are aimed, essentially, at eliminating or reducing the attractiveness of speculative short-term capital inflows while enhancing the inflow of the more stable and long-term FDI. In the second category are policy measures that are aimed at dealing with the instability that may be inevitably associated with capital flows. This category recognizes that there are significant benefits to be derived and there are important costs to be borne. Hence, the policy challenge is to maximize the benefits at a given cost or minimize the costs associated with a given level of benefits. This category thus involves the building of robust institutions and credible policy regimes as well as the appropriate analytical skills and policy-making and implementation capacity.

There is a long list of policy options that is available to countries which wish to manage large capital inflows (see, for instance, Goldstein, 1995). The policy measures that such a country selects from the list would depend on the nature of the inflows, the problems they raise and the particular characteristics and circumstances of the country. In general, the list includes sterilization through open market sales of domestic securities, increase in reserve requirements and tightening of prudential regulations, fiscal tightening, greater nominal exchange rate flexibility, increased liberalization of the trade regime, removal

of restrictions on capital outflows, and tightening of controls on capital inflows.

It is unlikely that any one of these policy measures can single-handedly solve the macroeconomic problems induced by capital inflows. It is therefore not unusual to deploy a mix of tools which may, at a minimum, consist of tight fiscal policy, foreign exchange market intervention, and temporary prudential controls. Calvo and Reinhart (1990) suggest that multiple policy responses to capital inflows in an African context may include the following: the central bank intervenes in the foreign exchange market by accumulating international reserves in an attempt to avoid nominal exchange rate appreciation; and sells treasury bills (or similar domestic debt instrument) to offset the associated monetary expansion; raises the reserve requirements of commercial banks in order to neutralize the effects on the money stock of its foreign exchange operations and thus keep the money stock constant. In addition, there is a supportive fiscal policy component to this package. In particular, fiscal austerity measures on the spending side should alleviate pressures on the real exchange rate; while fiscal surpluses deposited at the central bank would help to sterilize the expansionary monetary effects of the central bank's foreign exchange purchases.

Other policy packages can be constructed with different component parts to reflect both the nature of the problems and the characteristics of the country concerned. The fact of the matter, however, is that none of these policies is a panacea, as each may be associated with significant costs or its implementation may trigger other policy challenges. Hence, whatever packages are chosen, it must be recognized that there will always be difficult trade-offs between the potential short-run costs of large capital inflows and the side-effects of the policy measures used to deal with them. It may be instructive to illustrate some of these side-effects.

Sterilization is often the most popular policy measure taken by countries that experience the macroeconomic management challenges typically associated with large capital inflows. As reserves are accumulated in this process, the fear of inflation leads to a sterilization of the change in reserves so that it does not

affect the domestic money supply by using open market operations. But as the central bank acquires international reserves by issuing domestic debt instruments, other challenges emerge. For instance, domestic interest rate is not under pressure to be driven down; hence interest-rate differential subsists and may induce further capital inflow. Besides, sterilized intervention permits the continued build-up of accumulated reserves; some of which the government may be tempted to spend. In addition, sterilization has quasi-fiscal costs. Since it typically involves the exchange of higher-yielding domestic securities for lower-yielding international assets, a corresponding build-up of quasi-fiscal losses occurs. In any case, sterilization often loses its effectiveness eventually, as the substitutability between domestic and foreign assets increases.

Tightening fiscal policy typically comes along with sterilization, preferably through a reduction in public expenditure. The primary purpose of this is to reduce the pressure on the real exchange rate by lowering domestic absorption and thus limiting the increase in the relative price of non-tradables. But fiscal tightening may also promote capital inflows by signaling that the authorities are committed to prudent macroeconomic management which may, in turn, cause the exchange rate to appreciate, especially over the medium-term. In any case, fiscal tightening is often seen, in the context of these policy packages, as an auxiliary measure to the extent that the required degree of restraint is typically expected to come largely from the side of monetary and exchange rate policy. In addition, fiscal policy lacks short-run flexibility and thus, can not be relied upon for the required policy fine-turning. Furthermore, there is an inherent conflict between the use of sterilization and fiscal tightening which arises from the quasi-fiscal losses generated by the former. Over the medium-term, the fiscal policy component may assume increased significance if capital inflows reduce monetary policy effectiveness in circumstances where the central bank loses control over key monetary aggregates.

Monetary policy is generally central in the typical policy package aimed at addressing the macroeconomic management challenges caused by large capital inflows. But the potential effectiveness of monetary policy can be substantially eroded by certain features of the financial system that may also be

associated with the occurrence of large capital inflows; i.e., high domestic liquidity, short-term maturity of treasury bills, and increasing share of foreign-currency denominated bank deposits. The impact of the first two of these on the effectiveness of monetary policy are quite obvious, that of the third may benefit from more elaboration. Note, to start with, that as foreign-currency denominated bank deposits increase as a share of broad money, the share of reserve money to GDP tends to fall. In this context, the decreasing size of the monetary base makes expansion more inflationary.

When exchange rate flexibility is included in the mix of policy measures for managing capital flows, the intention is to allow the exchange rate to appreciate in response to large capital inflows, and to permit a greater scope for depreciation in order to discourage speculative inflows. This is not without a significant "downside" effect in the real sector of the economy. More specifically, exchange rate flexibility may lead to a larger real exchange rate appreciation which will, in turn, inhibit export growth while promoting the surge of imports. The imposition of high reserve requirements on commercial banks can adversely affect the allocation of credit by reducing financial intermediation. The tightening of prudential regulations may cause the same kind of problem. The liberalization of capital outflow can send positive signals and thus encourage further capital inflows; while restrictions imposed on various components of capital inflows can be bye-passed. Taken together, the various problems associated with the typical packages of standard policy measures that can be used to address the macroeconomic management challenges unleashed by large capital inflows have generated pressures to look in the direction of capital account liberalization for an effective and enduring solution.

## IV. The Role and Management of Capital Account Liberalization

In spite of the focus of research and policy analysis on the subject, especially since the Asian crisis of the late 1990s, capital account liberalization remains an issue with respect to which debate continues to rage. Economic theory provides a rationale for capital account liberalization which stresses that free capital mobility promotes an efficient global allocation of savings and a better

diversification of risk; both of these, in turn, stimulate greater economic growth and welfare ( Fischer, 1998). The efficiency gains derived from more optimal savings allocation and risk portfolio diversification constitute the major channels through which capital account liberalization is expected to boost economic growth; while the greater consumption smoothening associated with it can be significant for welfare. From the point of view of low-income countries, in particular, capital account liberalization may also be important for attracting foreign investment.

Ranged against this view which broadly supports capital account liberalization is another view which opposes it, both on theoretical and empirical grounds; it is argued, for instance, that the existence of considerable information asymmetry in international financial markets combined with significant domestic distortions means that free capital mobility would not necessarily lead to an optimal allocation of resources (Rodrik, 1998; Stiglitz, 2000). In addition, the magnitude of the gains that may be derived from capital account liberalization is relatively small. Finally, since the empirical evidence linking capital account liberalization to economic growth remains weak, much of the literature continues to question the wisdom of undertaking the clearly costly and risky reforms that are required for capital account liberalization given that the expected benefits to be derived are quite limited and uncertain (IEO, 2005).

Capital account liberalization can play an important role in attracting foreign investment to an economy and in helping to manage the macroeconomic implications of such capital flows. But capital account liberalization is itself associated with risks and distortions. Hence, the management of the process of capital account liberalization requires considerable sophistication in terms of analytical and institutional capacity. This may explain why much of the literature stresses the danger of opening the capital account too rapidly before supporting policies and appropriate institutional capacity are in place.

Because capital account liberalization poses various risks to financial and macroeconomic stability, it should be approached as an integral part of a comprehensive programme of economic reforms (Ishii et al, 2002). Several elements of such a reform package constitute important pre-conditions for

capital account liberalization. According to Galbis (1994), the list of prior reforms includes fiscal consolidation, non-inflationary finance of public deficits, macroeconomic stability, an appropriate monetary-fiscal policy mix, and a strong domestic financial sector. There are, of course, varying views with respect to the relative importance of each of these pre-conditions. Some would argue, for instance, that the most important precondition for capital account liberalization is a comprehensive reform and strengthening of the domestic financial markets and institutions. Others may stress the prior establishment and maintenance of economic stability as the critical pre-condition; while it may also be argued that attaining exchange rate flexibility before capital account liberalization has the advantage of enabling the economy to absorb capital account shocks at lower cost to the real economy. What is clear from the debate on pre-conditions for capital account liberalization is that it should come at the end of a long list of other policy and structural reforms which have been successfully completed and sustained. Hence, there is a fairly broad consensus that capital account liberalization must be viewed as a long-term goal which should be approached gradually, sequentially and systematically.

Stressing that countries should pursue capital account liberalization in a well sequenced and prudent manner, Ishii, *et al* (2002) offer both a set of principles and phases to guide the process. With respect to the sequencing of the liberalization process, the following principles should be applied:

- establish sound macroeconomic policies
- prioritize reforms for sustaining macroeconomic stabilization
- implement together reforms that are operationally linked
- complement financial reforms with prudential regulation and financial restructuring
- take account of concomitant risks of various types of instruments
- reflect the conditions in the non-financial sector in setting the pace of reforms

- start reforms which take time early
- reforms should take account of the effectiveness of the existing controls
- take account of political considerations in establishing the pace, timing and sequencing of capital account liberalization
- the arrangements for policy transparency and data disclosure should be adapted to support capital account opening.

In terms of operational strategy, Ishii, *et al* (2002) suggest that the process should start with a diagnosis of the existing institutions and capital account regulations and then proceed through the articulation of a three-stage plan for sequencing and coordinating capital account liberalization with other policies. The goals of the first stage are to achieve a high degree of macroeconomic stability, develop financial markets and institutions, foster good risk management by banks and other economic entities, and remedy the most important shortcomings in prudential regulations. At the end of this stage, capital account liberalization with respect to low-risk capital flows (such as FDI) can be accomplished.

The goals of the second stage consist of consolidation and deepening of the progress made in the first stage. At the end of this stage, considerable further capital account liberalization should take place. The goal of the third and final phase is to ensure that the macroeconomic and financial sector conditions have improved to the point where risks can be effectively managed. At this point, all remaining capital account controls can be lifted.

Neither the general principles nor the operational stages for implementing the capital account liberalization process discussed above mention a critical success factor, i.e., institutional capacity for research and analysis as well as policy design and implementation. It is this which comes into play at several key points when judgments must be made and decisions taken; such as the diagnosis of the pre-liberalization situation, applicability of the general principles, and the goals and time-duration of the operational stages. It is

difficult to over-emphasize the importance of the necessary human and institutional capacity involved.

## V. Concluding Comments

Globalization and the capital flows that it generates can bring significant benefits to economies which become more integrated into the global economy. But capital flows and their volatility also pose daunting challenges of macroeconomic management for low-income countries, given the inherent characteristics of their economies, the weaknesses of their economic institutions as well as the associated information asymmetries and policy distortions. Hence, prior cost-benefit analysis may be required before embarking on the process of capital account liberalization to ensure that its uncertain and limited benefits are worth the inherent risks and costs. Beyond this, the process itself must be carefully designed and implemented gradually, sequentially and systematically. The comprehensive reform package in which this process should be embedded will be particularly demanding in the use of sophisticated human and institutional capacity, the build-up of which deserves considerable attention and prioritization.

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# Capital Account Liberalisation: The ECOWAS Experience

*M.O. Ojo, Ph.D* *

## I. Introduction

During the last three decades, the rapid integration of the global economy, usually referred to as "globalization", has triggered phenomenal increase in international financial transactions. One of the elements of this dynamic process is the significant growth in international capital flows facilitated by progressive removal of restrictions on capital account transactions, implementation of various macroeconomic policy reforms, as well as the increased application of information and communications technologies. Capital account liberalization can enhance economic growth and development through access to foreign savings for domestic investment, improvement in the efficiency of resource allocation for greater competitiveness in the global economy. However, there is evidence that capital account liberalization that is not accompanied by appropriate policy reforms carries enormous risks that are detrimental to economic growth and welfare. Thus, a central issue is how to effect an orderly capital account liberalization in a specific economy.

Developing economies, especially in sub-Saharan Africa have undertaken significant economic reforms particularly in the financial sector in recent years, but these are generally not adequate to substantially enhance their status in the global economy. While there has been increased commitment to removing capital controls, the outcomes indicate that more efforts are needed to deepen the financial and structural reforms. The need to undertake these reforms is made more urgent by the efforts at economic integration which is seen as a window of opportunity for enhancing economic growth and welfare.

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For instance, the ECOWAS integration programmes have as one of the basic components the free movement of capital within the sub-region, as well as the creation of a single economic space through trade liberalization and the removal of barriers to the free movement of persons, goods and services. In pursuit of the objective of the common currency for the sub-region, the ECOWAS authorities have focused on the harmonization of fiscal, monetary and financial policies so as to facilitate the liberalization of money and capital markets. A major issue is how far the reform process has advanced to enhance further integration with the global economy.

The paper focuses on the status of capital account liberalization in the ECOWAS and the policy measures that could be adopted to facilitate the process of capital account liberalization in the scheme of regional integration. The implications for economic management in Nigeria are also discussed. Some of the relevant issues that the paper addresses are, the role of capital account liberalization in the economic integration process, the prerequisites for capital account liberalization and the policy reforms needed to enhance the benefits from capital account liberalization. To this end, the paper examines some relevant conceptual and theoretical issues in Section 2, while Section 3 is devoted to a review of the status of capital account liberalization in the ECOWAS. The policy implications for an effective strategy of capital account liberalization are examined in Section 4. Section 5 contains the summary and conclusion.

## II. Conceptual and Theoretical Issues in Capital Account Liberalization

For a clearer understanding of the subject of capital account liberalization, four issues are articulated in this section: definition of capital account liberalization, the potential effects of capital account liberalization, the role of capital account liberalization in the process of regional economic integration and the prerequisites for facilitating the process of capital account liberalization.

## II.1 Capital Account Liberalization

The concept of capital account is best understood in the context of a country's balance of payments (BOP). A country's BOP is a record of transactions between its residents and non-residents. The BOP has two major accounts namely the current and capital accounts. The current account details economic transactions which provide incomes for the recipients. The current account transactions include trade in goods (visibles), trade in services (invisibles), payments of factor incomes (dividends, interest and migrants' remittances from earnings abroad), and international transfers (gifts). The capital account records transactions which do not involve the receipt of income, but change the form in which assets are held. The capital account of the BOP is thus a record of international exchanges of assets and liabilities. The main elements of the capital account are foreign direct investment (FDI), portfolio investments (equity investments) and loans. Capital account liberalization therefore refers to a process whereby there is a systematic reduction or removal of restrictions on capital flows to a country. This also implies a higher level of integration into the global economy. Where a country deems it fit to impose restrictions on capital movements, the popular methods used include exchange controls or quantitative restrictions on capital movements, adoption of multiple exchange rate arrangements and imposition of taxes on external financial transactions.

## II.2 The Potential Effects of Capital Account Liberalization

The basic model for international capital movements follows the neoclassical theory of marginal productivity. Since it can be reasonably assumed that the marginal product of capital is higher in a capital-scarce country than in a capital-abundant country, capital will tend to move from the latter to the former until the point where diminishing marginal productivity sets in (Eichengreen et al, 1998: 12-14 and Nielsen et al, 1995: 49-52). This process increases welfare in both countries thus, global economy tends to gain as countries specialize in the production of financial services. The capital account liberalization engenders competition which induces more efficient financial sector and greater ability to enhance international productivity. Through capital movements, a nation's economy derives more income from the opportunities

created by the diversification of portfolio investments and sharing of risks. Higher incomes will encourage more savings, investment and economic growth. Capital flows also facilitate the transfer of technology and commercial know-how through properly negotiated technical agreements thus, creating further welfare gains.

The potential positive effects of capital flows notwithstanding, many countries restrain such flows thereby calling to question the basic assumptions underlying the positive effects of capital account liberalization. For instance, it is argued that the free movement of capital may not necessarily result in the efficient allocation of resources as the financial markets are not always efficient because of the prevalence of "information asymmetry". Also, capital flows may reduce welfare because of the presence of trade distortions and the use of subsidies or guarantees on transactions in the financial system. The use of capital controls may also be justified if they are needed for protection against risks associated with international capital flows. Equally, capital controls could be needed to protect fragile financial systems. Although there are gains from the free movement of international capital for developing countries, the domestic economy may however be fragile and therefore full benefits may not be derived from such flows. Some elements of capital controls may be unavoidable yet, international capital movements will continue to grow under the impulse of globalization. The central issue then is to institute the domestic reforms that will permit the efficient use of and prevent the negative effects of capital flows.

### II.3 Capital Account Liberalization and Regional Economic Integration

For a single country, capital account liberalization is managed within one economy, but where economic integration is involved, capital account liberalization may assume complexities as it involves several economies often with diverse features and management practices. Economic integration is a process by which a group of countries come together to create a single economic space. Where each country previously had its own unique set of economic rules and regulations, the integrating group of countries through its

supranational institutions now impose a new set of economic rules and regulations. Thus, in this setting, economic activities are organized such that national boundaries do not matter. Full economic integration implies free trade in all goods and services, perfect capital mobility, complete freedom of labour migration, complete freedom of entry for businesses and unrestricted flow of information and ideas. It also implies full harmonization of economic policies such as taxation. Full integration may involve the formation of a monetary union characterized by a single monetary policy, a common currency and integration of the financial markets. In order to reap the full benefits of the economic integration arrangements, the group of countries would eventually also adopt capital account liberalization with the rest of the world. This implies that every member country must adopt measures that would ensure free capital movements within the group and with the rest of the world. Against the above background, it can be observed that in most integration arrangements in the global economy, systematic capital account liberalization is being undertaken to enhance growth and welfare and to minimize the inherent risks.

## II.4 The Prerequisites for Effective Capital Account Liberalization

In order to remain part of the global economy the liberalization of a country's capital account is inevitable. This is particularly so for countries involved in economic integration. There are also enormous risks involved particularly as the integrating countries are at different stages of economic development. Attempts to impose capital controls often create new problems that constrain the attainment of the desired objectives of capital account liberalization. The critical issue to address therefore is what constitutes the minimum conditions necessary for effective capital account liberalization.

The experiences of developed countries, emerging market economies and developing countries indicate that for an effective programme of capital account liberalization that minimizes the dangers of ad hoc liberalization, a country or group of countries must ensure a stable macroeconomic environment, evident in sustainable strong economic performance, sound financial system as well as follow a well sequenced liberalization programme.

In order to ensure a stable macroeconomic environment, the economy must be free of domestic distortions such as high inflation, fiscal and monetary instability and external imbalances. This will result in reasonable and sustained economic growth within a diversified economic structure which is capable of absorbing domestic and external shocks. Furthermore, the financial sector must be sound and fully integrated in the context of an economic union. This aspect is critical as the major intermediary for capital account liberalization is the financial sector. A sound and integrated financial sector provides the basis and enabling environment for the implementation of a robust single monetary policy. Weak banking systems cannot support the appropriate framework for the conduct of a single monetary policy in an economic union.

Evidence shows that there must be strong prudential regulation for effective capital account liberalization. While it is an option to undertake prudential supervision after adopting capital account liberalization, the prudential reforms needed must be carried out before or concurrently with the capital account liberalization process. Prudential supervision and regulation are particularly needed in the area of foreign exchange risks assumed by financial institutions.

Another important condition for effective capital account liberalization is to sequence the process. This is very essential for a group of countries in an economic integration arrangement since the member countries are likely to be at different stages of economic and financial development, evolution of the institutional structures, legal and business practices. The sequencing of capital account liberalization will depend on the extent of domestic financial liberalization, the stage of development of the domestic financial markets and the size of outstanding constraints on the financial system. Where there are significant distortions in the domestic financial system, for example in a financial system with distressed segment, a policy of gradual capital account liberalization is needed while such distortions are being removed. Under a situation of distress in a financial system, unguided opening up of the capital account will worsen the health of the financial system. Thus, there is the need to remove insolvent institutions before expediting the process of capital

account liberalization. While there is need to be cautious in liberalizing portfolio investments in a country with poorly developed domestic infrastructures it is generally accepted that all efforts must be made to encourage the inflow of foreign direct investment which has a lot of benefits such as transfer of technology and efficient business practices. The liberalization of capital outflows is somewhat delicate if it will impact too negatively on the macroeconomic environment. For instance, macroeconomic disequilibria exist where the exchange rate is overvalued or interest rates are repressed with restrictions on capital outflows. Removal of such restrictions in a programme of capital account liberalization will affect both the public and private sectors. A cautious approach is therefore needed in promoting capital account convertibility.

From the above, there is no hard and fixed rule about the timing of capital account liberalization. It has to be in line with the presence of the above necessary conditions. This is the basis for sequencing of the process. The issue is more delicate for countries pursuing an integration programme. Within the timeframe allowed for the integration process, each country must move at its own pace determined by its domestic economic and financial environment. Some countries may have to move faster in order to catch up with those countries with relatively more developed financial systems. Empirically, the Asian experience of the 1990s is a guide to what could happen where capital account liberalization is not well guided and monitored. The Asian financial crisis was triggered by the rapid liberalization of capital inflows. When investors lost confidence in the Asian economies, there were massive capital outflows which negatively affected economic growth in the region. The general principle is that capital account liberalization not supported by appropriate macroeconomic policy reforms and robust prudential supervision and regulation tends to increase the risks posed by financial crisis.

## III. The Status of Capital Account Liberalization in The Economic Community of West African States (ECOWAS)

Both at national and regional levels, many countries have significantly liberalized capital movements to enhance economic activities particularly in

the last two decades. This has been the case with the developed and emerging market economies. The process has improved economic growth and welfare while in some cases, notably, South East Asia, it was accompanied by severe economic crisis. Similarly, vigorous attempts were made in the ECOWAS since the early 1980s to liberalise capital movements as part of their structural reforms and economic integration agenda. This section reviews the status of capital account liberalization in the ECOWAS. In line with the current integration strategy of the ECOWAS, the review is done at three levels the West African Economic and Monetary Union (WAEMU/UEMOA), the West African Monetary Zone (WAMZ) and the ECOWAS as a whole. The analysis depends largely on the survey carried out by WAMA, WAMI and ECOWAS Secretariat in 2005.

Generally, all capital movements among the WAEMU countries are liberalized, whereas capital transactions between the WAEMU and other countries including other ECOWAS countries are governed by regulations which seek to pursue a gradual capital account liberalization. WAEMU has fully accepted Article VIII of the IMF Articles of Agreement on current account transactions. The WAMA survey analysis identified 12 components of capital transactions. WAEMU imposes restrictions on eight components while only four items are free from restrictions. The result is that capital account openness in the WAEMU is only 33.3 per cent of the potential. However, the absence of capital controls among the eight members of the WAEMU is a significant achievement in the ECOWAS programme of capital account liberalization.

There are five countries in the WAMZ (The Gambia, Ghana, Guinea, Nigeria and Sierra Leone) with two countries as observers (Cape Verde and Liberia). The Gambia has the highest score on capital account liberalization in the WAMZ with a score of 90.0 per cent, that is, nine out of ten capital transactions are free of controls. The only one with controls is credit operations between non-residents and residents. The Gambia has also acceded to Article VIII of the IMF Articles of Agreement on current transactions. It is generally accepted that the openness of The Gambian economy has produced positive effects on investment and growth. However The Gambian economy is relatively small

within the WAMZ. The remaining countries in the WAMZ have not progressed as much as The Gambia in opening up their capital accounts. For instance, Ghana has no restrictions on only two of 12 components of capital transactions, a score of only 16.7 per cent. However, Ghana has acceded to Article VIII of the IMF Articles of Agreement on current account transactions. Guinea has liberalized five out of 11 capital transactions with a score of 45.5 per cent. It has acceded to Article VIII of the IMF Articles on current account transactions. Nigeria, with a score of 50.0 per cent is next to The Gambia in liberalization of the capital account. Notably, Nigeria does not have restrictions on derivatives and other instruments, inflows and outflows of direct investments, real estate transactions, among others. Nigeria has, however, not fully accepted the IMF Article VIII which demands no restrictions on current account transactions. Sierra Leone has no restrictions on four out of nine capital transactions indicating a score of 44.4 per cent. Cape Verde has no restriction on only one out of nine capital transactions, while Liberia has freed its capital account to the tune of 80.0 per cent.

Taking the ECOWAS as a whole, the evidence provided by the above information shows that the Community largely imposes controls on capital movements. The most important are on capital transactions (14 out of 15 countries), capital and money market instruments (13 countries), outflows of direct investment (12 countries), real estate transactions (13 countries) and personal capital transactions (12 countries). Others include derivatives and other instruments (9 countries) and provisions specific to institutional investors (8 countries). The transactions that are relatively free of controls include inflows of direct investment (13 countries), liquidation of direct investment (13 countries) and securities law (no country). The about average level of capital account liberalization in the ECOWAS is not unexpected. The macroeconomic environment of the sub-region is generally unstable. Financial systems are fragile and much below international standards. The prudential and supervisory systems face challenges of compliance with all the Basel Core Principles (BCPs). Financial stability is constrained by inadequate institutional structures.

## IV. Policy Implications For Effective Capital Account Liberalization in the ECOWAS

The prerequisites for effective capital account liberalization discussed earlier should logically be the basis of a policy agenda for an orderly capital account liberalization process in the ECOWAS. On the practicalisation of the framework, there is considerable consensus in the literature. The opening of a country's capital account is not a stand-alone action. There is general agreement that it should be part of national economic policy. Most importantly, capital account liberalization should fall within a programme of financial sector reforms. The essential financial sector reforms are by now common knowledge and they include the adoption of market-based monetary management, market determination of interest rates, enforcement of prudential supervision and regulations in line with international financial standards, choice of an appropriate exchange rate regime, restructuring of financial institutions and the elimination of problem institutions. If the financial sector reforms are properly managed, they can produce salutary effects on the real sector through the resultant improvement in savings mobilization for investment, increased credit to the private sector and better allocation of resources. Other structural reforms necessary for capital account liberalization should include price, exchange and trade reforms. Together with these financial sector and structural reforms, capital account liberalization can assist in strengthening domestic financial institutions and maintaining a stable macroeconomic environment. The domestic economy is set to face greater competition and risks which capital account liberalization will engender.

The best way to envision the processes of financial sector reforms is through case studies of country experiences. For instance, the Nigerian case which started in the mid-1980s has produced interesting results. The financial sector reforms have not always been carried on consistently. However, they have advanced rapidly in the last five years. It is now appropriate to articulate a programme of well-sequenced capital account liberalization. Nigeria should accept Article VIII of the IMF Articles of Agreement on current account transactions as soon as possible. Removal of the remaining capital controls should systematically be done given the progress of financial sector reforms which has been significant. Nigeria cannot rush into full capital account

liberalization in the immediate future.

The above policy proposals and strategy are applicable to a national context. Given the overall objective of this paper, the policy implications for integration in the sub-region should also be explored. A brief overview of four integration activities needed to facilitate capital account liberalization in the sub-region is presented below. It is proposed that the policy package should be implemented within a period of 3-5 years to fall in line with the integration programme.

- In order to forge the integration of the sub-regional economies, there is a need to strengthen the **promotion of macroeconomic stability**. The basic strategy for doing this is to comply with specified macroeconomic convergence criteria which are targets to be attained by member countries so as to achieve low inflation, stable fiscal and monetary conditions and external sector stability. Although the three integration Programmes (WAEMU, WAMZ and ECOWAS) are governed by different targets, they fall within narrow ranges. The target for inflation is single digit, while the requirement for the budget deficit to GDP ratio is a maximum of 4.0 per cent. The financing of the budget deficit by the Central Bank is limited to 10.0 per cent of the previous year's tax revenue and should be zero at the point of launching the monetary union. The minimum level of external reserves should be adequate to finance three months of imports. The record of performance of member countries has been unsatisfactory so far although significant improvement was recorded in 2005. The major initiative to restore macroeconomic stability is to curtail budget deficits and generally achieve fiscal consolidation. Revenue resources should be expanded through improvement of tax collection, tax administration and compliance, as well as reduction in tax evasion. On the expenditure side, transfers to inefficient public enterprises, phasing out of subsidies and privatization are some of the strategies for consideration. There is also need to curtail the expansionary fiscal stance of governments which have generally been supported by borrowing from the banking system. This process has continued to crowd out the private sector and undermined the development of the financial markets.

- With the significant progress in financial sector reforms in the member countries, there is **need for deeper financial sector integration** in the sub-region. The main components are the development of an efficient payments system, harmonization of the regulatory and supervisory systems, development of the capital markets and gradual unification of the monetary systems. All countries in the ECOWAS should strive to implement the Real Time Gross Settlement System so as to develop a common platform to support intra-community trade and cross border transfers, as well as the transmission of monetary policy. Efforts should be made for the supervisory systems in member countries to be fully compliant with the Basel Core Principles (BCPs). At present, compliance is about 30.0 per cent of the 30 core principles. If attained, countries would be able to detect and contain systemic risks. Further efforts should be geared towards upgrading the financial systems to the higher accord. The harmonization of financial rules and regulations should be given priority to provide the platform for financial integration. There is need to initiate a gradual coordination of monetary policies and harmonization of monetary policy procedures and instruments. In order to broaden capital market transactions and interlink the financial markets, the various stock exchanges should be coordinated such that the member stock exchanges will be allowed to trade in securities issued by firms across the single economic space. Prior to the adoption of the common currency, there should be quoting and trading in the national currencies. In other words, convertibility of the national currencies should be promoted to facilitate trade among the countries by reducing reliance on foreign exchange as a means of payment.

