ECONOMIC PAPER 34

Promoting Private Capital Flows and Handling Volatility

Role of National and International Policies

Report of a Commonwealth Working Group

COMMONWEALTH SECRETARIAT

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Foreword

Since the mid-1980s there has been a marked increase in international private capital flows with the growth of international trade and the increasing economic integration of business activity. Developing countries as a whole have witnessed significant increases in both portfolio flows and foreign investment. The bulk of these private flows, however, has been concentrated in a handful of developing economies, including several Commonwealth members, while the rest have yet to receive significant private capital inflows. Other economies have been faced with the problem of volatile movements in capital flows which have greatly complicated economic management and eroded some of the benefits of international capital mobility and economic reform.

There is considerable interest among Commonwealth members in ways to attract private capital flows and to minimise the risk of sudden surges in capital movements and to cope with such surges should they arise. The Commonwealth Finance Ministers Meeting in Bermuda in September 1996 discussed trends in private capital flows and their implications for economic development. In response to a request by Finance Ministers, I constituted a working group of senior finance officials to consider the role of national and international policies in encouraging private capital flows for investment. The Working Group on Private Capital Flows, under the Chairmanship of Mr. David Peretz, Deputy Director of the British Treasury, met in London this year. The Working Group's Report was endorsed by the Commonwealth Finance Ministers Meeting in Mauritius in September 1997 and the Commonwealth Heads of Government Meeting in Edinburgh in October 1997.

The Working Group concluded that, in general, private capital flows can bring notable benefits for economic development by increasing growth and investment. To ensure that the spread of the gains from increased private flows are maximised by all developing countries, the Group suggested action which should be taken by national governments, the international community and the Commonwealth. The Group stressed that the international community has a major role to play in promoting inward investment, particularly in countries that have had difficulty in attracting foreign investment, and in establishing multilateral arrangements to enable countries to cope with capital surges. As far as the Commonwealth is concerned, the Group recommended that it should do the following: develop a Commonwealth Code of Good practice for national policies that attract and sustain private flows; help groups of countries to develop regional strategies for investment promotion; assist countries to improve the regulatory and supervisory framework for their banking and securities markets; prepare a handbook 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. A number of the recommendations in the Working Group's Report are now being carried forward by the Secretariat. We are also undertaking a follow-up study of the lessons to be learned from recent developments in some currency markets and how countries can be protected against the destabilising effects of capital market volatility especially when it arises from speculative activities.

I warmly commend the Report and hope that it will be helpful to Commonwealth Governments in formulating national strategies for attracting foreign investment and minimising the risk of sudden surges in capital flows.

Emeka Anyaoku, *Secretary-General*

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.

1 Introduction

At their meeting in Bermuda in September 1996, Commonwealth Finance Ministers discussed international private capital flows and their implications for economic policy. They found much common experience, and asked a group of Finance Ministry officials to consider the issues further, to compare experiences, and to report by their next meeting in Mauritius in September 1997.

2 The Secretary-General was asked to constitute a small working group of senior Commonwealth finance officials on a broad geographical basis, and with diverse experiences in attracting private capital flows. Mr. David Peretz, Deputy Director of the British Treasury was elected to chair the meetings. The Working Group consisted of the following country representatives: Mr. Paul Barry, Chief Representative of the Reserve Bank of Australia; Mr. O. K. Matambo, Permanent Secretary, Ministry of Finance and Development Planning of Botswana, Mr. Alister Smith, Director and Mr. Bruce Rayfuse, Senior Chief, International Finance and Economic Analysis Division, Department of Finance, Canada; Dr. George Yankey, Director in the Legal, Private Sector & Finance Institutions Division of Ministry of Finance, Ghana; H.E. Professor Havelock Ross-Brewster, Ambassador of Guyana to the European Community, Brussels; Dr. Y.V. Reddy, Deputy Governor of the Reserve Bank of India; Mr. Locksley Smith, Special Assistant to Minister of Finance, Jamaica; Datuk Dr. Aris Othman, Deputy Secretary-General of Ministry of Finance, Malaysia; Mr. D. Manraj, Financial Secretary, Mauritius; Mr. Mueen Afzal, Permanent Secretary in the Ministry of Finance, Pakistan; Mr. Lesetja Kganyago, Ministry of Finance, South Africa; Mr. E. Tumusiime-Mutebile, Permanent Secretary and Secretary to the Treasury, Uganda; Mr. William Reuben Abel, First Secretary in the Ministry of Finance, Vanuatu; and Mr. G.D. Nyaguse, Chief Economist, Ministry of Finance, Zimbabwe.

3 The Group also benefited from the valuable participation of Dr. Kate Phylaktis of City University as their rapporteur, Mr. Pedro Alba from the World Bank; Mr. Matthew Fisher and Ms. Susan Schadler of the IMF. There were a number of invited experts: Mr. Azizali Mohammed, former Director of IMF and Adviser to G24; Professor Richard Portes, Director of Centre for Economic Policy Research (CEPR); Mr. Chris Tillet, Associate Director of Coopers & Lybrand; Mr. Kent Durr, Chairman Elect of CIGA Ltd; Mr. Robert Binyon, Managing Director of the Commonwealth Development Co-operation (CDC). Mr. Rumman Faruqi, Director of Economic Affairs Division of the Commonwealth Secretariat and his colleagues, Dr. Raj Kumar, Dr. Kaniz Siddique, Datuk Ramesh Chander and Dr. Bishakha Mukherjee contributed to the work of the Group and the preparation of the report. Valuable contribution was also made by Mr. Robert Burgess of the British Treasury.

4 The Group, like the Commonwealth, represented wide range of different countries: industrial countries, emerging markets, some of the world's most competitive and dynamic economies, and some poor countries in danger

of marginalisation from the developments in the global economy that are bringing benefits to other parts of the world. Despite these differences the Group found that they have a good deal of shared experience, and have had to face a number of common economic challenges.

5 The Group met twice, in February and June 1997, and this is its report. The report is divided into the following sections:

2 the growing role of private capital flows: opportunities and constraints;

3 national policies for enhancing and sustaining private capital flows;

4 handling volatility;

5 the role of the international institutions; and

6 the role of the Commonwealth.

The last four sections (3 to 6) include key conclusions, grouped together at the end of each section. Papers on individual country experiences are at the Annex.

6 The Group focused its conclusions in three main areas:

a what can and should individual Commonwealth countries do to promote and handle international flows of private capital; to guard against economic risks; and to reap the maximum economic benefit;

b what should the international community and institutions do to enhance private capital flows and deal with systemic risks;

c how the Commonwealth can help in the process: by spreading best practice among member countries; through policy advice and direct action through technical assistance and other means; and by co-operating and discussing together actions that it wishes the international institutions to take.

7 In each area the Group has given special attention to the problems of countries in danger of being marginalised from the benefits of international capital flows. The central and overriding conclusion of the Group is that there are considerable benefits to be had from international capital flows; that over the medium-term all countries can secure these benefits by developing the right kind of enabling environment for investment in their economies. However, in the short- to medium-term, there is much that the international community and the Commonwealth can do to help in the process. These conclusions are very much in line with those of other recent studies such as the World Bank's report: "Private Capital Flows in Developing Countries" (1997) and the Commonwealth Secretariat papers "Coping with International Capital Flows" by Richard Portes and David Vines (1997)and "Private Capital Flows and Development: The Role of National and International Policies" by Gerry Helleiner (1997).

2

Growing Role of Private Capital Flows to Developing Countries in the 1990s
Opportunities and Constraints

1 Overview
The pattern of private capital flows

8 International capital flows have increased markedly since the early 1970s and have, arguably, become as important as trade flows in promoting global economic integration. For the advanced economies, annual average gross foreign direct investment flows increased more than six fold between 1973-78 and 1989-94, while portfolio investment outflows increased 26 fold over the same period.

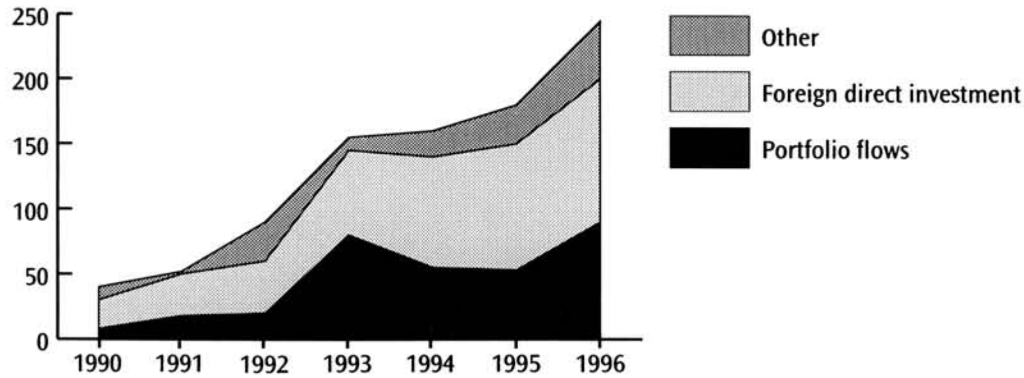
9 The increase in private capital flows to developing countries, both in terms of foreign direct and portfolio investment, has been even more marked. This trend has continued in recent years, not withstanding a brief pause in the first half of 1995 when debt and equity flows to some countries all but dried up following the Mexican peso crisis. Private capital flows to developing countries as a whole no more than flattened out in 1995 and have since increased by a further 50 per cent.

10 Developing countries are now an important destination for global private capital. Their share of foreign direct investment flows has risen from a low point of around 15 per cent in 1990 to 40 per cent in 1996. The rise in their share of global portfolio equity flows, over the same period, has been even more spectacular, from 2 per cent in 1990 to 30 per cent.

11 There have also been some important changes in the nature and composition of capital flows:

- the increase in private capital flows has coincided with a decline in official flows, which have fallen by around one half since the mid-1980s. Five years ago, official flows to developing countries were larger than private flows. But private capital flows are now five times the size of official flows.
- the fastest growth has been in portfolio investment – both in debt instruments and in equity. Foreign direct investment has also grown very rapidly.

Graph 1 **Private capital flows**
Net flows to developing countries $bn



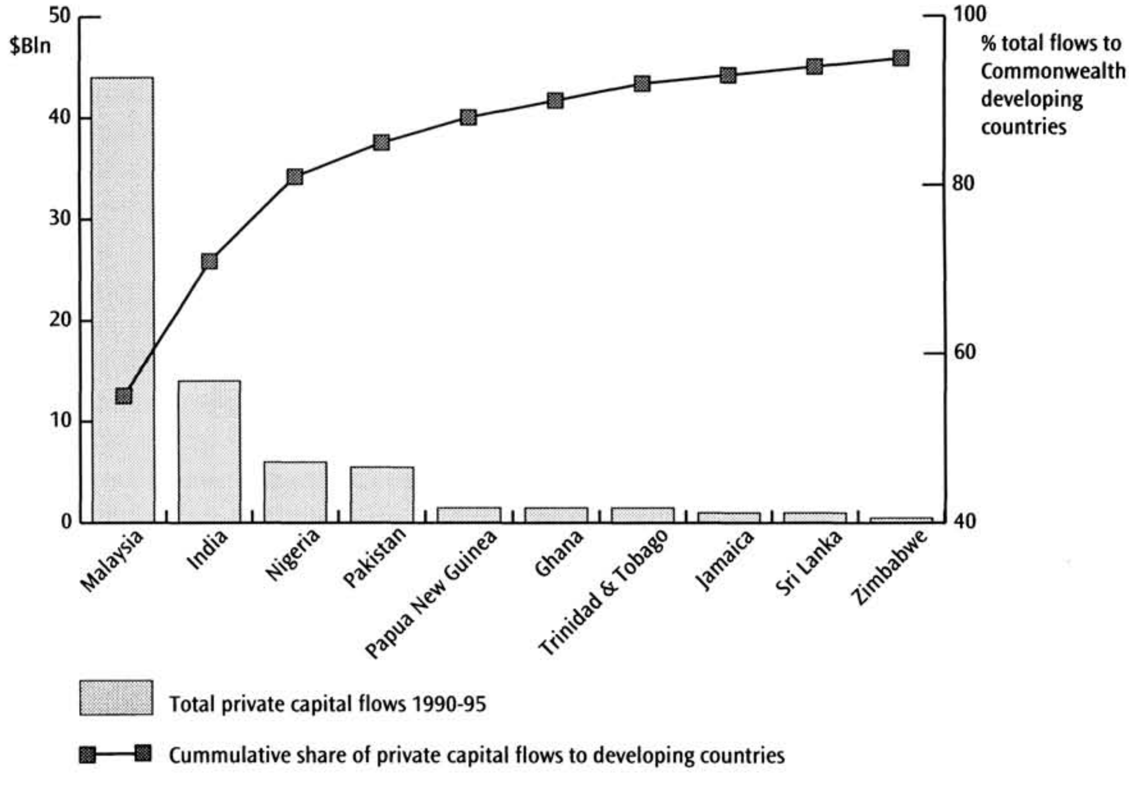
❖ the relative importance of commercial bank lending, which used to account for more than 65 per cent of all private flows to developing countries, has fallen dramatically. And, finally, there has been a shift in the destination of flows towards private borrowers. Public sector borrowing now accounts for less than one fifth of total private flows.

2 Marginalisation

12 New competition for capital has also emerged as economic and political conditions in Eastern Europe and Russia as well as in other parts of the world have improved. Since the mid-1980s, the number of developing countries that have been able to access the international capital markets has been increasing steadily. Around 30 countries are today considered credit-worthy by the international capital markets and banks. And, increasingly, these countries are able to attract private capital through a combination of different channels rather than relying entirely on banking flows or foreign direct investment for example. In most cases they still have to offer higher returns than industrial countries, reflecting the higher perceived risks.

13 Yet despite these developments, private capital flows to developing countries remain highly concentrated among a few economies. A dozen countries account for 80 per cent of net private capital flows to developing countries, while around 140 countries account for less than 5 per cent of flows. Much the same pattern applies to Commonwealth developing countries – six of which accounted for over 90 per cent of all private capital flows between 1990 and 1995 (see Graph 2). These difference are much less stark, however, when

Graph 2 **Concentration of private capital flows**



capital flows are scaled according to the size of the recipient economy, particularly among Commonwealth countries - many of which are small. Moreover there may be under-recording of flows in some cases, particularly in Africa. (In general, the Group notes that following liberalisation of exchange controls, countries need to establish new ways to capture data on inflows and outflows.)

14 Some developing country members such as Malaysia and Singapore are now foreign investors themselves. South Africa is also becoming a source of investment for the Southern and East African region. Intra-regional private capital flows between developing countries have been a new feature of the 1990s. This feature is most marked in terms of foreign direct investments in Asia, where intra-regional flows have accounted for around three-quarters of total direct investments in recent years.

3 Benefits of private capital flows

15 The potential benefits of international capital flows are substantial as demonstrated by the experience of the East Asian and Latin American countries. It has contributed to the shift in the thinking about the need for capital account liberalisation.

16 In some senses, the benefits are similar to the gains from international trade – both for individual countries and for the world economy as a whole. When combined with a more open trading system, capital liberalisation allows capital to flow to where it produces the greatest return, sharpening the incentives to save and invest, and helping to maximise economic growth. Access to international capital markets also allows companies and individuals new and better ways to manage their risks. For all these reasons industrial countries have, in recent years, removed restrictions on private capital outflows. Where it is prudent to do so, they should also consider relaxing any remaining restrictions, for example, in the share of institutional portfolios that can be held in foreign markets.

