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.

** Dr. Ojo was the former Director-General, West African Monetary Institute, Accra, Ghana. The views expressed herein do not represent the views of the institution to which he was affiliated.* *The author acknowledges the comments and suggestions of anonymous reviewers.*

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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