- There is need to **expedite the creation of the single economic space** in the sub-region through ensuring the implementation of existing agreements to which countries are signatory, especially the protocols on free movement of goods and persons, the ECOWAS Trade Liberalisation Scheme (ETLS), the adoption of the Common External Tariff (CET) and harmonization of indirect taxes and investment regimes. Although some progress has lately been recorded in the

implementation of these schemes, there is a lot of room for more progress. The subsisting challenges are to remove the seeming reluctance to apply the progressive removal of tariff and non-tariff barriers to the free movement of goods and persons, simplification of the rules of origin and approval procedures, the operationalization and effective management of the funds for compensation for loss of revenue and stepping up sensitization campaigns on the schemes to enhance the knowledge about the scheme of economic operators, implementation institutions and agents.

- The creation of the single economic space will be accelerated through faster **pursuit of programmes for promoting regional development and integration**. Intra-regional trade remains at a low level because of the inadequate and poor linkages of transport, communication and energy infrastructures. ECOWAS has, however, initiated programmes to interconnect existing networks in the area of transport, communications and energy. On road and maritime transport, countries should redouble their efforts to complete the remaining sections of the interstate roads network. The maritime component entails the promotion of private sector involvement through the harmonization of regulatory frameworks. On telecommunications, priority should be given to the harmonization of the telecoms regulatory frameworks and implementation of the roadmaps for a regional GSM roaming facility. On energy, there is need for further development of the sub-region's energy production potential so as to curb frequent power failures. The current projects, including integrated electric power grids project, the West African Power Pool and the West African Gas Pipeline Project, should be pursued to a logical conclusion.

## V. Summary and Conclusion

The paper set out to examine some of the theoretical and practical issues on capital account liberalization with a view to identifying appropriate policy actions that can enhance the level of capital account liberalization in the ECOWAS. There is general evidence that capital account liberalization can

enhance economic growth and development, but it poses enormous risks for growth and welfare if not accompanied by appropriate policy reforms. Through greater competition and diversification of investments, free capital movements induce more efficient financial sectors. Also, capital flows facilitate the transfer of technical and commercial know-how. However, as financial markets are not always efficient, capital flows may not necessarily result in the efficient allocation of resources. Capital controls may be necessary in the presence of trade distortions and fragile financial systems. However, in a dynamic global economy, capital account liberalization is inevitable and the major issue is to identify the basic prerequisites for ensuring that its benefits accrue to a country and the risks are minimized. In a regional integration arrangement, capital account liberalization assumes a complex dimension as it involves actions by several economies with different economic backgrounds and financial systems at different stages of development. At both national and regional levels, capital account liberalization must be undertaken within national economic policy reforms, especially in the financial sector, and sequenced as the reforms progress.

The ECOWAS countries have made significant progress in liberalizing capital movements, but substantial policy actions need to be undertaken to achieve full capital account liberalization. In the WAEMU, there are no capital controls among member countries, but the union has adopted a gradual liberalization framework towards other ECOWAS countries and the rest of the world. In the WAMZ, only The Gambia has fully liberalized capital flows, while other member countries are at an average level of liberalization. In the ECOWAS, the majority of countries impose controls on capital transactions, outflows of direct investment, real estate transactions and personal capital transactions. Inflows of direct investment and liquidation of direct investment are largely free of controls.

Capital account liberalization should be undertaken as part of national economic reforms particularly in the financial sector. Other structural reforms are also necessary. In a regional integration programme, each country must pursue with commitment its policy reform agenda. Coordination and harmonization of such reforms should be undertaken. The policy initiatives

needed to enhance the success of capital account liberalization in the ECOWAS include the sustenance of macroeconomic stability through fiscal consolidation, deepening financial sector integration through the development of efficient payments systems, improvement and harmonization of the regulatory and supervisory framework, integration of the capital markets and unification of the monetary systems. Capital account liberalization will be facilitated in the sub-region through effective implementation of the protocols and agreement on the free movement of goods and persons, as well as rapid implementation of the programmes for promoting regional development and integration, including those in transport, communication and energy infrastructures. Nigeria has become a leading country in the ECOWAS integration programmes not only in terms of maintaining the Community institutions, but also in implementing the various programmes. This is manifested by the strengthening of economic reforms in recent years.

The on-going reforms in the financial sector will enhance economic performance and institutions. A well-sequenced programme of capital account liberalization may be warranted at this point in time. But a lot of caution is needed to implement such a programme because the economic reforms must be sustainable.

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# Capital Account Liberalization: What Options for Developing Economies?

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## I. Overview

Economic growth and development has continued to elude developing economies largely due to policy inconsistencies and confusion, arising from either lack of the courage or the handling capacity on the part of their policy makers, to address the problems. As well, most of them often "dub" policies from advanced economies or seemingly successful emerging economies, with little consideration to their peculiar situations. Consequently, the policies either get implemented poorly or cannot be implemented at all. In many cases, the outcomes make the economies worse than before. It is important therefore, that new policy considerations draw from other country experiences in order to avoid such pitfalls.

Liberalization is a policy of creating a level playing ground for all economic agents that are interested in a particular economic activity. It could be seen from two perspectives namely,

**1.** Opening up a sector or industry for new domestic entrants, thus creating competition, and

**2.** Opening up for international players to enter the sector, industry or market, for reasons including importation of capital, expertise, best practice or as eligibility condition for policy support facilities from development partners.

Liberalization is one of the ten planks of the "Washington Consensus", a

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terminology used by economist John Williamson in 1989 to describe the ten-point reform package that was impressed on the world as the route for poor countries to follow in order to become prosperous. There are however, similarities and differences across nations, which explain why economic reform packages have varied in content and pace of implementation over time and across countries such as Russia, Mexico, Argentina, South Korea, Brazil, Romania, South Africa, India and China, to mention just a few. Thus, the design and implementation of liberalization (as well as its outcome) varied with the circumstances of each country and the cocktail of supporting policies.

Just like economic reform, the mistakes observed to have been made by one country guides the others seeking prosperity along the same route. For example, the under-achievement of reform and collapse of the Mexican economy in 1994 was attributed to over-dependence on foreign direct investment (FDI) and weak domestic saving, while the 1997/1998 crisis in the Asian Tigers was adduced to "crony capitalism" where a few private sector players dominated the system and they were somehow related to the government in-spite of the sound macroeconomic stability and high domestic saving.

This explains why the argument has been made that capital account liberalization, as a stand-alone policy, is unlikely to produce the desired outcome unless certain environmental conditions prevail and it is complemented with other supportive policies. If it is not complemented with other supporting policies or the fundamentals are not right, capital account liberalization (CAL) can precipitate foreign exchange and banking crisis, as it did in the late 1980's and early 1990's in both Europe and some emerging economies. It is not the state of development of an economy that makes capital account liberalization to precipitate a crisis; rather, it is the environment in which liberalization is done.

The ultimate aim of capital account liberalization is to allow the free flow of FDI in particular, both inward and outward. However, it has been discovered that a large volume of FDI inflow can be injurious to an economy that lacks the absorptive capacity or has weak economic fundamentals. Depending on the

state of that economy and its fundamentals, net outflow of FDI is equally not necessarily harmful to an open economy. Perhaps an important thing to note at this point is the need for consistency and robustness of policies, so as to retain investor confidence.

Prior to the Asian crisis, it was thought that contemporary economists had arrived at a good understanding of capital accounts, especially the challenges of its liberalization and how to handle them. In particular, sound macroeconomic policies were thought to be the critical factor for effective management of capital accounts. The Asian crisis made the importance of well-capitalized, well-managed and well-regulated financial system to come into sharper focus, according to Andre Icard (2003). He pointed out as well, the importance of shareholder discipline in a highly leveraged corporate capital structure.

This paper is in five sections dealing with, some basic facts about capital account liberalization, liberalization experiences, problems and prospects, policy options and recommendations, and conclusion, respectively. It is hoped that Nigeria, as a developing country, would have some useful lessons to draw from the conclusions.

## II. Some Basic Facts about Capital Account Liberalization

Capital account is a familiar term in the discussion of the balance of payments (BOP). It is a vital component of BOP that treats both inflows and outflows of long and short term capital, which is often treated as the balancing item against the current account deficit or surplus. It consists of capital movements in the form of investments, loans and grants. New foreign investments are therefore, as important as divestments, while loan receipts and their obligations (principal repayment and interest payment) as well as grants and aids matter to policy makers.

Liberalizing the capital account to facilitate capital flows has been an important policy issue since the end of the Second World War. It was brought to the centre stage of policy formulation and implementation for individual

countries that were seeking foreign financing for development projects and initiatives. Some countries have successfully liberalized their capital accounts, while others have had major foreign exchange and financial system crisis ensue from liberalization.

Liberal economists have argued against capital restrictions for years. This notwithstanding, they appreciate the dangers of badly handled liberalization, as reflected in the financial crises that erupted in most of the emerging economies that attempted capital liberalization without the supporting initial conditions. In the developed economies, with deep and diversified financial markets, honest and competent regulators, and macroeconomic policies that keep public borrowing and inflation in check, liberal regime for capital flow works best. Indeed, it works so well that the policy virtually elicits no debate. But this is not the case in the developing economies.

For developing economies, liberalization of the capital account has tended to prove very costly when combined with interest rate liberalization against the backdrop of weak macroeconomic policy environment and financial markets. The usual pattern is that when interest rates are deregulated, the rates tend to rise significantly, as has been the case in Nigeria. Domestic interest rates will, therefore, be significantly higher than international interest rates, producing a gap that ordinarily should encourage capital inflows (Table 1). Where liberalization induces large capital inflows, the local currency may appreciate while domestic liquidity may expand, generating inflationary pressure. Under the circumstances, liquidity management becomes a difficult task.

An important initial condition for CAL is ratio of current account deficit to the Gross Domestic Product (GDP). Where this exceeds the benchmark maximum of 5%, it can become injurious to the economy, as other conditions might encourage pent-up outflows (especially at commencement of liberalization) and further worsen the deficit. This will raise domestic (deregulated) interest rates, in an attempt to reverse the outward flows and make domestic currency denominated financial instruments more attractive.

Some types of capital flows are preferred to others. Capital flows of the "hot

money" type, particularly short-term bank loans, are risky and least preferred. Apart from the volatility risk, it is associated with the phenomenon of reversibility and domestic financial crisis. Though, difficult to attract and retain, FDI seems to be the best and most desirable form of capital inflow in relation to bank loans (often short-term), bonds and equities. So countries, whether advanced or emerging, are often encouraged to attract FDI and other long-term flows.

A common feature of international trade in both goods and capital is the wide range of choices. Trade in goods makes it possible for consumers in a country to access goods that they have not produced, and pay for them by producing and selling goods they do not wish to consume. In the same way, trade in capital makes it possible for countries to separate their savings and investment choices. They can invest more than they save by borrowing the difference from abroad; or they can invest less than they save by lending out the surplus. This is in line with the simple theory of international capital flows, by which the poor-country capital importers would invest more and produce more, while the rich-country capital exporters would invest less, but the income loss through this way would be more than outweighed by the additional income they receive from investments abroad. Thus, in the poor countries where domestic resources tend to be short in supply, capital inflows can be highly beneficial as they provide opportunities to accelerate capital formation and fuel growth.

In reality however, capital flows have both benefits and costs. Indeed, a flood of capital into economies with immature and poorly regulated financial institutions had tended to do more harm than good. This is one of the pitfalls of capital account liberalization.

There is a tendency in developing countries to seek to attract FDI at all cost, not minding that certain initial conditions must prevail, and their absence precipitates crises. Some of these initial conditions include:

1. Macroeconomic stability

2. Fiscal discipline

3. Strong and liquid financial system, both the money and capital markets

4. Minimal interest rate differential

5. Flexible exchange rate management regime

6. Robust external reserves

7. Fast growing GDP

8. Effective and efficient financial regulatory and supervisory framework

According to Bhagawtti (1998), "substantial gains [from capital account liberalization] have been asserted and demonstrated…", and Rodrik (1999) warned "Openness to international capital flows can be especially dangerous if the appropriate controls, regulatory apparatus and macroeconomic frameworks are not in place." Even the International Monetary Fund (IMF) in one of its reports in 2000 stated "… has emphasized the substantial benefits of capital account liberalization, but stressed the need to carefully manage and sequence liberalization in order to minimize risks." Rogoff (2002), "These days, everyone agrees that a more eclectic approach to capital account liberalization is required."

Cobbam (2001) was very specific in concluding that evidence does not support the theoretical arguments on the benefits of capital account liberalization, especially the linkage between the policy and poverty reduction. According to him, "CAL may contribute to reduced levels and stability of government finances, and hence reduced provision for the poorest and reduced investment. CAL and domestic financial liberalization may increase unemployment as finance is diverted away from rural areas and from smaller firms in search of higher investment gains."

Klein (2004) examined the relationship between capital account liberalization, institutional quality and economic growth in the context of theory and

evidence, and wrote that "..this research typically fails to find consistent evidence of a beneficial effect of open accounts on economic growth." He concluded that, following the warnings of Rodrik and Rogoff along with his own evidence-based research, "the environment in which capital account liberalization occurs is a potentially important determinant of its consequences."

Most of these facts evolved from the theoretical arguments and evidence-based research on capital account controls and restrictions vis-à-vis liberalization of capital accounts, as well as the particular experiences that many countries have had with these two policy extremes. In particular, countries such as China, Japan, Singapore, South Korea, Italy, France, South Africa, Philippines, Malaysia, India and Taiwan were surveyed recently (2003), when China was considering liberalizing capital accounts. The experiences of some of these countries are summarized in the next section. In its evaluation report for 2005, titled "The IMF's Approach to Capital Account Liberalization", the IMF admitted that there are several gaps between the theoretical arguments for CAL and the evidence, and argued for the mandate of the IMF to be expanded to include CAL at present, it is restricted to current account, even though its staff have been allowed to research into and offer advice to member countries on capital account issues.

## III. Capital Account Liberalization Experiences

Capital account liberalization is a parameter used in measuring the degree of openness of an economy, signalling the rate of inflow and outflow of capital from one economy to another without undermining its territorial integrity and independence. The extremes of the continuum are strict controls, which come in some variety, and liberalized markets, where economic agents freely interact under commonly applicable rules to clear the markets.

Capital account liberalization has worked better for currencies without history of capital controls and/or that are convertible. Ready examples are the Deutsche Mark, US Dollar and Hong Kong Dollar. This does not in any way suggest that these currencies have not had their share of trouble in the course of

time. Rather, the observation is that such troublous times have been easier to manage, in spite of what would appear to be out of sync with certain initial conditions for capital account liberalization.

During the late 1980s and early 1990s, attempts to combine exchange rate stability with the progressive liberalization of capital accounts in Europe ran into a series of foreign exchange crises. In Scandinavia, Latin America and East Asia, capital account liberalization gave rise to capital inflows too large for the domestic financial system to absorb. The financial crises associated with capital flows that Latin America experienced in the 1980s (Mexico in 1994 and East Asia in 1997-98) caused recession that was equivalent to years of economic growth. The Economist (2003:9) and Obadan (2002) estimated the financial crises of the 1980s to have cost Latin America an average of 2.2 per cent of GDP each year of that decade. Similarly, East Asia's financial crisis cost some 1.4 per cent of GDP a year.

The main features of this boom-bust cycle are as follows. Owing to faster growth, higher inflation or both, interest rates tend to be higher in the liberalizing economy than the international market levels[2]. This interest rate gap combines with the new opportunities offered by liberalization to lead to surging capital inflows, mostly in the form of short-term bank claims or portfolio inflow. The influx of foreign capital in turn provokes currency appreciation under a more flexible exchange rate regime, or to even larger capital inflows under a more stable exchange rate, which falsely implies that there is little risk to foreign currency borrowing. Either way, the recipient economy can experience rapid monetary and even more rapid credit growth, asset price bubble, and booming consumption and investment. The specific experiences of selected countries that have liberalized capital accounts and the lessons are as follows.

## Japan

The Japanese situation was succinctly captured by Mitsuhiro Fukao (2003) in the summary below:

- Regime of administrative control and multiple exchange rates between 1945 and 1949, which allowed Japanese enterprises to export freely, but imports strictly controlled.

- Massive official borrowing from the international market to finance post-war infrastructure renewal.

- Unified exchange rate between April 1949 and 1971, while inflation was brought under control and price controls and rationing were discarded altogether.

- In July 1960, non-resident free yen accounts were allowed.

- Japan joined the Organization for Economic Cooperation & Development (OECD) in 1964, which required her to liberalize international finance transactions.

- Current account surplus triggered policy shift from restriction of capital outflows to active encouragement of it. The growth in trade surplus pushed external reserves to $4.4 billion in 1970 (or above 4.0 per cent of GDP) and $7.9 billion in July 1971. Prepayments for exports of $4 billion between 16th and 27th August 1971 took reserves to $12 billion, encouraging Japan to adopt the floating exchange rate system.

- Financial market internationalization, both the money and capital markets.

- Internationalized business sector.

- Controls on interest rates on deposits.

- Troubled state-owned enterprises (SOEs).

Obviously, the outstanding motivations for capital account liberalization by Japan were macroeconomic stability (fiscal discipline plus tamed inflation),

membership of OECD, huge current account surplus (strong manufacturing and export orientation) and robust external reserves, and internationalization of the financial markets. Obviously, Japan did not liberalize because of external pressure (as China started experiencing about 2003), as most advanced economies were liberalizing just about then. Also, the problems with the SOEs were not so deep as those observed in China.

All these became irrelevant during the financial crisis of 1997/1998 simply because of a weak financial system the banks were big, but carried huge non-performing loans from a corporate sector that borrowed heavily and had substantial equity stake from the international market, coupled with poor corporate governance.

Fukao (2003) went on to state that, it is well known that it is not possible to achieve all three of the following desirable objectives of international monetary arrangements:

- Maintaining an independent monetary policy.
- Allowing free international transactions.
- Keeping exchange rate pegged to an anchor currency.

**Korea**

Yoon Je Cho and Robert N. McCauley (2003) highlighted the importance of current account deficit as one of the initial conditions for liberalization of capital accounts. They stated that it must not exceed the benchmark maximum of 5.0 per cent of GDP, and identified the following as issues in capital account liberalization, especially in Korea.

- “Crony capitalism” is a problem associated with liberalization, being the political angle to it. There are always beneficiaries from liberalization that some checks are required to temper their appetite for profit and temptation to stretch the liberty conferred by liberalization.

- Monetary policy must be consistent with other policies over time. The presence of interest rate regime and corporate finance, as well as monetary aggregates that are moderated along well-defined targets.

- Disciplined fiscal operations.

- Korea accelerated capital account opening in 1994, resulting in corporates preferring to take dollar-denominated loans, at a time that non-residents were prevented from investing in won-denominated domestic equity and debt.

- Liberalized interest rates resulted in large corporates (chaebol) shifting their funding demand to the non-bank financial institutions, which were not under sharp/close surveillance by the regulatory authorities. Dependence on commercial papers rose from 2.5 per cent in 1990-1992 to 13.1 per cent in 1993-1996 and peaked at 17.5 per cent in 1996.

- External reserves quantum compared to short-term corporate debts from abroad. Borrowing from abroad rose from 20.0 per cent in 1992 to 28.0 per cent in 1996.

- Strengthening of the supervisory capacity of financial system by the regulatory authorities. This was necessary to preclude unreasonable risk taking and obvious skill gaps that made Korean merchant banks to use short-term dollar deposits to finance long-term dollar loans.

- Capital market opening, i.e. internationalization, with restriction on corporate sale of equity abroad.

Cho and McCauley, drawing from the Korean experience made the following recommendations to China, which are also relevant to developing countries aiming at capital account liberalization:

- Develop framework for strengthening corporate governance, especially as large corporate debt expands.

- Strengthen supervision and regulation of the financial system.
- Long-term instruments should be liberalized before short-term instruments.
- Maturity matching and types of financial institutions matter. In particular, the treatment of banks should be similar to that of non-banks.
- Limit external corporate borrowing because of externalities of short-term foreign debts.
- Maintain constant surveillance on the offshore financing activities of banks, the corporate sector and non-bank financial institutions.

**South Africa**

South Africa was a pariah state, faced with severe financial sanctions in the 1980s because of its apartheid policy. This forced the South African authorities to impose a debt standstill in September 1985, as several foreign trade creditors refused to rollover and there ensued massive outflow of private investments. The nation suffered dearth of foreign exchange. From mid-1985 to mid-1994, the average outflow amounted to 2.5 per cent of GDP and 13.0 per cent of gross domestic fixed investment. For the nine years to 1994, the country was forced to depend on current account surpluses, bringing its foreign debt profile down from 126.1 per cent of annual exports of goods and services in 1985 to 89.2 per cent in 1993, and from 42.9 per cent of GDP to 21.6 per cent over the same period. At the same time, the South African Reserve Bank created the Forward Book[3] that allowed them to provide forward cover for private sector and government corporations to use trade credit. This became necessary because South Africa had no access to IMF and other official sources for financing trade deficits. The forward book reduced over time, as capital inflows increased.

The situation reversed in May 1994, as soon as President Mandela was sworn in there was a massive inflow of foreign investments and trade credit windows

opened afresh. The Government was also able to raise funds from the international capital markets. The scrapping of foreign exchange control on non-residents in March 1995 did not cause massive outflow as envisaged by several analysts, and the subsequent (in February 1996) rate correction was adduced to other factors and rumours. The country was forced to adopt the floating exchange rate system and commenced inflation targeting in 2000, about the same time that the open economies of Australia, New Zealand, Sweden, Canada and the United Kingdom adopted this monetary policy framework.

The specific components of the policy on capital account liberalization in South Africa were as follows:

- Abolition of capital controls on non-residents in March 1995.

- South African companies were allowed to make offshore investments and to raise foreign capital against their domestic balance sheets. Limits of ZAR500 million for outside Africa and ZAR750 million within Africa.

- Qualifying institutions (pension funds, long-term insurers and unit trusts) are allowed to make offshore portfolio investments - up to 15.0 per cent for pension funds and insurers, and 20.0 per cent for unit trusts.

- In July 1997, exchange controls on private individual investments offshore were lifted, and limit of ZAR750,000 imposed.

- Also in July 1997, residents were allowed to retain foreign income earnings abroad.

Some of the obvious factors in favour of capital account liberalization in South Africa were:

- Framework that was conducive to macroeconomic stability had been maintained. Government was committed to financial stability, including fiscal prudence.

- Monetary policy had been firmly anti-inflationary since the late 1980s, resulting in the inflation rate being brought down from double (peak of 21.0 per cent in 1986) to single digit, in spite of exchange rate volatility.

- Budget deficit in fiscal operations reduced from 8.5 per cent of GDP in 1992/1993 to 2.0 per cent in 2003.

- Healthy financial system - the banks were big and well capitalized.

- Liquid financial system.

- Strong financial infrastructure, especially the payments system.

- Improved internal political environment.

- Strong capability to handle external shocks.

**India**

India had a financial crisis in 1991 and liberalized her capital accounts in the aftermath and as part of its economic reforms package. By 1993/1994, she had started to see its impact on the inflow of FDI. The net inflow from all sources (excluding IMF) averaged about $8.89 billion per year over the seven years from 1993-94 to 1999-2000, strengthening and making the capital account of the BOP more resilient. Despite the exchange rate volatility in 1995/1996 that caused massive net outflows, the annual average came to $9.69 billion from a mere $3.9 billion during the previous two years, 1991/1992 to 1992/1993. Much of this had been in favour of non-debt creating foreign investment flows. More recently, the Indian monetary authorities introduced the following measures to further encourage FDI:

- Foreign investors needed only inform the Reserve Bank of India of new investments after 30 days of bringing their investments and 30 days of issuing shares.

- Non-bank financial companies can hold up to 100.0 per cent foreign equity if they are holding companies.

- Foreign investors can set up 100.0 per cent owned subsidiary (no limit on number of subsidiaries), subject to capital importation of $50 million, $7.5 million upfront and the balance in 24 months.

- FDI of up to 49.0 per cent is permitted in banking, subject to the guidelines of the Reserve Bank of India (RBI).
- Changes made to remove restrictions included:

  i. 100.0 per cent FDI permitted for B to B e-commerce

  ii. Dividend balancing on 22 consumer items removed

  iii. Cap on foreign investment in the power sector removed

  iv. 100.0 per cent FDI permitted in oil refining.

- Automatic route of FDI allowed for proposals in Information Technology and manufacturing activities in Special Economic Zones except for some items[4].

- 100.0 per cent FDI allowed in the Telecom sector and several other sectors, with conditions applying to certain sectors because of their state and/or strategic importance.

The country experiences reviewed above show clearly that liberalization of capital accounts is not a bed of roses. There are problems and pitfalls, which should guide policy options for developing economies that are seeking a faster route to prosperity, especially taking advantage of the global financial markets. These are examined in the next section.

## IV. Problems and Pitfalls

Problems usually arise with capital account liberalization when it is unplanned and/or it is not properly guided. Recall the argument that where liberalization induces large capital inflows, the local currency has a tendency to appreciate, along with expansion in domestic liquidity, which generates inflationary pressures. In such circumstance, liquidity management becomes a difficult task.

Hitch free and minimal risk capital account liberalization is hinged on stable macro-economy, characterized by high and sound macroeconomic and trade policies, strong financial systems cum supervisory infrastructure, sound private sector corporate governance and flexible exchange rate regime.

The lessons from the financial crisis that engulfed the Asian countries in 1997/1998, the much earlier Mexican and Russian experiences, and the peculiar situations of Scandinavia and South Africa are instructive to developing economies. Prior to the Asian crisis, it was well understood that sound macroeconomic policies are needed to minimize the risk involved in a liberalized capital account. After the crisis however, it became clear that a well-capitalized, well-managed and properly regulated financial system plays a critical role in stability. Equally important is the structure of corporate finance. For example, a highly leveraged capital structure without effective shareholder discipline can result in reckless borrowing and maturity mismatch that can easily precipitate financial crisis.

The benefits of properly designed and well-implemented capital account liberalization policy are many. The obvious ones include making funds available through foreign capital inflow (FDI type) to serve as gap-fill between domestic saving and investment. It makes the economy more competitive and open to global best practices. Also, it is a policy that demonstrates “political correctness” and therefore, will readily attract international support if crisis arises! To the foreign participants, it provides valuable opportunities for portfolio diversification, risk sharing, and inter-temporal trade, according to Eichengreen and Mussa (2004).

## V. Policy Options and Recommendations

The policy options and recommendations derive from the basic facts and country experiences reviewed in previous sections. In order to avoid listing too many issues for the attention of policy makers, the recommendations are restricted (in pursuit of liberalization!) to the following six key issues.

- First pursue *macroeconomic stability*, especially proper coordination of fiscal and monetary policies. In particular:

  i. Maintain fiscal discipline, which is one of the ten planks to the Washington Consensus, as mentioned earlier. Keep overall fiscal deficit at a maximum of 3.0 per cent.

  ii. Ensure consistency between monetary and exchange rate policies. See relationships between variables in Table 4.

- Strengthen *prudential measures* to check indiscriminate short-term, foreign-currency denominated borrowing.

  i. Limit banks' open net foreign currency position.

  ii. Tax short-term capital inflows to discourage excessive foreign exposures by non-financial companies and banks.

  iii. Adopt flexible exchange rate management system.

- Make *monetary policy* proactive and flexible enough to deal with market developments as they unfold.

- Strengthen *supervisory and regulatory structure* and *infrastructure* of the financial system, maintaining surveillance on maturity matching in external transactions of banks, non-bank financial institutions and the corporate sector.

- Limit the *variety of financial institutions*, to avoid regulatory arbitrage and go for *strong capitalization*.

- Strengthen corporate finance and *corporate governance*.

- Liberalize *long-term instruments* before short-term instruments.

- Target FDI for *sectors that offer fast growth opportunities* and development prospects.

- Ensure stable *political environment*, in order to retain FDI, especially the portfolio investments.

- *Privatize* as many of the SOEs as possible, perhaps except those considered strategic to the well being of the national economy.

- Make *sequencing* a function of the degree of resilience of the domestic financial system to external shocks and its ability to deal with larger flows of foreign capital. In particular, Eichengreen and Mussa (2004) recommend as preconditions:

    i. Accounting, auditing and disclosure requirements in the corporate and financial sectors to strengthen market discipline.

    ii. Remove implicit government guarantees.

    iii. Strengthen prudential regulation and supervision.

## VI. Conclusion

There is no doubt that contemporary economies, especially the developing economies, need to be reformed periodically in order to remain competitive and be able to attract foreign participation in their domestic economies. Such external participation creates a balance and needs to be properly managed.

Capital account liberalization is a route that many countries have gone in strengthening their economies, and indeed is seen today as the "politically correct" approach to managing the external economy. As attractive as its prospects and promises are, it requires some caution and a measure of pragmatism as well as keeping within prudent limits. It is obvious that capital account liberalization needs to be tempered with some measure of control in some aspects of the economy, to reflect the flexibility that competitiveness demands.

Proper sequencing of the different aspects of the liberalization policy is as important as the widely discussed capital account liberalization. As such, it is advisable that liberalization of the domestic financial system should always precede the opening up of the economy to foreign investors, while the current account should be liberalized before the capital account. Even within the capital account, the order should be inflow before outflow, and FDI rather than portfolio investment.

An orderly liberalization of the capital account must meet the pre-conditions (also termed 'initial conditions') of improved standards of monetary and fiscal policies, a robust financial system supported by effective regulation and supervision of financial institutions, strong corporate governance and political stability.

**Notes**

1. No capital exportation of any kind without official approval; restrictions on corporate borrowing abroad, either requiring approval or prohibited as for companies in the Free Trade Zone in Nigeria; no foreign currency denominated deposits in the domestic market; foreign currency purchases only available for travelers; foreign currencies purchased from official sources have list of eligible items; etc.