17 Foreign investment also encourages the transfer of technology, management skills and know how, with substantial benefits for host economies. Pressure on domestic companies, either to compete with foreign investors, or to compete among themselves in order to attract foreign investment, may also help to boost domestic productivity. Foreign investment could improve export performance if it takes place in export oriented activities. In addition, foreign investment can also aid the process of privatisation and in channelling investments into infrastructure development.

18 Foreign investment and the associated spillovers can have particularly beneficial effects on national financial markets by enhancing the depth and efficiency of those markets. The improved ability of the financial sector to allocate scarce resources can have strong positive knock-on effects for growth and investment.

19 Some have questioned whether private capital flows can redistribute world-wide savings on any major scale – noting, for example, that there is a tight link between national savings and investment rates. Government policies, the argument goes, would be better targeted at boosting domestic savings from which the bulk of investment will have to be financed. There is, however, a strong presumption that these policies to encourage domestic savings will also attract foreign savings. In most cases, they are likely to be complementary since domestic investors often influence foreign perceptions. Private capital has therefore tended to flow to those countries which already enjoy high domestic investment levels – that is where the relative rates of returns are higher.

4 Problems and risks of private capital flows

20 Private capital flows do, however, carry potential risks and costs, including contagion risks. The presence of microeconomic distortions in the economy can, for example, exaggerate and misdirect flows. That is why some countries, such as the UK, have pursued capital account liberalisation after, or as part of, a broader series of structural reforms. Experience indicates that countries that have benefited most from capital inflows, have been those that have successfully liberalised their domestic economies and reduced external barriers.

21 Capital flows can also greatly complicate macroeconomic management, particularly where capital flows are volatile. Capital account liberalisation in itself reduces the ability of domestic monetary authorities to set monetary policy independently of international interest rates. The impossibility of simultaneously maintaining free capital flows, monetary autonomy, and fixed exchange rates leaves policy makers with difficult choices to make when faced with surges in capital inflows or their sudden reversal. There are other types of problems as well. Some countries remain concerned to limit foreign ownership, at least in some industries. Fluctuation in capital flows can expose weaknesses in domestic banking system. The possible responses to counteract these difficulties are discussed in sections 3 and 4.

22 But the constraints on domestic macroeconomic policies can also have some very positive effects. Exposure to international financial markets imposes a discipline on governments which encourages the adoption of appropriate policies and, ultimately, tends to reward good policies. Equally, of course, it can increase the risks and costs when policy mistakes are made.

5 Sustainability of private capital flows

23 Rapid increases in private capital flows in recent years have been driven by a number of forces in both developed and developing countries. Increasing competition and rising costs in domestic markets – initially in industrial countries but also, more recently, in a handful of developing countries – have encouraged firms to look for opportunities to increase efficiency and returns by producing abroad. This has led to an increase in foreign direct investment flows and the increasing globalisation of production. Financial markets have also become more globally integrated following internal and external deregulation, advances in communication and information technology, and the development of increasingly sophisticated financial instruments. For the most part, these processes still have some way to run before global product and financial markets could be said to be fully integrated

24 Short term factors can, of course, also have a role in driving capital flows. The initial impetus for some of the surge in capital flows in the early 1990s was probably a search for higher yields following a decline in interest rates and a prolonged recession in the advanced economies. In the last few years, however, private capital flows to developing countries have withstood rising global interest rates in 1994, the Mexican peso crisis of 1994-95, and the availability of substantial returns on US and, to a lesser extent, European equities in the last two years.

25 Developing countries for their part have increased the attractiveness and accessibility of their markets by embarking on macroeconomic stabilisation and structural reform programmes, progressive reductions in barriers to trade and investment, measures to liberalise and strengthen their domestic financial

markets and privatisation of public enterprises. As the resulting improvements in economic fundamentals and creditworthiness began to take hold, and as emerging markets became more 'familiar' to investors, long term rates of return and opportunities for portfolio risk diversification have become attractive to some international investors.

26 Institutional investors in advanced economies have played a particularly important role in this respect. Mutual funds, which tend to be less heavily regulated than other institutions, have been at the forefront of increasing international diversification. More than 30 per cent of new investments by US mutual funds went to emerging markets between 1990 and 1994. Pension funds have now started to follow this trend. The share of foreign assets in pension fund portfolios has risen from 7 per cent to 11 per cent between 1989 and 1994 – equivalent to an increase in international investments by pension funds of nearly $500 billion. In the UK, where the process of international diversification is more advanced than in most countries, the share of international assets in pension fund portfolios has stabilised at around 27 per cent over the last few years.

27 The trend toward international portfolio diversification is, arguably, still at an early stage. Pension funds in most countries are still bound by ceilings on their exposure to foreign investments. But even where there are no such limits, the share of developing country assets in the portfolios of institutional investors is still small and well below their share in world market capitalisation of around 10 per cent. In the US, for example, mutual and pension funds hold an average of around 2 per cent of their portfolios in emerging market assets. Moreover, ageing populations in most advanced economies are generating demands for higher returns and pressures for pension reforms, which are likely to lead to substantial increases in global pension fund assets over the next 20 years or so. The Group agreed that where it is prudent to do so, institutional investors 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 emerging markets.

28 On the whole, these developments suggest that recent increases in private capital flows are sustainable. Sustainability, however, is not the same as stability of capital flows. Stability will depend in part on events in the world economy: the potential instability of private capital flows makes it even more important that the major countries should follow stable and predictable economic policies. Even then, there will be unpredictable events affecting global capital markets. In addition, flows to particular countries will fluctuate, reflecting, for example, shifting perceptions of a country's economic and policy fundamentals, or one-off investment opportunities associated with privatisation. For all these reasons it is necessary to have in place national and global arrangements that provide safeguards in the event of sudden or large changes in the volume and direction of flows.

3

Enhancing and Sustaining Private Capital Flows

29 In this chapter, we discuss the role of national policies in attracting and sustaining private capital flows, and in ensuring that those flows are put to best use within the host economy. While these policies may vary according to individual country circumstances, they will include sound macroeconomic fundamentals and the implementation of good microeconomic policies both on the human and on the institutional side. In this respect, foreign investors will look for many of the same factors that influence domestic private investors.

1 Commitment, credibility and sustainability of economic reforms

30 Sound macroeconomic policies along with a stable institutional and legal framework are essential for attracting and sustaining private capital flows. By reducing uncertainty, macroeconomic stability in combination with stable political and institutional framework allows investment and savings decisions to be made in a manner consistent with underlying economic fundamentals, thereby promoting the efficient allocation of resources. Conversely, countries without a stable policy and institutional framework present risks of instability and, importantly for foreign investors, balance of payments restrictions.

31 The experience of some economies suggests that, where there is the right institutional and political environment, markets can recognise and reward improvements in macroeconomic policies and hence creditworthiness. Strong economic growth following the implementation of economic reforms has led to a steady increase in capital inflows, for example, in China since mid 1980s and in India since the early 1990s.

32 Other countries, however, have found accessing the international capital markets to be a more drawn out process. Uganda and Ghana, for example, have relatively long track records of pursuing sound economic policies and structural reforms. Fiscal consolidation in the 1990s helped to promote macroeconomic stability and improve economic growth. But Uganda and Ghana have only recently attracted increasing flows of private capital. At the same time, other countries, especially some small states, have found it harder to establish credibility in world financial markets even after a long track record of relatively good policy performance.

2 Open markets

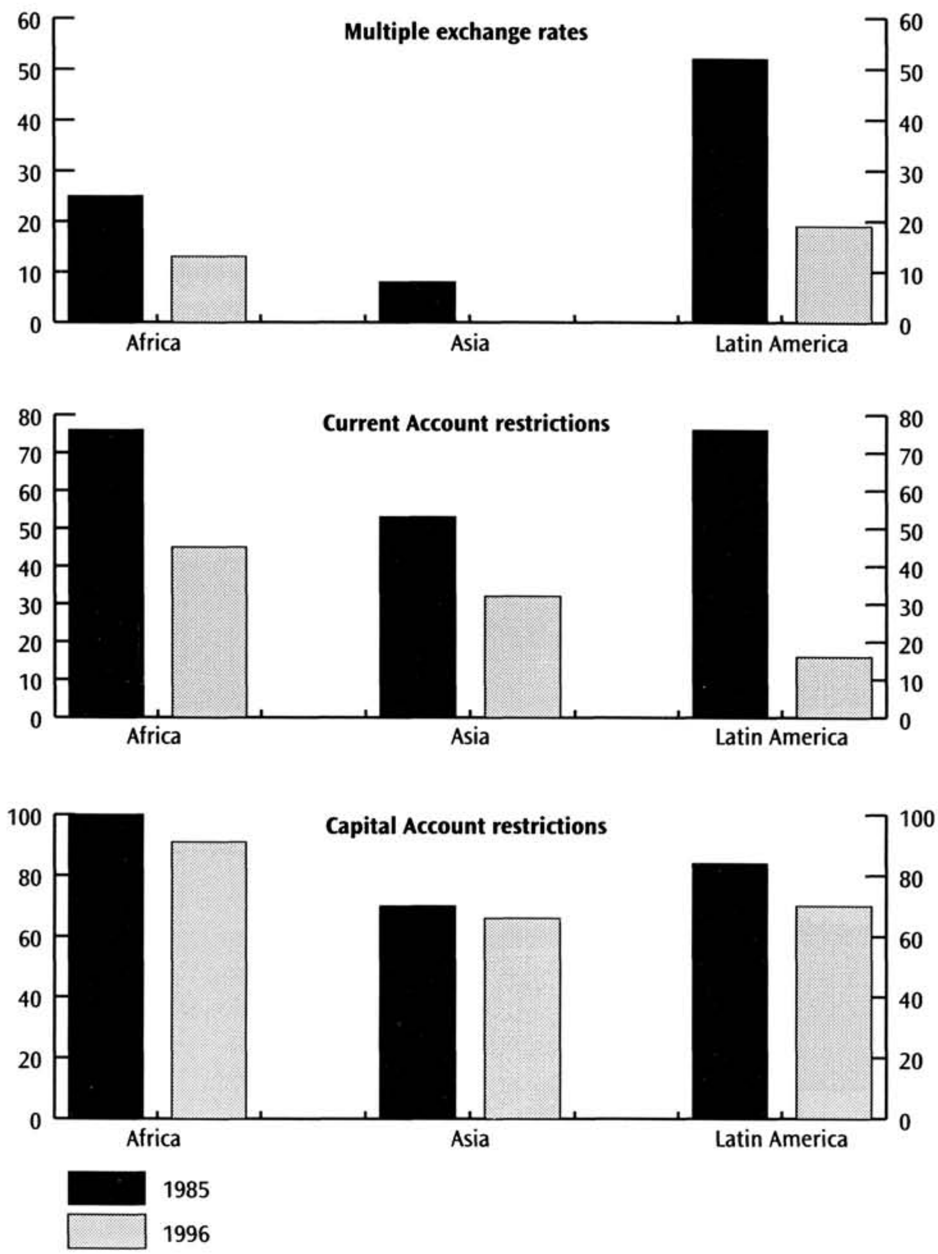
33 Within a stable macroeconomic environment, outward oriented trade policies provide the best environment for foreign investors particularly in the context of FDI. While import-substitution (and resource extraction) provided the main impetus to foreign direct investment in the early days of developing country industrial development in the 1970s and early 1980s, the most sustained growth of such investments in recent years has been into economies that are export-orientated.

34 Trade liberalisation tends to raise the rate of return on investment in countries which then become more attractive places in which to invest. There may be adjustment problems in the short run, but over time a move to

more open trade policies allows a country to exploit its comparative advantage in production, and promote the importation of lowest-cost products, often with embedded advanced technology. Trade also allows a country to use a larger variety of intermediate goods and capital equipment that then enhance the productivity of its own domestic resources.

35 The relaxation of foreign exchange controls themselves can also help to attract capital inflows. Private investors will want ready

Graph 3 **Proportion of developing counties with ...**



Source: IMF

access to foreign currency to import goods, and the freedom to remit dividends and profits and to repatriate capital. Relaxing controls on capital outflows can, therefore, encourage capital inflows (and the return of flight capital) because investors have the assurance that they can disinvest if they want to do so. In practice, the impact of foreign exchange controls (and their removal) on capital movements is difficult to observe directly. Country experience has been mixed. But experience in recent years has been that removing exchange controls has tended to coincide with an increase rather than a decline in net capital inflows.

3 Regional integration

36 Access to large markets remains important in attracting foreign investments that are geared mainly to those local markets. Some of the largest recipients of foreign direct investment have very large market themselves or, as in the case of India, the potential to develop such markets.

37 Greater regional integration is often proposed as a means of, among other things, attracting foreign investment - especially for those countries that do not have large domestic markets themselves. Where domestic markets are small and fragmented by distance and poor infrastructure, regional integration may be the only way to provide the economies of scale necessary to attract domestic market-orientated investments.

38 Sub-Saharan Africa including South Africa, has a sizeable market in terms of purchasing power and population. But this is spread over enormous distances with poor interconnections in terms of transport, communication and other market links. Effective integration could greatly improve the chances of sub-Saharan African countries to attract foreign investment, if this were supported by improvements in physical infrastructure. There have been a number of efforts at such integration, but without much success. Regional trade remains very limited and the lack of appropriate infrastructure remains a major barrier to the success of any further efforts.

39 Such regional arrangements need also to be open to trade with the rest of the world. The creation of regional blocs with significant external tariffs can have negative consequences for the countries that are excluded from them. This is a risk facing some Caribbean countries as NAFTA threatens to divert foreign investment away from them and towards, principally, Mexico.

4 Stability and transparency

40 As noted in para 29, appropriate macroeconomic policies and an open foreign exchange regime alone may not be sufficient for developing countries to sustain large private capital inflows. Stability and transparency need to be established in a number of key environments in which investors must operate. Private capital flows are more likely to be deterred in the absence of:

- a stable institutional framework for managing political change
- good governance: particularly transparency and accountability in public policy making
- well-defined property rights, which are enforced through sound legal and accounting frameworks (the Group noted the good track record of Commonwealth countries); and
- clear and transparent tax codes. Relatively low and stable corporate tax rates tend to be more important than a tax regime with many special or discretionary concessions offered to particular investors.

5 Attitude to foreign ownership

41 Foreign ownership remains a sensitive issue for many countries. (see box on foreign direct versus portfolio investment). Most governments, for example, place restrictions on foreign ownership where there are strategic concerns or involve public monopolies. Some have also sought to protect infant industries through such restrictions. But even proponents of this kind of interventionist industrial policy agree that promotion of infant industries should be targeted to those activities which would not, because of the costs and risks involved, receive sufficient investment under free market conditions; and that protective barriers should be small, selective, and limited in duration.

42 Restrictions are also motivated by concerns that foreign investment is more volatile than domestic investment. Some have argued that volatility has increased as markets have opened up in recent years (as in cases of major crises such as Mexico in 1994/95 and episodes of surges in Argentina and Thailand). Others believe that the increasing importance of institutional investors in international capital markets has contributed in reducing volatility. Evidence on either side is however, mixed. In any case, domestic investors can also be volatile and outflows of domestic capital have been among the major factors behind a number of recent episodes.

43 There are also practical difficulties in placing restrictions on foreign ownership. Foreign investors are often able to circumvent restrictions by channelling their investments through domestic companies, just as domestic investors can invest through, say, foreign mutual funds.

