Capital Account Liberalization: Reflections On Theory And Policy

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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

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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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