2. The interest rate differential in Nigeria is so significant that a liberalized policy environment should encourage the influx of foreign capital, (Table 1). The argument is that this situation will persist until inflation is

tamed and other macroeconomic fundamentals become internally consistent.

3. Forward Book is the foreign currency guarantees issued by the South African Government. It is oversold when greater than the external liquidity. The key instrument is the net open forward position (NOFP), which is the oversold Forward Book minus the net gold and foreign exchange reserves of the South African Reserve Bank. The IMF insisted that this must be brought down to zero in order to reduce the Government's foreign currency risks, which is simply the sum of government's external borrowings, the position of the central bank and derivatives outstanding. NOFP is naturally part of this.

4. Arms and ammunition, explosives and allied items of defence equipment, defence aircraft and warships; atomic substances; narcotics and psychotropic substances and hazardous chemicals; distillation and brewing of alcoholic drinks; cigarettes/cigars and manufactured tobacco substitutes.

5. Article VIII of the IMF's Articles of Agreement, which defines current account convertibility as freedom from restrictions on the making of payments and transfers for current international transactions and makes

**Table 1**: **Interest Rate Differentials** (%)

| Year | Nigeria | Europe | USA | Japan | UK |
|---|---|---|---|---|---|
| 2000 | 14.0 | 4.9 | 6.4 | 0.5 | 5.9 |
| 2001 | 20.5 | 3.2 | 2.4 | 0.1 | 4.1 |
| 2002 | 16.5 | 2.2 | 1.6 | 0.0 | 4.1 |
| 2003 | 15.0 | 2.2 | 1.3 | 0.0 | 4.4 |
| 2004 | 15.0 | 2.2 | 2.9 | 0.0 | 4.9 |
| 2005 | 13.0 | 2.7 | 4.8 | 0.1 | 4.7 |
| 2006 | 14.0 | 3.7 | 5.4 | 0.5 | 5.3 |

Note:Minimum Rediscount Rate (MRR) and LIBOR.

**Table 2: Nigeria: Maximum Lending Rates (%)**

| Year | %_1/ |
|---|---|
| 2000 | 26.20 |
| 2001 | 31.20 |
| 2002 | 25.70 |
| 2003 | 21.60 |
| 2004 | 20.40 |
| 2005 | 19.50 |
| 2006_2/ | 20.50 |

Notes:
_1/For merchant banks in 2000 and universal banks thereafter.
_2/Based on independent market surveys.
*Source: Central Bank of Nigeria Annual Report of 2005 and Statistical Bulletin of December 2004.*

**Table 3: Structure of Corporate Finance in Nigeria, 2004 _1/**

| Source | ₦'billion | % |
|---|---|---|
| Bank Loans & Advances | 149.2 | 60.38 |
| BA's & CP's | 55.2 | 22.34 |
| Foreign Trade Credit_2/ | 28.0 | 11.33 |
| Equities | 14.7 | 5.95 |
| **Total** | **247.1** | **100.00** |

Notes:
_1/ The excess of gross capital formation over gross savings, being deficit that needed financing. Where the total exceeded the gap, the corporate sector invested in bank deposits and other financial assets.
_2/ Nigerian companies rely on foreign trade credit only to the extent of 11.3% of their external financing need, obviously because of capital account restrictions.
*Source: Annual Report of the Central Bank of Nigeria (2005).*

**Table 4: Summary of Rate Movements**

| Economic Event/Indicator | | Effect on Interest Rate | Effect On Exchange Rate ($/₦) |
|---|---|---|---|
| BOOM | | ↑ | ↑ |
| SLUMP | | ↓ | ↓ |
| BOP SURPLUS | | ↓ | ↑ |
| BOP DEFICIT | | ↑ | ↓ |
| MONEY SUPPLY | ↑ | ↓ | ↓ |
| MONEY SUPPLY | ↓ | ↑ | ↑ |
| CAPITAL OUTFLOW | | ↑ | ↓ |
| CAPITAL INFLOW | | ↓ | ↑ |

**Table 5: Nigeria: Capital & Financial Account Balance (% of GDP)**

| Year | % |
|---|---|
| 2001 | -1.1 |
| 2002 | -3.6 |
| 2003 | -6.4 |
| 2004 | -7.9 |
| 2005 | -13.5 |

Comment: Obvious net outflows that signal need to consider seriously liberalization, as vehicle for reversing the trend.

**Table 6: Nigeria, Overall Fiscal Balance (% of GDP)**

| Year | % |
|---|---|
| 2001 | -4.3 |
| 2002 | -5.5 |
| 2003 | -2.8 |
| 2004 | 1.5 |
| 2005 | -1.1 |

Comment: Nigeria has done well in this to warrant capital account liberalization.

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# Capital Account Liberalization: Experience from the Emerging Market Economies

*Mike I. Obadan **

## I. Introduction

The liberalization of the capital account of the balance of payments is rooted in economic theory. Not only can it help to bridge savings and foreign exchange gaps in national economies, and hence promote higher economic growth, it can also lead to greater efficient allocation of resources internationally and greater portfolio risk diversification, among others (Obadan, 2005). Perhaps, in the light of this, and against the background of developed financial markets, the industrial countries set the pace in capital account liberalization in the 1970s following the collapse of the Bretton Woods fixed exchange rate system. The liberalization was further accelerated in the 1980s. But, perhaps, because of underdeveloped domestic financial markets and less favourable environments, many developing countries commenced moves from the mid-1980s to liberalize their capital accounts with promptings from the Bretton Woods institutions, namely the IMF, and the World Bank. Indeed, it was not until the 1990s, in the context of various structural adjustment programmes inspired by the Bretton Wood institutions that many developing countries stepped up capital account liberalization (CAL). Actually, the IMF initiated moves in the mid 1990s to amend its articles to incorporate capital account convertibility/ liberalization as part of its mandate. But then, until, perhaps, recently the downside of capital account liberalization had not been adequately acknowledged. And a good number of the developing countries went through financial liberalization without taking precautionary measures or meeting the pre-conditions in order to minimize risks and obtain desirable outcomes. With the crises and associated problems that have tended

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to accompany CAL, the opening of capital account has been a subject of intense debate with an emerging consensus on the need to manage the risks posed by rapid and large flows of short-term capital in a very liberalized environment.

In the light of the foregoing, this paper explores the experiences of the developing countries, in particular, the emerging market economies, in capital account liberalization. To this end, the paper is divided into five sections. To provide the necessary background, section 2 which follows, reviews and clarifies some issues. This is followed by section 3 which overviews capital account liberalization in developing / emerging market economies. Section 4 discusses some individual countries' experiences at liberalization. The last section concludes the paper by drawing attention to some lessons and pre-conditions for orderly and successful liberalization outcomes.

## II. Conceptual Clarification

### Emerging Market Economy

Antoine W. van Agtmael of the World Bank Group, in 1981, defined an emerging, or developing market economy (EME) as an economy with low-to-middle per capita income (Heakel, 2003). In practice, relatively big and small economies have fallen into the emerging market categorization because of their developments and reforms. EMEs are considered to be fast growing economies and characterized as transitional. The latter means that they are in the process of moving from a closed to an open market economy while building accountability within the system. The economic reform programme embarked upon by an EME is expected to lead it to stronger and more responsible economic performance levels, as well as engender transparency and efficiency in the capital market. Apart from implementing reforms, an EME is most likely receiving aid and guidance from larger donor countries and/or international financial institutions such as the World Bank and IMF. Besides, an EME tends to experience an increase in both local and foreign investment. Emerging market investments entail bigger risks and bigger rewards, thus providing an opportunity for investors to diversify while adding

risk. Among the notable EMEs are China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, Argentina, Brazil, Chile, Colombia, Mexico, Venezuela, Egypt, Israel, South Africa, Turkey, Hungary, Poland and Russia.

## Concept of Capital Account Liberalization

The capital account is the second broad component of the balance of payments. It records both the borrowing and lending of the residents of a country. Thus, items in the account are essentially transactions in financial assets which directly affect wealth and debt and hence national income in future periods. Capital account liberalization (CAL) refers to freedom from prohibitions on transactions on the capital and financial accounts of the balance of payments (Eichengreen and Mussa, 1998). It entails lifting restrictions on foreign capital inflows and outflows. According to Stiglitz (2003: 65), capital account liberalization has also meant eliminating the rules and regulations in developing countries that could stem the flows of speculative and volatile hot money - short-term loans and contracts that are usually no more than bets on exchange rate movements - into and out of countries. Correspondingly, a liberalized or open capital market is one in which individuals and firms can access international financial markets freely.

An open capital account implies capital account convertibility which refers to the freedom to convert local financial assets into foreign financial assets, and vice versa, at market determined exchange rates. In other words, it means the removal of foreign exchange controls. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by the rest of the world (Schneider, 2000: 6). However, capital account convertibility does not necessarily imply removal of tax-like instruments imposed on the underlying transactions which need not be viewed as incompatible with the desired goal of capital account liberalisation (Eichengreen, 1998). An open capital account also implies currency convertibility. A country is said to have achieved full currency convertibility of its currency when residents and non-residents are allowed to convert the local currency, at prevailing exchange rates, into foreign currencies

and to use the latter freely for international transactions (Nsouli and Rached, 1998; Obadan, 2005: 5).

**Strategies for Opening the Capital Account**

There have been debates among economists on the approaches to capital account liberalization in terms of the pace and sequencing of liberalization. In this direction, two broad approaches stand out, namely, the 'big bang' approach and the gradualist approach. The gradualist approach entails a more deliberate and phased strategy to economic reform that emphasizes reforms in the capital account. Under this approach, the phasing of liberalization may be based on distinctions between residents and non-residents as was done in India and South Africa. India liberalized current transactions and related controls on non-residents and effected some relaxations on FDI by corporates. Similarly, South Africa followed the sequence of abolishing controls on current transactions; abolition of exchange controls on non-resident investment by domestic corporates, etc. The gradualist approach also entails the liberalization of inflows before outflows. In the liberalization process, uses were made of both prudential limits in the form of quantity controls and price controls. The management of the open capital account by the use of price instruments and prudential limits was for the purpose of transforming the maturity structure of capital flows and insulating the impact of large and volatile flows on monetary and exchange rate policy. The experiences of Chile, Colombia and Malaysia are illustrative of this approach. In general, the gradualist approach takes cognizance of the need to prevent instabilities generated by financial liberalization before adequate institutional safeguards are put in place and hence stresses the wisdom in moving reforms in the real sector, improved financial regulation and current account liberalization before finally liberalizing the capital account.

The 'big bang' approach entails a more rapid transition to open capital account, in some cases involving a one-step process in simultaneously liberalizing controls on capital inflows and outflows. The argument is that since resources are lost through obstacles to free capital flows (as with any protectionist policy), the sooner it is liberalized the better. A number of countries have

moved to open capital accounts in a one-step process. Among them are Hong Kong, Costa Rica, Jamaica, Kyrgyz Republic, Mauritius, Uganda, Singapore, Trinidad and Tobago and Venezuela.

On the question of whether or not it is sensible to liberalize gradually or adopt a big bang approach, a consensus seems to have emerged. According to the report of a conference on "Capital account liberalization: A Developing Country Perspective", 2000, "given the potential benefits and costs of capital account liberalization and the fact that the poorly developed institutional structure (primarily in the financial system) of developing countries heightens the risk of crisis, the balance of evidence suggests that countries should adopt a gradual movement towards CAL within a broad reform effort".

**Capital Account Liberalization and Crisis**

The classic case for international capital account liberalization is that flows from capital abundant to capital-scarce countries raise welfare in the sending and receiving countries alike on the assumption that the marginal product of capital is higher in the latter than the former. Indeed, in autarky, the rate of return in the domestic market is assumed to exceed the rate in the rest of the world. And once the capital account is opened up, this differential generates a capital inflow and a larger capital stock in the home country. In the final equilibrium, GDP is higher because of the large capital stock. Domestic labourers gain at the expense of both domestic and foreign owners of capital, so also GNP is higher (Hanson, 1992: 2). Thus, CAL achieves an efficient allocation of world savings as capital scarce countries (with a correspondingly high marginal product of capital) can borrow from the rest of the world. The capital movements from rich to poor countries accelerate domestic accumulation and convergence (Gourinchas and Jeane, 2002: 5). Besides, CAL, it is argued, does not result only in enhanced growth and efficiency, but also creates opportunities for risk sharing and portfolio diversification, intertemporal consumption smoothing and trade, technology transfer and spillovers, among others (Eichengreen, et al, 1998: 12; Obadan, 2005).

However, the advertised benefits of capital account liberalization are

dependent on certain pre-conditions and accompanying factors, in the absence of which the elimination of controls on capital account may lead to macroeconomic instability and unstable financial markets. Indeed, in a significant number of countries, both domestic financial and external account liberalization have been associated with costly financial crises. As Eichengreen and Mussa (1998) have argued, although this association may somehow be deceptive, given that financial crises are complex events with multiple causes, there have been enough cases where financial liberalization, including CAL, has played a significant role in crises. International capital flows which result from capital account liberalization have tended to precipitate a crisis where capital flows out of a country suddenly. Although financial problems can result from the mismanagement of virtually any financial transaction, short term capital has tended to pose special problems for the maintenance of financial stability. In recent years, a large proportion of the increased international financial flows consist of liquid short-term capital attracted by arbitrage margins and prospects of speculative capital gain, rather than by long-term yields on productive investment. They are extremely volatile and subject to bandwagon effects, capable of generating gyrations in security prices, exchange rates, and trade balances. They make little contribution to the international allocation of savings or diffusion of technology and hence to a reduction in international disparities in per capita income (UNCTAD, 1997:94).

Capital account liberalization heightens the risk of crisis and amplifies the effects of policy distortions through a number of channels. First, is the inflow and outflow of short-term liquid and speculative capital as described above. Second, by allowing the entry of foreign banks, CAL, like domestic financial liberalization, can squeeze margins and remove domestic banks' cushion against loan losses. Third, like domestic financial liberalisation, it can facilitate gambling for redemption, in this case by offering access to elastically supplied offshore funding and by allowing access to risky foreign investment[1]. Fourth, a currency crisis or unexpected devaluation can undermine the

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[1] *Gambling for redemption refers to the pursuit of high-return but low probability investments by institutions with low or negative net worth*

solvency of banks and bank customers who have been allowed to accumulate large un-hedged foreign exposures by open capital accounts and lax regulations. Crisis can also be triggered by such factors as herd behaviour and bandwagon effects and contagion. Through the above channels, asymmetric information and policy distortions can give rise to crises with special force when the financial system has been liberalized.

A number of crisis episodes have occurred in the last two and half decades, the most notable ones being the Southern cone currency and banking crises of the early 1980s, the 1992 Exchange Rate Mechanism (ERM) crisis in Western Europe, the Mexican crisis and its spill-over effects in 1994 -95; and the East Asian currency and financial crises in 1997/98. In a number of cases, the crises occurred in the context of newly liberalized capital accounts. The susceptibility to financial crises has been heightened in those developing countries that went through the process of financial liberalization without taking precautionary measures or adhering to guidelines to minimize the risks. The financial crises that hit some developing countries, especially in Asia and Latin America, in the 1990s, with resultant huge economic costs, point to the negative effects of volatile short-term capital flows and the grave risks and dangers that accompany careless financial liberalization.

## III. Overview of Capital Account Liberalization in Emerging Market Economies

Substantial differences exist among the developing countries in terms of experiences with capital account liberalization. Regional differences also exist in the pattern of liberalization although CAL accelerated in all the regions in the 1990s. In general, those countries that liberalized before 1980, started from a strong balance of payments position (for example, Malaysia, Indonesia and Singapore). But more recently, developing countries have undertaken capital account liberalization under less favourable external conditions even in the presence of external arrears (Eichengreen, et al, 1998). The regional patterns reveal that Latin American countries were relatively open during the 1960s. But the 1970s witnessed some increase in the number of Latin American countries maintaining capital account restrictions. The prevalence of controls

increased in the early and mid 1980s, as highly indebted countries imposed restrictions on capital outflows in the wake of the external debt crisis. However, capital account liberalization resumed in the late 1980s and early 1990s.

A different pattern occurred in Asia reflecting a steady decline in the number of countries imposing capital account restrictions since the late 1970s. As the debt crisis affected East Asia less than Latin America, there was no increase around the time of the debt crisis. Capital account liberalization accelerated in the 1990s. In the Middle Eastern and European developing countries, no clear liberalization trend was visible until the early 1990s. The same observation applies to African countries where restrictions on capital account transactions were applied in virtually every country during the 1970s and 1980s. In the transition economies, capital account liberalization has proceeded speedily since 1990.

The experiences of emerging market economies in CAL can be examined from various angles such as sequencing and speed of liberalization, roles of monetary and exchange rate regimes, prudential supervision, developments following liberalization, etc.

**Sequencing**

In the context of the two broad approaches ('big bang' and 'gradualist' approaches) discussed earlier, the emerging markets embody a variety of experiences with respect to the sequencing of liberalization. A number of countries initiated 'big bang' liberalizations of the capital account, freeing all external transactions in a short time or rather abruptly. Among these countries are Argentina, Peru, Costa Rica, El Salvador, Jamaica, Trinidad and Tobago, Kenya, Venezuela, Honk Kong S. A. R, Singapore, Mauritius, etc. For example, Argentina, Peru and Kenya liberalized current and capital accounts simultaneously. Many other countries sequenced CAL before moving, at different paces, to liberalize the capital account. Thus, capital account liberalization in a number of developing countries has occurred gradually. It has been part of an overall approach to economic and structural reform and has

occurred after the establishment of current account convertibility. Chile, for example, liberalized current account transaction in 1977 and moved gradually to liberalize the capital account over the 1985 -94 period. In the same way India, after accepting the IMF's Article VIII obligations in 1994, moved cautiously in liberalizing the capital account, allowing convertibility only for non-residents. Indonesia and Korea both accepted Article VIII obligations in 1988 and pursued increased capital account liberalization in the early 1990s. Even then many restrictions still remained.

## Monetary and Exchange Regimes

Considering that in an economy with an open capital accounts the influence of international variables is transmitted more quickly than in an economy with a relatively closed capital account, it is important for an open capital account management to have an exchange rate policy that is flexible, with market participants bearing the exchange rate risk instead of the balance sheet of a central bank (Schneider, 2000: 28). However, in the developing world, CAL has been accompanied by a “polarization” in the choice of exchange rate regime, with countries responding to the environment of increased capital flows by either adopting hard currency pegs or moving toward greater nominal exchange rate flexibility. In other words, approaches to the choice of exchange rate regime have tended to be mixed. A fixed exchange rate regime backed by a currency board was adopted by Argentina, Estonia, and Lithuania, providing a strong institutional commitment to exchange rate stability and low inflation. Some developing countries instead opted for a more flexible exchange rate along with full convertibility, e. g., El Salvador, Peru, Venezuela. Others such as Mauritius, Trinidad and Tobago abandoned their formal pegs altogether. Yet, other countries, Indonesia, Malaysia and Singapore, adopted managed floating regimes, with a view to ensuring the competitiveness of export industries.

## Financial Sector Reform

Opening the capital account exposes the domestic financial system to foreign competition. In the light of this, most developing countries have attempted to

implement financial sector reforms either prior to, or in conjunction with liberalizing the capital account or soon after the capital account reform. These reforms typically include freeing interest rates on loans and deposits, developing indirect monetary instruments such as treasuring bills, and abolishing credit ceilings. Freedom from controls on capital movements heightens the role of domestic interest rates in avoiding destabilizing capital flows. Competitive domestic financial markets would ensure the achievement of market-based interest rates. Real interest rates were positive in most, but not all cases at the time that full convertibility was adopted. In some other countries, reform of the financial sector took place together with broader reforms that included capital account liberalization. For example, in the Baltic countries where a financial infrastructure did not exist, reforms had to be undertaken on all fronts simultaneously.

**Prudential Supervision**

Opening the capital account could increase the risks for banks, through the impact of increased volumes of capital flows on the deposit base and through a possible increase in exchange rate volatility on banks' open foreign currency positions. Capital account liberalization therefore requires strengthened supervision related to foreign exchange risks, generally undertaken as part of on-going, broad financial sector reforms. But then the area of prudential norms and effective regulation is one that is gravely deficient in many developing countries. Perversely, CAL in several countries has made the situation worse since it has led states to retreat from effective regulatory oversight. However, the experiences show that in many countries, reforms to strengthen prudential supervision and improve standards were under way prior to and during liberalization while in some others (e.g., Indonesia, Peru, Costa Rica) the reforms took place mainly during and after adoption of capital account convertibility. Prudential reforms have focused on improvements in the supervisory framework, especially adopting new regulations and reporting requirements, and increasing the ability of the supervisory authority to enforce regulations. Nevertheless, according to Eichengreen, et al (1998: 38), pre-existing weaknesses in banks' balance sheets and insufficient implementation or enforcement of prudential regulations led to the emergence of severe

banking problems in a number of countries that rapidly liberalized their capital accounts, such as Costa Rica, Latvia, and Venezuela. Also, the Mexican financial crisis of 1994-95, occurred against the background of inadequate financial supervision and regulation by the monetary authorities. Consequently, the banking system witnessed a rapid growth of credit to the private sector in the face of weak human resource capacity while imprudent lending practices were very conspicuous as easy access to external resources made it possible to incur debt in foreign currencies without a proper evaluation of exchange risk (Obadan, 2004). Besides, in the East Asian banking and currency crises of 1997-98, financial sector weakness and misdirected investment were major factors. These problems were exacerbated by the rapid liberalization of financial markets without a commensurate strengthening of supervision and regulation.

**Post-Liberalization Developments**

In the aftermath of capital account liberalization, some notable developments have occurred in emerging market economies in the areas of current account and balance of payments, inflows and outflows of capital, official foreign exchange reserves, inflation, capital controls and financial crises, among others. In general, the elimination of controls on capital account transactions led to an increase in capital inflows, with an accumulation of foreign exchange reserves and some worsening of the current account position. Official external reserve holdings grew in most countries. Besides, many countries that had accumulated substantial external payments arrears were able to reduce or eliminate them altogether through cash payments or rescheduling and, more importantly, to avoid accumulating new arrears. While current account deficits increased in some countries, for example, Argentina, Estonia, Peru and Singapore, they decreased in others, e.g, El Salvador, Jamaica and Malaysia. But then, to a certain extent, a larger current account deficit would be expected as credible reforms lead to larger capital inflows. It is also not surprising that international reserves tended to increase following capital inflows. Furthermore, in a number of Latin American countries Argentina, Mexico, El Salvador, Costal Rica, etc the overall balance of payments positions improved significantly although in some cases they deteriorated in later years.

As a result of financial liberalization, private capital flows to developing countries, particularly emerging market economies, increased in the 1990s. Net private capital flows to the developing countries expanded substantially rising from $44 billion in 1990 to $158.8 billion in 1994 and $299.0 billion in 1997. Tables 1 and 2 have the net capital account and financial account positions of some EMEs. But then, private capital inflows were highly concentrated in a small number of emerging economies. During 1990-97, some 12 countries accounted for 77.0 per cent of total private flows to developing countries. The most important recipients were China, Brazil, Mexico, Korea, Argentina and Malaysia. The East Asian emerging market economies that experienced crises in 1997-98 attracted huge capital inflows. For example, between 1994 and 1996 net private capital inflows as a share of GDP increased considerably, for example, by 7.0 per cent in Malaysia, 6.0 per cent in Indonesia, and 5.0 per cent in the Philippines (Obadan, 2004: 219). Also, Mexico, before its financial crisis in the 1990s, attracted unprecedented amounts of capital into the country, reaching $104 billion between 1990 and 1994. The volume of net capital inflows into Mexico accounted for 11.6 per cent of the total net inflows into developing countries in the 1990-95 period. Capital account liberalization, coupled with years of structural adjustment and macroeconomic stabilization, created a favourable economic outlook and the possibility of better returns to foreign capital. Generally, the increased foreign capital flows to emerging market economies have been due to factors such as liberalization of financial transactions, deregulation of financial markets, and accompanying high interest rates in relation to relatively low rates in the mature markets. Also important was the removal of controls on international capital movements and liberalization of trade and exchange controls.

In some cases, however, deficiencies in financial sector reforms (particularly in the areas of supervision and intervention) and poor macroeconomic policies and conditions have created problems. Indeed, some of the major recipients of the huge capital inflows have experienced sharp reversals causing a deep economic and financial crisis, which affected not only the region but also global financial markets. In both Mexico and East Asia, short-term destabilizing capital flows played notable role in their financial crises. More importantly, weak financial systems and misdirected investment/imprudent

lending practices featured prominently in the crisis. In Mexico, against the background of inadequate financial supervision and regulation by the monetary authorities, the banking system witnessed a rapid growth of credit to the private sector, reflecting imprudent lending practices. On the other hand, in East Asia, distorted incentives, inadequate disclosure and supervision, lax regulatory standards, poorly managed financial liberalization, and inadequate disclosure and supervision resulted in weak financial sectors and corporate governance all contributing to the banking and currency crises experienced in the 1990s.

Thus, while large capital inflows alleviate liquidity constraints for the recipient country, and foreign direct investment can contribute to increasing productivity through direct and spillover effects, the inflows have tended to pose problems for macroeconomic management, and sometimes led to crisis. Consequently, a number of developing countries have adopted controls on foreign capital. Controls on capital outflows have tended to be imposed or strengthened during periods of economic distress, particularly in countries facing severe capital flight. On the other hand, controls on inflows have been associated with periods of economic boom, typically when confidence rises following macroeconomic stabilization and reform (Eichengreen, et al, 1998: 38). Argentina, Chile, Mexico, and Venezuela reintroduced controls on capital transactions in the early stages of the 1980s debt crisis, as capital outflows mounted. Also, some countries that have experienced destabilizing surges of capital inflows have resorted to exchange controls or related incentives to cope with them. Among these countries are Brazil, Chile, Colombia, Korea, Malaysia, and Mexico.

However, there has been no consensus in the literature on the effectiveness of controls. Studies of the effectiveness of capital controls have tended to suffer, to some extent, from a lack of agreement on what constitutes effectiveness. Nevertheless, capital controls have been found to be effective considering the experiences of Chile, Colombia, Malaysia and even Thailand (Obadan, 2005: 66). Chile and Colombia explicitly used controls to enable them to simultaneously pursue internal and external balance in the context of large capital inflows. Malaysia (1994) and Thailand (1995-96) implemented capital

controls to limit inflows and regain a degree of control over monetary aggregates. Again, in 1998, Malaysia introduced control measures to eliminate offshore market for the local currency, provide a degree of monetary independence and insulate the economy from further adverse developments in international financial markets. Malaysia's capital controls allowed it to recover more quickly from the Asian financial crisis, with a shallower downturn (Stiglitz, 2003: 125). The capital control measures have generally taken the form of quantitative restrictions as well as differential reserve requirements on non-residents' deposits, and unremunerated reserve requirements on foreign borrowing, etc, as in Chile. Moreover, the various experiences suggest that controls can be effective in limiting external liabilities, shifting their composition and providing a degree of monetary independence in the short-to, possibly, medium-term (Obadan, 2005: 67).

## IV. Experiences of some Individual Emerging Market Economies

Experiences of individual emerging market economies in capital account liberalization have tended to vary, generally, in the spheres of sequencing of reforms, exchange rate policy and results of liberalization. A few of the experiences are reviewed as follows. (See Schneider, 2000: 65-80).

### Argentina

The country accepted the IMF's Article VIII obligations in 1968. Article VIII, Sections 2, 3, and 4, provides for freedom of payments and transfers for current international transactions. A member country normally accepts Article VIII only after eliminating all exchange restrictions, as defined by the IMF's Articles of Agreement. Argentina, however, liberalized both current and capital account transactions simultaneously in 1991. It adopted a currency board system of exchange rate management in 1991 that set the exchange rate of the peso to the US dollar at 1:1. In the light of the currency board system, under which the monetary base is determined by international reserves, the country lacked an independent monetary policy. Results of the capital account liberalization included:

- Attraction of large inflows of private capital. FDI and portfolio investment reached 11.0 per cent of GDP in 1993 compared with less than 1.0 per cent in 1990.

- Improved GDP growth rates and reduced consumer price inflation in the three years following the convertibility plan.

- No financial crisis. But the country suffered from the Latin American contagion in the wake of the Mexican crisis of 1994-95.

Argentina's experience suggests that while the sequencing of capital account liberalization is important, strong and credible supporting policies are required to sustain it.

**Chile**

Chile accepted Article VIII obligations in July 1977 and initially had a policy of rapid liberalization. But this ended in a banking crisis in the mid-1980s. And so, it gradually pursued CAL in the 1988-1997 period. In the initial phase of the recent reform effort (1985-89), the Chilean authorities focused on restructuring the banking system, trade reform, the selective liberalization of direct and portfolio capital inflows, and on creating the institutional independence of the Central Bank of Chile. In the later phases, the authorities concentrated upon the development of financial markets, the adoption of more flexible interest rate and exchange rate policies, and the progressive relaxation of controls on capital inflows and outflows. Indeed, in order to increase monetary independence, discourage short-term capital inflows, restrain real exchange rate appreciation, and limit total capital inflows, the authorities sought to control capital inflows by requiring foreign investors to place an unremunerated reserve (URR) at the central bank. The cost of the URR was inversely proportional to the maturity of the inflow. In 1983, the country replaced a fixed exchange rate regime with a crawling peg that sought to maintain a constant level of the real exchange rate against the US dollar. Later, a crawling band was introduced that enabled the exchange rate to float freely within a $\pm$0.5 per cent band (later $\pm$2.0 per cent).