44 There is a general trend to reduce restrictions on foreign ownership, linked in part to the shift of enterprises of the public sector. This trend is becoming more common as countries come to recognise and reap the benefits of foreign investment in terms of jobs, technology and other spillover effects.

6 Privatisation

45 Privatisation can and does generate significant interest, both among foreign direct and portfolio investors and among financial institutions as sources of advice on the privatisation process itself.

46 Between 1988 and 1992, foreign sources provided about 30 per cent of total privatisation financing for developing countries. Privatisation has been particularly important for some countries in Latin America and the Caribbean and, more recently, in eastern Europe where the public sector has traditionally played a greater role in the economy. In Jamaica, for example, the privatisation programme accounted for about 40 per cent of foreign direct investment flows between 1987 and 1990. While foreign investment in privatised infrastructure will not have as direct an impact on export earnings as investment in exporting activities, the improvement in infrastructure may nevertheless be crucial for success in exporting.

Box 1 **Composition of foreign investment: FDI versus portfolio flows**

Most countries have, to varying degrees, sought to influence the composition of capital inflows, typically favouring foreign direct over portfolio investment. Ownership restrictions may also vary by sector, with lower limits frequently imposed in banking and financial sectors. This is motivated by a number of factors:

- general political economy concerns about foreign investors owning domestic companies which can in turn be magnified by a lack of transparency in the mergers and acquisitions process;
- fears that portfolio investors lead to volatility in asset markets insofar as they cause prices to move more sharply than would be justified by 'fundamental' factors. Portfolio investors, the argument goes, are interested in short run capital gains and dividends rather than in contributing to the long run health of domestic companies (and hence the domestic economy as a whole). Foreign direct investors, by contrast, are presumed to base their decisions on longer term economic and political fundamentals, and are therefore less volatile in their short term behaviour;
- fears that, because of their wealth, foreign investors will be able to buy large shares in domestic firms and capture the majority of capital gains and dividends that flow from rapid economic growth.

The effects of foreign equity investment on domestic corporate performance are debatable. On the one hand, some investors tend to follow an index-based approach and have little interest in underlying performance of the companies in which they invest. Others may simply be unable to play an effective role in domestic corporate governance because they do not have enough information to do so. Ownership restrictions, however, by confining foreign investors to small equity stakes, can reinforce such ineffectiveness.

On the other hand, foreign equity investment can lead to improvements in company performance, through demonstration effects as domestic companies seek to attract foreign investment, and also foreign practices are adopted by domestic shareholders In India, for example, foreign portfolio investment in domestic financial institutions has led to better corporate governance, both directly in the institutions involved, and indirectly on a wider scale by setting a new benchmarks in standards.

A preferable way to provide a counter-balance to foreign involvement in domestic equity markets would be to build up domestic institutional funds (pensions and mutuals). A stronger domestic institutional base would provide additional depth and liquidity to domestic capital markets. Domestic institutional investors could help to stabilise those markets by stepping in if, for example, many foreign investors were selling at the same time for reasons not related to domestic factors or to the domestic capital markets. This may in turn require further reforms of the domestic legal and regulatory framework for investment, particularly in the area of investor protection.

7 Infrastructure

47 The importance of good physical infrastructure in attracting foreign investment is also largely self evident. For example, Hong Kong and Singapore, have remained attractive to foreign investors because of good infrastructure, despite being high wage economies.

8 Human capital

48 While cost of labour does remain a factor, upgrading of skills is increasingly important in attracting inward investment. A host country with a larger supply of trained and trainable labour is likely to attract more foreign investment than others. This investment is also more likely to be of higher quality and in linkage intensive-activities such as engineering, that require a strong local supplier base with a diverse range of technical skills, but also allow the host economy to capture the beneficial spillover effects of foreign investment more readily. So national policies to improve levels of human capital are of great importance.

9 Investment promotion, targeting and special incentives

49 Promotion and targeting strategies can also be successful in attracting inward investment. Success is dependent on the development of clear long term strategies. The most successful investment promotion agencies tend to have, for example, a comparatively narrow focus – concentrating on identifying specific opportunities and targeting them very closely both in terms of sectors and specific markets that they regard as being particularly effective for them. Uganda, for example, is looking towards Malaysia as a more likely source of investment than Singapore. Other agencies are also starting to target individual companies.

50 Perceptions among potential investors can be particularly important. African countries, for example, suffer from a blanket image insofar as they tend to be regarded as a single entity – and one that is failing. South East Asia by contrast now has an exceptionally powerful image as a stable and strong economic base. Investors, therefore, accept lower rates of return in Asia than they do in Africa. Perceptions can, however, change rapidly as the recent currency crises in a number of South East Asian economics have demonstrated.

51 Follow up and use of networks to support existing investors are also of fundamental importance, in two ways:

- ❖ by generating reinvestment which is a common feature among the biggest recipients of foreign investment
- ❖ by maximising the value of the investment to the domestic economy and helping to embed those investments into the economy. Companies which are tied into the local economy, use local suppliers, have local markets, and are involved in local joint ventures, are less likely to move than simple assembly or 'screw-driver' operations that import most of their inputs and export most of their outputs. This in turn places a premium on investment in education and human capital to raise the skill levels of local labour forces.

10 The role of financial markets

52 The strength of domestic financial markets and the banking sector in particular is a key factor in enabling a country both to avoid the pitfalls and exploit the benefits of integration with the international capital markets.

53 Private capital flows carry dangers for vulnerable financial systems, as discussed below. But they can also enhance the role of domestic capital markets in increasing domestic invest-

ment and better allocating capital among potential investments. They provide access to larger supplies of investment resources for domestic capital markets generally, and to larger amounts of loanable funds for the banking system. They also allow more efficient diversification of risk through the availability of new financial instruments. And they generate increased financial market competition.

54 Increases in private capital flows have been a key factor behind improving the depth and liquidity of domestic capital markets in many countries. Trading activity has expanded in parallel with the growth in market size. But within this global trend toward larger capital markets, the largest increases in market size have been in developing countries. Equity market capitalisation in the major emerging markets, for example, has risen from 7.2 per cent of GDP in 1985 to 42.9 per cent in 1994 (Table 1). The African experience is illustrated in Box 2.

Table 1 **Stock market growth (market capitalisation, per cent GDP)**

	1985	1994
Emerging markets	7.2	42.9
o/w India	6.9	44.0
Malaysia	52.0	281.6
Pakistan	4.4	21.6
Sri Lanka	6.2	24.6
Major markets	54.6	68.2
o/w UK	70.8	118.2
memo: South Africa	n/a	185.2

Sources: IFC Emerging Markets Fact Book, and Emerging Markets Investor Fact Book

55 But most emerging markets still have some way to go to match the depth and liquidity of capital markets in most advanced economies. And a great many more markets are still at the pre-emerging stage. In Malaysia, which is arguably one of the world's more advanced emerging financial market, one fifth of all securities trades do not settle on the contractual settlement date. This is four times more than in the US. Bid/ask spreads (and therefore the cost of equity capital) in emerging markets tend to be significantly higher than in advanced economies.

56 In order to compete for new issues and investors, not only with advanced markets but also with a growing number of emerging markets, developing countries will need to develop their capital markets. Better capital market infrastructure, protection of property rights, and a well conceived and properly enforced regulatory framework can all facilitate market development by promoting investor interest and liquidity, and reducing systemic risks and volatility. The experience of some East Asian countries, such as Singapore and Malaysia, suggests that this development can take place in a very short space of time.

57 However, open capital markets also increase the risks of potential financial instability which can then undermine the benefits of private capital flows and magnify the impact of macroeconomic and financial problems. International financial flows have exposed the underlying vulnerability of weak financial systems in several emerging market countries. The early establishment of a robust financial system is therefore an essential element in avoiding or coping with such problems. The viability of domestic financial systems has important implications for handling volatility in capital flows and for the liberalisation process itself. These are discussed further in section 4.

Box 2 **The Emergence of Stock Markets: Africa**

The evolution of capital markets in Africa in recent years has been rather dramatic. To date, Africa has 16 stock exchanges. Most are less than 10 years old. A statistical comparison of some African Stock Exchanges is attempted in the table below.

In recent years, activity in African capital markets has been boosted by a number of positive developments. Political changes have enabled political pluralism to emerge in many countries. Greater accountability and transparency of government actions is another development. Economic reforms have given rise to liberalisation and led to freeing up of exchange controls and exchange rates. At the same time privatisation of state-owned enterprises, lifting of price controls and reducing the monopoly of marketing and distribution of products; and deregulation of trade flows has created an environment for the private sector to function. Consequently, African markets have made significant progress. Activity in a number of capital markets that have been dormant for years picked-up significantly and a number of new markets have emerged in the last decade. Furthermore, countries such as Uganda and Tanzania are taking steps to launch their own stock exchanges. In a number of established stock exchanges, activity has been boosted by increased listings of companies, partly made possible by privatisation of state-owned enterprises.

African markets are however, relatively small, illiquid, indeed at a rudimentary stage of development. The total number of listings is less than 2,000 (Egypt, Nigeria and South Africa account for almost 75 per cent of all listings). This compares to a country such as India which has around 6,000 listed companies.

The continuing success of stock exchange development in Africa is likely to depend on the speed and effectiveness of creating the right environment. The evolution of viable and efficient financial markets with diversified banking and non-bank financial sectors and an appropriate legal and regulatory and supervisory system. Financial market development tends to be sensitive not only to the legal, regulatory and tax frameworks existing in a country, but also to country, country, country, the nature of macroeconomic and sector policies being pursued.

Country	GDPcurrent prices ($US Millions)1995	Population (Million) 1995	Year established	Number of Listed Companies mid 1995	Market capitalisation (US$ Millions) mid 1995	Average dividend yield of companies quoted (%) mid mid 1995
Botswana	4,318	1.5	1989	11	340	6.5
Namibia	3,033	1.5	1992	8	200	2.6
Zimbabwe	6,522	11.0	1974	60	2,050	5.4
Zambia	4,073	9.0	1994	7	790	0.9
Kenya	9,095	26.7	1960s	52	1,690	4.8
Nigeria	40,477	111.3	1960s	147	775	5.7
Ghana	6,315	17.1	1990	17	1,750	1.6
Ivory Coast	10,069	14.0	1976	27	525	6.9
Morocco	32,412	26.6	1950s	51	6,090	2.7
Mauritius	3,919	1.1	1989	24	1,580	n.a.

Source: IFC, Euromoney/World Bank

11 Conclusions

58 This sections brings together the Group's conclusions on the role of national policies in attracting and sustaining private capital flows, and in ensuring that those flows are put to best use within the host economy.

- i sustained implementation of sound macro-economic and structural policies is as important for attracting and sustaining private capital flows as it is for promoting healthy domestic economic development
- ii investors are attracted by stability in the political process, and by reliable and transparent legal, accounting, regulatory and tax systems
- iii 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 of capital inflows
- iv open trade and investment policies, particularly in well-integrated and rapidly growing regional markets, 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
- v regional integration can 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
- vi where it is prudent to do so, institutional investors 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
- vii governments should be careful about imposing restrictions on foreign ownership and consider whether existing restrictions are necessary or useful
- viii 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
- ix investment in a well functioning physical infrastructure, can also in itself help to attract private capital flows.
- x a skilled and trainable work force is another key factor in attracting investment. National programmes to invest in human capital are critically important to enhance competitiveness and attract investments in high value added activities.

59 The Group recognised that even after the implementation of many 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 credibility.

4

Handling Volatility of Private Capital Flows

60 The experiences of countries who have received large capital inflows during the 1990s indicate two potential problems: sudden large surges of capital inflows and equally sudden slowdown or cessation of inflows, or outflows. The magnitude of these flows can be as large as 4 to 5 percent of GDP on an annual basis. Reversals of flows can also be very substantial if investors lose confidence in domestic macroeconomic policies, as was the case in Mexico, Turkey, Venezuela, Argentina, Brazil and Thailand. Countries that are considering opening their capital account may therefore be concerned about the risk of experiencing greater volatility in private capital flows.

61 This volatility of private capital flows may sometimes be due to external factors: shocks arising in the international economy (including changes in international interest rates and terms of trade). Or it may be due to domestic shocks including economic policy changes. Institutional weaknesses in a country's financial markets can magnify the effects of various shocks causing a greater degree of volatility in the early stages of financial integration.

62 There have, however, been significant differences in volatility among countries. Asian countries have generally shown less volatility, and have reduced levels of volatility when compared to Latin America in the 1980s, suggesting that country conditions remain the primary determinant of volatility. It may also reflect the fact that Asia has sought to attract more FDI than portfolio investment which is believed to be more volatile than the former.

63 The volatility of portfolio investment flows compared to FDI is a contentious issue. On the one hand, FDI is believed to be less volatile because it is more costly to reverse and is based on long-term economic and political fundamentals rather than shifts in international financial conditions. The opposite is true for portfolio flows which are more sensitive to short-term differentials in rates of return and investors can divest themselves more easily of their stock of equities or bonds. On the other hand, there is increasing evidence that using various hedging instruments, FDI flows can also be volatile. (For example, transnational corporations can respond quickly to country circumstances by managing international intra-firm financial transactions and by borrowing in domestic currency against their fixed assets, and switching into foreign currency.)

64 The remainder of this section discusses how countries can guard against and best handle volatility in capital flows. It starts by discussing the disciplinary effect that capital market integration imposes on macroeconomic policy. It considers the impact of both capital outflows and inflows and the policy dilemmas in macroeconomic management that governments face in handling capital surges. It also looks at the implications of capital market integration for the financial sector and capital account liberalisation.

1 The effects of capital market integration on macroeconomic policy

65 Governments and central banks in financially integrated countries find themselves operating in an environment where capital flows are highly sensitive to changes in domestic and foreign economic policies, events and interest rates. Compared to economies that are less integrated into world financial markets, both domestic events - including changes in domestic policies - and international events, will have a different, quicker and larger impact on the economy. Capital market integration thus affects and in some ways limits the scope for domestic macroeconomic management. In one respect at least this is beneficial: it places a higher premium on the steady pursuit of sound domestic policies, and requires swifter action when policy is going off course. But there are other more specific implications for the conduct of policy.

66 First, the ability to conduct independent monetary policy and maintain interest rates that differ from international interest rates, becomes increasingly difficult if the government wishes to target the nominal exchange rate. In a completely open economy, with a fixed nominal exchange rate, domestic interest rates will be determined by external factors and will be equal to the foreign interest rates adjusted for a risk premium and any expected exchange rate changes. The authorities cannot, therefore, conduct an independent monetary policy. By targeting the exchange rate effectively over a long period, countries can reduce the expectation of future exchange rate changes, and hence the risk premia and the difference between domestic and foreign interest rates. Countries following such a policy can find themselves faced with complex policy dilemmas, where domestic circumstances require the interest rate to be different from the international rate.

67 In a semi-open economy, however, domestic interest rates can differ from foreign interest rates for at least a period. For example, if the authorities adopt a more expansionary monetary policy, which reduces domestic interest rates and increases the differential, then there could be a lag before there is serious downward pressure on the exchange rate, forcing either a devaluation or a reversal of the original interest rate change.

68 Second, financial integration increases the importance of responsible fiscal management. With a fixed exchange rate regime and constraints on monetary policy, fiscal policy becomes the only available instrument for influencing aggregate demand in response to external shocks. In using fiscal policy as a short-term stabilisation instrument, governments must of course also pay attention to medium term fiscal solvency.

