

Executive Summary

In response to a request from Commonwealth Finance Ministers at their last meeting in Bermuda in September 1996, a Working Group of Senior Commonwealth Finance Ministry Officials met in London earlier this year to consider the role of national and international policies in encouraging private capital flows for investment. The Group's views reflect a wide variety of experience: from industrial countries, from emerging markets, from some of the world's most dynamic and competitive economies, and from some poor countries that have yet to benefit from developments in the global economy. But despite these differences, the Group found that they have a good deal of shared experience, and that they have had to face a number of common economic challenges.

- (ii) The Group's overriding conclusion is that private capital flows – which have increased dramatically in recent years – can bring substantial benefits to an economy by promoting growth and investment. Some countries, however, have not yet been able to attract private capital flows of any significance. And in others, volatile movements in capital flows – whether due to external developments, contagion effects or to domestic factors, including policy changes – have greatly complicated economic management and eroded some of the benefits.
- (iii) There are, however, a number of measures that national governments and the international community can take to facilitate and attract private capital flows; to minimise the risk of sudden surges in capital movements; and to cope with such surges should they nonetheless arise. In considering the role of national policies to attract private capital, the Group drew the following conclusions:
 - ❖ Sustained implementation of sound macroeconomic and structural policies is as important for attracting and sustaining private capital flows as it is for promoting healthy domestic investment.
 - ❖ Investors are attracted by stability in the political process, and by reliable and transparent legal, accounting, regulatory, and tax systems.
 - ❖ The early establishment of robust and well regulated financial and banking systems is important, and essential to safeguard against financial stress in the event of a reversal, or a large change, of capital flows
 - ❖ Open trade and clear investment policies, particularly in well-integrated and rapidly growing regions, provide the best environment for foreign investors to operate in. The relaxation of foreign exchange restrictions can in itself help to attract private capital flows.
 - ❖ Regional integration can therefore be helpful in attracting private capital flows. This may in turn require improvements in transport, communication, and other market links within the region. It would, however, be counter productive for countries to pursue regional integration at the expense of wider multilateral trade and investment liberalisation.

- ❖ Where it is prudent to do so, institutional investors in more developed economies should be allowed to take advantage of increasing opportunities for portfolio diversification through the relaxation of restrictions on the share of their assets that can be held in foreign markets.
 - ❖ Governments should be careful about imposing restrictions on foreign ownership and consider whether existing restrictions are necessary or useful.
 - ❖ Countries should take advantage of privatisation programmes, and private involvement in domestic infrastructure projects, as a way of attracting foreign investors and improving the quality of infrastructure.
 - ❖ Investments in a well functioning physical infrastructure can also in itself help to attract private capital flows
 - ❖ A skilled and trainable workforce is another key factor in attracting investment. National programmes to invest in human capital are critically important to enhance competitiveness and attract investment in higher value added activities.
- (iv) The Group recognised, however, that even after the implementation of some of these measures, it can take a number of years to establish credibility among the international investment community – especially for those countries which are new to international capital markets. Good marketing in the form of investment promotion and targeting strategies can help to overcome barriers and establish this credibility. It can also help to attract investments from new sources, especially into niche sectors.
- (v) In considering appropriate national policy responses to surges in capital flows, the Group drew the following conclusions:
- ❖ Getting the fiscal-monetary policy mix right, and encouraging domestic saving, can help to reduce the risk of volatile swings in private capital flows.
 - ❖ The basic economic policy choices in handling capital inflows are:
 - permitting flexibility in the exchange rate with some nominal appreciation;
 - fiscal policy tightening; and
 - sterilised intervention and temporary controls on capital flows.
 - ❖ Countries will want to use a combination of these policies according to their circumstances. With this in mind, the Group also noted that:
 - monetary expansion to counter any nominal exchange rate appreciation is not recommended: in due course it will lead to faster inflation and therefore real exchange rate appreciation;
 - there will be limits on the extent of possible fiscal tightening in the short run; and
 - sterilisation and controls on capital flows can provide short term breathing space but may not be effective in the event of large and persistent capital surges.
 - ❖ Potential volatility in capital flows also has implications for the sequencing of reforms and the speed of capital account liberalisation. The Group agreed that the process of liberalisation is likely to vary according to the circumstances of individual countries, but that experience suggested a number of steps that governments should take before opening up their capital account:

- improve public sector finances, reduce inflation, and reduce external imbalances;
 - strengthen domestic financial markets, by improving financial infrastructure and the regulatory and supervisory framework for banks and other financial institutions, and by lifting restrictions on interest rates and the allocation of loanable funds;
 - tackle other major structural distortions in the economy; and
 - after capital account liberalisation has taken place, governments need to continue to monitor both capital flows and their financial sectors – and to do so more carefully than in the past.
- (vi) The Group also stressed that the international community has a key role to play, both in facilitating private capital flows – in particular to those countries that have yet to attract significant private investment and are at risk of marginalisation – and in putting in place multilateral arrangements to help countries to cope with capital surges.
- ❖ The International Financial Institutions can help to improve the economic prospects of all countries, through their advice, through lending and co-financing of public and private projects, and through the provision of guarantees against loans from international banks. By doing so, they play a valuable catalytic role in increasing capital flows – particularly to those countries which are not yet familiar to international investors.
 - ❖ The Group welcomed the World Bank Group's use of guarantees to catalyse private sector development. It emphasised that guarantees should provide additionally in access to resources and an equal treatment to both foreign and domestic investors. It noted the role of the Multilateral Investment Guarantee Agency (MIGA) in covering political risks, and that the Bank was endeavouring to provide guarantees to private lenders to support infrastructure development.
 - ❖ The Group recognised the importance of enlarging the IMF's responsibilities and jurisdiction in respect of capital flows. It noted that, following an appropriate amendment of its Articles, the IMF would be well placed to help its members to liberalise their capital accounts when they are ready to do so and satisfactory transitional and other arrangements are in place.
 - ❖ The Group welcomed the IMF's new Emergency Financing Mechanism and the expanded New Arrangements to Borrow, and would like to see an early increase in IMF quotas that is sufficient to enable the Fund to respond adequately, quickly and flexibly to countries facing financial crises. The Group also stressed the need for advancing procedures for orderly workouts of sovereign debt.
 - ❖ The Group also supported arrangements among Central Banks at the regional level to provide emergency assistance in dealing with short term capital surges.
 - ❖ With respect to the emerging role of the WTO in investment matters, the Group recognised the need for consistency and avoidance of duplication between the IMF and the WTO in the treatment of investment.
- (vii) Finally, the Group considered the specific role that the Commonwealth should play in enhancing and sustaining private capital flows to its members. The Group agreed that the Commonwealth, acting through its Secretariat, could and should build on its existing role in the following ways:
- ❖ develop a Commonwealth 'Code of Good Practice' for national policies that attract and sustain private capital flows;

- ❖ help groups of countries develop regional strategies for investment promotion;
- ❖ assist countries to improve the regulatory and supervisory framework for banking and securities markets; and to create an enabling legal environment for inward investment; and to monitor capital flows;
- ❖ draw up a hand book of best practice in investment promotion;
- ❖ extend the Commonwealth Private Investment Initiative to new regions; and
- ❖ encourage the creation of Privatisation Trust Funds and new mechanisms for risk insurance and guarantees.