Over the 1994 - 97 period, Chile attracted a high FDI equivalent to 6.0 per cent of GDP. The macroeconomic environment has been stable with low inflation, a balanced fiscal position and high rates of economic growth. Studies on the effectiveness of capital controls on inflows suggest that:

- the controls have provided room for an independent monetary policy by increasing the wedge between domestic and international interest rates;

- the controls have lengthened to some extent the maturity structure of capital inflows;

- controls had no effect on the level of total inflows and on the exchange rate.

Some analysts have, however, argued that the URR has increased the cost of capital significantly (over 21.0 per cent), especially for small, and medium-sized Chilean firms that found it difficult/impossible to evade the controls on inflows. Nevertheless, the Chilean experience demonstrates that an incremental process of capital account liberalisation within a strong supporting reform framework can be very effective. Chile had a strong institutional capacity to manage a capital control regime that allows it to be implemented efficiently and insulated it from corruption. Another lesson is that controls can be used flexibly to both encourage capital inflows and diminish their potentially more harmful effects on monetary independence.

**Korea**

Throughout its period of rapid industrialization from the 1960s to the late 1980s, the Korean economy was characterized by extensive government intervention. Over the course of the late 1980s, Korea pursued a policy of gradually liberalizing the domestic financial system and the capital account, but this was accelerated in 1993 under the administration of Kim Young Sam. The country accepted Article VIII obligations in 1988, ensuring full convertibility for current account transactions. Liberalization of the capital account was gradual and selective and a comprehensive liberalization plan was

not adopted until 1993. Even then, Korea's policy towards capital account transactions was guided by developments in the current account. Financial sector reform, including efforts to improve regulation and supervision, was pursued concurrently. But this later turned out to be inadequate with the eruption of the East Asian financial crisis. As part of the reform process, Korea moved from pegging the won to a basket of currencies to the Market Average Exchange Rate system in order to allow the exchange rate to be determined more by market forces.

The capital account liberalization led to increased access of Korean financial institutions to external financing and a rapid expansion of foreign debt which nearly trebled from $44.0 billion in 1993 to $120.0 billion in 1997. The worrisome aspect of this debt was its structure which showed that the share of short-term debt rose from an already high 43.7 per cent in 1993 to an extremely high 58.3 per cent at the end of 1996. Besides, although measures were taken in the 1990s to liberalize and strengthen the financial sector, persistent weaknesses of oversight and regulation remained which helped to propel the country into a crisis in 1997 in the context of the Asian crisis. The rise in the short-term debt to reserves ratio and concerns about the stability of the financial sector encouraged continual pressure against the won. When the won was forced out of its trading bank, its value promptly collapsed, from an average of 804 won per US$1.0 in 1996 to an average of 1401 won per US$1.0 in 1998. One major lesson from the Korean experience is the danger of liberalizing the capital account in the context of inadequate prudential regulation and an unreformed financial system. The regulatory regime failed to monitor the activities of the finance companies and this greatly increased the vulnerability of the country to sudden capital flow reversals. With the absence of state coordination and poor financial intermediation, funds flowed into low quality investments in sectors which already had problems with overcapacity. The Korean experience points to the need to comply with appropriate conditions for liberalization in terms of financial sector reform, improved regulation and sequencing. Korea experienced failure in sequencing by liberalizing short-term flows first as part of crisis management in 1997-98 before liberalizing long-term flows.

**India**

After decades of inward-looking and interventionist policies, India, over the course of the 1990s, began a cautious and gradual move towards more capital account openness. Capital account convertibility has proceeded gradually in the context of a broad reform agenda that encompasses trade, competition and industrial restructuring. Emphasis has been placed on reform of the financial system as a pre-condition for CAL. India accepted Article VIII in 1994. The Tarapore Committee on capital account liberalization, in 1997, recommended a cautious approach that seeks to establish the preconditions for liberalization on a sound footing. These include fiscal consolidation, an inflation target and, most importantly, the strengthening of the financial system. As a result, more stable flows such as direct and portfolio investment were liberalized first, followed by partial liberalization of debt-creating flows, derivative transactions and capital outflows. Financial sector reform continued concurrently. The exchange rate policy has focused on flexible exchange rates in the context of a managed float.

Despite the liberalisation efforts, India has maintained capital controls. Controls which have been quantity based rather than market-based have been oriented towards limiting the country's external debt, particularly reducing excessive exposure to short-term foreign debt. India's experience shows that controls have been largely effective in two ways:

- limiting measured capital flows and in shifting their composition towards long-term flows;

- preventing, along with other factors, a build-up of short-term external liabilities that could increase the country's vulnerability to externally-generated crisis; and

- insulating the country from the 1997 Asian crisis.

Although capital controls did not prevent India from experiencing high levels of external indebtedness and BOP crisis in 1980 and 1991, they effectively

shifted the composition of capital inflows towards more stable, long-term flows. Thus, India could receive the benefits of capital account liberalisation and limit vulnerability.

**Malaysia**

Malaysia accepted Article VIII obligations in 1968. The capital account had always been relatively open. From the mid-1980s, portfolio inflows have been free of restrictions and banks' foreign borrowing and lending in foreign exchange have been free (except for net foreign exchange open position limits). Before the Asian financial crisis, cross-border activities in the national currency, ringgit, were also free. Financial sector reform has been accelerated in the wake of the crisis. Before the July 1997 crisis, Malaysia operated a managed float of the ringgit. But it was pegged to the U. S. dollar with the imposition of controls in September 1998.

One key result of the relatively liberalized capital account regime was the attraction of large inflows of foreign capital, comprising both short-and-long-term, in the early 1990s. Capital inflow rose form 5.3 per cent of GDP to 8.3 per cent in 1993. This was induced mainly by a high interest rate differential and expectations of a ringgit appreciation. But then the increased inflows enhanced concerns regarding sustainability and stability. And the high costs of sterilization and its maintenance of high interest rates led the authorities to implement controls on short-term inflows, particularly in the form of borrowing by banks and ringgit deposits opened by bank and non-bank foreign customers. In 1997, in the midst of a financial crisis, Malaysia implemented controls on capital outflows in order to limit downward pressure on the exchange rate and upward pressure on domestic interest rates that were exacerbating the contraction, which was already undermining the financial system. In September 1998, the authorities imposed direct exchange capital control measures which sought to contain ringgit speculation and the outflow of capital by eliminating the offshore ringgit market. The controls on capital inflows were largely successful in achieving their objectives of containing short-term inflows and the monetary expansion and instilling stability in the foreign exchange market. Monetary aggregates significantly reduced and the

capital account surplus fell in response to a reversal in short-term inflows in the second half of 1994. Long-term flows such as FDI were not affected in the same way, the controls on outflows imposed in late 1998 were effective in eliminating the offshore ringgit market.

Even though Malaysia's fundamentals were relatively strong (high growth, low inflation, full employment, relatively strong financial system and, in contrast to Thailand and Indonesia, no massive build-up of short-term overseas debt), the country was also hit by the 1997 Asian crisis. This was due to two vulnerabilities that had been developing: a massive accumulation of outstanding domestic credit and a large exposure of the banking system to the property sector and share trading. Speculators viewed the massive increase in bank credit as evidence of a decline in the quality of borrowers and reasoned that an interest rate defence of the ringgit was untenable. The crisis which ensued revealed weaknesses generated by rapid credit expansion and the consequent deterioration of bank asset quality. The Malaysian experience thus suggests the importance of close central bank monitoring of the uses to which foreign funds are being directed and whether their properties are consistent with the type of inflows. Besides, improved bank surveillance and enforcement is required to rapidly ensure provisioning in banks with escalating non-performing loans.

## V. Lessons / Conclusions

Capital account liberalisation, in recent years, has been undertaken in the context of increasing pace of globalization. Unlike the developed countries, the developing countries that have liberalized have done so under less favourable external conditions, even in the presence of external arrears. Nevertheless, capital account reforms have been undertaken in view of the expected benefits of enhanced economic growth, greater efficiency, risk diversification, intertemporal consumption smoothing, and technology transfers, among others. But the downside of CAL and the accompanying free flow of capital was until recently, perhaps, not adequately acknowledged or appreciated (Obadan, 2005). Thus, while liberalization is generally beneficial, it also heightens a country's vulnerability to crises; reversals in capital flows

can precipitate severe currency, banking and balance of payments crises. Indeed, the record of the last 20 years, particularly, the financial crises that hit some emerging market economies in East Asia and Latin America in the 1990s, with resultant huge economic costs, point to the negative effects of volatile short-term capital flows and the grave risks and dangers that accompany careless financial liberalization. In the past, some emerging market economies liberalized in a big bang way while others adopted a gradualist approach. But given the relatively poorly developed institutional structures, primarily in the financial systems, the balance of evidence suggests that countries should adopt a gradual movement towards capital account liberalization.

Thus, one very important lesson from the past experience is that capital account liberalization needs to be undertaken in a measured way and orderly manner, and pragmatically, more especially as it is not an all-or-nothing affair. Each country has to decide on the degree of CAL based on its own conditions. Besides, countries need to adequately prepare their economies and ensure that a number of both macroeconomic and non-macroeconomic requirements / pre-conditions are met. The macroeconomic requirements include the following:

- tackling of major fiscal imbalances and achieving macroeconomic stability first;
- a sound monetary policy that complements and is facilitated by fiscal discipline;
- a flexible exchange rate policy;
- a higher level of external reserves is needed as a buffer against sudden financial shocks;
- inflation control; and
- maintenance of current account deficits within prudent limits

The other pre-conditions for successful capital account liberalization include

financial sector reform and strengthening, proper sequencing of CAL, appropriate policies towards FDI, and better and effective governance in both public and private sectors. Among these, the central importance of financial sector reform, prudential norms and effective regulatory supervision cannot be overemphasized. Effective banking, supervision and regulation, and observance of prudential norms are crucial for financial sector soundness. Indeed, some have argued that capital account liberalization, per se, has not been the cause of financial crises, but rather the failure of supporting policies prudential regulation and monitoring, weaknesses of the financial sector and lack of flexibility in exchange rate policies. Thus, it is necessary to develop a sound financial sector which will enable banks to invest capital inflows prudently and weather shocks. Very importantly, countries should avoid the danger of precipitously removing restrictions on capital account transactions before major problems in the domestic financial system have been addressed.

Besides financial sector strengthening, the proper sequencing of capital account liberalization is indispensable in order to have orderly and less destabilizing outcomes. The sequencing should be such that the restructuring and liberalization of the domestic financial sector precedes the opening up to foreign investors. The current account should be liberalized before the capital account is liberalized in a gradual way. Even within the capital account, the order of liberalization should be inflow before outflow. Also, FDI should be liberalized first rather than portfolio investment. Finally, the management of the open capital account may need to be supported with capital controls of a prudential nature in order to deal with balance of payments pressures and macroeconomic disturbances generated by volatile capital flows. Both theory and practical experience point to the legitimacy of using capital controls of a prudential nature. Capital controls have been found to be effective as the experiences of some emerging market economies like Chile, Malaysia and Colombia have shown, particularly in the use of price instruments to alter the maturity structure of inflows and their impact on monetary and exchange rate policy. In general, the indirect or market-based instruments of control are believed to be more effective and have less adverse effects.

## Table 1: Net Capital Account Positions of Some Emerging Market Economies

| | Brazil | Argentina | Korea | Peru | India | South Africa | Israel | Singapore | Russia |
|---|---|---|---|---|---|---|---|---|---|
| 1989 | 23.0 | n.a | -318.4 | -19.6 | 7,212.5 | -26.9 | 357.3 | -40.8 | n.a |
| 1990 | 35.0 | n.a | -331.2 | -25.0 | 5,528.1 | -56.2 | 728.0 | -21.9 | n.a |
| 1991 | 42.0 | n.a | -329.5 | -31.0 | 3,450.3 | -35.8 | 856.6 | -33.9 | n.a |
| 1992 | 54.0 | 15.7 | -407.0 | -33.0 | 4,075.3 | -421.0 | 1069.7 | -37.9 | n.a |
| 1993 | 81.0 | 16.1 | -475.1 | -44.5 | 7,074.3 | -57.0 | 862.0 | -71.4 | n.a |
| 1994 | 173.0 | 17.5 | -436.5 | -58.32 | 10,575.6 | -66.6 | 785.6 | -84.1 | 2,408.0 |
| 1995 | 352.0 | 14.2 | -487.6 | 31.68 | 3,860.9 | -39.9 | 608.8 | -72.7 | -348.0 |
| 1996 | 494.0 | 50.8 | -597.6 | 21.6 | 11,847.8 | -47.1 | 575.6 | -138.7 | -463.0 |
| 1997 | 482.0 | 66.3 | -607.6 | -49.9 | 9,634.7 | -192.61 | 552.1 | -189.8 | -796.0 |
| 1998 | 375.0 | 72.9 | 171.1 | -57.3 | 8,583.9 | -55.9 | 397.1 | -225.8 | -382.0 |
| 1999 | 339.0 | 149.1 | -389.3 | -54.3 | 9,578.6 | -61.9 | 568.7 | -191.0 | -326.0 |
| 2000 | 272.5 | 105.9 | -615.2 | -67.2 | 11,235.0 | -51.9 | 455.2 | -162.8 | 10,675.0 |
| 2001 | 36.0 | 156.5 | -731.1 | -68.2 | 7,645.3 | -31.2 | 678.9 | -161.2 | -9,377.9 |
| 2002 | 433.0 | 406.1 | -1086.8 | -95.4 | 11,054.1 | -14.9 | 150.6 | -160.4 | -12,395.9 |
| 2003 | 298.2 | 70.1 | -1402.1 | -93.5 | n.a | 1.6 | 45.4 | -167.6 | -995.0 |

*Source:IMF. International Financial Statistics, CD-ROM, 2005.*

## Table 2: Net Financial Account Positions of Some Emerging Market Economies.

| | Brazil | Argentina | Chile | India | Venezuela | Colombia | Egypt | Israel | Turkey | Poland | Singapore |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1989 | -11,426 | -8,083.0 | 1,241.0 | 7,212.5 | 3,650.0 | 478.0 | 360.7 | -464.3 | 780.0 | -1,796.0 | 1,250.5 |
| 1990 | -5,441 | -5,884.0 | 2,857.0 | 5,528.1 | -4,061.0 | -2.0 | -11,039.0 | 592.9 | 4,037.0 | -8,731.0 | 3,947.4 |
| 1991 | -4,868 | 182.0 | 963.9 | 3,450.3 | 2,204.0 | -777.3 | -4,706.0 | 641.4 | -2,397.0 | -4,183.0 | 2,345.6 |
| 1992 | 5,889 | 7,630.3 | 3,132.0 | 4,076.3 | 3,386.0 | 183.0 | -168.0 | -450.9 | 3,648.0 | -1,045.0 | 1,793.1 |
| 1993 | 7,604 | 20,327.6 | 2,994.9 | 7,074.3 | 2,656.0 | 2,701.4 | -762.0 | 1040.7 | 8,963.0 | 2,341.0 | -1,211.9 |
| 1994 | 8,020 | 11,360.0 | 5,293.6 | 10,575.6 | -3,204.0 | 3,392.6 | -1,450.0 | -958.6 | -4,194.0 | -9,065.0 | -8,840.9 |
| 1995 | 29,306 | 4,989.3 | 2,356.6 | 3,860.9 | -2,964.0 | 4,559.7 | -1,845.0 | 4205.8 | 4,643.0 | 9,260.0 | -1,071.2 |
| 1996 | 33,426 | 11,713.1 | 5,660.4 | 11,847.8 | -1,784 | 6,683.0 | -1,459.0 | 4536.6 | 5,483.0 | 6,673.0 | -7,925.5 |
| 1997 | 24,918 | 16,745.8 | 6,742.1 | ,634.9 | 879 | 6,587.5 | 1,957.8 | 7206.8 | 6,969.0 | 7,410.0 | -11,511.6 |
| 1998 | 20,063 | 18,935.9 | 1,966.5 | 8,583.9 | 2,689.0 | 3,306.9 | 1,901.0 | -171.7 | -840.0 | 13,282.0 | -17,784.8 |
| 1999 | 8,056.0 | 14,448.1 | 237.5 | 9,578.6 | -516.0 | -550.9 | -1,421.4 | 2874.8 | 4,979.0 | 10,462.0 | -14,186.4 |
| 2000 | 29,376.2 | 7,852.7 | 787.7 | 12,235.0 | 2,969.0 | 71.2 | -1,646.0 | 3164.8 | 8,584.0 | 10,221.0 | -5,750.5 |
| 2001 | 20,331.3 | -14,971.0 | 1,362.2 | 7,645.3 | -211.0 | 2,484.4 | 189.8 | 1240.7 | -14,644.0 | 3,173.0 | -14,380.6 |
| 2002 | -3,908.9 | -20,582.3 | 2,097.2 | 11,054.1 | -9,246.0 | 1,309.0 | -3,332.7 | -1,526.7 | 1328.0 | 7,180.0 | -13,558.4 |
| 2003 | -163.8 | -15,812.3 | 629.8 | n.a | -5,124.0 | 811.7 | -5725.0 | -2,526.9 | 6,959.0 | 8,734.0 | -25,088.7 |

Note: Financial Account comprises inflows (assets) and liabilities on direct investment, portfolio investment (comprising equity securities and debt securities), financial derivatives, and other investment assets (relating to monetary authorities, general government, banks and other sectors).

*Source: IMF. International financial statistics, CD-ROM, 2005*

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# Capital Account Liberalization in Nigeria: Problems and Prospects

*Ayodele Festus Odusola **

## I. Introduction

Capital account liberalization is one of the lynchpins of globalisation and it is often seen as an inevitable path to economic development for developing countries. This is based on the premise that liberalizing capital account would permit financial resources to flow from capital-abundant countries, where expected returns were low, to capital scarce countries where expected returns are high. The extant literature is replete with the potential benefits of capital account liberation. The policy when effectively implemented, allows resources to flow into the liberalizing countries thereby reducing cost of capital, increasing investment and promoting economic growth (Fischer, 1998 and 2003; Henry, 2003a).

While capital inflows could provide important resources for economic development, its surges, reversals and volatility may create new sources of systemic risks. Until the experience of the past one and a half decades, the main issue of contention was about timing and sequencing of capital account liberalization within the context of overall macroeconomic reform or stabilization. However, the widespread of financial crises across the continents of the world (with particular attention to Asia and Latin America) brought some form of concern about whether to even liberalize or not. To some extent, capital account precipitates inflow of speculative hot money, which is a major causative factor of financial crises in many countries. Although the argument of whether capital account liberalization is predominantly beneficial or harmful remains inconclusive, the consensus is however moving towards the type of liberalization that throws up minimal development challenges. This

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paper examines the problems, prospects and challenges of foreign private capital flows in Nigeria. To this end, the paper is structured into six parts. Following the introduction is section two that provides the framework for capital account liberalization. Section three examines the Nigerian experience on capital flows while section four highlights best practices from proximate economies. Section five addresses the key challenges and prospects of managing effective capital accounts while section six concludes the paper.

## II Framework for Capital Account Liberalization

### II.1 Conceptual Issues

In a generic sense, capital account liberalization is about allowing capital to flow freely into and out of a particular country. This connotes a deliberate policy that allows domestic businesses to borrow from foreign banks, foreigners are allowed to purchase domestic debt instruments as well as invest in the domestic stock market (Henry, 2003 a and b). As defined by Stiglitz (2002), it entails stripping away the regulations intended to control[1] the flow of hot money in and out of the country, especially short term loans and contracts that are usually taken during favourable exchange rate movements. These regulations could take several forms: direct or administrative control (e.g., outright prohibition, explicit quantitative limits, and approval procedures), indirect or market based controls (such as multiple exchange rate system, explicit or implicit taxation of cross border financial flows, and other price- and quantity-based measures) (Ariyoshi, et al, 2000).

Capital account liberalization (CAL) is the process of removing restrictions from international transactions related to the movement of capital. It can involve the removal of controls on both domestic residents' international financial transactions and investments in the home country by foreigners. Liberalization can apply to both inflows and outflows of capital. Capital account restrictions can take various forms including: limiting domestic banks' foreign borrowing; controlling foreign capital coming into the economy; limiting the sectors or industries in which foreigners can invest and restricting

[1] *Capital control could also serve other important purposes, including national sovereignty, protecting national security, and achieving specific social objectives.*

the ability of foreign investors to repatriate money earned from investments in the domestic economy.

Capital account liberalization can be categorised into two broad categories: debt and equity. Debt market liberalization occurs when domestic economic agents (banks, companies and even governments) are free to borrow in hard currencies from foreign banks to finance investment activities. Experience has shown that this is more problematic and often very difficult to sustain. The main danger of this type of liberalization is that more attention is always given to short-term borrowing[2]. This often generates a mismatch between the term structure of borrowers assets (which is always long term) and their foreign currency denominated liabilities (that are usually short term) thereby making the country in question to be exposed to high level of vulnerability[3]. Whenever the lenders are reluctant to issue new loans, liquidity problems ensue. If this is not well managed, it could precipitate the onset of serious financial crises as experienced in many Asian and Latin American countries in the 1990s.

An emerging consensus on capital account liberalization is that the magnitude and maturity profile are very important for success. In specific term, the size and maturity profile of a country's external debt liabilities are compatible with the magnitude and maturity profile of its assets. Any attempt to disregard this basic principle could expose the country to vulnerability that could trigger some deleterious effects.

Liberalization of the stock market is another variant of capital account liberalization. With this, foreigners are allowed to hold shares in domestic capital market. Through inflow of foreign funds, stock market liberalization leads to lower interest rates. Arising from diversification benefits associated with stock market liberalization, which increase stock market values, equity premium is reduced thereby leading to lower cost of equity capital (Henry, 2000 and 2003b). The reduction in cost of capital, to a large extent, encourages firms to expand their operations through increase in installed capacity, i.e.

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[2] *This refers to a loan with a maturity of less than one year*

[3] *In addition to expansion of existing businesses, reduction in cost of capital arising from stock market liberalization provides opportunities for businesses that were not profitable before liberalization to become more profitable after liberalization. .*

building new factories and installing new machineries.[4]

Managing capital account liberalization could be challenging and the associated benefits are not automatic. Benefits from capital account liberalization are a function of the soundness of the domestic financial system. When the financial system is in quagmire or badly managed, many of the advantages whittle away. Whenever the news of imprudent lending or corporate insolvency emerges, economic prospects and stock market responds accordingly. Ordinarily, as a rational economic agent, when this happens, foreigners and even domestic investors are more disposed to moving their funds to less risky but high return yielding economies. What are these benefits and costs? These are examined below.

## II.2 Benefits of Capital Account Liberalization

The theoretical benefits of the linkage between capital account liberalization and the overall economic growth have been well referred to in the literature (Fischer, 1998; Henry, 2003b; Obadan, 2004; and Le Fort, 2005). The much-mentioned benefit of capital account liberalization is the opportunity of increasing the array of assets available in the local markets as well as efficiency and competition in the provision of financial assets. As a corollary of market competition and efficiency, it promotes preservation of policy disciplines. It also allows for inter-temporal optimisation and risk sharing through portfolio diversification. Within the saving-and-foreign exchange gaps theory, growth benefits abound for developing countries that are traditionally short of capital through foreign capital inflows. Investment is no longer constrained by domestic savings. There is therefore the potential for enhanced economic growth through increased capital accumulation.

Growth could also arise from efficiency gains such as efficient allocation of resources through financial deepening, exposure to higher standards in accounting, auditing and disclosure principles. In most cases, prudential frameworks that tend to enhance the level of efficiency in the financial system

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[4] *In addition to expansion of existing businesses, reduction in cost of capital arising from stock market liberalization provides opportunities for businesses that were not profitable before liberalization to become more profitable after liberalization*

always accompany capital account liberalization. In addition, increased international competition can force domestic players to become more efficient, stimulate innovation and improve productivity. If the distribution of growth arising from these various sources is well managed, it could spur improved welfare conditions for the majority of the citizens.

Another source of growth and welfare enhancement, as postulated by Wang (2002), is intertemporal optimisation. This allows for an economy that is experiencing temporal recession to borrow from foreign economies to smoothen its consumption stream, which reduces its dampening effect on domestic aggregate demand. If external debt position is adjudged sustainable, this contributes significantly to welfare enhancement.

Liberalization of capital account also allows for international portfolio diversification. Domestic market agents have the opportunity of diversifying country specific risks, which ordinarily cannot be diversified under capital account restrictions. However, because most asset transactions in developing countries are restricted to banking transactions, foreign direct investment gains from portfolio diversification are often limited to developed countries.

As established by Henry (2003b), the evidence on cross-sectional analysis reveals that cost of capital falls and capital market activities boom when capital accounts are liberalized. The study revealed that cost of capital fell by 2.4 percent, growth rate of capital stock rose by 1.1 percentage points and output per capita grew by 2.3 percentage points over a period of five years in 18 countries (including Nigeria) that implemented capital account liberalization[5]. Consequently, investment activities rise as profit maximizing firms reduced marginal products of capital thereby raising the growth rate of capital stock. The declining cost of capital and investment booms are the first effect generated by capital account liberalization. As a direct consequence of growth accounting framework, investment boom generates temporary increase in the growth rate of output per worker and the overall growth of the economy.

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[5] *Other countries included Argentina, Brazil, Chile, Colombia, India, Indonesia, Jordan, Korea, Malaysia, Mexico, Nigeria, Pakistan, The Philippines, Taiwan, Thailand, Turkey, Venezuela and Zimbabwe.*

Although the theory of capital account liberalization is about capital accumulation, the issues of total factor productivity and technological change do not enter into the story, some proponents have however argued that this could be a derived or indirect effect. As argued by Obstfeld (1994), any economic reform that raises the efficiency of a given stock of capital and labour will also increase the growth rate of technology. In specific terms, liberalization may ease binding capital constraints thereby allowing firms to adopt technologies that could not be financed prior to liberalization. Besides, it is also possible that increased risk sharing associated with liberalization could encourage riskier or higher growth technologies.

In a more simplistic way, this policy would enhance stability by diversifying the sources of funds to developing countries. Such funds assist in bridging the resource gap that many developing countries often face. The reality however is that this can only happen in tranquil and stable periods. As experienced in the post 1997 crisis in Asia and Latin America, banks find it very difficult to lend to countries in crisis.

Ordinarily, liberalization creates a climate to attract investment both within and outside the country. Foreign direct investment (FDI) in particular creates employment opportunities, facilitates the process of technology adaptation and promotes growth. FDI, for instance, has played important role in the economic development of countries such as Singapore, Malaysia and China[6], not so much for capital because of high savings rate or for the entrepreneurship, but for the access to markets and new technology that accompanied such investments. Foreign capital was translated to growth and development because these countries were able to check the abuses of foreign investors. This is not to say a similar thing applies to all countries. The cost in term of displacement of local industries and predatory pricing could be serious particularly in countries where there is weak or no competition law.

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[6]*It is important to note that this is not always the case in all countries. Experience has shown that when foreign businesses come in they often destroy local competitors with deleterious impact on entrepreneurial spirit and growth. For instance, the entrance of Coca Cola and Pepsi into any domestic market has overwhelmed soft drinks manufacturers around the globe. There is hardly any country they entered where one of the domestic companies become a price leader in the market.*

## II.3 Costs Associated with Capital Account Liberalization

Capital account liberalization is not costless. It does not only overheat the economy as a result of capital surge and expansion of aggregate demand, it also increases volatility in prices and exchange rates due to volatile movement of capital flows and transmission of foreign shocks. The opponents of capital account liberalization however pose a contrasting view to some of the arguments raised above. Dani (1998) and Stiglitz (2002) argue that capital account liberalization attracts speculative hot money[7] that makes the economy more susceptible to financial crisis. Due to asymmetry of information in many developing economies, markets become inefficient and negative effects of capital account liberalization could manifest in such forms as adverse selection, moral hazard and herd behaviours (Wang, 2002). In the case of Latin America and Asia, abrupt outflow of money left behind collapsed currencies and weakened banking system. To them, the effects on investment, output and other real variables are apparent and do not have any serious impact on the welfare. While capital account liberalization does not necessarily lead to financial crisis or welfare reduction, it is true that high capital mobility can easily drive an emerging country to be more vulnerable to outside shocks by complicating macroeconomic management.

Although most of the Latin American economies were emerging from heavy regulation and control, as argued by Eichengreen (2005) and DeLong and Eichengreen (2002) the zealous push for capital account liberalization by the Fund was not as a genuine intellectual and policy conviction that capital account liberalization could lead to economic transformation. Rather, it was a way of expanding the political and bureaucratic mandate of the International Monetary Fund as well as the US Treasury.

Stiglitz tried to point out the dangers of capital account liberalization. He posits thus (Stiglitz, 2002:65):

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[7] *As defined by Stiglitz (2002:7), this refers to money that comes into and out of a country, often overnight, often little more than betting on whether a currency is going to appreciate or depreciate.*

> *Whereas the more advanced industrial countries did not attempt capital market liberalization until late in their development-European nations waited until the 1970s to get rid of their capital market controls-the developing nations have been encouraged to do so quickly.*

He argued that developing countries are not equipped to manage what had proved under the best circumstances to be very difficult and fraught with risks. The argument that capital account liberalization promotes investment boom is questionable. In practical sense, speculative money cannot be used to build factory or create jobs. Loans of short-term maturity cannot be used to finance long-term investments that often induce growth. In a way that always constrains the operation and expansion activities of business entities, firms that benefit from volatile capital inflows are often advised to set aside in their reserves an amount equal to their short term foreign -denominated loans.