69 Third, financial market integration reduces the effectiveness of capital controls. This is discussed further below in sub-section 3(d).

70 Finally, financial market integration gives exchange rate management a different perspective. Exchange rate management remains an option, as noted above, but in some circumstances allowing exchange rate movement, or a move to a floating rate, may be the best option. Holding the rate down, for example, in the face of strong upwards pressure, may mean accommodating inflation and losing control over the domestic price level, undermining confidence in the government's policies and, in due course, an uncomfortable reversal of funds.

2 The macroeconomic impact of capital flow surges

71 A number of financially integrated countries represented in the group, including both industrial and developing countries, have had experience of handling periods of strong

capital inflows. The most important macroeconomic risk is that such inflows result in an excessive expansion of aggregate demand, and create inflationary pressures. If a country maintains a fixed exchange rate, or resists exchange rate appreciation, reduces official interest rates and intervenes in the foreign exchange market to purchase the foreign exchange generated by the capital inflow, that may lead to monetary expansion, and greater domestic demand. If the domestic economy does not have sufficient capacity to meet this demand, this will trigger an acceleration in domestic inflation together with a deterioration in the current account. In due course rising domestic prices will cause the real exchange rate to appreciate, adding to the deterioration of the current account, already caused by the increase in aggregate demand. At that point capital flows may go sharply into reverse.

72 Two important initial economic conditions may make a country particularly susceptible to such episodes. First, the initial fiscal-monetary policy mix. In general a tight monetary policy which is accompanied by a loose fiscal policy drives interest rates high and attracts capital inflows to unsustainable levels. So keeping fiscal policy tight is important. A second initial condition of importance for capital flow surges is the imbalance between domestic savings and foreign inflows. Encouragement of domestic savings is one policy response that can help to reduce long-term vulnerability to capital inflows. Increasing domestic savings bridges the gap between savings and investment so that less foreign savings and capital inflows are required - and there are some encouraging international examples in this regard. Chile, for example, which increased its domestic savings over time and its saving ratio stood at 33 per cent during the period 1991-93. Its success lies in its establishment of a compulsory private pension system. The accumulated funds have been invested in the open financial markets and not held as book reserve credits with the government as is often the case in the developing world.

73 The next section looks at experience with handling periods of strong capital inflows, when they occur.

3 Possible domestic policy responses

74 The experience of both industrial and developing countries suggests that a mix of different policy responses is likely to be the most appropriate way to handle volatile private capital flows. The nature of that mix will vary according to individual country circumstances. It may also change over time depending on whether capital flows are sustained

(a) Fiscal Policy

75 Fiscal policy is a very important policy instrument in stabilising the economy in the face of external financial shocks. For a well integrated economy under a fixed exchange rate regime, it may be the government's only available policy option for reducing absorption and tackling inflationary pressures in the economy. Under flexible exchange rates, governments can use a mixture of monetary and fiscal policies. Some countries have handled episodes of capital inflow effectively by tightening fiscal policy but there are limits on its use: it usually cannot be changed quickly, and often needs to be set in a medium term framework. Moreover the use of fiscal policy by itself may be impractical in circumstances where the magnitude of the required fiscal adjustment is very large. Fiscal policy has, however, been used by some countries successfully, e.g. Chile, Malaysia.

(b) Exchange rate adjustment

76 A second option is to tighten monetary policy while floating the exchange rate. The resulting appreciation of the domestic currency will

tend to both discourage net inflows through the capital account and, in time, create a current account offset through a reduction in the current account balance as exports become less competitive. It will also cause a rise in interest rates, or at least eliminate the need to reduce them to maintain the exchange rate, hence reducing domestic demand.

77 The higher the capital inflows and the greater the appreciation, the higher would be the loss of profitability of the export sector. But it is worth remembering that the alternative may be a similar real appreciation, but achieved with a rise in inflation caused by an expansionary monetary policy required to defend a nominal fixed exchange rate. This is clearly a less desirable outcome.

78 On the whole, developing countries have not favoured the adoption of completely floating exchange rates. But many have permitted some flexibility, adopting exchange rate bands around a crawling central parity in order to accommodate some nominal appreciation in response to inflows. Others, while keeping fixed rates, have permitted step revaluations on occasions.

(c) Intervention, sterilisation and debt management

79 Another policy open to countries seeking to hold fixed exchange rates is to sterilise the effects of an inflow on the money supply through intervention in the foreign exchange market. Sterilisation operations have been used by many countries which have experienced net capital inflows. They have taken three forms: a reduction in the monetary base through open market operations; a transfer of public sector deposits from commercial banks to the Central bank; and an increase in reserve requirements to domestic financial institutions reducing thus the expansion of the monetary base or the growth of broader monetary aggregates. There are a number of other options for sterilisation of capital inflows, notably the use of foreign exchange swaps. Swaps tend to be flexible since there is no need for a stock of short-term government securities, as in open market operations. They have been used successfully in the past for sterilisation (e.g. by countries such as Indonesia), though one constraint is that the use of swaps depends on a liquid foreign exchange market.

80 In general, the effectiveness of sterilised intervention depends on the degree of substitutability between domestic and foreign interest-bearing assets. For example, when sterilisation takes place through the selling of domestic public debt, there will be a fall in the price of securities and a rise in domestic interest rates. That will make domestic assets even more attractive to foreigners, increasing capital inflows and aggravating the problem.

81 There is, however, a cost incurred by the public sector when sterilisation takes place through open market operations, which has to be taken into account. That cost relates to the difference between a) earnings on accumulated net foreign assets and b) the payments on domestic currency instruments. It is often the case that the former is less than the latter. For example, the government in Jamaica has experienced substantial fiscal costs from sterilised intervention.

82 There is a general consensus in the Group that sterilised intervention is a temporary measure which can buy time but does not provide a permanent solution, and can be costly. It can nevertheless be useful in the case of temporary capital inflows, and to buy time while longer term policy responses are being considered.

(d) Controls on inflows

83 Many countries have also tried a variety of direct and indirect controls in response to

surges in capital flows. These can take many forms. They can take the form of non-remunerated reserve requirements on new foreign credits or foreign currency deposits. These are equivalent to taxes. They can take the form of limits on the foreign exchange liabilities of banks. They can also take the form of a ban, on the sale of short-term securities to foreigners by residents. Such controls were for example, imposed by Malaysia at the beginning of 1994 in response to a sharp acceleration of capital inflows in 1993.

84 It is, however, very difficult to assess the effectiveness of such capital controls. In some countries there was a reduction in net private capital inflows as controls were introduced, in others an acceleration. The problem with such before-after assessments is that there are also other factors at work. The general consensus, is that on the whole, in integrated economies, such controls can only be effective in the short-run - given the world-wide integration of financial markets and the sophistication of financial intermediaries. Even then controls over capital inflows are more likely to be effective than those over outflows. In general, the effectiveness of capital controls depends on a variety of factors, such as:

- The state of technology: this affects the transaction costs in conducting arbitrage amongst different financial centres. If these costs are low, it will be more difficult to implement effective controls.
- The design of the controls themselves, in particular their comprehensiveness and a country's administrative capacity to enforce them. Controls which apply only to some types of assets can be evaded through substitution to other assets. The extent of the substitution depends on the depth of the country's financial markets. In such a situation controls will be ineffective in limiting the total amount of flows, though they may alter the composition of flows.

  The degree of openness of the economy. This determines the scope for evading controls through under and overinvoicing of trade transactions and the use of leads and lags on trade credits. The existence of money laundering provides additional channels through which funds can be moved across borders.

85 Empirical evidence has shown that capital controls can drive wedges between domestic and international interest rates, thereby providing the country with a certain degree of independence in setting its domestic interest rates. The Group's conclusion, therefore, is that they may be useful for countries at an early stage of financial integration. A recently published World Bank report advises that the use of restrictions may plausibly be warranted when surges of foreign money encourages poorly run and supervised banks to lend imprudently. There is consensus that controls can only buy time, and they are not a solution to a sustained surge in inflows.

4 Implications of capital market integration for the financial sector

86 The banking system in many developing countries plays a greater role in financial intermediation than in industrialised countries. Another general characteristic of banking systems in a number of developing countries is their fragility, as indicated by Moody's financial strength ratings. In an environment of increasing capital market integration, these characteristics accentuate the vulnerability of countries to strong capital inflows or outflows, and that in turn increases macroeconomic vulnerability. For example, in the absence of a well supervised banking system, surges of capital inflows can result in the imprudent expansion of credit for consumption, speculative purposes, or the

financing of a construction boom. As a result, banks' portfolios become exposed to volatile sectors and to severe losses when sentiment changes and asset prices fall, causing a banking crisis. Experience with a series of banking crises that have been associated with episodes of surges in capital inflows, such as that in Chile over the period 1978-81, has implications for the liberalisation process.

5 Implications for the liberalisation process

87 The potential volatility of private capital flows highlights a number of issues concerning the liberalisation process. One issue relates to the sequence of liberalisation and stabilisation policies, another to the order in which the sectors will be liberalised and a third to the speed of the liberalisation process.

88 In general macroeconomic stabilisation should precede liberalisation: this means improving public finances, tackling inflation and reducing external imbalances. The financial sector should also be strengthened before liberalisation: - by improving the regulatory and supervisory frameworks; and by establishing clear standards and rules of accounting, auditing and legal procedures. Where there is a deposit insurance scheme, it must be appropriately targeted and priced to reflect risk levels.

89 Capital market integration is thus best engineered against a background of macroeconomic stability, liberalised domestic financial markets and a well regulated and healthy financial sector. However the state of the financial sector is constantly changing with new financial innovations often accompanying capital inflows. Governments therefore need to be vigilant in ensuring the continued stability of their financial sectors after liberalisation.

90 On the issue of the speed of liberalisation, many countries have expressed a preference for gradualism. Malaysia is cited as a success story by liberalising its economy slowly. The experience in South Africa with capital account liberalisation also appears to support the gradual approach. South Africa removed foreign exchange controls in 1983 following a "big bang approach" and was forced to reimpose them in 1985. More recently it has followed a more gradual approach in removing the controls. Other countries, however, including the UK in 1979, have successfully followed a more rapid approach, finding that once they began to remove controls they had to move more quickly than originally intended across the board.

91 There is a consensus that there are no set rules, as country circumstances differ and policies adopted need to reflect the country context.

6 Conclusions

92 This section brings together the Group's conclusions on the handling of volatility of capital inflows and outflows and the implications of such volatility for policy and the sequencing of liberalisation:

i Getting the fiscal/monetary policy mix right, and encouraging domestic saving, can help to reduce the risk of volatile swings in private capital flows.

ii The basic economic policy choices in handling capital inflows are:

(a) permitting flexibility in the exchange rate with some nominal appreciation

(b) fiscal policy tightening

(c) sterilised intervention and 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.
- ❖ Sterilisation and controls on capital inflows can provide short term breathing space but may not be effective in the event of large and persistent capital surges.

iii. Potential volatility in capital flows has also implications for the sequencing of reforms and the speed of capital market liberalisation. The Group concluded 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 accounts:

- ❖ improve public finances, reduce inflation and reduce external imbalances.
- ❖ strengthen domestic financial markets by improving financial infrastructure and the regulatory and supervisory framework for banks and financial institutions, and by lifting restrictions on interest rates and the allocation of loanable funds.
- ❖ tackle other major structural distortions in the economy.

After capital account liberalisation is in place governments need to continue to monitor both capital flows and their financial sectors - and to do so more carefully than in the past.

5

The Role of International Policies, Agencies and Agreements

93 This section explores the role of international organisations in facilitating capital flows to developing countries, in particular to those countries that are at risk of marginalisation and have not yet succeeded in attracting significant private investment. The IMF's role in assisting countries to dismantle capital controls and enhancing the confidence of international investors is examined along with the general issue of the IMF modifying its Articles of Agreement to accommodate capital account convertibility. The section also discusses the international policies that have and should be put in place to help countries cope with capital surges. The role of emergency financing, debt workouts and early warning systems of possible problems arising from capital inflows is elaborated. WTO's role in the investment area is also commented upon.

1 Policies by international organisations

94 International organisations such as the World Bank and the IMF can play a catalytic role in increasing private capital flows to the poorer developing countries, by improving the prospects of those countries. They can do so by encouraging sound domestic policies and through their own lending operations, in this way assisting them to reach a stage of development where private flows would be attracted. For some countries, removing an unsustainable burden of debt will be an essential first step. The Group attaches considerable importance to the rapid implementation of the HIPC initiative.

95 The World Bank Group has used guarantees on the limited basis to support private sector development through leveraging its resources. Such guarantees provide ways of mobilising private finance for public sector projects thereby releasing public funds for other investments. The Working Group concluded that IBRD guarantees, which are at present available primarily to foreign investors, should be made available to domestic investors. The Multilateral Investment Guarantee Agency (MIGA) has met with considerable success in promoting FDI by providing investment guarantees against political risks, including the risks of currency transfer, expropriation, and war and civil disturbance. However, the Group noted that MIGA was facing capacity constraints and exposure limits, and that there were also other limitations associated with MIGA guarantees. First, the scheme is only available to foreign investors and the Group was of the view that this was a limiting factor and excluded domestic investors. The Group observed that MIGA might not be competitive, but it fills a gap for political risk insurance and re-insurance not provided by national and private insurers. Further encouragement of private insurers to enter the guarantees market would help to ensure the setting of more appropriate price terms.

96 The Group noted that the Bank is also considering the use of IBRD guarantees as a means to support IDA funding for infrastructure projects by the private sector, which it is currently unable to do under its existing Articles. The view was expressed that under

its Charter, guarantees were substitutable on a one-to-one basis and therefore did not lead to additionality. In addition, bank guarantees must also receive a counter-guarantee at the national government level, whereas many projects come under the jurisdiction of sub-national governments. The Bank is undertaking a review to examine ways in which to increase the flexibility and resources for its guarantee programme, including:

- issuing guarantees that do not require a counter-guarantee from the host government;
- guaranteeing lenders to municipal and provincial governments;
- offering new products to develop domestic financial markets and access to international markets;
- permitting greater capacity to provide guarantees for projects in IDA countries;
- not counting the guarantee fully against country borrowing limits; and
- leveraging capital to a greater extent than is possible for the IBRD guarantee under IBRD articles.

The Group welcomed this review of the guarantee programme and looked forward to its recommendations.

97. More generally, the Group agreed that the International Financial Institutions (IFIs) have a key role to play in encouraging and helping countries to take the whole range of measures set out in Section 3 to enhance and sustain private capital flows.

2 Amending IMF Articles

98 Various multilateral, bilateral, and regional agreements and initiatives have contributed to the liberalisation of capital movements. For the most part, however, these agreements are either among a restricted group of countries (as in OECD Code of Liberalisation of Capital Movements and the EU Directives) or concentrate on the protection of direct investment rather than the liberalisation of capital movements. There is no one agreement that has near universal membership, which covers a broad set of capital movements, including permission for residents to invest abroad, and which also pays due regard to the macroeconomic, structural and balance of payments implications of capital flows.

99 The IMF, with its mandate to oversee the international monetary system, is well placed to promote the liberalisation of capital flows. It has almost universal membership and it advises and supports countries as they deal with the many policy issues related to capital flows. The IMF already covers, in its Article IV consultations with its members, issues related to the capital account for assessing the scope of capital account liberalisation. More recently the IMF has begun to consider an amendment of its Articles to reflect developments in global capital markets. There is a broad agreement for giving the IMF a mandate to promote capital account liberalisation together with the appropriate jurisdiction to do so.

