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Managing Capital Flows: Observations from the Front Line

by Nasser Saidi

Much attention is being given lately by the media and economic observers to the problems raised by "hot money" flows and their volatility, resulting in calls for intervention to restrict international capital flows. This viewpoint should be tempered by going back to economic fundamentals: The fact is that to improve growth prospects in any economy, including those of the Middle East and North Africa region, substantial investment capital is required. The specific investment capital requirements relate to:

> *Structural Needs. The region needs to: a) modernize or replace its aging physical infrastructure, the bulk of which was put in place in the 1970s at the height of the oil price boom. This effort calls for annual investments in physical infrastructure estimated in excess of US$20 billion over the next decade; b) invest in new capital and technology to develop its substantial natural resource base and diversify its production structure; and c) provide capital for its demographically young and rapidly growing population and labor force; and*
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> *Macroeconomic Needs. The region requires substantial capital to: a) finance the process of privatization of publicly owned assets; b) provide funds for large-scale economic reforms and liberalization programs that are necessary in a number of these countries; and c) finance the transition away from economic regimes characterized by command-type, socialist economic structures.*

Despite the strategic importance and urgency of these requirements, the region has received comparatively limited amounts of foreign capital. As the table below shows, the MENA region attracted only US$6.9 billion (or 2.85 percent) out of the US$243.8 billion in total net private capital flows to all developing countries.

Table 1: Net private capital flows to developing countries (US$ billions)

Developing Countries	1990		1996	
	Amount	in %	Amount	in %

Latin America & the Caribbean	12.5	28.15%	74.3	30.50%
Middle East & North Africa	0.6	1.35%	6.9	2.85%
South Asia	2.2	4.95%	10.7	4.41%
East Asia & Pacific	19.3	43.47%	108.7	44.61%
Europe & Central Asia	9.5	21.40%	31.2	12.80%
Sub-Saharan Africa	0.3	0.68%	11.8	4.84%
Total	**44.4**	**100%**	**243.8**	**100%**

Similarly, the region received only 2.01 percent of foreign direct investment flows and a mere 3.66 percent of project finance. In addition, its access to international capital markets was extremely limited both in terms of amounts as well as in terms of the number of countries with access to such markets.

Table 2: Selected indicators in the MENA Region

	Middle East & North Africa	Total Emerging Markets	MENA/ Total Emerging Markets
Net Private Capital Flows to Developing Countries (Bn US$)	6.9	243.8	2.83%
Project Finance (Mn US$)	750.0	20,484.0	3.66%
Foreign Direct Investment (Mn US$)	2,200.0	109,700.0	2.01%
Funds Raised on International Capital Markets (Mn US$)	2,882.0	125,506.0	2.30%
Foreign Exchange Raised by Privatization Revenues (Mn US$)	497.0	58,458.0	0.85%
Market Capitalization (Bn US$)	102.0	2,226.0	4.58%
Value Traded (Bn US$)	28.1	1,586.8	1.77%
Number of Listed Companies	1,092.0	22,263.0	4.90%

Sources: IFC Factbook 1997, Global Investment Finance 1997.

By contrast, it is estimated that over US$600 billion in funds originating in the MENA countries are invested outside the region. In this context, the main issue is: What set of economic and financial policies should the countries in the region pursue to attract and retain capital flows, and to provide incentives for the repatriation of funds invested abroad and use those funds productively? It is not so much a matter of managing capital flows — as is the case in the Latin American and Asian economies — but rather of attracting capital flows. To use an analogy, the main objective is not the fine-tuning of the engine to reach optimal performance, but more important the procurement of the petrol to make the engine run.

Lessons from Experience: Some Stylized Facts

In terms of how shorter-term economic policy concerns relate to the management of capital flows, the main issues are whether there are links between financial flows, as well as banking and/or financial crises and balance of payments and/or currency crises — that is, large changes in international reserves and/or exchange rates occurring over short periods. Clearly, in open economies with an important external sector — both in goods and assets — volatility of capital flows may lead to increased instability and turbulence affecting domestic monetary and financial aggregates. This would in turn lead to volatility in asset prices — including equity, fixed income and property — as well as in money market interest rates and exchange rates. Moreover, turbulence in the financial markets induced by volatility in capital flows may carry into the real sector, affecting property and construction cycles as well as labor, goods and services markets.