Evidence abounds in the literature about the danger of capital account liberalization. In many countries, liberalization of capital account has become a new source of financial instability, which exacerbated financial disruptions whenever they occurred. As examined by Arora (2001:58), "…financial crises seem to have been occurring with greater frequency at the same time that the economies are becoming globalized". Empirical evidence has shown that capital account liberalization played a very critical role in the financial crises of Mexico (1994-95), East Asia (e.g., Malaysia, Korea, Indonesia and Taiwan in 1997-98), Russia and Brazil (1998), Turkey and Argentina (2001), and Nigeria in the 1990s (Nordhaug, 2002; Fay and Nordhaug, 2002; Moskow, 2000; Odusola, 2001 and 2002). In explaining the critical role of globalisation in the vicissitudes of the newly industrializing countries of Thailand, Malaysia and Indonesia, Fay and Nordhaug (2002:77) posit thus:

> *Large volumes of volatile foreign short term credit and portfolio investment have frequently been invested in non-tradable and assets market speculations, while this hot money and herd behaviour of international investors increase the risks of financial crisis.*

While capital account liberalization precipitates financial crisis, when such crises loom large, large withdrawal of capital by foreign investors and creditors propagate economic recession in many countries. For example, external loans and security lending to the financially fragile countries of the East Asian region declined abruptly from $23.0 billion in the second quarter of 1997 to an outflow of almost the same amount in the third quarter of the same year and by the first quarter of 1998, the outflow has reached $35.0 billion (Kaufman, 2000 and Odusola, 2004). The situation is even worse in private capital flows. Net private inflows, which were $103.0 billion in 1996, dropped to near zero in 1997 and to an outflow of $28 billion in 1998 (Council of Economic Advisers, 1999). In the case of Thailand, for instance, capital reversal amounted to 7.9 percent of GDP in 1997, 12.3 percent in 1998 and 7 percent for the first half of 1999 (Stiglitz, 2002). The effects are not limited to this region alone, they are also high in Latin America and Africa. This point to the fact that the emerging financial system has become more volatile and this volatility could pose a serious threat to financial stability in specific and macroeconomic stability in general.

Another good example of the benefits of capital account liberalization that is often put forward by its proponents is that foreign banks are necessary for domestic macroeconomic and banking stability. The reality has shown that the outcome is not as rosy as predicted. In Argentina, prior to the banking collapse of 2001, foreign banks dominated the financial landscape. The other side of the story is that they merely lent to multinationals while very big and medium scale enterprises complained of lack of access to capital. Even when the government rose to bridge the credit gap, this could not make up for the market failure. Although the influx of foreign banks in Argentins stabilized the banking system from total collapse after the 2001 crisis, it did not insulate the economy from economic turmoil and decline. Foreign banks contributed to banking stability but created macroeconomic instability. It is easy to create sound banks (banks that do not lose money to bad loans) by investing in non-risky and non-real sector activities. The same situation holds for Bolivia when foreign banks decided to pull back on lending in 2001 during the financial crisis thereby complicating the macroeconomic environment (Stiglitz, 2002). The main challenge therefore is not to create normative sound banks but to create sound banks that are eager to provide credit for real sector growth.

Le Fort (2005) reveals that credit booms fuelled by capital inflows that precipitate expansion in domestic aggregate demand which considerably exceed the potential output endanger macroeconomic stability. This results in unsustainable high current account deficit, a swing in real exchange rate, and a vulnerable banking system.

Another cost of capital account liberalization is that the management of domestic monetary policy becomes complicated. The barometric role of the central banks becomes relatively ineffective. The subtle form of influence by the monetary authority often becomes weakened under a liberalised capital account. Foreign banks are less responsive to policy signals of expanding credit when the economy needs stimulus and of contracting it when there are signs of being overheated.

The foregoing shows that capital account liberalization is not costless. It does not only create macroeconomic instability but could also fuel financial crisis (banking and currency crises). It promotes high-level speculation and complicates domestic monetary policy management. Most funds that come particularly through short-term inflows are not often directed at financing the real sector of the economy. Other costs include the opportunity costs of concessions offered by governments, adverse effects on domestic savings, discouragement of domestic entrepreneurship, adoption of inappropriate technology, erosion of domestic economy autonomy, and adverse effect on balance of payments.

## III. The Nigerian Experience

Although substantial efforts have been put in place to attract foreign investment into the country since the attainment of political independence in 1960, the adoption of the structural adjustment programme (SAP) in 1986 augmented these efforts. With a view to setting the pace for capital account liberalization, the financial system was liberalized in 1987 with the attraction of many foreign investors. The foreign exchange market was equally reformed. A more liberalized system replaced the erstwhile regulated one. This included the Second-Tier Foreign Exchange Market (SFEM) and the

Autonomous Foreign Exchange Market (AFEM), the establishment of Bureaux de Change, etc. Other policy initiatives that were aimed at liberalizing the capital account included the abrogation of the Nigerian Enterprise Promotion Decree, the introduction of new industrial policy, the Industrial Development Coordination Committee, the Privatisation and Commercialisation Decree, and the debt conversion programme which by June 1997 had approved applications that were worth $2,851.50 million, among others.

As a matter of fact, most policies on capital flows were directed at foreign direct investment because portfolio investment is relatively new and still remains less significant in Nigeria. While FDI is acquired for lasting interest and to secure effective control of management of the affected enterprise, portfolio investment aims at benefiting from dividends, capital gains or interest earnings. Because the latter is more volatile, it makes the effect of capital reversal detrimental to the recipient economy. Hence, most countries try to be cautious on outright liberalization. As examined in the earlier section of this paper, portfolio investment has become a notable feature of developed and emerging economies of the world. Portfolio flows accounted for substantial part of the Asian and Latin American capital flows over the last two decades.

The total inflow of foreign capital, which stood at ₦251.0 million in 1970, rose to ₦757.4 million in 1975. The zeal with which the government was encouraging foreign capital waned in the early 1970s because of the diminutive impact on local enterprises and the economy. Outflow of interest, profits and dividends on accumulated investment and repatriation of capital put pressure on the country's balance of payments. In order to protect local entrepreneurs and reduce the pressure on balance of payments, the Nigerian Enterprises Promotion Decree of 1972 and 1977 was promulgated. This Decree bared foreigners from participating in certain economic undertakings and required indigenous equity participation that ranged from 40 percent to 60 percent in some sectors of the economy. This to a large extent led to the liquidation of some companies especially in the banking sector.

Consequent upon this development, cumulative private investment that grew by 201.0 percent between 1970 and 1975 declined at an annual average of 0.3 percent between 1976 and 1978 and by 3.8 percent between 1978 and 1981. As indicated in Table 1, it grew by 14.3 percent between 1980 and 1985 partly as a result of the dramatic growth rate recorded in 1982 (it jumped from ₦584.9 million in 1981 to ₦2, 193.4 million in 1982). With the introduction of SAP in 1986, a near annual steady growth of 9.9 percent growth was recorded between 1986 and 1990. It would be recalled that SAP provided the basis for deregulating the economy under which a number of institutional, structural and market reforms were undertaken to open up the economy with a view to creating the enabling environment for attracting the requisite foreign investment. In 1988, for instance, FDI-friendly framework was put in place through the establishment of the Industrial Development Coordination Committee (IDCC) as embodied in Decree No 36 of 1988. The IDCC streamlined the multiplicity of institutions responsible for registration and approval of foreign companies in the country. In addition to the Commercialisation and Privatisation that removed restrictions placed on foreign ownership of enterprises in the country, the industrial policy of the same year also created some opportunities for foreign investment in the country. These to a large extent accounted for the appreciable average annual growth of 77.0 percent during 1990-95. The rapid growth of 615.6 percent experienced in 1995 led to the remarkable annual average growth for the period.

The year 1995 is often regarded as a year when the most serious commitment was made in creating a conducive environment towards attracting foreign private investments into the country. Through Decree 16 of 1995, the Nigerian Investment Promotion Commission (NIPC) was established with the primary mandate of promoting foreign private investment in the country. To complement Decree 16 in removing all forms of impediments to foreign investments, the Foreign Exchange (Monitoring and Miscellaneous) Decree No 17 of the same year was also promulgated. In addition to this, fiscal incentives to encourage foreign investment include the 100 percent tax holidays for 7 years and tax reduction for investors that provided their own infrastructure and undertook research and development (CBN, 2001 and

Obadan, 2004). Consequently, cumulative private investment rose from ₦57, 929.88 million during 1991-95 to ₦143,008.50 million and ₦188, 943.1 million during 1996-2000 and 2001-2004, respectively. This represented an annual average growth of 5.9 percent and 10.9 percent, respectively.

Table 1 also shows the growth rate of the various components of foreign private investment. As shown in the Table, the growth rate of paid-up capital is steadier than other liabilities. The former oscillated between 8.0 percent and 49.5 percent between 1980 and 2004 while the latter ranged between -3.9 and 755.5 percent during the same period.

**Table 1: Cumulative Foreign Private Investment (Value and Growth Rate)**

| | Paid -Up Capital (million naira) | Other Liabilities (million naira) | Cumulative Private Investment (million naira) | Growth of Paid -Up Capital | Growth of Other Liabilities | Growth of Cumulative Private investment |
|---|---|---|---|---|---|---|
| 1980-85 | 2,898.33 | 2,423.77 | 5,322.10 | 13.2 | 17.2 | 14.3 |
| 1986-90 | 6,203.10 | 4,193.32 | 10,396.42 | 19.6 | -3.9 | 9.9 |
| 1991-95 | 29,479.56 | 28,450.32 | 57,929.88 | 49.5 | 755.5 | 77.0 |
| 1996-00 | 65,927.60 | 77,080.94 | 143,008.50 | 8.0 | 4.2 | 5.9 |
| 2001-04 | 10,2183.00 | 86,760.08 | 188,943.10 | 19.0 | 2.5 | 10.9 |

*Source: CBN (2004): Central Bank of Nigeria Statistical Bulletin, Volume 15, December 2004.*

As evident in Table 2, the flow of foreign private investment predominantly favoured the mining and quarrying sector although it experienced some lull between 1980 and 1990. This notwithstanding, its relative share has been on the declining trend since 1995. From a share of 47.5 percent in 1995, it declined through 2004 to 24.9 percent. Although the share of manufacturing and processing was at the peak in 1990, it declined to about 23.0 percent between 1995 and 2003 before rising to 41.3 percent in 2004. Clearly, agriculture was seriously marginalized with a relative share that was less than 1.0 percent between 1997 and 2004. A major implication of this is that for capital account

liberalization to be pro-poor, it must be able to expand the sector where the poor people's economic activities dominate. In the case of Nigeria, agriculture, small and medium scale enterprises are pivotal. A similar observation of marginalization is also made for transport and communication, building and construction, and trading and businesses. However, due to the deregulation of the communication subsector and the banking consolidation, foreign inflows into these areas are beginning to rise in recent times.

The role played by the privatisation of public enterprises as a vehicle to liberalize capital accounts was of particular importance. It created ample opportunities for foreign firms to come as technical partners during the privatisation efforts. Cement companies are a good example of this. The deregulation of the communication sector through the introduction of global system of mobile telecommunication in 2000 also ushered in many foreign investors, particularly from South Africa. The same is true for the banking consolidation of 2004/2005 that attracted $652.00 million from foreign investors.

The United Kingdom was a major source of foreign inflows up till 1990 when its contribution ranged between 37.5 percent and 65.4 percent while the share of USA has equally dwindled since 1975. The share of USA's foreign inflows into the country in recent times is merely above 50.0 percent of its contribution in 1975. The rest of Western Europe became prominent when UK's contribution declined. However, the Western Europe's share has been on the declining trend. It declined from 64.9 percent in 1995 through 2004 to 34.7, percent, see Table 3.

Net outflows were not a serious problem until 1989 and 1990 when, for the first time, the net aggregate outflows were negative. The net outflows rose from ₦439.4 million in 1989 to ₦464.3 million in 1990. A number of factors have been alluded for this development. First, the deregulation of the foreign exchange market and the introduction of Bureaux de Change resulted in substantial outflows. The second factor, as presented by Obadan (2004), is the divestment of investment interests by USA and some European countries from the Nigerian enterprises perhaps as a result of outstanding obligations not honoured.

Figure 1 reveals the pattern of FDI, portfolio investment and other long-term capital in the country between 1980 and 2004. Non-internalisation of the country's money and capital market and non-disclosure accounted for why portfolio investment is relatively a new phenomenon in the country. It did not feature in the country's balance of payments until 1985. Portfolio investment in Nigeria comprises transactions in bonds, debentures, promissory notes, equity investment, preferred shares or stocks, mutual funds, investment trusts and treasury bills (Obadan, 2004). Net portfolio inflow rose from N151.6 million in 1986 to N4,353.1 million in 1987 but declined through 1991. It recorded net outflows between 1989 and 1998, excepting 1992. It is important to note that between July 1995 and July 1996, about US$6.0 million foreign portfolio investment was made in the Nigerian capital market through the Nigerian Stock Exchange (NSE) for the first time since 1962. Foreign investment raised through the NSE rose from US$1.14 million in 1995 to US$32,99 million in 1996[8]. From 1999, however, it has been on a rising trend though still remaining marginal. The rising trend since 1999 resulted from the stable macroeconomic environment, strong anti-corruption initiative, commitment to economic reforms especially the deregulation of the telecommunication sector, banking consolidation, privatisation efforts and the IMF's backed Policy Support Instruments (PSIs). An important feature of the portfolio investment is the inherent high level of instability that may not be congenial for macroeconomic management. Figure 1 shows a good picture of this endemic instability. Figure 2 also provides the trend of the gross inflows of portfolio investment in the country.

[8] *For details see Onosode (1997).*

**Figure 1: Dynamics of Net Portfolio Investments**

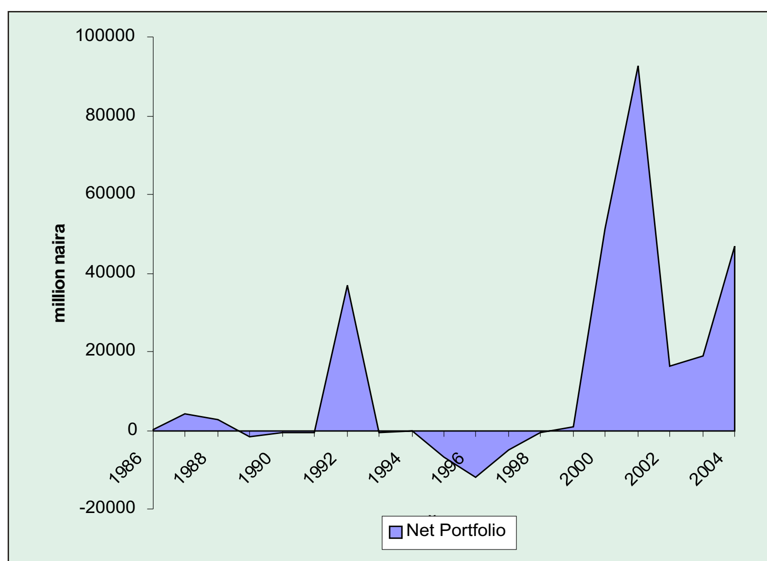



**Table 2: Distribution of Cumulative Foreign Private Investment by Sectors**

| Year | Mining & Quarrying | Manufacturing and Processing | Agriculture, Forestry & Fisheries | Transport & Communication | Building & Construction | Trading & Businesses | Miscellaneous Services |
|---|---|---|---|---|---|---|---|
| 1970 | 51.4 | 22.4 | 1.1 | 1.4 | 1.4 | 20.6 | 1.8 |
| 1975 | 41.9 | 22.1 | 0.8 | 1 | 4.9 | 25 | 4.2 |
| 1980 | 18.7 | 41.5 | 3.3 | 1.7 | 8.5 | 19.1 | 7 |
| 1985 | 10.9 | 33.5 | 1.9 | 1.3 | 6.7 | 39.7 | 6.2 |
| 1990 | 10.5 | 60.7 | 3.2 | 2.3 | 7.1 | 16.4 | -0.2 |
| 1995 | 47.5 | 23.2 | 1 | 0.3 | 1.3 | 2.5 | 24.2 |
| 1996 | 46.3 | 24.3 | 1 | 0.4 | 1.5 | 3 | 23.5 |
| 1997 | 46.2 | 24.4 | 0.9 | 0.5 | 1 | 2.8 | 24.2 |
| 1998 | 39.3 | 22.6 | 0.8 | 0.5 | 2.6 | 6.9 | 27.4 |
| 1999 | 38.2 | 23.5 | 0.8 | 0.5 | 2.6 | 7.1 | 27.3 |
| 2000 | 38.5 | 23.7 | 0.8 | 0.5 | 2.5 | 7.1 | 26.8 |
| 2001 | 38.3 | 23.5 | 0.7 | 0.6 | 2.6 | 7.4 | 27 |
| 2002 | 37 | 24 | 0.7 | 1 | 2.6 | 7.4 | 27.3 |
| 2003 | 34.6 | 25.6 | 0.7 | 1.6 | 2.5 | 8.1 | 27.5 |
| 2004 | 24.9 | 41.3 | 0.5 | 1.7 | 2.1 | 8.1 | 21.5 |

*Source: CBN (2004): Central Bank of Nigeria Statistical Bulletin, Volume 15, December 2004.*

**Table 3: Percentage Distribution of Foreign Private Investment in Nigeria by Sources**

| Year | Total(million naira) | UK (%) | USA (%) | Western Europe (%) | Others (%) |
|---|---|---|---|---|---|
| 1970 | 1,003.2 | 44.3 | 22.9 | 22.4 | 10.4 |
| 1975 | 1,812.1 | 37.5 | 23.4 | 25.8 | 13.3 |
| 1980 | 3,620.1 | 39.3 | 15.6 | 30.6 | 14.5 |
| 1985 | 6,804 | 52.8 | 12.6 | 23.5 | 11.0 |
| 1990 | 10,436.1 | 65.4 | 2.0 | 14.5 | 18.1 |
| 1995 | 119,391.6 | 13.2 | 15.5 | 64.9 | 6.4 |
| 2000 | 157,535.4 | 20.8 | 13.9 | 53.6 | 11.7 |
| 2001 | 162,343.4 | 22.0 | 14.1 | 52.5 | 11.8 |
| 2002 | 166,631.6 | 22.1 | 13.5 | 51.8 | 12.6 |
| 2003 | 178,478.0 | 23.4 | 14.2 | 49.5 | 12.6 |
| 2004 | 249,220.6 | 19.7 | 11.4 | 36.7 | 32.4 |

*Source*: *CBN Statistical Bulletin, Volume 16*, December 2004.

In Nigeria, foreign direct investment could either be for the establishment of new enterprises or expansion of the existing ones through increase in paid-up capital, profit ploughed back into the business, trade and suppliers credits, and net liabilities to head offices of the parent companies (usually in the form of loans, royalties and technology). Foreign capital inflows through newly established enterprises rose from ₦27.9 million in 1990 through 1993 to ₦1,405.4 million but later declined to ₦292.5 in 1994 partly because of the political crisis that resulted from the annulment of June 12, 1993 Presidential election. Over the entire period, investment in machinery and equipment grew by an annual average of 57.7 percent while cash in foreign currencies grew by 42.3 percent (Obadan, 2004). Overall, capital inflows through newly established enterprises remain grossly inadequate.

Generally, the inflow of FDI rose from ₦212.5 million in 1976 to ₦735.8 million and ₦2,452.8 million in 1986 and 1987, respectively. The rate of

growth during this period averaged 151.5%. The sharp increase was largely attributed to the implementation of foreign investment policies, particularly the various components of SAP such as the financial sector and exchange rate reforms as well as the privatisation policy. The amendment of the 1958 Income Tax Relief in 1988, which expanded the tax incentives and concessions under the Pioneer Status, also contributed to this. After the amendment, the pioneer status entails 100 percent tax-free period for 5 years for pioneer industries and 7 years for those pioneer industries located in economically disadvantaged areas. Tax holiday in respect of dividends received by non-Nigerian companies having not less than 10 percent holding in Nigerian companies for a period of three years while withholding tax on dividends was also reduced from 15 percent to 5 percent. In addition, 30.0 percent tax concession was given to companies adhering to local raw materials utilization for five years.

With the Privatisation and Commercialisation Decree of 1988, total inflow of FDI rose to ₦13,877.4 million in 1989, representing a growth rate of 707.7%. In 1990, it declined to ₦4,686.0 million. With the promulgation of the Export Processing Zones Decree No. 34 of 1991, inflow of FDI rose to ₦14,463.1 million, a growth rate of 109.1%. By 1995, when the NIPC came into existence, inflow of FDI was ₦75,940.6 million and later rose to ₦111,295.0 million in the following year, with an average growth rate of 144.1%. Total inflow of FDI from 1997 to 2004 was ₦1.3 billion. Figure 2 presents the trend of FDI from 1980 to 2004. This achievement was possible because of additional incentives that government put in place which included, but not limited to:

- 10 percent tax concession for five years on local value added efforts particularly to encourage local fabrication in the engineering sector;
- 2 percent tax concession for five years on in-plant training concession;
- 10 percent tax concession for five years for companies exporting not less than 60 percent of their products;
- 20 percent of the cost of providing additional basic infrastructures such

as road, water, and electricity as tax relief;

- 100 percent tax holidays for seven years for locating in economically dis-advantaged places;
- Abolition of excise duty with effect from January 1998;
- Other export incentives include duty drawback, refund of excise duty paid on export manufactures, retention of 100 percent of export proceeds in the foreign currency domiciliary account by non-oil exporters, tax-free interest earned on export loans, accelerated tax depreciation and capital allowance for manufactured exports, abolition of export licence, rediscounting and refinancing facilities, Export Development Fund (with respect to export promotion activities), establishment of Calabar Export Processing Zone, the Export Expansion Grant Fund Scheme (EEGFS), and the Nigerian Export Credit Guarantee and Insurance Scheme later replaced by NEXIM.

In spite of the policy initiatives introduced by government since 1986 and the avalanche of opportunities that abound in the country, the performance of FDI could be adjudged to be low, see figure 2.

As shown in Figure 2, other long-term capital (net) is a major source of deficit for the balance of payments. What appeared marginal prior to 1995 became volatile and exceedingly negative after the promulgated NIPC and Foreign Exchange Decrees of 1995. This is an issue deserving serious attention from policy makers. This tends to suggest a debt market liberalization problem that needs to be seriously managed for sustainability. This phenomenon depicts a situation where long-term debts are used to finance short-term assets. The need to examine the relevant provisions with a view to realigning this component of FDI inflows to the health of the economy is imperative.

Other areas of policy concern are the net errors and omissions otherwise called the unrecorded net flows. What appeared undisruptive prior to 2000 has turned out to be an economic management challenge since 2000, see Figure 4. This

tends to suggest that it has become a major source of capital flight in the country. The monetary authorities and the Economic and Financial Crime Commission need to direct their searchlights into this direction.

Over the past years, political instability, inhibitive investment policies, weak macroeconomic fundamentals, and structural weaknesses manifesting in excessive transaction costs of doing business were considered to be major impediments to foreign investment in the country. While macroeconomic stability has been achieved which has improved the global rating of the health of the economy, structural weaknesses still abound. Poor infrastructure as manifested in inadequate and costly telecommunications services, erratic and epileptic electricity supply, inadequate water supply, poor road networks; corruption and insecurity of life and property, especially the recent developments in the Niger delta region remains a challenge.

Specifically, the performance is considered to be very marginal given the rate at which the naira depreciated during the period. However, when compared with other large economies in Africa (South Africa, Egypt and Algeria), Nigeria's performance seems bad. Nigeria is next to South Africa. Due to limited openness in such countries like Egypt and Algeria, they both ranked behind Nigeria in terms of FDI inflows (Table 4 and Figure 3). On average, Nigeria accounted for 14.0 percent and 8.2 percent of Africa's FDI inflows in 1996-99 and 2000-03 periods against South Africa's 18.1 percent and 16.7 percent. This to some extent shows that Nigeria still needs to brace up to the challenges of attracting foreign private capital into the country.

A major conclusion from the foregoing is that capital account liberalization has not really posed a serious problem to the economy. First, portfolio investment still remains a new phenomenon with relatively small size. However, things might change as a result of the consolidation of the banking sector. Second, the share of FDI in gross fixed capital formation remains relatively small. Between 1998 and 2003, it ranged between 9.2 percent (2003) and 12.2 percent (1998). Three, net outflow is not yet a serious issue in Nigeria with the exception of the experience in 1989 and 1990 which came as a result of exchange rate deregulation during the period. This notwithstanding, both net outflows of

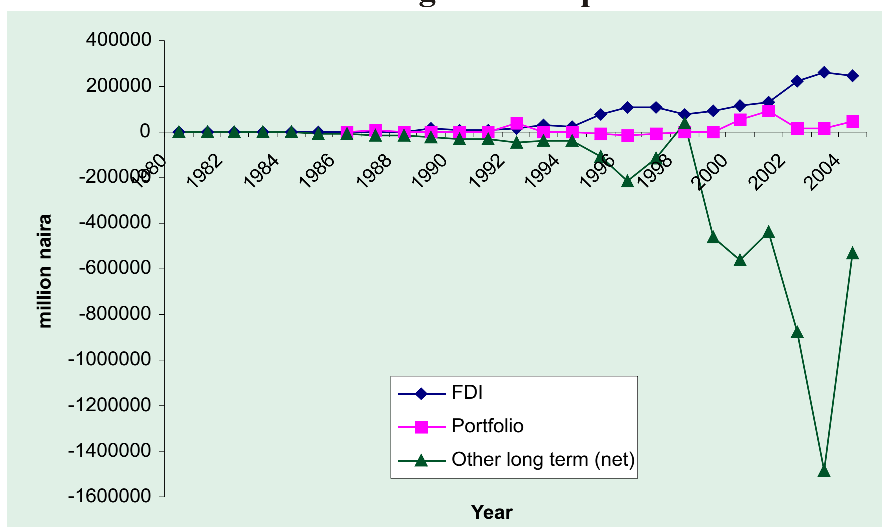
other long term capital and unrecorded net outflows are posing a threat to balance of payments. The fact that the costs of incentives put in place might outweigh the quantum of foreign investment attracted may tend to suggest limited effectiveness of the incentive structures put in place.

**Table 4: FDI Inflows in Africa and Selected African Countries**

| Year | Africa | Nigeria | South Africa | Egypt | Algeria | Ghana |
|---|---|---|---|---|---|---|
| 1996 | 5331 | 1593 | 818 | 636 | 270 | 120 |
| 1997 | 10919 | 1539 | 3817 | 887 | 260 | 82 |
| 1998 | 9144 | 1051 | 561 | 1076 | 501 | 56 |
| 1999 | 11590 | 1005 | 1502 | 1065 | 507 | 267 |
| 2000 | 8728 | 930 | 888 | 1235 | 438 | 115 |
| 2001 | 19616 | 1104 | 6789 | 510 | 1196 | 89 |
| 2002 | 11780 | 1281 | 757 | 647 | 1065 | 50 |
| 2003 | 15033 | 1200 | 762 | 237 | 634 | 137 |
| 1996-99 | 9246 | 1297 | 1674.5 | 916 | 384.5 | 131.25 |
| 2000-03 | 13789.25 | 1128.75 | 2299 | 657.25 | 833.25 | 97.75 |

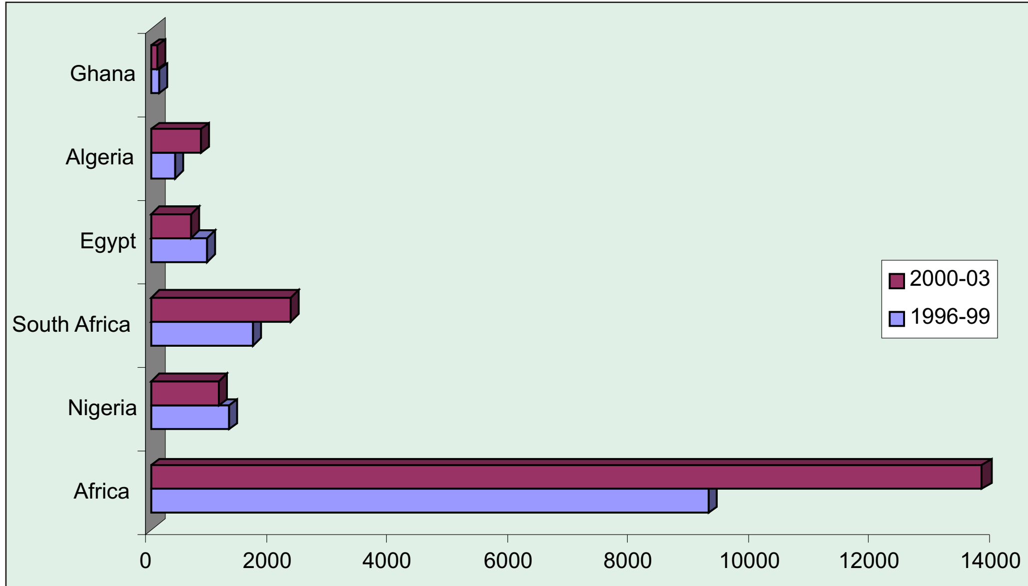
*Source: AfDB and OECD (2005): African Economic Outlook 2004/2005*

**Figure 2: Foreign Direct Investment, Portfolio and Other Long Term Capital**



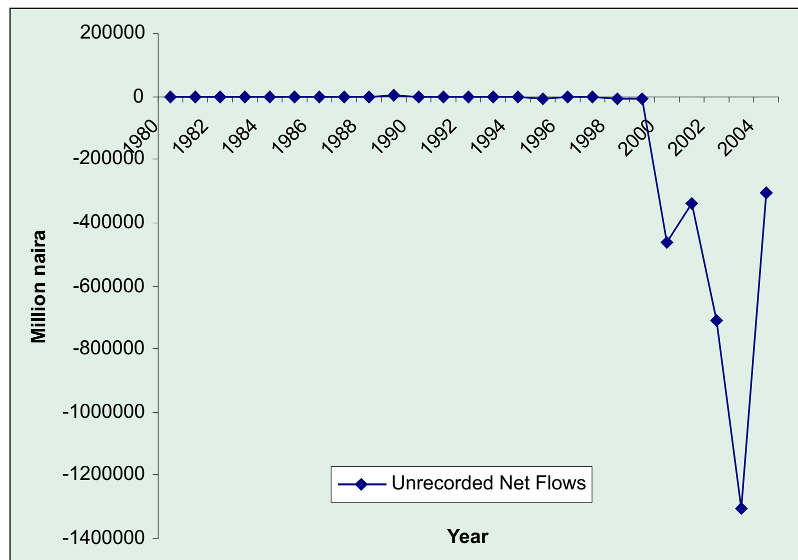

*Source: Computed from CBN's Statistical Bulletin Volume 15 December 2004.*

**Figure 3: Gross FDI Inflows in Selected Countries in Africa, 1999-2003**




*Source: Computed from AfBD and OECD (2005).*

**Figure 4: Unrecorded Net Flows in Nigeria, 1980-2004**




*Source: Computed from CBN's Statistical Bulletin Volume 15 December 2004.*

## IV. Best Practices from Proximate Economies

The fact that the Nigerian situation has not really posed a serious threat to the economy does not mean there are no opportunities for the country to learn from what is happening in other parts of the world. Both the global and individual country's experiences offer lessons for Nigeria. As a global response to the vicissitudes of capital account liberalization, the Basel Committee has amended the capital adequacy framework to promote safety and soundness in the international financial system by giving special attention to the activities of large and internationally active banks (Basel, 1999). The modified framework is now giving greater scope for the use of internal credit ratings and portfolio models in establishing minimum capital. Although the Basel modification did not change the capital adequacy ratio from 8.0 per cent, many countries are now considering the possibility of increasing the ratio[9].