100 The Group recognised the importance of enlarging the Fund's responsibilities and jurisdiction in this area, and gave general support to proposals in this direction. The Group also recognised that there were a number of issues which required clarification and further discussion including the need for (a) a clear and workable definition of capital account transactions to be covered under such an amendment; (b) suitable transitional arrangements; (c) approval of policies for continuation and/or reimposition of controls under certain circumstances; and (d) consideration of the possible need for Fund resources.

3 International policies on capital surges

101 The move to capital account convertibility by countries will improve their ability to attract capital flows but it also implies that countries run increased risks due either to adverse external developments or to domestic policy mistakes. In this section, we consider suggestions for improving the international monetary system to cope with such situations.

(a) IMF data standards and early warning systems

102 The IMF Executive Board agreed in 1995 on a list of indicators that all countries should provide to it on a regular basis. These indicators would serve as an early warning system of possible problems ahead. These indicators included exchange rates, international reserves, central bank balance sheets, reserve money, broad money, interest rates, consumer prices, external trade, the external current account balance, external debt/debt service, the fiscal balance and GDP/GNP.

103 The IMF is developing a set of standards to guide members in publishing economic and financial data, accession to the standards being voluntary, to keep markets better informed. The standards cover apart from the indicators listed above, industrial production, unemployment, wages or earnings, producer or wholesale prices and domestic credit. The IMF is in the process of preparing a general standard for all members. For some of the countries with less developed statistical systems even the general standards could be achieved only over time and with substantial technical assistance. The Group recommends that the Fund (and, possibly, the World Bank) earmark additional resources to support country efforts in this direction.

104 Although all these developments were welcomed, the Group was sceptical that in practice there would necessarily exist a strong connection between the performance of these indicators and the emergence of a crisis. Difficult to measure factors not on the list, including policy-makers' perceived resolve and commitment, would also be important. Nevertheless, any action that increases the information available to markets, and hence improves the ability of markets to anticipate risks, must be welcomed.

(b) Emergency financing

105 The globalisation of capital markets is already affecting the role of the IMF as a lender for balance of payments reasons. While countries with increased access to capital markets no longer have to rely on the IMF as a provider of liquidity, others, when encountering financing difficulties, are apt to require assistance on a larger scale than in the past. In these cases the IMF's role should be catalytic. Private lenders may be unwilling to continue financing the country in crisis periods as they have no power to impose policy conditionality on borrowers. The IMF, however, is able to attach conditions to negotiated country adjustment programmes, and once countries are seen to be adhering to these conditions, confidence tends to be restored, and leads to the resumption of private capital flows.

106 The IMF has set up new procedures for activation of the Emergency Financing Mechanism (EFM) to enable the IMF to respond and, if necessary, to provide funds in support of members facing a crisis in their external accounts.

107 These new procedures have just been used in agreeing a programme for the Philippines, but have yet to be tested by a major crisis (on the scale of Mexico). At the

same time, the IMF is increasing its resources by expanding the amounts available to it under the General Agreements to Borrow (GAB) through the New Arrangements to Borrow (NAB). This will permit the Fund to react quickly where exceptionally large sums are needed for the largest countries which pose systemic threats to the international financial system. In addition, the Group would like to see an early increase in quotas that is sufficient to enable the Fund to respond adequately, quickly and flexibly in giving support to all countries when needed. The Group would also like to see an early agreement on an "equity" allocation of SDRs.

108 There is also a role for Central Bank co-operation for emergency assistance in exceptional circumstances. Such co-operation can range from information sharing, co-ordinated foreign exchange operations, foreign exchange swap agreements and more highly structured temporary credit facilities. Such co-operation, often on a regional basis, can be expedited as quickly as it is required and perhaps more quickly than assistance provided by the IMF. But there are limits to its effectiveness and thus it is important that the IMF should continue to have a primary role in managing the international financial system. Recent co-operation among the East Asian Central Banks in supporting the Thai Baht was only temporarily successful in buying time for the Thai authorities. It did not prevent a second wave of speculative attacks on the Thai Baht.

(c) Debt workouts

109 In a crisis, even with strong policy action and some financial support from the IMF and elsewhere, countries may encounter difficulties in meeting debt repayments. In these cases, there may be a need for temporary suspension of payments as a way of gaining time to negotiate orderly debt workouts with private creditors. In such cases, IMF may consider lending into arrears provided the debtor country is making strong adjustment efforts and negotiating with its creditors.

4 WTO's role in foreign investment flows

110 Although the primary role of WTO is in the area of trade, agreements concluded at the end of the Uruguay Round expanded its role to encompass a number of trade related foreign investment issues. These agreements established rules and regulations that are geared towards the creation of a hospitable environment in host countries for certain types of trade-related investments. These agreements also established dispute resolution mechanisms.

111 The role of the WTO in this area is still evolving. Four agreements were reached on a number of measures touching on investment, namely Agreement on Trade-Related Investment Measures (TRIMs); Agreement on Subsidies and Countervailing Measures (ASCM); General Agreement on Trade in Services (GATS) and Agreement on Trade Related Intellectual Property rights (TRIPs). Further developments have taken place since the conclusion of the Uruguay Round. For example, WTO's Singapore Ministerial Meeting agreed to establish a working group on trade and investment to examine the linkages between trade and investment issues in the context of existing agreements and agree on a possible work programme.

112 While there is no universal agreement, these developments could have an impact on the consideration of investment issues in WTO. For example, there is the issue of how to reconcile the differential treatments applied to investments in service sectors

and in goods production given the blurring of the differences between trade in goods and services. Differences in national treatment of like products under GATT and services in the GATS can give rise to disputes. These considerations make it necessary, that the WTO examine investment issues in a general framework without prejudice to the final outcome. The WTO Ministerial Council has been given the mandate to begin such an examination.

113 The Group felt that in any future discussion of investment issues in WTO, effort should be made to avoid conflicts or duplication with agreements currently being negotiated at the IMF.

5 Conclusions

114 The Group 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 the multilateral infrastructure to help countries to cope with capital surges. This section brings together the Groups' conclusions on the role of international policies, agencies and agreements:

i The IFIs can help to improve the economic prospects of all countries through lending, through advice, through 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.

ii The Group welcomed the World Bank Group's use of guarantees to aid private sector development and suggested that such guarantees should lead to additional resource flows. It noted the role of MIGA in covering political risks, and that the Bank was endeavouring to provide guarantees to private lenders to support infrastructure development.

iii 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 account when they are ready to do so and when satisfactory transitional and other arrangements are in place.

iv The Group welcomed the 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 react adequately, quickly and flexibly by lending to countries facing financial crises. The Group also stressed the need for advancing procedures for orderly workouts of sovereign debt.

v The Group also supported arrangements among Central Banks at the regional level to provide emergency assistance in dealing with short term capital surges.

115 With respect to the role of the WTO on investment matters, the Group recognised the need for consistency – and avoidance of duplication – between the IMF and the WTO in the treatment of investment.

6

Commonwealth's Role in Enhancing Private Capital Flows

116 In this section we examine the role of Commonwealth in enhancing and sustaining private capital flows and consider ways in which its activities in this area can be further strengthened. As a group of countries at different stages of financial integration but with many common features in legal and administrative systems, Commonwealth countries have much to learn from each other. Acting through the Secretariat, Commonwealth countries can provide technical assistance and policy advice to help member countries attract private capital flows. And acting together, Commonwealth countries can bring pressure to bear on international institutions in the kind of ways discussed in section V.

1 Existing Activities

117 Through its ongoing policy development and technical assistance programmes, the Commonwealth Secretariat seeks to assist member countries in promoting private capital flows and private sector development. These overall objectives have been pursued through specially designed investment funds; organising advice on developing and sustaining capacity in member countries, particularly small states; helping member countries create the enabling environment to attract and sustain capital flows; and strengthening the role of market forces and the private sector. The following areas have been of special focus:

- assisting governments in creating the right enabling environment; and in developing appropriate strategies and policies relating to fiscal, financial and regulatory regimes to promote private investment;
- playing a catalytic role in mobilising long-term capital through the establishment of investment funds;
- assisting the development of domestic capital markets including the establishment, maintenance and regulation of securities markets;
- assisting governments in negotiating with foreign investors, especially in mining and petroleum projects, where the Commonwealth has developed special expertise;
- providing a range of specialised and targeted capacity building programmes on corporate planning, strategic management, enterprise restructuring, competitiveness and foreign investment promotion strategies;
- advising on country – specific policy issues relating to private sector development and strengthening the functioning of markets by establishing appropriate legal and institutional frameworks, including intellectual property rights;
- preparation of feasibility studies for new enterprises and restructuring and modernisation of existing small scale enterprises across sectors; and
- advising on formulating policies on commercialisation and privatisation, including strategy and individual enterprise-level assistance, and post - privatisation management to strengthen enterprises.

118 The Secretariat has developed a comparative advantage in providing an assistance package which covers the full range of activities described above. It has the advantage of deploying in a cost-effective manner multi-disciplinary teams, drawing on in-house as well as outside expertise, and on the familiarity it has with the laws and policies of Commonwealth countries. It has been able to tap effectively a wide range of experience amongst Commonwealth countries to help other Commonwealth countries, as well as catalysing the various sources of private finance for development purposes. The Secretariat has built up the confidence of its members in these activities over a period of time through close interaction with member governments and by avoiding any apparent conflict of interests.

119 Much of this support is demand driven and provided to member governments on request or in response to ministerial mandates; in certain cases the Secretariat also considers requests from governments to enhance the capacity of the private sector itself, an area which may require more emphasis. The Commonwealth Fund for Technical Co-operation (CFTC) is an important instrument for supporting programmes in these areas.

2 Future role of the Commonwealth

120 The Group agreed that the Commonwealth and its Secretariat, working within existing resources, should continue to play a strong role in assisting countries to mobilise private capital flows, specialising in areas where it has a comparative advantage. This is particularly important at a time when member countries are facing new challenges to remain competitive in attracting foreign capital.

121 First, it should build on the conclusions of this Report in advising member countries on the policies needed to attract and sustain private capital flows. In this regard, the Group has a number of proposals, under this heading:

(i) ***A Commonwealth Code of Good Practice*** for national policies that attract and sustain private capital flows. It suggests that the conclusions to section 3 and section 4 be incorporated into a code of good practice that could be adopted and promulgated by the Commonwealth. Box 3 summarises the principles that might underlie such a code. The Secretariat might usefully incorporate this into a handbook for use by Commonwealth countries. It would provide a framework for more detailed work by the Commonwealth Secretariat in the specific areas mentioned below.

(ii) ***Regional strategies for promotion of investments:*** The Secretariat already provides assistance for country-specific investment promotion activities. It can enhance its effectiveness by developing appropriate regional strategies to attract investment and leveraging its limited resources by collaborating with other partners both at regional (i.e. SADC) and international level (i.e. the World Bank, MIGA) to avoid duplication. Experience in East Asia suggests that a regional strategy should attempt to:

- ❖ develop a targeted promotion strategy to attract investment on a regional or a subregional basis: this model could be especially relevant to African economies with small markets and poor infrastructure;
- ❖ establish a network of major firms in the region which could serve as joint venture partners and provide information on local/regional market conditions;

- co-ordinate a programme of regular sector reviews to assist investment promotion agencies with targeting, and the identification of emerging prospects; and
- promote an "information interchange" capable of exchanging information and intelligence between Agencies, and also provide information and other materials to private sector companies in a given region.

(iii) **Improving the regulatory framework for banking and securities markets:** In light of the report of the working party on financial stability in emerging market economies and the call by the G7 summit at Denver to assist emerging market economies to strengthen their financial systems and prudential standards, there is a need to encourage sharing of experiences and provide technical assistance and training to Commonwealth regulators and supervisors.

There remains major gaps in many emerging markets of the Commonwealth. These

Box 3 **Key elements for a Commonwealth Code of Good Practice**

There are a number of measures that national governments can take to facilitate and attract private capital flows and to minimise the risk of sudden surges in capital movements.

- sustained implementation of sound macroeconomic and structural policies, which are as important for attracting and sustaining private capital flows as they are for promoting healthy domestic economic development; and which can help to reduce the risk of volatile swings in private capital flows.
- stability in the political process, and stable and transparent legal, accounting, regulatory, and tax systems.
- the early establishment of robust and well regulated financial and banking systems, which are an essential safeguard against financial stress in the event of a reversal of capital inflows
- open trade and investment policies, particularly in well-integrated and rapidly growing regions. The relaxation of foreign exchange restrictions can in itself help to attract private capital flows.
- regional integration, but not at the expense of wider multilateral trade and investment liberalisation.
- where it is prudent to do so, allowing institutional investors 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 overseas markets.
- governments should be careful about imposing restrictions on foreign ownership and consider whether existing restrictions are necessary or useful
- privatisation programmes, and private involvement in domestic infrastructure projects, as a way of attracting foreign investors and improving the quality of infrastructure
- more and better investment in physical infrastructure
- a skilled and trainable workforce. National programmes to invest in human capital are critically important to enhance competitiveness and attract investment in higher value added activities.
- good marketing in the form of investment promotion and targeting strategies, which can help to establish credibility with investors

In handling capital inflows, and in particular in dealing with capital surges, countries have three basic economic policy choices: permitting flexibility in the exchange rate with some nominal appreciation; fiscal policy tightening; and sterilised intervention and controls on capital flows.

- there are limits on the extent of possible fiscal tightening in the short run; and on the effectiveness of sterlisation and capital controls in the event of large and persistent capital surges
- countries will therefore want to use a combination of policies according to their circumstances
- monetary expansion to counter any nominal exchange rate appreciation is not recommended
- after capital account liberalisation has taken place, governments should continue to monitor both capital flows and their financial sectors – and to do so more carefully than in the past.

In addition to action at the national level, the international community has a key role to play, both in facilitating private capital flows and in putting in place the multilateral infrastructure to help countries cope with volatility of capital flows.

gaps relate mainly to delays in payments and settlement and weaknesses in the legal and regulatory basis for compensation funds, takeovers and insider trading. Sharing of experiences between the mature developed markets and emerging markets within the Commonwealth can help the latter group of countries to further strengthen their regulatory framework.

In many Commonwealth member countries banks remain highly fragile. While virtually all developing countries have adopted the capital requirements that meet the Basle Accords' minimum standards, these countries face a much higher degree of risk and a more volatile environment. Similarly there is need for greater national and regional level co-operation among different types of regulators despite the increasing co-operation between the Basle Committee and International Organisation of Securities Commissions (IOSCO). There is however no forum for regular discussions on banking supervision among Commonwealth countries. The Commonwealth can assist by organising such a forum to encourage discussions amongst member countries and different types of regulators. These discussions could also help identify the needs for technical assistance and training for capacity building with respect to developing infrastructure and regulation for the financial sector as a whole, especially for the smaller and weaker member countries in the Commonwealth.

(iv) ***Creating an enabling environment:*** The Group recognised that providing legal protection is vital for investment, both foreign and domestic. In many countries the legal system are weak, inefficient and often slow and there are difficulties in enforcing contracts. Commonwealth countries can help each other in improving the functioning of countries' judicial systems and provide advice and technical support to facilitate good business practices.