This is not the forum to get into the underlying theoretical rationale for the potential links between international capital flows and the host economy; there is a vast literature on the topic. The main point is that those links — when they emerge — are generally related to fundamental factors that induce volatility in international capital flows as well as in domestic economic variables. It is volatility in external factors (such as changes in foreign interest rates and other world business cycle events) and in domestic policies (monetary, financial and fiscal policies) that generate volatility in both international capital flows, as well as in domestic asset prices and financial and monetary aggregates.

Turning to the results of empirical analysis, are there lessons or "stylized facts" to be drawn that can be used as a guide for front-line policymakers? The empirical literature suggests that there are a number of factors linked with financial crises. These factors, which vary across countries, are listed below without any order of relative importance.

> ***Real exchange rate appreciation. If persistent and not accompanied by a commensurate growth in productivity, it may lead to substantial price distortions and protracted current account deficits. In turn, these may result in a balance of payments crisis, which would force adjustments in the exchange rate policies, and in a financial and banking crisis.***
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> ***Excessive growth of domestic credit. Whether to the private or the public sector, if domestic credit grows excessively relative to current and prospective economic growth, it may induce a boom-and-bust credit cycle leading to a financial crisis, a loss of international reserves, and a balance of payments crisis associated with outflows of foreign capital.***

Excessive growth of government credit. Typically this generates high domestic inflation rates, real exchange rate appreciation, higher and more volatile interest rates, and lower private sector investment. All this eventually leads to current account deficits and losses of international reserves accompanied by capital outflows, which in turn forces changes in exchange rate policy.

A low ratio of international reserves to M2. This generates a "vicious cycle" of capital outflows, higher domestic interest rates, banking crises induced by a bust in the credit cycle, financial crises, lower international reserves, etc. There is a clearly bi-directional causality with a low ratio of reserves to M2, which acts as an indicator/signal of existing problems.

Short-run sterilization of capital flows. Monetary policymakers can achieve improved short-term control of monetary aggregates, interest rates and overall financial market liquidity by sterilizing capital flows. Indeed, sterilizing capital flows over the short-run — particularly if they are induced by short-term domestic economic or political developments — reduces the volatility of exchange rates and interest rates, generating macroeconomic stability.

"Dollarized" economies are more resilient to the volatility of capital flows. The banking system in "dollarized" economies faces a reduced risk of currency mismatching in its loan portfolio, and international interest rates shocks are transmitted to domestic on-shore foreign currency rates.

Apart from these "stylized facts," a number of additional factors are considered important by the front-line policymakers. Broadly, they relate to public debt management.

The maturity structure of domestic debt matters. A large concentration of short-term debt is a high risk factor and may lead to financial and balance of payments crises. It is important to increase as much as feasible the maturities of domestic public debt and avoid a concentration of short-term debt — be it domestic or external.

Debt ownership is important. A large share of domestic debt — particularly short-term debt — in foreign portfolios is a high risk factor. External developments and shocks may lead to capital outflows. This in turn may result in banking and financial crises, higher domestic yields, substantial losses of international reserves and, potentially, a fiscal crisis. Policymakers should therefore carefully monitor and manage both the maturity profile of debt and the share of debt owned by non-residents.

Use of debt proceeds is important. Using the proceeds of domestic or external public (or private) debt to finance current expenditures or consumption eventually results in a balance of payment crisis, capital outflows and a loss of international reserves.

Financial market structure is important. The volatility of capital flows and their potential for generating banking crises and/or balance of payments crises is substantially reduced in the presence of active secondary markets, characterized by the

necessary "breadth, depth and liquidity." Active secondary markets with asset price flexibility can efficiently cushion the effects of volatile capital flows. Crises are more likely in thin markets with limited domestic participation.