The new framework has developed some measures that now influence banks' international activities. Some of these include using external risk assessment prepared by rating agencies in establishing risk weights for sovereign borrowers[10]. Attaching weights to over-the-counter derivatives and securitized assets is another specific aspect of the new framework. There is also a provision for prudential oversights over highly leveraged institutions. In addition, sound practices for loan accounting, credit risk disclosures and bank transparency will help in mitigating the impact of capital flows in any economy.

Prudential guidelines are not costless. If not carefully designed and applied, they could have unintended and undesirable consequences by providing distorted incentives that result in excessive risk-taking in specific areas, as well as facilitate contagion. It could also lead to self-fulfilling downturn in the

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[9] *Increasing capital adequacy has the advantage of making financial system failure less likely and when they do occur, the private sector bears the major cost and also reduces incentive for banks to gamble for resurrection. On the other hand, higher capital adequacy ratio raises banks' cost thereby reducing the level of intermediation. To some extent, large differences in capital adequacy ratio between countries reduce competition thereby reducing capital flows in countries with higher ratios (Ariyoshi, et al, 2000,p: 34-5).*

[10] *In the 1988 Accord, sovereign risk weights are based on a generalized approach, i.e., whether a country belongs to the OECD or not.*

economy in terms of capital withdrawals to other economies where the incentives are higher.

Mistakes many countries made on prudential guidelines during turbulent capital flows is that they fail to strike appropriate balance between reducing threat of excessive risk taking and containing freedom of institutions to take the normal risks inherent financial intermediation. To this end, monetary authorities should ensure that regulation against capital flows is not done at the expense of weakening the role of prudential policies in maintaining safety and soundness of domestic financial system.

Countries like India and China were able to insulate their economies from the contagion of the late 1990s because their current account liberalization mostly emphasized opening up of the economy to foreign direct investment and portfolio equity investment. These countries to a large extent reduced significantly reliance on volatile short-term debt flows. Other factors include maintaining flexible exchange rate system and adequate stock of foreign exchange reserves.

Arising from liberalization of capital account, many countries experienced very volatile movement of capital in the late 1990s. This, to a large extent, weakened the monetary policy autonomy in directing monetary policy towards domestic objectives, impaired the stability of the monetary and financial system, and added undue pressures on foreign exchange and inflation. This informed the reintroduction of prudential policies and capital control. For instance the use of capital controls to limit short-term capital inflows was experienced in such countries as Brazil (1993-97), Chile (1991-98), Colombia (1993-98), Malaysia (1994) and Thailand (1995-97). The following shows case studies from some countries on the policy responses to capital account liberalization.

***Brazil:*** In changing the composition of capital account from short to long-term inflows, Brazil restricted or banned investments in certain assets, increased the entrance tax[11] for some portfolios, and used other measures to increase the

[11] *To influence the level, maturity and composition of portfolio, differentiated tax rates was adopted in Brazil. Taxes were imposed based on their inverse relationship with maturity of capital especially during the Mexican crisis in 1995.*

maturity of permissible investments. Other measures include banning the use of short-term capital for fixed income investments, restricting foreign investors access to market derivatives, raising the minimum maturity level especially minimum maturities for all currency loans to three years. During this period, Brazil experienced massive sterilization of accumulated reserves with substantial fiscal costs in terms of fiscal deficits, exchange rate appreciation and current account deterioration. In fact, most of these measures were circumvented through financial engineering and sophistication of the financial market that reduced the cost of circumvention relative to the incentive to circumvention thereby necessitating additional restrictions.

***Chile:*** Arising from the strengthened external sector between 1984 and 1988[12], there was a surge in capital inflow from 1989. The boom in capital inflow in Chile presented a classical case of monetary policy dilemma (Ariyoshi, et al, 2000). During the structural and macroeconomic reform in Chile, the monetary authorities assigned monetary policy a domestic inflation target while exchange rate was assigned current account target. However, when the capital account was fully deregulated, it became very difficult to set monetary and exchange rate policies independently.

At the onset, government sterilized foreign exchange intervention and tightened fiscal policy that imposed substantial cost on the central bank[13]. In response to this, selective controls on capital inflow were imposed in June 1991. Some of these involve imposition of 20 percent unremunerated reserve requirement (URR)[14] on foreign borrowing, a minimum stay requirement for direct and portfolio investments from abroad, regulatory requirements for

[12] *The current account deficit was cut from 11 percent of GDP in 1984 to 1 percent in 1988 and the economy grew at an average of 5.7 percent over the period.*

[13] *This is in the form of the difference between the interest cost of sterilization and return on foreign assets, which was estimated to be about 1 percent of GDP per annum in the 1990s (Ariyoshi, et al 2000).*

[14] *The imposition of URR, a market based capital control and a variant of Tobin tax, served multiple purposes. These are to discourage short term inflows without discouraging long term foreign investment; to reduce the risks faced by institutions intermediating on these type of investment and to increase the autonomy of the monetary institutions by minimizing the effects on the exchange rate of tight monetary effect as well as reduce the burden of monetary policy dilemma (Ariyoshi, et al 2000). Ab initio, URR was only charged on debt flows but was later extended to non-debt flows such as trade credit, foreign deposits and some foreign direct investment that are speculative in nature when they became a major channel of short term capital inflows.*

domestic corporation borrowing from abroad, and extensive reporting for banks for external transactions (Ariyoshi, 2000 and Le Fort, 2005). These were complemented by further liberalization of capital outflows, widening of exchange rate band and continuation of tight fiscal policy. When the 20 percent URR was becoming less effective, it was raised to 30 percent but was later reduced to 20 percent[15] when the contagion effect of the Asian crisis substantially reduced the flow of short-term capital in the region. As shown in Le Fort (1999), URR altered the composition of capital in Chile substantially. The share of medium- and long-term capital increased from 23 percent of total inflows in 1990 to 62 percent in 1997-98[16]. Figure 5 further supports the finding of Le Fort particularly with net portfolio flows and foreign direct investment responding appropriately to the policy changes.

The Chilean experience on prudential framework presents a good case study in that it gave credence to the need to strengthen the financial system, adoption of sound macroeconomic policies especially fiscal policy stance that moved from excessive deficit to surplus condition and flexible exchange rate system. To reduce the heat of capital inflows on the system, gradual capital outflow liberalization was also encouraged. One of the factors that contributed to the success made in Chile is the development of prudential framework for the financial system which established high disclosure standards, stringent rules for loan classification and provisioning, strict limit on connected lending and on banks exposure to foreign exchange risks, clear procedure for correction of liquidity or solvency problems and strict compliance of all banks to the Bank for International Settlements for capital adequacy ratio. These contributed substantially to the sound health of the financial system[17].

A major conclusion from the Chilean experience has been that capital controls

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[15] *This was further reduced to 10 percent and 0 percent in 1998 when the contagion effects from the Asian crisis was significantly reduced. URR was focused on large transactions and individual foreign exchange transactions of less than US$200,000 were exempted (Le Fort, 2005: 11).*

[16] *Quantitative evidence on the effectiveness of URR is inconclusive partly because of conflicting official statistics on capital flows.*

[17] *For instance as at March 1999, the level of non-performing loan was as low as 1.68 percent while provision for bad loans was at a comfortable level of 127 percent. The financial system maintained a capital adequacy level of 11.5 percent.*

are an integral component of the overall economic reforms programme and that the country recognised the significance of financial sector reform quite early in terms of establishing prudential guidelines and sound credit culture in the financial system.

***Colombia***: Following the comprehensive structural and economic adjustment programmes that covered trade system, capital account system, exchange rate system, banking sector, privatisation, and strong regulatory framework undertaken by government, Colombia also experienced a boom in capital inflows in the 1990s. Private capital inflows for instance rose from 0.2 percent of GDP in 1990 to over 7 percent in 1997 with an annual average of about 4 percent between 1990 and 1997. As obtained in Chile, prudential guidelines that entailed sound banking regulation and supervisory framework, domestic strategy for financing public sector, tight credit conditions and emphasis on foreign direct investment were integral part of the economic reform programmes.

Although the surge in capital inflows helped in financing the widening current account deficit, it however created some destabilizing effects on the system. Apart from exerting upward pressure on the exchange rate it also raised a serious concern about external competitiveness of the country's tradable. This generated some policy responses from government. An immediate policy response was the partial sterilization the ripple effects of inflow through aggressive open market operations (OMO). Apart from the cost on the financial balance of central bank, which was as high as 0.8 percent of GDP in 1991, the aggressive OMO also raised the domestic interest rate, which further attracted short-term foreign capital inflows into the country. To stem the tide of rising interest rate, an expansionary fiscal policy was adopted which weakened the effectiveness of monetary policy. As a response to this development, the local currency (peso) was devalued, restrictions on capital outflow were eased, and import liberalization was also accelerated.

In spite of these measures, capital inflows were still on the rising trend. Consequently, far-reaching policies were introduced. A 10 percent withholding tax on transfers and non-financial private services was introduced

in July 1992. Another form of capital control was introduced in September 1993 with the emergence of URR[18] for all external borrowings. To mitigate the effect on exchange rate, a crawling peg regime was introduced in early 1994 with the bandwidth set at ±7 percent and the rate of crawl based on the expected inflation differential with major trading partners (Ariyoshi, et al, 2000).

These measures were able to change the structure of external debt stock from medium - and long-term share of total debt stocks of 40 percent in 1993 to 70 percent in 1996. However, net private capital flows remained very strong (it rose from 2.1 percent of GDP in 1992 to 5.9 in 1997).

***Malaysia:*** Malaysia experienced an unprecedented level in both short- and long- term capital surpluses between 1990 and 1993. While the short-term capital as a ratio of GDP rose from 1.2 percent to 8.9 percent during the period, the ratio for the long-term capital stood at 5.7 percent in 1990 and 8.2 percent in 1993. As pointed out by IMF (1995), economic fundamentals accounted for the inflow of long-term capital while interest differential accounted for the short-term flows.

The monetary authorities was faced with the trade off of either solving the problem of inflation by maintaining high interest rate or address the destabilizing effect of short-term capital by reducing the interest rate differential against Malaysia. The latter option was considered important by the monetary authority and a combination of monetary and exchange rate policies were adopted. Sterilization was considered as the best option but its implementation was very costly due to weak financial structure in the system and interest rate also rose. Hence, capital flows rose, the ringgit became more appreciated with its destabilizing effects on trade and investment. Besides, government lost control over monetary aggregates and inflation and the financial system became unstable.

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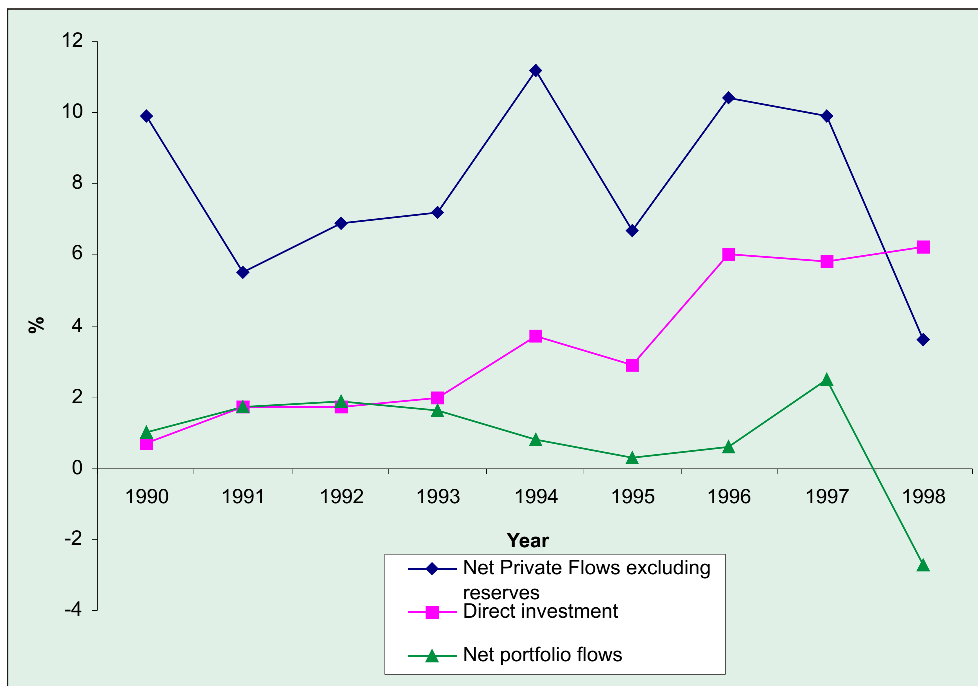
[18] *The URR was adjusted many times to reflect the current reality with a view to making it better focused. Generally, it was imposed on external loans with maturity of 18 months or less. Certificate on URR facility is originally denominated in foreign currency but redeemable in local currency after 18 months.*

**Figure 5: Foreign Investment Flows in Chile, 1990-98**




To arrest the level of macroeconomic and financial instability in the system, direct control measures which were primarily aimed at limiting short-term capital inflows in the form of bank foreign borrowing and ringgit deposits by bank or non-bank foreign customers were introduced in 1994. Among the measures include: prohibiting residents from selling Malaysian money market securities of less than one year maturity to non-residents; commercial banks were prohibited from engaging in non-trade related bid-side swaps or forward transactions with non-residents; imposition of ceilings on banks net liabilities excluding trade related and foreign direct investment; and commercial banks were mandated to place with the central bank the ringgit funds of foreign banking institutions and maintained non-interest yielding accounts.

One clear message from this set of policies is that the control measures were meant to be a temporary one. Hence it was discontinued at the end of 1994 but the prudential guidelines remained in place. The measure led to depreciation of

the ringgit and correction of the stock market. Due to sharp narrowing of interest rate, short-term capital inflows were curtailed. Monetary aggregates decelerated and exchange rate became stable. Important lessons from the Malay's experience is that control was effective because of consistent mix of monetary and exchange rate policies; and because of continuous strengthening of the prudential regulations.

***Thailand:*** Capital account liberalization took place quite early in Thailand. Promotion of free capital flows (especially portfolio and equity investment) started as early as 1985 but became more pronounced between 1990 and 1995 while outflows were liberalized only gradually during 1990-92 and 1994. Banks were not restricted from foreign borrowing but were placed on net open position limits. Residents, on the other hand, could be contracted freely but they were subject to the provision that proceeds should be repatriated through authorised banks or placed in foreign currency account.

The liberalized capital market coupled with the pegged exchange rate since 1984, created wide interest rate differential in favour of the country. This created strong incentives for interest rate arbitrage and speculative activities, which resulted in high volatile short-term capital inflows; this was estimated at over 60 percent as at 1993. Consequently, the Thai economy, in spite of being noted for tight fiscal policy, became overheated from the middle of 1993. This manifested in the form of demand pressure, which resulted in high inflation and increased current account deficit.

In the face of fixed exchange rate policy and limited indirect monetary instruments, monetary policy became quite complicated. The main policy responses were combined monetary policy, prudential guideline and market based capital controls. To reduce the inflationary impact of the inflow, interest rate was raised in March 1995, credit plan was extended to cover large finance companies and related institutions, loan-deposit ratio was reduced whenever it was above the accepted average, and sterilization operations was stepped up. Specific measures were put in place in August 1995 to control capital inflows. These included: establishment of asymmetric open position limits for short- and long-term positions; establishment of a reporting requirement for banks on

risk control measures in foreign exchange and derivative trading; and a 7.0 percent reserve requirement[19] on non-resident baht accounts with less than 12 months maturity and on finance companies' short term foreign borrowings. Banks were also restricted from extending credit to non-priority sectors during the period. These measures generated desired results at the early stage. The effects were however short-lived because of the decline in US interest rates. Consequently, capital account surplus rose from 8.5 percent of GDP in 1994 to 13.1 percent in 1995. While short-term capital rose from US$7.4 billion in 1994 to US$12.7 billion in 1995, long-term capital (mostly portfolio investment) also increased from US$4.6 billion to US$8.1 billion during the same period.

Following, the need to reverse increase in capital inflows, the 7 percent reserve requirement was extended to non-resident baht borrowing with a maturity of less than one year and to new short-term offshore borrowing of maturity of less than one year by commercial and Bangkok International Banking Facility (BIBF) banks. This, apart from reducing the net flow of capital substantially also reduced the composition of capital inflows. Short-term capital inflows fell from 62 percent in 1995 to 32 percent in 1996 (Ariyoshi, et al 2000). The share of long-term loans of BIBF rose from 14 percent in 1995 to 34.3 percent in 1996, reduced the non-resident holding of baht accounts as well as reduced the share of short-term debt to total debt stock from 50 percent to 43 percent during the same period[20]. Some key lessons are discernible from the country's experience. The effectiveness of the measures was hindered because reforms in the financial system lagged behind capital account reforms. The goal of liberalizing current account position cannot be maximized when the interest rate differentials between the liberalizing country and its trading partners or neighbouring economies do not align or reduce substantially. Besides, capital controls are not substitutes for prudential guidelines and sound macroeconomic policies.

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[19]*The reserve is kept with the central bank.*

[20]*It is instructive to note that the measures were unable to reduce substantially credit to unproductive sectors with no foreign exchange earning potential.*

## V. Key Challenges and Prospects

One of the major arguments of capital account liberalization is that it allows for fund diversification and it bridges the domestic saving-investment gaps. Unless a guided approach as exhibited in Malaysia in 1997 is undertaken, the pro-cyclical nature of foreign capital may not lead to the desired economic transformation. In practical sense, capital flows out during recession, when they are mostly needed, and flows in during a boom, when the need for it is relatively lower thereby exacerbating inflationary pressure.

The challenge of ensuring macroeconomic stability especially monetary and exchange rate policies is commonplace in the literature. Large and persistent inflows complicate the implementation of monetary policy, as is the case in Thailand. The boom in capital inflows could also present a classical case of monetary policy dilemma. In the face of high capital account liberalization, it becomes difficult for monetary authorities to assign domestic inflation targeting to monetary policy while at the same time assigning current account targeting to exchange rate policy. Setting monetary and exchange rate policies independently is always a herculean task.

Financial institutions are a major stakeholder in international transactions. Because they accept cross-border and foreign currency deposits, initiate external borrowings; make foreign loans and investments, have branches across borders, and intermediate cross border transactions, they are often exposed to excessive risk taking. Rapid inflows and sudden reversals could impact on the health of the financial institutions and systems. These shocks if not properly handled could trigger financial panics and systemic crisis as experienced in Malaysia and Thailand in 1997/8, Spain in 1992 and Venezuela in 1994-96. The recent consolidation in the country further increases the likelihood of exposure if prudential guidelines are not fully enforced and monitored. This is more demanding given the fact that capital inflows into the banking system could fuel credit expansion, foreign exchange risks and maturity mismatches in foreign currencies[21].

[21] *As argued by Johnson and Otker-Robe (1999), capital account liberalization could introduce additional risks (credit risk, market risk, and liquidity risk) that may increase the magnitude or complicate the management of risks that banks typically faced in their domestic activities.*

For capital control to be effective, it has to be comprehensive and forcefully implemented. China and India provide a good example of this up till the 1990s. It is important to note that irrespective of the effectiveness of capital account control at the initial stage, it often loses effectiveness over time as markets exploit the potential loopholes in the system to channel the 'undesired' inflows. It is only in sophisticated financial system (as experienced in Brazil) and strong enforcement capacity (as is the case in China and Chile) that the incentives could be reduced appreciably as experienced in Brazil. Colombia also reduced circumvention by subjecting some trade credits to URR. One major lesson from the implementation of capital account liberalization is that it should be approached slowly and very cautiously. Many mistakes were made in most of the countries that have implemented capital account liberalization. This relates to mistake of sequencing and spacing. For instance, forcing liberalization before safety nets are put in place, before adequate regulatory framework and before the country could withstand the adverse consequences of sudden changes in market sentiments do not produce the desired results. In practical sense, when the financial system is characterised by structural weaknesses, capital account liberalization poses significant risks, hence it should be of lower priority in the short-term.

An emerging reality from the experience on capital account liberalization over the past one decade is that there has been a good deal of learning. The major lesson from the experience is that capital account liberalization is a particular aspect of the larger process of economic and financial development. Emerging countries have learned that the regulation of capital flows in and out of a country is only one aspect of the larger task of economic and financial regulation and financial markets regulation is only one part of the broader process of economic and financial development. Capital account liberalization can occur naturally in the course of economic and financial development. However, because the development of financial markets differs in different countries, one-size-fits-all advice regarding capital account liberalization is unlikely to be productive. It would be imprudent to attempt to apply the same advice regarding the structure and sequencing of policies toward the capital account. Hence, premature capital account liberalization, initiated before the development of domestic financial markets can be dangerous and

counterproductive (Eichengreen, 2005)[22]. Clearly, addressing a complex issue like policy toward the capital account in a very simplistic manner often suggested by the international financial architecture could only lead to more frustration and deleterious effect on developing countries' economies.

Prudential guidelines have been used extensively to mitigate the effect of capital account liberalization in many countries of the world. Prudential guidelines, if well implemented, are capable of strengthening the capacity of the financial system to withstand volatile market conditions. Argentina and Chile have made substantial progress in using prudential guidelines in mitigating the effects of destabilizing capital flows. Evidence from successful countries have shown that establishing and maintaining prudential standards rests on some fundamentals, namely, public regulation and supervision, internal practices and control, and market discipline. The monetary authorities would have to examine these very critically and determine to what extent Nigeria has adhered to these pillars before the benefits of prudential guidelines on cross border transactions can be maximized. It is important to note that even in advanced economy, managing prudential guidelines are weakened to some extent by the rapid innovations in financial technology. The fact that management and supervision of financial system cannot keep pace with the technological innovation, timely identification of financial risks becomes compromised.

## VI. Conclusion

Capital account liberalization has not posed a serious problem to economic management in Nigeria. Portfolio investment still remains a new phenomenon with relatively small size while the share of FDI inflows and net flows as a proportion of gross domestic product between 1990 and 1997, for instance, remained at 4.4 percent and 1.2 percent. In fact, net outflow is not yet a serious issue in Nigeria. The effect of banking consolidation might change the scenario if appropriate prudential guidelines are not put in place. However, net outflows of other long-term capital and unrecorded net outflows are posing a

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[22] *Eichengreen was a former Senior Policy Advisor at the International Monetary Fund.*

threat to balance of payments. The fact that the costs of incentives put in place might outweigh the quantum of foreign investment attracted may tend to suggest limited effectiveness of the incentive structures put in place. While a wide spread between the deposit and lending rate may suggest an inefficient financial system, it is also important to address the structural impediments to foreign investment in the country. Issues such as adequate provision of electricity, water, roads as well as fight against corruption and maintenance of security of life and property are vital to addressing this.

This notwithstanding, Nigeria has a lot to learn from other countries that experienced vicissitudes of capital accounts. Experience across the globe indicates that various policy responses accompanied surge in foreign capital inflows. Depending on the nature of inflows, policy options often given serious consideration include sterilization through OMO, increase in reserve requirements, fiscal tightening and greater exchange rate flexibility. Other policy options are further trade liberalization, removal of restrictions on capital outflows, and tightening of restrictions on capital inflows. An emerging consensus is that none of these brings the desired solutions because each of them involves significant costs or brings different policy challenges. Evidence from different studies however shows that unremunerated reserve requirements was successful in changing the composition of inflows towards longer-term maturities thereby reducing countries' vulnerability.

No matter the extent of effectiveness of capital account control, it often loses its steam over time as markets exploit the potential loopholes in the system to channel the 'undesired' inflows. An alternative approach to managing the risks associated with capital flows is not to impose administrative control, but to limit the vulnerability of the economy to the risks associated with the flows through the application of prudential framework to the financial institutions. On the other hand, liberalization of capital account does not just happen by sentiment or by coercion. Rather, some economic prerequisites are needed. It should be an integral element of a comprehensive economic reform programmes with some form of sound regulatory framework. Greater exchange rate flexibility and more stable and robust financial system are needed before capital account liberalization is embarked upon.

An emerging issue is how to manage the risks of international capital flows which to a large extent has led to the adoption of capital controls in many countries, particularly in controlling the volume, composition and volatility of such flows. The facts emerging from the experience of capital control as a way of reducing the effect of liberalization are that no single measure is effective across the country; selective controls targeted against some range of transactions, as opposed to comprehensive measures, are easily circumvented; administrative capacity and level of financial development matters in achieving results; sound macroeconomic policies, strong prudential policies and effective supervisory capacity of the monetary institutions matter. The sequencing of financial and external liberalization has also become a critical factor in the literature. Financial sector reform and consequently financial stability are precursor of capital account liberalization. External sector liberalization has serious implications on the entire financial infrastructure such as market development, governance, prudential regulations and supervision, and monetary operations.

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# Sequencing Capital Account Liberalization

*Bright Okogu and Philip Osafo-Kwaako**

*The increased integration of international financial markets provides both opportunities for economic growth as well as challenges for macroeconomic management in developing countries. By liberalizing their capital accounts, developing country economies stand a better chance of leveraging resources from the international capital market for investment and growth, and also enable their domestic investors to diversify their portfolio of investments. Capital account liberalization is, however, not without its challenges. Recent financial crises in some emerging market economies highlight the need for an appropriate sequencing of liberalization policies. Country experiences indicate the need for macroeconomic stabilization, current account liberalization, liberalization of the financial sector and effective prudential financial sector regulation as preconditions for successful opening of the capital account. This paper focuses on the case of Nigeria and examines whether, following the successful implementation of the recent reform program, appropriate policies are now in place for effective capital account liberalization. We conclude that there is no simple answer as to the sequencing process partly because the preconditions are not cast in absolutist terms. Similarly, reforms are a process rather an event suggesting that a gradualist approach to liberalization is needed as Nigeria's economic reforms are consolidated. Ultimately, the major benefits of capital account liberalization in Nigeria may result not from its direct effect on GDP growth, but instead, by promoting various collateral benefits such as strengthened domestic institutions, improved financial supervision, and greater macroeconomic discipline.*

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## I. Introduction

The increased integration of international financial markets has been one of the most notable developments of the past two decades. The rise in international capital flows to developing countries has been particularly significant, and spurred by demand for developing country debt and equities which have become increasingly attractive to international investors[1]. Aggregate net resource flows to developing countries increased nearly fourfold from $62 billion in 1985, to $227 billion in 1995; and further doubled to about $443 billion in 2005 (World Bank, 2006). There is considerable debate in the literature on the benefits of capital account liberalization. By liberalizing their capital accounts, developing countries could improve access to international capital needed for investment and growth, and also enable domestic investors to diversify their portfolio investments. The experiences of some emerging economies however provide lessons on potential risks associated with capital account liberalization, such as overheating of the domestic economy and asset price inflation. Effective macroeconomic management is needed if developing countries are to benefit from international capital flows, while minimizing its undesirable side effects.

This paper examines the case of Nigeria, and assesses whether appropriate policies are now in place for successful capital account liberalization. Our focus here is on the pace and sequencing of liberalization. In this paper, capital account liberalization is defined as the removal of prohibitions on transactions in the capital and financial accounts of the balance of payments. It includes the removal of exchange and other controls which may hinder the movement of international capital, either as foreign direct investments or short-term portfolio capital.

The remainder of this paper is organized as follows. Section 2 examines the theoretical literature on the benefits of capital account liberalization and briefly summarizes some empirical results on the relationship between capital account liberalization and growth. Section 3 presents some principles of

[1]*For example, net private flows (debt + equity) more than tripled in the past five years, from $154 billion in 2001 to about $491 billion in 2005 (World Bank, 2006).*

successful capital account liberalization, while section 4 reviews some country experiences to draw lessons on appropriate sequencing of capital account liberalization. Section 5 reviews Nigeria's recent economic reforms and examines whether appropriate policies are in place to support capital account liberalization. Section 6 provides a summary of previous arguments and outlines future challenges for Nigerian policymakers on the sequencing of capital account liberalization. The paper is concluded in section 7.