(v) ***'Best Practice' handbook on investment promotion:*** Commonwealth countries seeking investment in an increasingly crowded and sophisticated market must be able to compete effectively. In this environment, the investment promotion agencies can help attract investment, particularly to those countries less familiar to the international investment community. Four of the world's ten most successful agencies in the last decade have been in Australia, Malaysia, Singapore and the UK. The experiences of these countries indicate that investment promotion agencies perform best in an environment that has the right economic and regulatory framework. But their performance also depends on a number of other factors, such as (a) ability to target and reach investors; (b) being "client-oriented"; (c) having longer term strategic plans; and (d) promoting close co-operation between relevant public sector bodies, the private sector and investment promotion agencies. The successful experiences of Commonwealth countries could be used to develop guidelines of 'Best Practice' for the benefit of investment promotion agencies in other countries.

(vi) ***Monitoring Capital Flows:*** With the dismantling of foreign exchange controls, mechanisms for collecting detailed information on foreign capital transactions through the banking system have become diffused and uncoordinated Following these changes minimal amounts of information are being collected on foreign exchange transactions and no single administrative mechanism exists for assembling comprehensive information on foreign capital flows. The responsibility for the collection of various types of information on foreign investment ultimately rests with at least three institutions, each seeking to collect the information that fits its specific needs: the Central Banks, the investment promotion agencies and the national statistical offices; each collect data on foreign and domestic enterprises, with varying degrees of success, for different purposes, using standards and definitions appropriate for their specific needs. The resulting data are incomplete, and inadequate for monitoring capital inflows. The Commonwealth Secretariat with its track record in setting up a debt recording and management system should be able to help countries in designing appropriate data collection systems.

122 Second, Commonwealth countries can act together in promoting specific new mechanisms and activities:

(i) ***Commonwealth Private Investment Initiative:*** In 1995, the Commonwealth Finance Ministers launched the Commonwealth Private Investment Initiative (CPII), which was subsequently endorsed by the Commonwealth Heads of Government at their meeting in Auckland.

The main objective of CPII is to mobilise long-term capital for commercial investments in developing member countries. CPII is a collaborative venture between the Commonwealth Secretariat and the Commonwealth Development Corporation (CDC). Under the management of CDC, a co-ordinated series of regional investment funds are being set up to invest in unlisted companies, privatised or privatising companies, new ventures, small/medium private sector businesses, and infrastructure development activities. Simultaneously the funds will attempt to ensure a high rate of return to investors and make a significant contribution to economic development by investing long-term, as opposed to traditional approaches to such funds which tend to focus on short term investments or target blue-chip companies. These funds can also have strong demonstration effects.

The first of these funds i.e., the Commonwealth Africa Investment Fund (Comafin), was launched in 1996 with a paid-in capital of $63.5 mn. This was raised from a variety of sources within the Commonwealth such as CDC and investment institutions in Brunei, Malaysia, Singapore, South Africa, Botswana, Mauritius and Zimbabwe. Similar funds are being set up in other regions of the Commonwealth e.g. Pacific Islands, South Asia and the Caribbean.

The Group believes that it is in the mutual interest of all Commonwealth countries to actively support CPII by investing in the establishment of these funds. Looking ahead, there seems to be considerable scope for further deepening and strengthening of such initiatives by examining the possibility of setting up specialised sector funds or privatisation trust funds to assist member countries in their privatisation efforts.

(ii) ***Privatisation Trust Funds (PTF):*** The PTF concept is increasingly being used as a mechanism for restructuring and privatising public sector enterprises. Such funds can also be set up for interested Commonwealth countries as a natural extension of CPII. These funds help to warehouse privatised assets which can be sold in the local market at a later stage either as individual company shares or as mutual funds. Often domestic investors, both large and small, are unable to participate individually in privatisation efforts at the outset. The PTF can help to generate both domestic and foreign savings and enable local investors to take part in privatisations at a later stage.

(iii) ***Risk Insurance and Guarantees:*** Typically, such insurance is not readily available to many member countries of the Commonwealth especially the least developed. The recently established Commonwealth Investment Guarantee Agency (CIGA) offers one prospect of filling this gap. The types of investment risks CIGA will cover include individuals or corporations who own equity or have made loans in any Commonwealth country, against confiscation, expropriation and nationalisation and inconvertibility of dividends and/or exchange transfer embargoes.

CIGA has been set up as a private limited company. It will create a partnership amongst Commonwealth Governments, the World Bank through MIGA, existing Government backed investment insurance schemes, the Commonwealth Secretariat, the private insurance and reinsurance market, and investors in Commonwealth countries. A co-operation agreement between MIGA and CIGA has been signed. Host Governments will be consulted during the acceptance procedure to be applied by CIGA when vetting new risks. This will ensure the support of the host government. The establishment of CIGA is not expected to duplicate MIGA activities but will seek to "top up" cover available from MIGA or bilateral government schemes. The Secretariat is well placed to play a catalytic role in supporting such private sector initiatives and making these easily accessible to member countries.

3 Conclusions

123 It is important to strengthen Commonwealth co-operation to enhance and sustain private capital flows. Member countries can help each other and benefit from each others' experiences. They can also act together to create mechanisms to assist such flows; and to influence relevant decisions made in international institutions.

124 Section V sets out the Group's conclusions on current relevant debates in the international institutions.

125 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 improve the regulatory framework for banking and securities markets, create an enabling legal environment; and monitor capital flows;
- draw up a hand book of best practice in investment promotion;
- extend the Commonwealth Private Investment Initiative to new regions and sectors; and
- encourage the creation of Privatisation Trust Funds and new mechanisms for risk insurance and guarantees.

Annex

Country Experiences with Private Capital Flows

1 Australia

Private capital flows have been a very important factor in the development of the Australian economy and a major influence on the evolution of the financial system and monetary policy making.

Main Trends

Australia has long been a heavy net capital importer, mirroring a substantial current account deficit. Gross inflows have averaged about 3.5 per cent of GDP since the fifties. They surged from the late seventies to reach a peak of 10 per cent of GDP in the late eighties, followed by some contraction in the nineties to an average of 6 per cent of GDP. Year to year movements have probably been more volatile in recent decades than in the sixties and seventies.

The composition of capital flows has changed substantially since 1980:

- equity investment has accounted for most of direct foreign investment in Australia;
- during the eighties, there was a heavy inflow of debt or foreign borrowings which to some extent funded net equity outflows, but these trends have been unwound in the nineties; and
- Australian capital inflows have always come from a wide range of countries but there have been substantial swings at times in the relative importance of these various investment sources. For example, capital flows from the EU and Japan waned sharply in the late eighties/early nineties but the US stepped up its investment in Australia during this period.

These trends clearly illustrate that the size and structure of the Australian capital account has changed considerably, often quickly.

Reasons for Trends

There are perhaps three general forces behind these trends.

First, private capital flows have been driven by the structure of the Australian economy - a resource rich, geographically large country with a small savings base relative to its investment needs.

Second, a generally favourable investment environment, characterised by political and general financial stability, well-functioning markets and infrastructure and strong legal, professional and education systems, has underpinned Australia's ability to attract foreign investment on a sustained basis. On the other hand, Australia has not relied on specific inducements or incentives to foreign investors to invest in particular sectors.

Third, the major influence on the timing and form of private capital flows has been the process of financial reform over recent decades that has produced a fully deregulated financial system, including a liberalised capital account. In particular:

- until the 1970s, all international transactions were subject to exchange control. Investment flows most encouraged were those that helped development, encouraged new technology, established new products and processes or included some form of domestic participation. Australian investment abroad was virtually prohibited. Specific capital controls were used at various times throughout the 1970s. The financial system generally was subject to heavy interest rate controls and restrictions on lending by banks and markets in bonds were cleared at non-market prices;

- during the 1970s and 1980s, the domestic financial system and capital account were more or less liberalised simultaneously. The key changes were: progressive freeing of bank's interest rates and lending; introduction of market-based tender arrangements for treasury bills; floating of the exchange rate and abolition of exchange controls in 1983; and greater freedom of entry for foreign banks from 1985. Today, Australia has no substantial capital account restrictions; and
- throughout the 1980s and 1990s, the Australian government undertook a series of significant liberalisations of its foreign investment policy. While screening of proposed foreign investment over certain thresholds continues by the Foreign Investment Review Board (FIRB), the basis of the FIRB's deliberations is that all foreign investment will be approved unless considered contrary to the national interest. Foreign investment in residential real estate, civil aviation, banking, media, telecommunications and shipping is subject to special restrictions, including foreign ownership limits.

Some Issues and Lessons

Benefits of Capital Inflows

Australian experience suggests that private capital flows have promoted Australia's economic growth and development over a long period. Given the country's investment-savings imbalance, capital inflow has been a very necessary supplement to domestic savings. Much of the benefit has come from international financial integration and the liberalisation of domestic financial arrangements associated with that; namely, increased operating efficiency in banks and businesses and better allocative efficiency arising from the removal of distortions in funding costs and portfolio diversification.

However, Australia has been mindful that a capital importing country must be able to service its debt over time to maintain credibility in the international financial markets. While the use of foreign capital for productive investment purposes rather than mainly current consumption undoubtedly helped, credibility also required maintenance of a sound macroeconomic environment including sustained implementation of appropriate monetary, fiscal and other policies.

While concern has been expressed from time to time about the consequences of capital mobility, this not been such as to cast serious doubt about the net benefits of foreign investment and an open capital account. Such concerns are an inevitable consequence of international interdependence and the best general response to such concerns has been to maintain sensible economic policies. Indeed, there has been a widespread agreement in Australia that the disciplines imposed by international markets have been a key factor aiding the development of good policy making and that this is one of the important benefits generated by private capital mobility.

Problems of Openness

Like other countries, Australia has experienced difficulties from time to time in dealing with volatile capital flows. The main concerns have been with ensuring that the intended effects of monetary policy on money supply/interest rates are not undone by capital "surges" and maintaining financial market stability in the face of volatility and particular external shocks. In broad terms, problems have over the years been dealt with in three ways, namely:

- selective use of specific capital controls in the 1970s such as an embargo on short-term capital flows and a variable deposit requirement whereby funds borrowed abroad were lodged in $A non-interest accounts at the

Reserve Bank of Australia until the borrowing was repaid;

- sterilisation of capital inflows by adjustments to domestic policy instruments; and
- reliance on a floating exchange rate with intervention in the forex market to maintain orderly market conditions.

The first two approaches were used in combination prior to the move to a floating exchange rate regime and deregulated capital account in December 1983. In essence, these major policy shifts were made because resort to capital controls and sterilisation proved to be generally ineffective under a basically fixed exchange rate.

A major lesson from Australian experience, therefore, is that it is not possible for a small open economy relying heavily on foreign capital flows to set its exchange rate and domestic interest rates simultaneously and to sustain these settings if international financial markets judge them to be inappropriate. Sterilisation of unwanted capital flows can get policy into a vicious circle in which capital inflows generated by efforts to tighten domestic monetary conditions with the exchange rate fixed can quickly lead to further inflows, sterilisation and further inflow as the appropriateness of the exchange rate comes increasingly under question and speculative capital flows are sparked. Capital controls can at best give temporary respite and cannot for long prevent the need for more fundamental adjustments to macroeconomic policies.

Some other more specific problems from Australian experience with capital controls are that:

- it can be very difficult to identify short term or "hot" capital flows. Long-term portfolio investment is not necessarily more stable than investment in shares or short term money market securities;
- exchange controls are costly and can reduce economic efficiency; and
- reliance on controls can undermine confidence in general economic management.

The move to a floating exchange rate allowed Australia to deal more effectively with volatile capital flows and to strengthen domestic monetary policy making. External pressures are taken on the exchange rate rather than on domestic interest rates and monetary aggregates.

While it has been judged necessary from time to time to intervene in the forex market in the face of volatile conditions, this has not been to avoid adjustment to macro policies at a more measured pace. Such intervention can be a useful signal that policy makers consider the markets to be moving inappropriately relative to fundamentals but can only be effective if domestic economic policies have credibility, i.e. the markets believe that those policies will in fact be adjusted in time and as necessary if the intervention is not sufficient.

Lessons from the reform process

Some broader lessons from Australia's experience with the process of financial reform, including liberalisation of the capital account, include:

- financial reform in Australia has been gradual rather than a sharp response to major crisis. However, there did seem to be major points in the process at which the need to liberalise markets became irresistible;
- there was no detailed long term plan; instead reform has been the result largely of pragmatic responses to developments against the background of a strengthening intellectual commitment by policy makers to market-oriented solutions;
- reform in some parts of the financial system reinforced pressures for reform in other areas;
- it is difficult, and probably not a good thing, to separate deregulation of the domestic financial system from liberalisation of capital flows;

- deregulation can have a number of transitional problems as markets and financial institutions adapt to the new, freer, environment. For example, the Australian banks experienced a rapid expansion in credit growth and deterioration in asset quality in the late 1980s and early 1990s as they exercised new-found freedom to expand their activities and compete for market share. Amongst other things, this experience demonstrated the need for banks to have high quality risk management systems and for sound arrangements for prudential supervision to be in place which set down a range of minimum prudential standards, consistent with international best practice;
- financial reform and reliance on markets is not a panacea for all ills. Markets impose substantial discipline on domestic economic policies and achieving and maintaining credibility in this area is crucial; and
- wider microeconomic reform, such as lowering tariff barriers and promoting competition in the domestic economy, is important in creating a favorable environment for productive investment, which allows the economy to make the best use of the capital inflows it is able to attract.

2 Botswana

Background

In Botswana, the private capital inflows have been of a comparatively small magnitude, highly volatile and mainly associated with the development of infrastructure involving major mining projects, although in recent years, they have also been significant in the manufacturing sector. Since 1983 Botswana has had a current account surplus, so that, unlike most other developing countries, net capital inflows into Botswana have not been aimed at financing current account deficits. They have instead, been guided more by direct considerations of investment in projects in the public as well as private sectors. Net private capital inflows have amounted to an average of 1.4 per cent of GDP over the years 1982-1995. Most of these inflows have been in the form of foreign direct investment. Portfolio investment began to show a significant increase during the 1990s with the establishment of the Botswana Stock Exchange.

During 1982, Botswana was not able to sell all her diamonds because of the world economic recession and as a result, a current account deficit of US$44.2 mn was recorded. Government then instituted a number of measures to deal with the situation which included a 10 per cent devaluation of the Pula, tighter monetary policy, and a public sector wage freeze during the year. As a result, the current account improved to a surplus of US$1.8 mn in 1983. The net private capital inflows to Botswana increased steadily from 1983 to 1987, when a net outflow of US$83.7 mn was recorded, which was mainly on account of outward investment by Government into the De Beers Consolidated Mines and the purchase of the railway assets of National Railways of Zimbabwe which were within Botswana. Large amounts of private capital inflows were recorded between 1988 and 1992 due to investment in the development of the Soda Ash mine in the country. In 1993 net private capital outflow of US$156.4 mn was registered, which was due to Government's purchase of the shares of a foreign company, AMAX, in the Botswana Roan Selection Trust (BRST).

Apart from the major mining projects, the continued inflow of private capital flows during the 1990s was due to the relatively higher expected rates of return of investment in the manufacturing and services sectors. This was made possible by the relatively stable macroeconomic environment involving a more liberal exchange control regime and a special investment incentive programme, the Financial Assistance Policy (FAP). Both local and foreign investors are equally eligible for assistance under FAP, although its coverage is limited to manufacturing and some service sectors of the economy.