Policy Responses and Recommendations for the MENA Countries

Given the various factors summarized above, are there implications for macroeconomic policy? Should monetary policy or, more generally, macroeconomic policy be geared to managing capital flows? Should taxes on capital inflows be imposed to limit such flows and reduce their effects on the economy?

The bulk of the evidence and experience suggests that taxes or other barriers to capital flows are, at best, a short-term palliative, but cannot be an effective or long-term solution. The case for controls on capital flows on a comprehensive or large-scale basis, including imposing taxes on them, is not proven. The main lessons of experience suggest that to address the issues arising from substantial or volatile capital flows, policymakers should gear macroeconomic policy towards getting the economic fundamentals right. They should: a) direct monetary and exchange rate policy to control and reduce inflation and avoid real exchange rate appreciation; and b) pursue fiscal restraint and sustainable government budget deficits. The conduct of economic policies geared to maintaining monetary stability and fiscal restraint will, if credible and pursued by reputable policymakers, reduce the volatility of capital flows. In other words, macroeconomic stability reduces the volatility of capital flows.

Even more important than the obvious call to pursue policies leading to macroeconomic stability as the most appropriate response to substantial or volatile capital flows is the need to invest in the enhancement of the operation of markets and institutions.

In this connection, two sets of recommendations should be considered.

Policymakers in MENA countries should seek to foster the development of the money, debt and equity markets. The objective should be to promote domestic saving and orient international capital flows towards investment in productive activities and physical capital investment, thus building up real assets and the capacity of capital-importing economies to service external debt. Developing the financial markets and particularly the equity market reduces the risk that international capital flows — intermediated through the banking system — will eventually lead to a banking crisis. Efficient capital markets will reflect the return/risk characteristics of investments and price securities more directly than bank-intermediated capital flows. As a result, any volatility of capital flows will be reflected in security market prices and yields, instead of through adjustments in monetary and credit aggregates and the rather limited response of bank interest rates.

Policymakers should develop regulatory institutions and adopt international prudential and regulatory standards and criteria. Two specific aspects require the attention of

policymakers. First, central banks need to be given more independence from government. This will allow them to adjust discount rates more flexibly in response to the volatility of capital flows and to conduct open market operations with a view to generate monetary stability. For instance, Lebanon's ability to deal somewhat successfully with very large capital flows (more than 30 percent of annual GDP) characterized by a high degree of volatility related to regional instability and domestic political concerns can be attributed to: a) using a flexible interest rate policy, with a rapid response to monetary developments; b) monitoring and managing the monetary and liquidity consequences of domestic public debt; and c) limiting the access of foreign non-resident institutions to the government's short-term domestic debt market.

Second, banking supervisors should have enhanced powers to adopt, implement and enforce international norms and standards, including prudential norms (as promulgated by the BIS). These include: a) imposing standards for capital adequacy, liquidity requirements, and pricing and evaluation of risks affecting bank assets; and b) requiring appropriate bank lending policies, including exposure and concentration, consolidation of domestic and foreign entities, and disclosure of off-balance sheet exposure and risk. Imposing these standards, with competent, independent authorities is the main answer to maintaining bank soundness and loan performance, thereby reducing the risk of banking crises.

To conclude, the countries in the MENA region face a different set of issues in managing capital flows than those affecting countries in Latin America and Asia. The main issue in the MENA countries is more structural and fundamental, namely the pursuit of economic and other policies that will attract and retain capital. However, the main lessons learned from the "stylized facts" are relevant to policymakers in the region and can help in the development of an "early warning system" with a set of indicators based on those listed above under "Lessons from Experience." Taxes or other barriers to capital flows are only a palliative and not a solution to the issue of managing capital flows. More important measures include: a) the pursuit of macroeconomic policies — inflation control and stabilization, fiscal restraint with sustainable government budget deficits — that will constitute the basis for stability in *both* domestic economic and financial variables, as well as in international capital flows; and b) the development of efficient, liquid financial markets and regulatory institutions that adopt international prudential and regulatory criteria and standards.

Further Readings

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