## II. Some Current Literature on Capital Account Liberalization

### II.1 Review of the Theoretical Literature

There are two main schools of thought in the theoretical debate on the benefits of the capital market liberalization. The first hypothesis is based on an “efficient market” argument, whereas a second school of thought argues that “information asymmetry” hinders the efficient operation of global financial markets.

The 'efficient market' view is derived from neoclassical arguments of allocative efficiency, and may be summarized in five parts as follows. First, it is argued that states should focus on maximizing their GNP (i.e. net income of their citizens), and not solely their GDP (i.e. the output of the country). Liberalizing their financial markets therefore supports a more efficient allocation of international capital, provides outlets for investments, and enables domestic economic agents to obtain the highest possible returns on their investments, even if abroad[2]. Second, open capital markets benefit a country by providing opportunities for inter-temporal trade and cross-border diversification of investment portfolios. Inter-temporal trade enables countries to borrow in times of low incomes, and to repay when incomes are higher,

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[2] *For example, according to Cooper (1999), the McKinsey Global Institute noted that South Korean entrepreneurs had access to more favorable investment opportunities abroad, compared to investing in major domestic industries which provided slightly lower returns. In such an instance, restricting export of South Korean capital would result in lower national income, and even further, may discourage domestic savings.*

thereby achieving consumption smoothing[3]. By allowing portfolio diversification, capital mobility provides risk-sharing, and enables countries and firms to reduce their exposure to local shocks by spreading their investments in various markets[4].

Third, for middle-income and developing countries which tend to be net importers of global capital, liberalization of their capital accounts permits an inflow of international capital. Such funds are needed to support investments, finance trade, and enhance growth. Fourth, capital account liberalization will result in a global competition for funds which will encourage states to improve their domestic business climates for investments. In an environment with global capital mobility, states will be rewarded (with increased capital flows) for ensuring macroeconomic discipline, improving their domestic investment climates, and obtaining favorable international credit ratings[5]. Finally, it is argued that it is increasingly difficult to enforce restrictions on capital mobility- a good example being the high levels of capital flight from developing countries. Therefore, from an efficiency viewpoint the mere costs of policing the implementation of capital controls are likely to outweigh the intended benefits of monitoring, and result in significant distortions and welfare losses. In addition to the above arguments, membership of the IMF obliges countries under Article I (IV) the "…establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade".

A slightly contrasting view, based on "information asymmetry" theory, argues that financial markets are heavily dependent on access to information, which may be unequally available to economic agents (Stiglitz, 2000). Information asymmetry results in various problems due to moral hazard behavior (e.g.

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[3]*Essentially countries run current account deficits with capital account surpluses in one period, and then run capital account deficits in subsequent periods.*

[4]*Even for countries as a whole, such capital flows are beneficial in equilibrating temporary imbalances in their current accounts (Cooper, 1999).*

[5]*More generally, a number of 'pull' factors are believed to assist in attracting foreign capital including, prevailing investment climate, credit ratings, secondary market prices of sovereign debt, domestic rates of return, and interest rate differentials between domestic and foreign markets.*

banks financing low quality projects because international funds are available), and adverse selection problems (e.g. where it is difficult to distinguish between good and bad investment opportunities). The existence of such distortions suggests that efficiency arguments may have limitations in financial market liberalization.

In addition, financial markets sometimes tend to behave erratically, resulting in "herding" or "bandwagon" behavior by speculators[6]. International capital flows can sometimes be pro-cyclical, and exacerbate instability in emerging market economies. For example, there are many instances where capital account liberalization tends to spur the flow of short-term portfolio capital ('hot money') which tends to be highly reversible compared with more long-term foreign direct investments (Stiglitz, 2000). The information asymmetry school of thought argues for limitations on capital mobility, and a strengthening of regulatory institutions to oversee international capital flows. In summary, the concern is centered on the risk of domestic financial crises, as well as increased vulnerability to instability in international markets.

Besides these two main theories, a third argument in support of capital account liberalization has recently been proposed by Kose, Prasad, Rogoff and Wei (2006). Kose, *et al* acknowledge that capital account liberalization may provide the benefits of GDP growth and reduced consumption volatility as suggested by the 'efficient markets' argument above. However, they further argue that increased financial integration could provide additional 'collateral benefits' to liberalizing countries. In particular, the process of capital account liberalization could serve as a catalyst in providing various 'collateral benefits' to liberalizing countries such as fostering financial market and institutional development, promoting better financial supervision, and improving macroeconomic discipline. We find this view proposed by Kose, *et al* to be particularly useful in assessing the potential benefits of capital account liberalization for Nigeria.

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[6]*See Bikhchandani and Sharma (2001) for a recent review of herding in financial markets.*

**Review of the Empirical Literature**

In the empirical literature, studies which assess the impact of capital account liberalization on economic performance have provided inconclusive results. Two major types of measures are found in the empirical literature: *de jure* (or rules-based measures) and *de facto* measures (Kose, *et al*., 2006). *De jure* measures often construct indices based on IMF data published in the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)[7]. *De facto* measures however rely on relevant economic variables to construct an index of capital account liberalization. For example, such measures estimate openness by examining disparities between national savings rate and investment rates, second, by looking at differences in onshore-offshore interest rates, and third, by using the ratio of actual capital inflows and outflows to GDP (see for example, Kraay, *et al*., 2002). It is important to note that *de jure* measures typically indicate the presence or absence of controls, but not the level of *intensity* of these restrictions[8]. This consideration is particularly important for recently reforming countries where it is clear that progress is being made but the policies have not yet been fully consolidated. The international financial institutions such as the IMF, that develop and use openness measures for policy design would need to go deeper by refining these measures.

Most empirical work estimates the impact of capital account liberalization on other growth variables such as level of schooling, investments, and level of GDP. Results point to modest positive gains attained for capital account

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[7]*For example, Quinn (1997) constructs indices which reflect the intensity of capital account liberalization based on AREAER descriptions. Scores from 0-2, increasing in steps of 0.5, are assigned for various economies. A score of 0 indicates that capital flows are forbidden, 0.5 indicates that there are capital controls or severe restrictions, 1.0 and 1.5 indicate various forms of tax-like restriction, whereas a score of 2.0 indicates that flows are completely free of any restrictions.*

[8]*Thus, we can assess the current level of openness of Nigeria's capital account based on its current AREAER classifications. According to the recent AREAER report (IMF, 2006), Nigeria maintains restrictions on 6 out of 11 categories of capital account transactions. There are controls for transactions related to: capital market securities, money market instruments, commercial credits, liquidation of direct investment and personal capital movements. There are no restrictions on: direct investments, collective investment securities, derivatives and other instruments, financial credits, guarantees, sureties, and other financial backup facilities, and real estate transactions. We can therefore calculate Nigeria's score simply as 6/11 or estimate a more detailed score based on the actual descriptions above.*

openness particularly for developed and middle-income countries, but with minimal gains for low-income countries[9]. Recent research by the IMF similarly finds no strong relationship between capital account liberalization and growth, although it stresses the importance of strong intermediary institutions in ensuring the benefits of openness (Prasad, *et al*, 2003). Capital account liberalization is however still viewed as a desirable option for most developing countries, but with greater emphasis placed on the sequencing and speed of reforms (Johnston, 1998; Eichengreen, *et al*, 1998). In the next section, we consider some principles of appropriate sequencing of capital account liberalization, and subsequently examine some country case studies.

## III. Sequencing Capital Account Liberalization

It is important to note here that the debate on capital account liberalization is an evolving one. In 1997, for example, a committee set up by the Fund came up with a recommendation for its Article in this respect to be amended from a wholesale promotion of liberalization to one which would "…enable the IMF promote the *orderly liberalization* of capital movements" although the amendment eventually did not happen. Following the Asian crisis of the late 1990s, the focus of the debate shifted from the merit of capital account liberalization, to the preconditions for successful liberalization, i.e. policy sequencing. On balance, there is widespread acceptance among economists that successful capital account liberalization should be preceded by: macroeconomic stabilization; domestic financial sector reform; current account liberalization; and prudential regulation of the financial sector (Fischer and Reisen, 1994; McKinnon, 1993; Johnston, 1998). Each of these factors is examined briefly below.

Macroeconomic stabilization and fiscal adjustment are viewed as the first essential step for successful capital account liberalization. This is particularly important as there is the likelihood of the loss of monetary autonomy with a

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[9] *See for example, Quinn (1997) and Edwards (2001).*

fully liberalized capital account[10]. Fiscal control is therefore needed to accommodate any adverse effects of capital movements. Stabilization must therefore be achieved prior to the reform, to ensure that more expansionary fiscal policies could be utilized to accommodate any contractionary shocks due to liberalization of the capital account (Fischer and Reisen, 1994).

Domestic financial sector reform is also needed prior to liberalization, particularly when there are instances of financial repression. This could involve a range of policies such as high reserve ratios and liquidity requirements, legal ceilings on interest rates and credit expansion, and restrictions on lending portfolios by banks. Financial repression is undesirable as it reduces incentives for savings, and results in the misallocation of capital to inefficient and unproductive activities. In such an environment, where the authorities set real domestic interest rates at a low level, capital account liberalization may result in significant capital outflows and result in a balance-of-payment crisis. It is also argued that without financial sector reform, removal of capital controls could result in a case of immiserizing external borrowing. In such an environment, capital inflows are misallocated, so that the social rates of return on investments are lower than the costs of funds, leaving domestic citizens worse off.

Current account liberalization is also conventionally viewed as a precondition for successful capital account liberalization (Edwards, 1984; McKinnon, 1973, 1993). Current account liberalization in this regard encompasses both reduction of tariffs, as well as the removal of restrictions on payments for current account transactions. When capital controls are removed, capital inflows are likely, resulting in the possibility of a real exchange rate appreciation. An appreciated real exchange rate may be undesirable as it may harm competitiveness and reduce demand for domestic exports. Successful trade liberalization is however often accompanied with some depreciation of the real exchange rate - in order to stimulate exports and dampen domestic

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[10] *Resulting from the so-called trilemma or Impossible Trinity that 'it is impossible to achieve the following three desirable goals simultaneously: exchange rate stability, capital market integration and monetary autonomy. Any pair of goals is achievable…but requires abandoning the third.' (Joshi, 2003:2)*

demand for imports induced by tariff reduction[11]. Trade liberalization is therefore essential to counteract the likelihood of a real exchange appreciation resulting from the removal of capital controls. It is therefore advisable to pursue liberalization of the current (trade) account first, followed by a gradual relaxation of restrictions on the capital account[12].

Finally, successful opening of the capital account also requires strengthening of domestic institutions and prudential financial sector regulation. Such prudential practices are needed to ensure soundness of domestic financial institutions, effective risk management, and protect investors. Specific policies may include improving regulation and supervision, promoting competition in the financial sector to ensure efficient allocation of resources, introducing legal and accounting best practices to address systemic risks, and removing bad loans from the balance sheets of banks (Agenor and Montiel, 1999).

## IV. Lessons from Country Case Studies

The recent experiences of some emerging market economies provide instructive lessons on the sequencing and impact of capital account liberalization. In this section, we summarize the experiences of Chile, Korea, Indonesia and Thailand as presented by Johnston, *et al* (1997)[13].

For Chile, reform of the financial sector was conducted prior to capital account liberalization. The authorities focused on a restructuring of the banking system, implementation of trade reforms, and liberalization of exchange rates. Institutions tasked with financial regulation and supervision were also strengthened. The country adopted a gradual approach in liberalizing the capital account, by initially permitting inflows of direct and portfolio investments, and subsequently, relaxing restrictions on capital outflows during

[11] *See Agenor and Montiel, 1999: 703-10 for a review of empirical evidence on this issue.*

[12] *Besides its effect on the real exchange rate, others have argued that liberalizing the capital account in the presence of restrictive trade policies will only tend to amplify existing distortions in the domestic economy (see Edwards and van Wijnbergen, 1986).*

[13] *Covering the period 1985-96, and in the case of Thailand, for the period stretching from 1985 up to the 1997 currency crisis*

the reform process. Similarly, Korea pursued a gradual and sequenced liberalization program. Financial sector reforms, trade reforms and exchange rate reforms were conducted, while the government focused on ensuring current account surpluses. Capital account transactions were gradually liberalized as the authorities relaxed restrictions on capital inflows and outflows.

In contrast, in the case of Indonesia, capital account liberalization facilitated reform of domestic financial institutions. Authorities focused on growth of the real non-oil sector, and relaxed restrictions on direct investment flows. Various financial and monetary policy reforms were subsequently carried out to improve the functioning of the domestic financial system. Portfolio capital inflows were finally liberalized in 1989, but have been subject to close supervision by the authorities. Capital outflows were liberalized at an early stage of the reform process, while capital inflows (particularly portfolio investments) were liberalized much later and gradually. As a result of its relatively stronger fundamentals, Indonesia initially managed the regional currency crises in June 1997 somewhat better than its neighbours. However, speculative pressure on the Indonesian rupiah grew in July 1997, and prompted the central bank to abandon its managed exchange rate regime.

Finally, in the case of Thailand an uncoordinated approach to capital account liberalization with weak institutions resulted in a financial crisis. As part of an export-led growth strategy, trade and industrial policy reforms were carried out, while capital inflows were liberalized to attract foreign investments. Capital outflows were only gradually liberalized. Moreover, despite an initial reform of the banking sector in 1985, the financial sector remained weak, and many banks had an over-exposure to property sector by the mid-1990s. Inadequate supervision of the financial sector, coupled with large current account deficit, rising inflation and high interest rates, precipitated a sudden reversal of capital inflows and resulted in a currency crisis in 1997.

The country case studies broadly illustrate the need for a properly sequenced approach to capital account liberalization and stress the importance of developing strong domestic financial institutions. In Chile and Korea, a

gradual and proper sequencing of capital account liberalization was conducted, whereas in the case of Indonesia an initial opening of the capital account supported the development and strengthening of the domestic financial system. The experience of Thailand, in particular, highlights the need for strong domestic institutions to support the process of capital account liberalization.

## V. Implications for Nigeria

The foregoing discussion has surveyed the theoretical and empirical literature on the potential benefits and risks of capital account liberalization. In this section, we consider whether the appropriate preconditions and complementary policies are now in place for a successful liberalization of Nigeria's capital account. Nigeria currently maintains some restrictions on its capital account transactions[14]. In this section, we examine at what stage during the current economic reforms is it appropriate for the authorities to consider full liberalization of Nigeria's capital account. To conduct our assessment, we examine recent progress in Nigeria on each of the preconditions discussed earlier in section 3.

### *Macroeconomic Stabilization*

There is evidence that Nigeria had one of the most volatile economies in the past two decades (World Bank, 2003). A pro-cyclical expenditure pattern and persistent fiscal deficits often resulted in high inflation and low growth in the economy. Macroeconomic stabilization and fiscal adjustment were therefore needed in Nigeria, not only in the context of facilitating an opening of the capital account, but more broadly to support growth.

Recent economic policies have emphasized macroeconomic stabilization as a central component of the reform agenda. To improve the management of oil revenues, a benchmark price for oil was introduced in the government budget. Despite recent high oil prices, prudent benchmark prices of $25, $30, and $35

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[14] *See footnote 2 under the section on review of empirical literature*

per barrel were adopted for government budgets in 2004, 2005, and 2006, respectively; the 2007 budget currently under consideration by the National Assembly is based on $40 per barrel. These are significantly lower than the actual prices, making it easier to maintain monetary stability. The use of the fiscal rule has delinked government expenditures from oil revenues, and reduced the pro-cyclicality of government fiscal activities.

Government fiscal balance has improved considerably from previous deficits (of about 3.5 percent of GDP) to a consolidated fiscal surplus of about 10 percent of GDP in 2004, and 11 percent of GDP in 2005. Recent improvements in monetary policy have also strengthened macroeconomic stability in the Nigerian economy. Monetary targets have been achieved, and inflation reduced. The 12-month average inflation rate to July 2006 had declined to about 13.5 percent. Interest rates have also gradually declined with prime lending rates averaging about 16.5 percent in the first quarter of 2006 (CBN, 2006). The improved fiscal discipline of the government, and improved macroeconomic environment resulted in the negotiation of a successful debt relief package for Nigeria[15], as well as the country's first ever sovereign credit rating[16].

### *Current Account Liberalization*

Prior to the tariff reform, Nigeria maintained a complex tariff structure, comprised of about 19 bands (with 5146 lines at the HS-8 digit level); and with tariffs ranging from 2.5 percent to 150 percent. For most of the post-independence period, Nigeria's trade regime was viewed as complex, protectionist and opaque (WTO, 2005). Following the structural adjustment programme (SAP) in 1986, a seven-year tariff schedule was adopted, which significantly reduced tariff averages. A subsequent revision of the tariff structure in 1995 further reduced average tariffs and simplified the tariff structure. Despite these revisions, however, the tariff regime was still largely

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[15] *As a result of the debt relief package, Nigeria successfully exited the Paris Club, and reduced its external debt burden from $35 billion to $5 billion.*

[16] *Both Fitch and S&P assigned Nigeria a sovereign credit rating of BB- with a stable outlook. This places the country's debt rating at par with other emerging economies such as Brazil, Turkey, Venezuela and Vietnam.*

viewed as opaque and complex. Since 1978, the government had introduced policies on import prohibitions, which provided for an outright ban on selected products, which were viewed as strategic for the economy, or in response to complaints from manufacturing sector. The ad hoc use of import prohibitions as well as other upward tariff revisions greatly reduced the predictability of the tariff regime, as actual tariffs applied at the ports often deviated from published tariffs.

As part of the recent economic reform program, Nigeria liberalized its current account, by embarking on a comprehensive trade liberalization program aimed at creating an open trading environment. The goal was to revise the previous tariff structure, and adopt the Common External Tariff (CET) as proposed by ECOWAS. Under the new ECOWAS tariff structure, Nigeria has adopted a four-band arrangement, with duty rates of 0, 5, 10, and 20 percent for capital goods, raw materials, intermediate products, and finished goods, respectively. Consequently, the simple (unweighted) average tariff has declined from about 25 per cent to 17 per cent. A temporary 50 per cent band exists but to be phased out by end-2007 while existing import bans are also to be eliminated progressively. Trade liberalization reforms have simplified the tariff structure in line with the government's objective of reducing uncertainty and unpredictability in the country's trade policy regime (NPC, 2004)[17]. But here again, the question arises as to what 'level' of trade liberalization is deemed adequate to support successful capital account liberalization.

### *Domestic Financial Sector Reform*

Although there is widespread evidence that an efficient financial sector is important for long-run economic growth, implementing such reforms has been difficult in Nigeria in the past. The financial system was repressed prior to the structural adjustment program (SAP) that was introduced in 1986, as evidenced by the negative real interest rates of that period (Table 1). Even during the period of SAP, ceilings on interest rates were occasionally

[17] *See Chapter 7 of NPC (2004), the National Economic Empowerment and Development Strategy (NEEDS).*

reintroduced[18]. In this regard, market-based reforms were proposed to ensure that the 'true' cost of capital would be achieved and, thus, ensure a more efficient allocation of resources. However, initial attempts at financial liberalization in Nigeria yielded poor results. A poorly supervised and inefficient financial sector, weak institutions and poor governance created opportunities for arbitrage, patronage, and rent-seeking behavior[19]. The reform of the foreign exchange market during the SAP (discussed below) illustrates this point.

Prior to the reforms of the late 1980s, foreign exchange sales in Nigeria were highly controlled, and rationed by use of import licenses. In 1986, the foreign exchange market was liberalized, with the Central Bank adopting a two-tiered structure for the provision of foreign exchange. A first window operated at a fixed exchange rate, to provide foreign currency for government transaction such as debt servicing and financing foreign missions. A second, auction-based window was established (i.e. the Second-tier Foreign Exchange Market, SFEM), which provided access to foreign exchange to licensed dealers. The previous fixed exchange rate regime (which was determined by the authorities) was also relaxed in favor of a floating exchange rate regime. Bureaux-de-change were also permitted to operate beginning in 1989, and an informal parallel market also existed for foreign exchange trading. Between 1986 and 1993, the authorities tried out various foreign exchange auction mechanisms.

Large premiums existed in the foreign exchange market, and the multi-tiered market provided opportunities for arbitrage and rentier practices (Table 2). With the relaxation of rules for bank establishment in 1987, the number of financial institutions in the country grew rapidly, with the number of banks

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[18] *Interest rate controls were initially removed in 1987, and spurred the gradual increase of nominal lending rates by financial institutions (see Table 1 below ). Controls were briefly reintroduced in 1991 when a poorly managed reform program had led to the development of several distressed banks, and the diversion of capital to other unproductive activities. Interest rate controls were however abandoned in 1992, but with a stipulation for a 5 percent spread between cost of funds and lending rates (see Ikhide et al, 2002).*

[19] *A broader survey of Nigeria's financial liberalization under the Structural Adjustment Program (SAP) is provided by Lewis et al, 1997; Okogu, 1992; 1999; and Ikhide et al, 2002.*

increasing from 41 in 1986 to 120 in 1993 (Lewis, *et al*, 1997). There is evidence that many new small banks as well as the elite with access to political offices could obtain foreign currency at low (official) prices, and reap substantial returns by re-selling in the bureaux de change or parallel market[20]. This inefficiency in the foreign exchange market was compounded by weak regulation of financial institutions, and by the early 1990s, there was widespread concern about the rising systemic risk in the Nigerian banking sector (Lewis, *et al*, 1997; Ikhide, *et al*, 2002). A complete liberalization of Nigeria's capital account in the presence of such internal distortions was likely to exacerbate risks in the existing financial system.

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[20] *To obtain the extent of this distortion, it is worth noting that the World Bank estimated that the indirect subsidy arising from the spread between official and market rates amounted to $500 million in 1990 alone (Okogu, 1999).*

## Table 1: Nigeria: Lending and Deposit Rates (1975-2005)

| Year | Nominal Deposit Rate | Nominal Lending Rate | Inflation Rate | Real Deposit Rate | Real Lending Rate |
|---|---|---|---|---|---|
| 1975 | 3.00 | 6.25 | 42.85 | -39.85 | -36.60 |
| 1976 | 2.67 | 6.50 | 20.00 | -17.33 | -13.50 |
| 1977 | 2.83 | 6.00 | 16.66 | -13.83 | -10.66 |
| 1978 | 4.15 | 6.75 | 21.42 | -17.27 | -14.67 |
| 1979 | 4.47 | 7.79 | 5.88 | -1.41 | 1.91 |
| 1980 | 5.27 | 8.43 | 11.11 | -5.84 | -2.68 |
| 1981 | 5.72 | 8.92 | 25.00 | -19.28 | -16.08 |
| 1982 | 7.60 | 9.54 | 4.00 | 3.60 | 5.54 |
| 1983 | 7.41 | 9.98 | 26.92 | -19.51 | -16.94 |
| 1984 | 8.25 | 10.24 | 36.36 | -28.11 | -26.12 |
| 1985 | 9.12 | 9.43 | 8.88 | 0.24 | 0.55 |
| 1986 | 9.24 | 9.96 | 6.12 | 3.12 | 3.84 |
| 1987 | 13.09 | 13.96 | 9.61 | 3.48 | 4.35 |
| 1988 | 12.95 | 16.62 | 56.14 | -43.19 | -39.52 |
| 1989 | 14.68 | 20.44 | 50.56 | -35.88 | -30.12 |
| 1990 | 19.78 | 25.30 | 6.71 | 13.07 | 18.59 |
| 1991 | 14.92 | 20.04 | 13.28 | 1.64 | 6.76 |
| 1992 | 18.04 | 24.76 | 44.44 | -26.40 | -19.68 |
| 1993 | 23.42 | 31.65 | 57.69 | -34.27 | -26.04 |
| 1994 | 13.09 | 20.48 | 56.91 | -43.82 | -36.43 |
| 1995 | 13.53 | 20.23 | 72.71 | -59.18 | -52.48 |
| 1996 | 13.06 | 19.84 | 29.30 | -16.24 | -9.46 |
| 1997 | 7.17 | 17.80 | 8.19 | -1.02 | 9.61 |
| 1998 | 10.11 | 18.18 | 10.29 | -0.18 | 7.89 |
| 1999 | 12.81 | 20.29 | 6.67 | 6.14 | 13.62 |
| 2000 | 10.6 | 17.98 | 6.9 | 3.7 | 11.08 |
| 2001 | 10.2 | 18.29 | 18.9 | -8.7 | -0.61 |
| 2002 | 16.25 | 24.4 | 12.9 | 3.35 | 11.6 |
| 2003 | 13.86 | 20.48 | 14.0 | -0.14 | 6.48 |
| 2004 | 12.9 | 19.15 | 15.0 | -2.1 | 4.15 |
| 2005 | 10.23 | 17.85 | 17.9 | -7.67 | -0.05 |

*Source: Ikhide et al (2002) for 1975-99 data; IMF/Central Bank of Nigeria for 2000-2005*

**Table 2: Nigeria's Foreign Exchange Market (₦/$), (1986-1994)**

| Year | | Nominal Rate | Parallel Rate | Spread (%) |
|---|---|---|---|---|
| 1989 | Q1 | 7.40 | 10.51 | 42.03 |
| 1989 | Q2 | 7.48 | 10.58 | 41.44 |
| 1989 | Q3 | 7.25 | 10.30 | 42.07 |
| 1989 | Q4 | 7.51 | 10.66 | 41.94 |
| 1990 | Q1 | 7.90 | 9.48 | 20.00 |
| 1990 | Q2 | 7.94 | 9.53 | 20.03 |
| 1990 | Q3 | 7.96 | 9.55 | 19.97 |
| 1990 | Q4 | 8.34 | 10.02 | 20.14 |
| 1991 | Q1 | 9.43 | 12.99 | 37.75 |
| 1991 | Q2 | 9.47 | 13.05 | 37.80 |
| 1991 | Q3 | 10.95 | 15.09 | 37.81 |
| 1991 | Q4 | 9.87 | 13.60 | 37.79 |
| 1992 | Q1 | 12.49 | 18.23 | 45.96 |
| 1992 | Q2 | 18.57 | 19.44 | 4.68 |
| 1992 | Q3 | 18.85 | 20.81 | 10.40 |
| 1992 | Q4 | 19.59 | 22.84 | 16.59 |
| 1993 | Q1 | 22.28 | 28.19 | 26.53 |
| 1993 | Q2 | 22.22 | 34.86 | 56.89 |
| 1993 | Q3 | 21.89 | 37.65 | 72.00 |
| 1993 | Q4 | 21.89 | 43.91 | 100.59 |
| 1994 | Q1 | 21.89 | 49.73 | 127.18 |
| 1994 | Q2 | 21.89 | 50.43 | 130.38 |
| 1994 | Q3 | 21.89 | 66.91 | 205.66 |
| 1994 | Q4 | 21.89 | 81.02 | 270.12 |

*Source: Okogu (1999)*

More recently, financial sector reform has also been a major component of Government's economic reforms. In the past, the Nigerian financial sector had been weak in supporting economic development due to its fragmented nature and the weak capital base of banks. To reform the sector, the Central Bank of Nigeria (CBN) launched a bank consolidation program in mid-2004 in which all deposit money banks were required to raise their minimum capital base from about N5 billion to N25 billion by the end of 2005. Banks failing to meet

these new requirements were expected to merge, or else have their licenses revoked. During the consolidation process, the number of banks in Nigeria was reduced from 89 to 25, largely as a result of mergers and acquisitions. In the process of meeting the new capital requirements, banks raised the equivalent of about $3 billion from capital markets, and attracted about $652 million of FDI into the Nigerian banking sector. A similar reform is also being carried out for the insurance sector.

Foreign exchange markets have also been liberalized, with the government adopting a wholesale auction format which merged the previous retail Dutch Auction System and the interbank market for foreign exchange. The official exchange rate has remained stable, while the previous parallel market premium was eliminated by mid-2006. Indeed, as shown in Table 3, the spread between the two rates has narrowed in line with the progress of the economic reforms.

The recent bank consolidation reforms in the financial sector, liberalization of interest rates, and convergence of exchange rates must be viewed as the beginnings of an improved financial sector. These reforms would need to be consolidated in the coming years to ensure the development of a strong financial sector. Closely linked to the subject of financial repression has been the history of inadequate prudential supervision in the Nigerian banking sector which is the focus of the next section.

***Prudential Regulation of the Financial Sector***

Following financial liberalization in 1986, there was a rapid growth in financial institutions, with the number of banks tripling to about 120 by 1992. Various other financial institutions such as mortgage, insurance and brokerage houses also expanded, spurred by opportunities in retail trade, foreign exchange trading, and urban real estate (Lewis, *et al,* 1997).

Regulatory oversight however did not keep pace with the rapid growth of financial institutions in the late 1980s and 1990s. The Nigerian Deposit Insurance Corporation (NDIC) was established in 1989, while the CBN

Decree (No 24 of 1991) and the Banks and Other Financial Institutions Decree (BOFID, No 25 of 1991) were enacted[21]. Yet weak supervision of the sector remained. There is evidence that many banks had poor balance sheets and made limited lending to the private sector, and engaged predominantly in other short-term arbitrage activities. By 1993, it was estimated that about half of the licensed banks were distressed.

Since 2003, various prudential practices have also been adopted by the Nigerian authorities to support the development of sound domestic financial institutions, to promote effective risk management, and to protect investors. Weak regulatory oversight had fostered the growth of several weak and distressed banks in the 1980s and 1990s.