Investment Climate and Private Capital Flows

Botswana's success in attracting private capital flows has been due to a number of factors which complemented each other:

- Botswana has enjoyed relative political stability for many years compared to most African countries, including her neighbours.
- From being of the poorest countries in the world in terms of per capita GDP at independence in 1966, Botswana has been able to maintain a steady economic growth. During the 1980s, growth in real GDP averaged about 10 per cent per annum and despite the economic recession that engulfed the world in the early 1990s, Botswana continued to record positive growth rates except for 1992/93.
- Immediately following independence, Botswana concentrated its efforts towards the development of infrastructure such as roads, health facilities, utilities and other social services to improve the efficiency in the provision of services and reduce basic costs faced by investors.
- Botswana has been able to provide a sound macroeconomic environment with a stable exchange rate, stable interest rates, a relatively low inflation rate and budgetary surpluses. Through the central bank, measures were introduced to absorb domestic excess liquidity and ensure that the balance of payments surpluses did not lead to excessive monetary expansion.
- The country has a healthy stock of foreign exchange reserves and a very low external debt to GDP ratio. Restrictions on foreign currency transfers, which are considered a serious constraint facing investors in most of Africa, are very minimal. During the 1990s, Botswana commenced a policy of a gradual and progressive liberalisation of exchange controls and in 1995, the country was admitted into the IMF's Article VIII status under which members are obliged to remove all controls on the current account. Foreign Currency Accounts are now allowed onshore, subject to limit of P10 mn for resident companies and P1 mn for individuals. This will not only facilitate the payments for imports of goods and services but also protect residents of Botswana against adverse exchange rate fluctuations.

Botswana Stock Exchange and Foreign Portfolio Investment

The stock market, which was opened in 1989 and formulated in 1995 as the Botswana Stock Exchange, plays an important role in the mobilisation of savings, and channelling these resources into long-term development activities. By October 1996, the cumulative foreign investor's stock market activity recorded by the Botswana Stock Exchange stood at P156 mn out of a total capitalisation of P1,187 mn.

Foreign portfolio investors cannot collectively hold more than 49 per cent of a listed company's shares excluding "direct investor" held shares. Foreign investors holding more than 5 per cent of the issued capital of a company are categorised as direct investors. Dual listing of companies between the Botswana Stock Exchange and other stock exchanges was allowed beginning in 1996 to further improve the flow of portfolio investment across countries. This is however, subject to there being no exchange controls in the other country which may prohibit or hinder the free movement of funds to Botswana. It is expected that this dispensation will be utilised in the near future. The restriction of 5 per cent for foreign investors shareholding in a listed company and the aggregate of 49 per cent holding do not apply to a foreign and dual listed company.

Outward Investment

At present, institutional investors such as life assurance companies and pension funds are allowed outward portfolio investment of up to 70 per cent of their total assets per annum. The limit for outward direct investment is set at P10 million per annum for resident companies and P100 000 per annum for individuals. However, there are no limits with respect to remittances of dividends.

Other Relevant Factors

Another attractiveness of Botswana as a destination for private capital is the wider market offered by Botswana's membership of the Southern African Customs Union (SACU) and the Southern African Development Community (SADC). Botswana's accession to the World Trade Organisation (WTO) in 1994 and the Lomé status also provide the investor with a stable trading environment. The establishment of the Trade and Investment Promotion Agency (TIPA) in 1984, a one stop service agency for investment and trade promotion, is one of the vehicles for facilitating foreign private investment. A number of special incentives are also offered such as financial grants through the FAP, relatively low and stable tax structure, provision of serviced commercial and industrial plots including factory shells as well as a welcoming and supportive Government machinery. Currently, corporate taxes in Botswana are among the lowest in the Southern African region at 25 per cent in general and 15 per cent for manufacturing companies. The top marginal rate of personal income tax at 30 per cent, will be further lowered to 25 per cent with effect from 1st July, 1997, thus equalising it with the corporate tax rate.

Although Botswana has not been involved in any major nationalisation of private companies, there is a sizeable state enterprises sector and therefore, there is scope for partial or full privatisation of some of them to enhance efficiency. Joint ventures with the involvement of foreign and citizen investors are encouraged, but there is no legal requirement enforcing citizen participation.

Despite having attracted substantial amounts of private flows, Botswana suffers from a number of disadvantages and constraints in attracting foreign investment. Firstly, there is the negative perception by investors of the African continent as a whole. Also, despite Government's efforts to develop its human resources, Botswana still faces a shortage in the area of skilled and productive manpower to quickly absorb and diffuse new technology that comes with foreign direct investment. The Revised National Policy on Education (1994), which is currently being aggressively implemented, is intended to improve the country's human resources with a view to enhancing productivity and competitiveness in a changing global environment. Another inhibiting factor to attracting investments in Botswana especially in the agricultural sector, is natural calamities such as the recurrence of drought.

Conclusion

Botswana has benefited from substantial flows of FDI in the past, most of which were directed to the mining sector. It is looking for sustainable diversification of the economy in other sectors like manufacturing, tourism and services. Although there have been some flows in these sectors in recent years, the scale has to be much larger if the economic growth targets adopted for the period of the Eighth National Development Plan are to be realised. Much policy reform has already been put in place to make the country attractive and friendly for prospective foreign investors. In the coming years, Botswana is expected to further liberalise and eventually eliminate exchange controls, simplify licensing and other regulatory controls on investment, invest in the development of both infrastructure and human resources and undertake efforts at achieving regional co-operation and integration of markets.

3 Canada

Trends

Canada has traditionally been a net capital importer. Reflecting its relatively large endowment of natural resources in relation to its population, investment opportunities have tended to outpace domestic savings and foreign capital has been imported to develop Canada's natural resources and manufacturing sectors. As a result, for much of its history, Canada has run current account deficits.

There was, however, a marked deterioration in the current account deficit (measured as a share of GDP) from 1984 to 1989, before it stabilised at about 4 per cent of GDP in the early 1990s. One of the primary factors behind this deterioration was a rise in the government deficit (as recently as 1993, the total government deficit on a national accounts basis was 7 per cent of GDP), which lowered domestic savings. As a result, foreign savings were required to bridge the gap between domestic savings and investment, and the current account deficit widened.

Recently, the situation has been reversed. A current account surplus was posted in 1996. The reduction in Government borrowing (the total government deficit on a national accounts basis is expected by the OECD to fall to 0.2 per cent of GDP in 1997) has been a significant factor behind the reduction in foreign borrowing and the dramatic improvement in the current account balance. As a result, Canada was a net capital exporter in 1996.

Nonetheless, as a very open economy, capital inflows still play an important role in the Canadian economy, and Canada's recent experiences may provide some valuable insights on attracting and coping with private capital flows. In financing its external imbalances over the years, Canada has experienced significant changes in the composition of its capital inflows. While the volatility of capital flows data make cross-year comparisons difficult, some basic trends emerge:

- Reflecting the impact of rising government deficits, capital inflows in the late 1980s and early 1990s were dominated by fixed income securities, particularly claims on the public sector. Over the same period, Canada's susceptibility to volatile capital flows was exacerbated by a shift towards debt obligations with shorter maturities, making debt financing more sensitive to fluctuations in short-term interest rates.
- Canada's reliance on new foreign borrowing has recently ended due to the success of the federal and provincial governments in putting Canada's fiscal house in order. Its exposure to fluctuations in short-term interest rates on existing debts has also improved, as steps have been taken to lengthen the duration of its debt obligations. In fact, foreign purchases of government bonds have diminished as a proportion of capital inflows and there has been a significant foreign disinvestment out of short-term government paper.
- Since 1993, foreign direct investment (FDI) has generally increased in value terms and as a proportion of total capital inflows. The increased importance of FDI reflects the more accommodative policy stance towards foreign investment that has been adopted in Canada over the past decade. In Canada, FDI has historically been much less volatile than portfolio investment (although the volatility of each has increased over time). The recent shift in the composition of its inflows in favour of FDI thus bodes well for Canada.

Coping with Private Capital Flows

An important factor in how Canada has coped with capital flows from a macroeconomic perspective is that it has long maintained a flexible exchange rate regime. This has allowed it to pursue an independent monetary policy, aimed at domestic price stability, and maintain its ability to adjust to trade shocks and capital flows.

Canada has a formal inflation target, which is to maintain the core CPI inflation rate (which excludes food, energy and indirect taxes) within a band of 1 to 3 per cent. The Bank of Canada has developed a monetary conditions index which is used to summarise the overall stance of monetary policy The index is defined as a weighted combination of the changes in short-term interest rates and the trade-weighted exchange rate measured from an arbitrary base year. The Bank of Canada selects a target or desired track for monetary conditions that will result in projected inflation staying within the target band six to eight quarters ahead. Subsequently, if there is a divergence between actual and desired monetary conditions, policy adjustments are made.

Debt management techniques can also be used to reduce the proportion of short-term public debt and to limit foreign exchange exposure. As a rule, the federal government does not borrow in foreign currencies (other than occasionally in U.S. dollars to replenish official reserves), and it sees considerable merit in the so-called "Dooley rule", under which countries borrow long and in domestic currencies to reduce capital risk.

In the long term, a country's reliance on capital flows and its vulnerability to reversals of such flows, can be reduced by encouraging domestic savings. This can be achieved by reducing government deficits and maintaining low and stable inflation.

Finally, financial sector stability has also been of critical importance. The depth and breadth of Canada's financial markets has allowed it to weather periods of significant market turbulence. As a result, Canada would encourage other countries to put considerable emphasis on strengthening the regulatory framework in the financial sector.

4 Ghana

Background

The period before 1983 witnessed a considerable decline in Ghana's economy: it registered negative growth rates; its industrial infrastructure was heavily run down; and there was scarcity of foreign exchange needed to import necessary equipment, plant and machinery and industrial inputs, and low capacity utilisation of most industries.

All this culminated in the launching of Ghana's Economic Recovery Programme (ERP) in 1983, which sought, among other things, to reverse the negative growth of the economy and to correct the imbalances and the rigidities which contributed to the poor performance of the economy during that period. Sixteen years after the ERP, Ghana has witnessed an overhauled and a stable macro-economic environment, an improved monetary and fiscal regime, a reasonable investment climate and an infusion of discipline into the national economy.

Ghana has made significant progress since 1983 in pursuing sound macro-economic policies. Through a structural adjustment programme, it has altered relative prices to favour efficient production, liberalised the market, and focused public investment on improving physical, economic and social infrastructure. The economy has grown at an average rate of 5 per cent per annum during the last nine years.

However, the improvement so far registered has been largely due to an increase in public sector investment. Private investment has risen only modestly, except in the mining sector where between 1985 and 1996 the country attracted a total capital of about US$1.8 billion.

Measures to Encourage Investment

To encourage the inflow of investment capital into the other sectors of the economy, in the early 1990s the Government undertook a number of bold measures. Among these measures was the setting up in 1991 of the Private Sector Advisory Group (PSAG) to review all laws as well as institutional and administrative procedures which affected business and capital inflow into the country.

PSAG made far-reaching recommendations which were accepted by the Government. These included the repeal of a number of Price

Control Laws, the Wealth Tax Law, and the Manufacturing Industries Act, 1971, which has made it obligatory for industrial concerns to obtain industrial licences before commencing manufacturing. The recommendations of the PSAG sought to ensure that laws and administrative procedures were more supportive of the private sector and business activity as well as making them consistent with the liberalising and deregulating thrust of Government economic policy reform.

The PSAG also recommended the repeal of the Ghana Investment Law, 1985, PNDC Law 116 and worked towards the promulgation of the Ghana Investment Promotion Centre Act, 1994, Act 478. The Act introduced a fundamental change in the administration of investments in Ghana. Act 478, unlike PNDC Law 116, was promotional, rather than regulation oriented. Approvals of investments (except in mining and petroleum) are no longer required. Instead investments are registered and a Certificate of Registration issued which gives official recognition to such investments. The Act makes the grant of incentives and other benefits automatic and transparent and reduces the waiting period for which an investor could get a certificate from several months to, at most, five working days. Act 478 also provides equal treatment to both foreign and domestic investors.

The new Code provided the legal basis for the restructuring of the regulation-oriented investment authority (The Ghana Investment Centre) into a promotional-oriented Investment Centre (Ghana Investment Promotional Centre (GIPC)). This has enabled the GIPC to undertake more investment promotional missions both within the country and abroad, which, in some instances, were led by the President and the Vice-President.

The promulgation of Act 478 and the investment promotional missions have resulted not only in increased foreign investor interest in the country but also in a considerable increase in the inflow of foreign direct investment into the country. For example, the Ghana Investment Promotion Centre recorded 56 projects in the first quarter of 1997 as compared with 27 and 36 in the same period of 1995 and 1996 respectively. Estimated total investments in the first quarter of 1997 was US$286.25mn compared with corresponding investments of US$32.76mn and US$29.7mn in the first quarters of 1995 and 1996 respectively.

The significant increase in registered projects during the first quarter of 1997 is an indication of the positive impact of investment promotion activities being undertaken by the GIPC. The promotional activities have also been helped by generous investment incentives, which include automatic exemption on customs duties on all plant, equipment and machinery imported for investment activities, automatic immigrant quota in proportion to value of investments and competitive tax holidays. Other measures that have helped include mere registration as opposed to approval of investments, reduced entry and establishment requirements, an improved investor friendly service, increased guarantee of safety of investments by the 1992 Constitution and Act 478, the continuing improvement of the industrial infrastructure and the political stability currently enjoyed by the country.

Ghana Stock Exchange and Portfolio Investment

Before 1991 when the Ghana Stock Exchange (GSE) was established, inflows of portfolio investment into the country were almost nonexistent. However, since 1991 and especially 1993 (when the Bank of Ghana permitted foreign portfolio investors to acquire shares of domestic companies traded on the GSE without prior approval by the Central Bank), there has been a dramatic increase in the volume of portfolio investment by foreign investors. Individual foreign portfolio investors are individually permitted to own not more than 10 per cent in any single company and cumulatively not more than 74 per cent of the total shareholding of any single local company. There has been a demand for legislative changes to enable foreign portfolio investors to own as much as 100 per cent of the shareholdings of any Ghanaian company listed on the Stock Exchange. However, in view of the impact of possible massive capital surges by portfolio investors on the economy, the review of this issue is proceeding with caution.

To help sustain the inflow of portfolio investments into the country, the Government in 1991 exempted investors from paying capital gains tax on all securities traded on the GSE for a period of five years. This exemption was renewed for another 5 years after its expiry in 1996. In addition, withholding tax on dividends on shares traded on the exchange was recently reduced to 10 per cent. Furthermore, the management and administration of the Ghana Stock Exchange has been improved, and a Securities Commission is being established to help perform the delicate balancing function of developing the young securities industry and regulating it in order to protect the interest of investors and thus maintain public confidence in the industry.

Other Factors

Privatisation of State-Owned Enterprises (SOEs) has also been a source of foreign capital inflow into the country. After the initial difficulties, improved and considerably transparent management of the Divestiture Programme has resulted in increased attraction of both foreign and domestic capital to the SOEs. Capital receipts from this source are transient and will end with the completion of the sale of earmarked SOEs.