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[21] *Replacing the CBN Act of 1958 (as amended) and the Banking Decree of 1969 (as amended)*

## Table 3: Nigeria's Foreign Exchange Market (1999-2006)

| | Official rate | Parallel market rate | Spread (%) |
|---|---|---|---|
| 1999Q1 | 86.69 | 93.82 | 8.22 |
| 1999Q2 | 93.25 | 100.50 | 7.77 |
| 1999Q3 | 94.88 | 102.68 | 8.22 |
| 1999Q4 | 96.64 | 101.10 | 4.61 |
| 2000Q1 | 100.05 | 105.47 | 5.41 |
| 2000Q2 | 100.98 | 105.50 | 4.48 |
| 2000Q3 | 103.66 | 114.41 | 10.36 |
| 2000Q4 | 104.02 | 119.98 | 15.34 |
| 2001Q1 | 110.64 | 125.13 | 13.10 |
| 2001Q2 | 113.26 | 136.14 | 20.20 |
| 2001Q3 | 111.71 | 134.73 | 20.61 |
| 2001Q4 | 112.28 | 134.02 | 19.37 |
| 2002Q1 | 115.33 | 137.59 | 19.30 |
| 2002Q2 | 117.95 | 136.10 | 15.39 |
| 2002Q3 | 125.14 | 137.16 | 9.61 |
| 2002Q4 | 126.69 | 138.51 | 9.33 |
| 2003Q1 | 127.30 | 138.57 | 8.85 |
| 2003Q2 | 127.91 | 139.02 | 8.69 |
| 2003Q3 | 128.10 | 140.50 | 9.68 |
| 2003Q4 | 134.62 | 147.51 | 9.58 |
| 2004Q1 | 135.25 | 143.12 | 5.82 |
| 2004Q2 | 133.08 | 138.92 | 4.39 |
| 2004Q3 | 132.82 | 139.95 | 5.37 |
| 2004Q4 | 132.87 | 139.52 | 5.01 |
| 2005Q1 | 132.85 | 139.10 | 4.70 |
| 2005Q2 | 132.85 | 139.10 | 4.70 |
| 2005Q3 | 131.44 | 145.19 | 10.46 |
| 2005Q4 | 129.31 | 143.62 | 11.07 |
| 2006Q1 | 128.23 | 145.35 | 13.35 |
| 2006Q2 | 127.19 | 141.27 | 11.07 |
| 2006Q3 | 127.06 | 129.75 | 2.12 |
| 2006Q4 | 127.01 | 128.64 | 1.28 |

*Source: Central Bank of Nigeria*

Against this backdrop, recent improvements in supervision by the CBN are noteworthy. The Central Bank's supervisory powers are being strengthened, with a migration from a prudential supervision system to a risk-based approach within the framework of the Basel-II Accord. Capacity-building programs to support the development of central bank officials in various risk assessment tools have been organized as well as the upgrading of supervision software used by the authorities. A new Draft Corporate Governance Code of Conduct is being developed to oversee activities of stakeholders in the financial sector. Finally, as a precautionary measure, Government is also developing contingency plans to ensure the smooth handling of merger breakdowns if they occur in the future.

The Central Bank implemented various measures to ensure a smooth liquidation of banks which failed to meet the new capitalization requirements. Appropriate legislation-under the Nigeria Deposit Insurance Corporation (NDIC) Act-also provides a comprehensive framework for addressing the case of private depositors who may be affected by the liquidation process.

At present, the CBN has presented drafts of the CBN Act as well as the BOFI Act Amendment Bill to the National Assembly. Successful passage of these Bills would grant the Central Bank greater autonomy in performing its oversight functions of domestic financial institutions.

## VI. Time for Capital Account Liberalization in Nigeria?

In the light of the above discussion, the question that policymakers will have to deal with is not whether, but how to introduce capital account liberalization. It is a logical and inescapable step for a reforming economy with ambition to optimize its engagement with the international financial markets. Recent developments indicate that Nigeria has made significant progress towards meeting the prerequisites for liberalizing the capital account. These include progress in fiscal consolidation, reforms in the domestic financial system, including strengthening regulatory institutions, and providing an appropriate framework for the effective utilization of international capital flows. The sequencing signposts-macroeconomic stabilization, current account

liberalization, financial sector reform and prudential supervision of the banking sector-are acknowledged to have improved in Nigeria since the reforms.

However, it begs two questions: firstly, has the “improvement” gone far enough to satisfy the requirements for liberalization and how much more “improvement” is needed to reach the desired level of comfort? Secondly, given the evidence of poor management of the past two decades, can it be taken for granted that the reforms have sufficiently taken root to warrant full capital account liberalization? The questions are related, and the answer would appear to be that a longer period of sustained economic management and reforms, including of institutions, may be needed before comprehensive opening of the financial account. In this context, the adoption of appropriate legislation, such as the Fiscal Responsibility Bill, the amended Central Bank Act, and the BOFI Act, would help by ensuring the institutionalization of prudent fiscal, monetary and banking sector policies.

In relation to the economic policy and management of the past twenty years, the recent economic reforms signal an initial recovery and convalescence period for the Nigerian economy. In this vein, an additional period of sustained economic reforms and growth is still needed, which would signal long-term recovery of the economy, and the maturity of the institutions needed to support the challenges of managing unfettered international capital flows. By maintaining the current course of economic reforms, and introducing appropriate legislation to support the reforms, Nigeria would improve institutional and regulatory capacity of its financial sector, thereby enabling the country to further integrate its financial sector into global markets. As argued by Kose, *et al* (2006), the major benefits of capital account liberalization to developing countries may be obtained not from its direct contribution to increased GDP growth or reduced consumption volatility, but instead by providing a set of 'collateral benefits'. In the case of Nigeria, given a history of weak economic management, the actual process leading to further opening of the capital account could engender greater institutional development, improved financial supervision, and greater macroeconomic discipline.

Another factor worthy of consideration is that a resource-dependent, emerging economy like Nigeria may require extra caution in moving towards capital account liberalization precisely because it has one less degree of freedom: oil revenue is exogenous to the economy. The present favorable fiscal and monetary aggregates (good fiscal balance, excess crude oil revenue savings, large and rising level of international reserves, etc.) though attributable primarily to prudent management, have occurred against the backdrop of a favorable external environment. The strong performance of the international oil market has shifted the terms of trade strongly in favor of the Nigerian economy. Policymaking in respect of any factors that could have a bearing on any of the four sequencing signposts must be considered realistically. In this context, the present high oil price regime cannot be taken for granted for the purpose of planning. If, for example, the price were to revert back to its long-run average of about $27 per barrel, the present strong fiscal position could be threatened and the CBN will have to let the naira depreciate or risk losing international reserves. Under such a scenario, if the capital account is already liberalized, there could be speculative attacks on the naira, and there could also be reverse capital flows, particularly as “hot money” moves out. Hence, an analysis of the sequencing of capital account liberalization in a resource-dependent economy requires careful consideration, probably with more stringent requirements. Such economies need to achieve a higher degree of fiscal, monetary, structural and institutional consolidation than other economies before opening up the capital account.

## VII. Conclusion

Nigeria's recent economic reforms have set the country on a path of recovery, including meeting the basic prerequisites for capital account liberalization. However, these need to be deepened and sustained for a while, including underpinning the reforms through legislation, before moving to full liberalization. This is even more important in the case of an oil-dependent economy such as Nigeria's which may be susceptible to large external terms-of-trade shocks. Overall, the process of preparing for capital account liberalization in Nigeria could provide 'collateral benefits', and spur the strengthening of the domestic institutions, greater macroeconomic discipline, and improved financial supervision.

Going forward, further research is needed to support policymaking as Nigeria considers its options for capital account liberalization in the future. While a number of authors have reviewed liberalization of the Nigerian financial sector in the 1980s and 1990s (see, for example, Lewis, *et al*, 1997; Ikhide, *et al*, 2002), few have systematically evaluated the options for capital account liberalization. Three areas of research could help improve our understanding in this regard. First, given the available data for Nigeria in the past three decades, it may be valuable to quantify the extent of capital account restrictiveness in each year (for example, based on Nigeria's AREAER descriptions), and examine its impact on portfolio and FDI inflows into the country. In the light of the importance of institutions, a second, and more forward-looking research exercise, may be to develop an *institutional quality* index for Nigeria's financial sector, which tracks its performance over time. Based on qualitative information, this index could be constructed for financial sector institutions in Nigeria (as well as other countries) for the past two decades, and updated annually. Such an exercise could enable policymakers to effectively benchmark Nigeria's *institutional* performance against other emerging market economies. Finally, some research on the specific depth of reform needed for a resource-dependent economy like Nigeria's could shed some light on the timing of capital account liberalization.

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# Capital Account Liberalization: The Way Forward for Nigeria

*Sam Omoruyi**

## I. Introduction

A major structural change in the international economy during the 1980 and 1990 decades has been the growing integration of capital markets in the industrial countries. The integration has reflected both the dismantling of capital controls and the removal of restrictions that have constrained competition and asset prices flexibility in domestic financial markets.

Some related developments that easily come into focus are reductions in various barriers to trade in goods and services (trade liberalization) and movements of exchange rates towards the market (exchange rate liberalization). Arguably, whereas capital account liberalization has tended to outpace trade liberalization, it has moved in tandem with exchange rate liberalization. However, the exchange rate arrangement will be that which should best stabilize the price level in an economy with a partially and fully liberalized capital account. The optimal change in exchange rate arrangements would reflect both the changes in the financial structure of the economy as liberalization takes place.

Thus, capital account liberalization (CAL) is a complex and multifaceted issue, which if not properly addressed could increase risks of a crisis in a country with serious negative consequences for the real sector, e.g. a sudden reversal of capital flows and maintenance of fixed exchange rates. CAL could also affect the relationship between the stock of base money (B) and money

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supply (M), ($M=\propto B$), as the removal of interest rate ceilings and emergence/availability of new financial instruments could affect the money multiplier ($\propto$).

Thus, economists generally who have no problems about trade liberalization are hesitant to recommend CAL, especially to countries with

- weak banking systems; or
- no previous experience with trade liberalization.

Even so, there was a global movement towards CAL in the 1990s for a number of reasons: First, CAL signaled policy shifts or commitments to domestic policies. Second, it enabled countries to smoothen their consumption path; third, it was often used to signal a change in regime; reassure investors by signaling the authorities' willingness to tolerate capital outflows; and finally, it worked to penalize loose monetary policy: easier access to foreign exchange made the central bank vulnerable to rapid reserve losses-that is, to currency substitution and thereby depreciation. It was also believed that CAL reduced inflation and to that extent raised economic growth and reduced poverty.

The purpose of this paper is to dwell in some detail on CAL, emphasizing the preconditions for its safe implementation, the degree and sequencing of implementation, effects of CAL, noting costs and benefits and the way forward to its effective administration in Nigeria. The paper draws heavily on the work of Alex Cobbam of Oxford University and on background documents for the Closed Door National Workshop on the "Feasibility of the Convertibility of the Naira in the West African sub-region" (Omoruyi, 1997).

The paper is divided into six sections. Section I is this introduction. Section II dwells on theoretical issues including sequencing typology and impact of capital inflows on money supply. Section III focuses on management of CAL while Sections IV highlight the effects of CAL and country experiences, respectively. Section V contains the conclusion, while section VI outlines the way forward.

## II. Theoretical Issues

### II.1 Definition

Capital account liberalization (CAL) is the process of removing restrictions from international transactions **related** to the movement of capital, (Cobbam, 2001). It involves allowing not only foreign direct investment (FDI), but also capital inflows to **bond** and **equity** markets and to the **banking** sector. CAL can apply to both inflows and outflows of capital. Capital account restrictions can take various forms including:

- limiting domestic banks' foreign borrowing;
- controlling foreign capital coming into the economy;
- limiting the sectors of industry in which foreigners can invest; and
- restricting the ability of foreign investors to repatriate money earned from investments in the domestic economy.

A range of examples of controls grouped according to the above taxonomy is presented in Table 1 below:

**Table 1: Types of Capital Controls Used**

| Types of Flow to Domestic Economy | Controls on Inflows | Controls on Outflows |
|---|---|---|
| Portfolio<br>Equity | **Forms:** Blanket control, inflow tax (percent of transaction value) minimum stay restrictions,<br>**Intention:** Reduce volatility and change maturi ty composition of inflows (towards longer-term) | **Form:** Blanket control – up to 100 percent tax<br>**Intention:** Last resort measure – prevent deepening of crisis, allow government maintain lower interest rates hence reduce damage to industry (investment) |
| Bonds | **Form:** Restrictions on foreign holding (up to 100 percent)<br>**Intention:** Reduce volatility | As above |
| Direct Investment | **Form:** Investment Boards<br>**Intention:** Ensure integrity of national industry | **Forms:** Profit repatriation restrictions, or reinvestment requirements<br>**Intention:** Ensure local economy benefits |
| Bank Lending | **Forms:** Reserve requirements on foreign borrowing – enshrined in Basle Accord (preferably reserves held in foreign currency).<br>**Intention:** To remove risk of bank collapse precipitated by withdrawal of foreign credit (and remove exchange risks on forex borrowing) | As portfolio flows |

***Note:*** *Controls listed above are those that apply to foreign capital flows. Domestic capital is also subject to the same controls, to reduce volatility and as a last resort measure in the same way, and also to prevent the flight of capital intended to avoid taxation or the detection of related crime.*

## II.2 Sequencing Typology

The literature is replete with suggestions that appropriate sequencing of events is imperative for the maximization of benefits from capital account liberalization (CAL). The sequencing is as follows, listed in order of implementation:

- put in place trade liberalization;
- undertake macroeconomic reforms, notably sound financial system reforms with good supervisory framework;
- maintain independent monetary policy and flexible and sustainable exchange rate regimes;
- maintain sound level of international reserves;
- maintain good database on capital flows;
- liberalize capital account gradually, analyzing the situation closely using balance of payments official data and other sources;
- maintain detailed contingency plans in case trends turn out to be negative. The plans could be built hypothetically in response to questions such as:
  - ➢ What will the authorities do if capital flows are significantly higher than expected?
  - ➢ Which type of capital controls should the authorities use (price or quantity)?
  - ➢ Should prudential policies be stricter for banks in a framework of open capital account?

- What if there is a sudden reversal of capital inflows?
- Which outflows controls for residents/non-residents might be appropriate?

- review existing legal framework for consistency;
- train staff to effectively enforce new regulations. Is government social capital adequate for CAL?
- balance openness with controls of capital account, recognizing lags in policy implementation: perception, recognition lag and impact lag.

## II.3 Monetary Supply Impact

Foreign capital inflow can be registered in the monetary survey as follows:

$$M = NDA^b + NFA^b \quad (1)$$

$$NDA^b = Cg + Cp \quad (2)$$

$$M = Cg + Cp + NFA^b \quad (3)$$

But $$G - T = \Delta Cg - \Delta NFA^g \quad (4)$$

$$-\Delta Cg = -(G - T) - \Delta NFA^g \quad (5)$$

$$\Delta Cg = (G - T) + \Delta NFA^g \quad (6)$$

Substitute (6) in (3)

$$\Delta M = (G - T) + \Delta NFA^g + \Delta Cp + \Delta NFA^b \quad (7)$$

where
M = money supply, broadly defined (or $M_2$)
NDA = net domestic assets
NFA = net foreign assets
Cg = credit to government (net)

G- T = government overall deficit (revenue less current and capital expenditures)
G = government expenditure (current and capital)
T = government revenue
$NFA^b$ = net foreign assets of the banking system
$NFA^g$ = net foreign assets of the central bank or government.
Cp = Credit to private sector.

Equation 7 can be used to analyze the effects on the money supply of foreign capital inflows by the government to finance a deficit. When government borrows from the external credit market, so that there is a decline in $NFA^g$, and transfers the proceeds of the borrowing to the banking system, then the net effect will be an increase in $NFA^b$ and an equivalent increase in money supply associated with the foreign inflow to finance the deficit.

Thus, external capital inflow impacts on the economy through exerting a negative impact on the net foreign assets of government or central bank through a corresponding increase in government liabilities. In the absence of sterilization activities to neutralize the impact of such inflows on money supply, capital inflow leads to the expansion of money supply, leading to short-run increase in the price level and depreciation of the exchange rate and ultimately, monetary and economic instability. Thus, a major management technique for capital inflow is the adoption of measures to sterilize the inflow of capital, e.g. by selling bonds, to return the money supply to its original level and prevent the emergence of inflationary pressure. This counteracts the money supply expansion because selling bonds involves taking domestic currency in exchange, and hence reduces the available money supply-which in turn reduces the upward pressure on prices. Government has in effect increased its liabilities-in the form of bonds issued but also increased its assets by the same amount, in the form of foreign exchange reserves.

Sterilization has its costs apart from increase in bonds liabilities; it has implication for foregone fiscal expenditure on areas that could have positive impact on the poor. Besides, sterilization cannot be successfully operated as a long term policy because inflows of capital are generally the result of an

interest rate differential between the domestic and international markets. Sterilization, involving the issue of more bonds (presumably at the same or higher interest rate to ensure demand) will not address this problem of capital flow volatility and may even exacerbate it, and therefore cannot be a long-term solution. Some salient points need be noted at this point in the effective management of Capital Account Liberalization (CAL).

## III. Managing Capital Account Liberalization

A prior consideration in the management of capital account liberalization (CAL) is its sequencing of implementation as outlined in section II of this paper. Government manages the components of capital inflows: equity, bonds, banking sector inflows, foreign direct investment (FDI) etc. These flows are not homogeneous and each type of flow should be analyzed separately. They have to be adequately managed as they create serious restrictions on government policy making. The management of CAL takes account of a number of issues:

- **Sequencing of implementation**
  Countries must carefully manage and sequence liberalization in order to minimize the risk of crises. The ordering may be as indicated in section II of this paper.

- **Hedging domestic currency**
  Capital inflows especially the short-term flows, being not as stable as long-term ones, put upward pressure on the domestic exchange rate because investors purchase local currency to invest in the stock market. The pressure leads to exchange rate appreciation, raising the cost of exports and lowering imports. To prevent this from happening, government must **sell** domestic currency and buy the incoming foreign exchange, thus building up reserves of foreign currency. Building up foreign reserves would increase the domestic money supply by the amount in question. This can be illustrated using a major strand of the four-equation Polak model:

  $$\Delta M = \Delta Cg + \Delta Cp + \Delta \text{OA (net)} + \Delta NFA - \Delta QM \qquad (8)$$

Where;

| | | |
|---|---|---|
| M | = | Money Supply (Narrow definition, M1) |
| $C_g$ | = | Credit to government etc. |
| $C_p$ | = | Credit to private sector |
| OA (net) | = | Other assets less other liabilities of the central bank |
| NFA | = | net foreign assets |
| QM | = | Quasi money = time and savings deposits. |

Inflows raise net foreign assets (NFA) swelling money supply (M) ceteris paribus.

- **Government may sterilize the inflow**
  Thus the **next step** is for government to **sterilize the inflow** by selling the equivalent value of government bonds to return money supply to its original level, and prevent inflation.

- **Investment of built-up reserves in securities**
  In effect, government liabilities have increased in the form of bonds issued, while its assets have also increased by the same amount, in form of foreign exchange reserves. If those reserves are invested in interest-bearing assets, e.g. US Treasury bills, the position of government has not really worsened by CAL. However, all these maneuvres in the form of government reaction to inflows, may involve cost depending on the interest rate differential between domestic interest rate and (in this case) the US interest rate.

**Example**

It may be interesting to note Stiglitz (2000) example on the cost to government on this issue: Assume a company in a developing country borrows $100 million from a US bank, and is to pay 20 percent interest since it is perceived as highly risky lending. If the government holds foreign exchange reserves (in US Treasury bills) to offset the borrowing, the government receives 5 percent interest. The annual cost to the developing country of this arrangement is then $15 million (i.e. 20 5 percent of $100 million). The cost to the government, on the assumption of full sterilization, may be different. Government may decide

to sell bonds to the value of $100 million in a bid to maintain a stable money supply and pay say 15 percent interest on the bonds, being relatively risky compared with US Treasury bills. The direct cost to the government is then $10 million a year (i.e. 15 percent of $100 million - 5 percent of $100 million it received for holding US Treasury bills). The foregone fiscal expenditure of government is then $10 million a year. The effect of capital inflows is to reduce the level of government expenditure.

## IV. Effects of Capital Account Liberalization

In the preceding section, the paper, **inter alia**, noted the actions which government may take to manage capital account liberalization to minimize its destabilizing effect on the economy.

This section seeks a more detailed analysis of the effects of capital account liberalization on government finances and policy.

### Effects on government finances and policy

Following liberalization, the removal of controls on foreign direct investment, capital inflows to bonds and equity markets and on the banking sector may constrain government finances by the cost of managing inflows and increase levels of macroeconomic instability which can affect government revenue sources notably cuts in aid flows and reduction in government income. The reduction in income will involve spending cuts, historically targeted at investment in education and health, among others. Reduced infrastructure investment contributes to poor economic performance and reduced ability of government to raise taxes effectively.

### Costs of managing inflows

- CAL triggers equity flow booms leading to increased bond, bank and possibly direct investment inflows. These inflows exert upward pressure on the domestic exchange rate because investors purchase local currency to invest in the stock market. Exchange rate appreciates, raising the cost of exports and lowering those of imports.

- However, sterilization with all its associated costs, cannot be operated successfully as a long term policy, because capital inflows are generally the result of an interest rate differential between domestic and international markets. Sterilization involving the issue of more bonds may exacerbate the costs to government and domestic industry in raising debt financing for investment.

- Capital inflows could mean government adoption of pro-cyclical policy. Some beneficial response to capital inflows may derive from government policy wishing to prevent a depreciation of the exchange rate. Autonomous inflows of foreign capital may **reduce** the depreciation of the exchange rate and allow a relaxation of monetary policy (and hence increased growth), with outflows **increasing** the depreciation and requiring a monetary contraction. The cost here is that monetary policy would have been seen to be highly pro-cyclical with countries' economic conditions rather than acting to stabilize the economy has led to instability. Under this scenario, government increases spending in booms and cutbacks during recessionary outflow periods and hence increased macroeconomic volatility.

  In any event, whether the aim of government policy is to prevent an appreciation or a depreciation of the exchange rate, the management of capital inflows has costs in terms of increased instability of government finances and the macroeconomy and also of reduced government expenditure under the assumption of sterilization of inflows.

- **Market discipline**
  CAL operates under conditions of market discipline. Market discipline acts as a deterrent against allowing high levels of inflation or running fiscal deficits. In this way, CAL induces "small" government, with negative poverty effects through reduced capital expenditure/investment, growth and inflation.

In sum, CAL negatively affects government finances through a number of ways including:

- Cost of managing inflows;

- Need for fiscal prudence to satisfy market view under CAL. This implies cuts to expenditure, especially capital expenditure. Disproportionate cuts in recurrent expenditure involving small cuts in transfers that directly benefit the poor. Since the poor can ill afford any cuts in spending on them, CAL would cause hardship to the poor.

- Increased level of macroeconomic instability following liberalization can affect government revenue sources, notably cuts to aid flows.

- Instability of government finances: volatility of government revenues undermines its ability to commit to programme of expenditure. It also constrains government ability to attract complementary private investment.

- CAL opens domestic bond markets to international investors and hence allows greater liquidity for governments and domestic corporate bond issuers. Governments can then raise additional finance through bond issues. But what have been the experiences of countries in liberalizing their capital accounts? What has been the degree of implementation of CAL? The table below contains the country experiences.

**Country Experiences with Capital Account Liberalization**

| Countries | Gradual CAL (with significant restrictions) | Substantial CAL | Comprehensive CAL |
|---|---|---|---|
| Zambia | | | ✓ (1994) |
| Ghana | | | ✓ |
| Uganda | | | ✓ |
| Kenya | ✓ | | |
| Malawi | | | ✓ (1980s) |
| Lesotho | | | ✓ (1990s) |
| South Africa | | | ✓ (1990s) |
| Franc Zone | | | |
| Egypt | | (1980s)✓ | |
| Israel | | ✓ | |
| Jordan | | ✓ | |
| Lebanon | | ✓ | |
| Turkey | | ✓ | |
| Algeria | ✓ | ✓ | |
| Morocco | ✓ | | |
| Syria | ✓ | | |
| Tunisia | ✓ | | |
| India | ✓ | | |
| Chine | ✓ | | |
| **East Asia** | | | |
| Taiwan | ✓ } (1960s & 1970s) | | |
| Korea | ✓ } | | |
| Malaysia | } | ✓ | |
| Thailand | } | ✓ | |
| Philippines | | ✓ | |
| Singapore | | | ✓ |
| Hong Kong | | | ✓ |

## V. Conclusion

This paper has reviewed the preconditions for effective implementation of capital account liberalization (CAL). It has also articulated the costs as well as the benefits of CAL. It has identified the roles which institutional stakeholders in the management of the economy need to play to provide an enabling environment for CAL to succeed.

There is no doubt that a completely closed capital account is not an option for any country. The issues really are the degree, sequencing and timing of opening up the capital account. The country is bracing up to meet some of the major preconditions for CAL implementation. For example, financial systems reforms are on-going. The exchange rates, while not fixed, have been flexible

and stable. Government has been pursuing the policy of fiscal consolidation, de-emphasizing deficit spending. Also trade liberalization has been underway.

The above issues represent a manageable pivot around which to implement CAL even if on a gradual basis. Fortunately, the “impossible trinity” of CAL, independent Central Bank and a fixed exchange rate does not exist in Nigeria.

Even so, some nagging worries need to be addressed, including:

- database on capital inflows
- contingency plans to contain volatility in flows/absence of framework/capacity for risk management
- reforms in trade liberalization to enhance its effectiveness
- framework for sterilization of capital flows
- capital market development; enhanced financial intermediation required as catalyst for investment in the real sector.
- review of investment code/existing legal framework to address the needs of CAL; and
- public-private partnership for infrastructural development; reforms targeted at the micro level are urgent.

While making efforts to address those outstanding policy agenda, Nigeria could safely adopt a gradual CAL with significant restrictions. Algeria, Morocco, Syria, Tunisia, India and the East Asian countries of Taiwan, Korea and Malaysia adopted the gradual approach. Countries such as Zambia, Ghana, Uganda, Singapore and Hong Kong have implemented CAL comprehensively with substantial rebound to the high credit ratings of their economies.

This is not to suggest that the policy of gradual implementation of CAL is a panacea for coping with CAL. It is not; it is only a cautious approach to a complicated CAL policy. It should be remembered that even if macro fundamentals in a country are sound, financial system in good health, when a country opens up its capital account, either gradually or comprehensively, problems may still arise.

## VI. The Way Forward

- The **capital market** needs to be broadened and deepened to provide avenue for foreign investors to invest. In this regard, the investment code should be reviewed to accommodate foreign investor participation in the market.

- The mechanism of **sterilization** should be well articulated and if need be, the powers of the monetary authorities to sterilize destabilizing inflows should be supported by an additional provision in the CBN Act.

- The Ministry of Finance, Central Bank and National Planning Commission should jointly adopt a framework for **risk management**, particularly, as volatility of capital inflows can destabilize government finances and breed macroeconomic instability. Capacity building for staff in this area is crucial for effective management of CAL.

- The Central Bank should continue to fine-tune **reforms in the financial sector** to breed confidence in the international community. It should also continue to improve on the current methodology that has stabilized the exchange rate in recent times. Also, efforts should be made to maintain a realistic exchange rate that track the fundamental equilibrium exchange rate (FEER). A flexible and sustainable exchange rate is one that is consistent with the implementation of CAL.

- The various **incentive packages** for foreign direct investment should be fine-tuned and structured more in line with global trends.

- Policy must not be allowed to be pro-cyclical leading to situations where economic booms are matched with relaxed monetary policy and great spending; recessions are visited with contractionary monetary policy and reduced expenditures. Such pro-cyclical policies engender macroeconomic instability that induces capital flight and inhibits capital inflows.

- Since CAL operates under **market discipline** which frowns at high inflation and fiscal deficit, government should be careful, while maintaining a policy of fiscal consolidation in line with CAL, not to significantly reduce expenditures targeted at the poor. Poverty reduction should continue to remain the article of faith underlying fiscal operations.

- The National Planning Commission, Debt Management Office (DMO) and Central Bank should take steps to maintain **reliable database on grants**, concessional loans and foreign direct investment. Such a database would be helpful to government in developing contingency plans to cope with wild volatility of capital inflows.

- **Trade Liberalization** should be re-visited in order to assuage the incidental costs through subsidies, import duty relief etc. Trade liberalization is an important prerequisite to effective CAL.

- Monetary policy should continue to be pursued in collaboration with the Ministry of Finance. This coordination should be strengthened as successful CAL implementation needs it.

- The private sector should be encouraged to assist in the development of the capital market in terms of increased holdings of securities and maintenance of ethical standards in the market. In this regard, government should catalyze private sector partnership in infrastructural development by conducting its affairs with accountability, transparency and due process.

- The country must hedge against capital flight after removal of controls. This could be achieved by maintaining macroeconomic stability, sound institutions and a track record of sound and consistent policies. In addition, there is need to:

    - improve incentives for investors

    - provide incentives to tax capital less, allowing tax burden to fall more on workers and consumers. This, however, may raise issues of distributive equity, especially as higher tax on labour affects the poorest most heavily.

    - develop infrastructure.

- SMEs should be targeted for greater funding in order to compensate for diversion of financing for more technologically efficient investment sectors following CAL. Credit allocation to SMEs might need to increase following CAL e.g. as in China. There might also be a need to encourage more sub-branch units of banks to reach a mass rural clientele and hence broadening significantly the provision of financial services to the poorest who might be disadvantaged following CAL e.g. Bank Raky in Indonesia did this in 1999.

- Government should note the appropriate sequencing of implementation of CAL to avoid macroeconomic crises. Implementation should be gradual with significant restrictions on capital flows.

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