Financial sector reforms have also been undertaken under the Financial Sector Adjustment Programme. Under the Programme, foreign exchange transactions have been liberalised, credit allocation and interest rate determination processes have been fully deregulated and the quality of financial services and their delivery improved. Seven banks were restructured with some non-performing assets transferred to a newly created government policy agency, the Non Performing Assets Recovery Trust. The legal and regulatory framework within the financial sector has been improved and a number of private banks, discount houses, leasing companies and brokerage firms have also been established. Two major state-owned banks have been privatised which attracted both domestic and foreign capital.

The Government has also concluded Double Taxation Treaties and Investment Promotion and Protection Agreements with a number of capital exporting countries, which for investors from these countries, provide additional protection. Ghana has also acceded to the Convention establishing the Multilateral Investment Guarantee Agency which provides insurance against breach of contract, political risk and non-repatriation of capital.

To sustain and increase the level of capital inflow, Ghana has persisted to achieve a stable macroeconomic environment. This has included a relentless war against inflation. The annual inflation rate which was about 200 per cent in 1983, when the ERP was commenced, was steadily brought down over the years to 18.0 per cent in 1991 and 10.0 per cent in 1992. Unfortunately, the slippages of late 1992 led to a surge in inflation rising to an end of year rate of 70.8 per cent in 1993. This was again brought down to 32.7 per cent at the end of 1996, and is projected to be reduced further to 20 per cent by the end of 1997.

Ghana has also liberalised its foreign exchange regime. This liberalisation has been anchored in Act 478 which guarantees the unconditional and free transferability of invisible capital, profit and dividends of investors. Similarly, the liberalisation of the exchange rate determination which ended the over valuation of the local currency resulted in increased private transfers from abroad to Ghana. Between 1992 and 1995 private unrequited transfer by non-resident Ghanaians and others constituted the third highest foreign exchange earnings after gold and cocoa. A liberalised exchange rate policy is being pursued with the Central Bank intervening only when necessary.

Another problem which Government has had to deal with is the country's debt burden. During the mid 1980s almost a total of about US$600 million representing short term commercial loans was paid off, and Government has since then been very consistent with its debt repayment obligations and has succeeded in reducing its debt service ratio from between 47.8 and 64.0 per cent between 1968 and 1989 to 26.7 per cent in 1996.

The Government has also declared the country as a free zone area and is establishing export processing zones in Tema and Takoradi for a start.

In addition, the Government has developed the Ghana Trade and Investment Gateway Programme. This Programme seeks to make Ghana the gateway for trade and investment to West Africa. In furtherance of this, the country's two ports have been declared as free ports and the international airport has declared a liberalised open sky policy. All these policies are anchored in a much bigger programme dubbed Vision 2020 which seeks to transform Ghana into a middle-income country by the year 2020.

Conclusion

The current considerable inflow of capital into Ghana has been made possible by investor friendly laws, policies and attitudes, promotional and protective laws, stable macroeconomic environment, liberalised foreign exchange and political stability.

5 India

Background

India entered the nineties with large internal and external financial imbalances which were exacerbated by the Gulf crisis of August 1990. Given the large current account deficit and the consequent need to finance it through large scale external borrowing, it was imperative to restore international confidence. The balance of payments crisis was thus the main trigger for economic reforms in India, which was long overdue. A national consensus emerged around the need for economic reforms, recognising within it the importance of external private capital inflows.

The broad approach to reform in the external sector was laid out in the Report of the High Level Committee on Balance of Payments (Chairman, Dr. C. Ranagarajan). It recommended, inter alia, liberalisation of current account transactions leading to current account convertibility, compositional shift in capital flows away from debt to non-debt creating flows and away from short term debt; regulation of external commercial borrowings, gradual liberalisation of outflows and disintermediation of Government in the flow of external assistance. The Committee also recommended the introduction of a market-determined exchange rate regime and discontinuance of the practice of extending exchange guarantee by the Reserve Bank of India and Government.

Emerging Importance of Private Capital Flows

The stance of policy is reflected in the predominant role assumed by foreign investment in India's external financing requirement during the nineties, with its share rising from barely 1 per cent in 1990-91 to a little over 50 per cent in 1995-96. Foreign direct investment (FDI) has emerged as the most significant vehicle of private capital, rising from US$ 150 million in 1991-92 to US$ 2.1 billion in 1995-96. Data for 1996-97 indicate that FDI flows at US$ 2.7 billion could well exceed the level recorded in the preceding years. Since 1992-93, most of the direct investment has come from USA followed by UK, Japan and Germany. Direct utilities and investment has mainly been garnered by engineering industries, financial services sector, electronics/electrical equipment, chemical/allied products, and food and dairy products. The proportion of direct foreign investment into India, however, is small at around 3 per cent of the overall FDI flows to developing countries during 1996.

Portfolio investment has registered a quantum jump in recent years. Indian corporates have been permitted to raise funds abroad through Global Depository Receipts (GDRs) and convertible bonds/floating rate notes. Offshore funds have been launched and made open-ended. Foreign institutional investors (FIIs) have been allowed to participate actively in the Indian stock markets. The inflows into India arising from GDRs were of the order of US$ 1,602 million and US$ 1,839 million during 1993-94 and 1994-95 respectively. While GDR inflows at US$ 149 million were somewhat subdued in 1995-96, they have picked up again during 1996-97 to US$ 920 million up to December 1996. Portfolio investment flows on account of FIIs has averaged around US$1.7 billion during 1993-94 to 1995-96. The total FII inflows during 1996-97 were US$ 1.9 billion. The dimension of these flows should be assessed in the light of the overall slump in global portfolio flows to developing countries witnessed during 1994-1995.

In the aftermath of the payments crisis of 1990, the approach to external commercial borrowings has been one of prudence, with self-imposed ceilings on commitments and a careful monitoring of the cost of raising funds as well as the end use thereof. In the recent period, in response to the augmented needs for external finance of the industrial sector, a sequential deregulation in recourse to commercial credits, both short-term and long-term, is underway. Accordingly, disbursements of commercial borrowings which had declined to US $ 1.1 billion in 1992-93 rose to nearly US$ 4 billion in 1995-96 and are expected to maintain the same level in the current year. Further, while before reforms, most of external commercial borrowings, including short-term, were on account of public sector, there is a significant shift in favour of the private sector in the nineties.

With a view to creating a congenial environment for private capital flows, sweeping liberalisation has been effected since 1991 in the areas of trade, industry and foreign investment. The guiding principles underlying the policy approach is the progressive removal of quantitative restrictions, greater space for foreign enterprise with a level playing field and the provision of incentives to channel capital flows into productive sectors. Under trade policy, there has been a virtual elimination of licensing, a progressive shift of restricted items of imports to Open General Licence (OGL) and lowering of tariff barriers. Industrial policy has been characterised by delicensing, removal of monopoly clauses defining large industrial houses and removal of reservations for public sector enterprises. Rapid transformation of the economy in terms of growing integration with the global economy needs a sound financial sector. The reforms in this area are guided by three specific objectives - competitive efficiency, functional autonomy and accountability. Alongside the deregulation of the banking industry including free entry for private sector banks, the thrust of monetary policy has been towards the reduction of reserve requirements, deregulation of interest rates and widening and deepening of financial markets. Simultaneously, measures have been undertaken to strengthen the institutional framework in banking, non-banking financial companies, financial institutions and stock markets through prudential norms, capital adequacy stipulations, improvements in payments and settlement mechanisms, strengthening of the supervisory framework, and institutional measures including recapitalisation.

The stance of exchange rate policy is to ensure that exchange rate movements are in alignment with macroeconomic fundamentals. External payment restrictions have been liberalised with convertibility on the current account under the obligations of Article VIII of the IMF's Articles of Agreement. Convertibility has been extended to several items of the capital account such as foreign investment, non-resident deposits and commercial borrowings. In pursuance of the commitment made by the Union Finance Minister in his Union Budget speech for 1997-98, the Reserve Bank of India appointed a Committee on Capital Account Convertibility (CAC). The Committee, which submitted its Report in May 1997, has made sweeping recommendations regarding the preparation of the economy for CAC. It has recommended a three year time frame for institution of CAC with the strength of present macro conditions warranting implementation of measures of the first phase, i.e., in 1997-98. Drawing from international experience and assessment of the country specific situation, the Committee has recommended important pre-conditions to CAC and set out a road map sequencing the move to CAC. With a view to modernising the regulations governing foreign exchange transactions to reflect the integration of the Indian economy globally, efforts are on to replace the existing Foreign Exchange Regulation Act by a more flexible Foreign Exchange Management Act.

The broad approach to targeting of foreign direct investment is through a dual route and through varying percentages of foreign ownership in different sectors. Activities and extent of ownership in different sectors are listed where the approval is automatic while in regard to the rest, a case by case approval by a high powered Board is adopted. Portfolio investments are restricted to select players viz. Foreign Institutional Investors (FIIs), non-resident Indians/overseas corporate bodies (OCBs). They could, subject to some restrictions, operate in equity or debt markets. FIIs are permitted to invest in equity subject to ceilings of 10 per cent for individual FIIs in a single company and 30 per cent collective investment ceiling in a single company FIIs are also allowed to invest in dated government securities.. Indian corporates are permitted, again through a process of approval of individual cases satisfying general guidelines, to access funds through Global Depository Receipts and Euroconvertibles. External commercial borrowings are also subject to a 'dual route' viz., automatic and case by case approval, based on the size and sector. An overall ceiling is kept for such flows - both for short term and medium to long term. The overall ceiling, however, does not, apply to borrowings with maturities above 10 years. In respect of NRI deposits, control over inflows is exercised through specification of interest rates for deposits in schemes. Different reserve requirements are also stipulated for encouraging or discouraging such flows. A 'dual route' is followed in respect of private capital outflows.

The general approach has been to have a 'mix' of what could be considered volatile and those that are less volatile, a mix of automaticity and selectivity through 'dual route', and a process of gradual, virtually year-to-year liberalisation within this approach, responding to experience gained and the capital flows relative to current account deficits.

Managing Capital Flows

Since 1993, India has had to contend with surges in capital flows. In general the short-term response has taken the following forms:

- raising of reserve requirements;
- reviewing the pace of removal of restrictions on capital inflows, or relaxation of end-use specifications;
- liberalisation of capital outflows;
- partial sterilisation through open market operations;
- deepening the foreign exchange market; by routing an increased volume of transactions through the market, and
- providing momentum to liberalisation of imports and shifting of policy emphasis to enhancement of absorptive capacity.

In 1995-96, over-valuation of the Rupee and subsequent correction through a phase of volatility and misalignment exposed the Indian economy to the dangers of exchange market turbulence and the bandwagon effects of speculative activity. These developments have served to underscore the crucial importance of sound and credible macroeconomic policies.

6 Jamaica

Introduction

The structure of capital flows to the Jamaican economy has undergone major changes over the past 20 years. It can be divided into two broad periods. First, the economic adjustment period where official capital flows dominated and second, the adjustment and post-adjustment periods where private capital flows began to dominate capital inflows. These changes have brought both benefits and challenges to the management of the economy.

Economic Adjustment Period

Beginning in 1974, the Jamaican economy entered a period of decline following the first oil price shock. For an open dependent economy with merchandise imports equivalent to some 60 per cent of GDP and exports of goods and tourism at some 55 per cent of GDP, the oil price effect was severe. The change in the external circumstances occurred against the background of an intensification of inward-looking import-substitution policies, and an increase in government regulations and the ownership of production and commercial activities. By the late 1970s, there were clear signs of disequilibrium in the economy, with the major economic indicators deteriorating.

Against this background, the authorities embarked on programmes of structural adjustment in co-operation with the multilateral institutions beginning 1977 which continued throughout the 1980s and the last Extended Fund Agreement with the International Monetary Fund ended in 1996. During the early years of the adjustment programme, the economy mainly benefited from official capital inflows from multilateral and bilateral sources. The Adjustment Loans involved reforms in several areas including inter alia: trade and exchange regime (including the abolition of exchange controls in 1991) and monetary and public sector reform including an aggressive privatisation programme.

Summary Out-turn of Economic Adjustment Programme

After a less than spectacular out-turn for several years, the adjustment programme is now reaping success with the major economic indicators pointing in the correct direction as is evident from the following:

- the net international reserves of the Bank of Jamaica have improved steadily moving from a negative US$ 375.0 mn in March 1988, to around $700mn at the end of January 1997, exceeding the targeted 16 weeks of imports;
- the external current account has improved steadily - from a negative 11.2 per cent of GDP in 1985 to a positive 1.4 per cent in 1993 and balance in 1994; there was a small deficit in 1995;
- the external debt of the public sector, which grew steadily from US$ 1.7 bn in 1980 to US$4.0 bn in 1989, has fallen to US$3.5 bn at the end of 1995;
- the debt service ratio has improved continually since 1985 from 39.7 per cent to 19.4 per cent at the end of 1995;
- the unemployment rate has declined from 25.0 per cent in 1985 to 16.8 per cent;
- inflation, which averaged 16.3 per cent in the period 1985-90, peaked in 1991 at 80.2 per cent but decelerated steadily and for the current fiscal year, is projected at 10.0 per cent; and
- the overall public sector deficit which averaged 17 per cent of GDP for the period 1980-84 (including the operations of the Central

Bank) improved steadily to a positive 2.2 per cent in 1992, 1.5 per cent in 1993, 4.8 per cent in 1994, and 3.0 per cent in 1995.

While in general the indicators have been positive, growth has been weak, averaging less than 2.0 per cent over the period 1989-95. Contributing to this relatively low growth has been a very high interest rate regime which has been used as a principal tool, along with the fiscal discipline and a flexible exchange rate regime, to bring the necessary adjustment to the economy.

Capital Flows Out-turn

The combination of the abolition of exchange controls, the high interest rate regime and the favourable economic indicators have contributed to the change in the composition of capital inflows. Starting in 1990, private capital inflows have surpassed official capital flows. Whereas in the period 1986 to 1989, official capital inflows averaged US$570.5 mn. annually, and had an average contribution of 69.0 per cent annually to total capital inflows, from 1990 to 1995 private capital flows have averaged US$719.8 mn annually with an annual average contribution to capital flows of some 67.9 per cent. In the last year for which data (1995) are available, private capital flows reached US$1.1 bn or 82.9 per cent of total capital inflows. As for composition of flows, during 1990 - 95, short term flows have dominated, averaging US$406.6 mn or 55.9 per cent of the total.

Benefits from Private Capital Flows

Jamaica has derived several benefits from the private capital inflows. Apart from supplementing domestic savings, the strong improvement in the reserves has facilitated a "graduation" from the IMF type adjustment lending; strengthened the hands of the authorities in negotiating loans with the multilateral financial institutions; and increased the ability of the authorities to intervene in the foreign exchange market to offset speculative tendencies and to smooth exchange rate movements.

Incentives

The Government has largely maintained the various incentives offered to many sectors (e.g. manufacturing, agriculture, mining, motion picture, tourism) during the adjustment period. The incentives are by way of exemption from income tax and import duties and, in some cases, capital allowances. While there has been some capital inflow based on the incentives offered, especially in the garments sector, it is difficult to estimate the amounts, as, with the removal of exchange controls, there is not yet in place an adequate reporting system for disaggregating these flows.

Industrial Policy

The Government in 1996 put together an appropriate framework to enhance economic development within the context of a National Industrial Policy. The policy is designed to deal systematically with the challenges of the present, and the 21st Century, especially to compete internationally in all areas including attracting capital.

Central to the industrial policy, has been the identification of five major clusters or sector groups which offer great potential for significant long-term expansion: services -tourism, entertainment and sports; services and technology - shipping and berthing, telecommunications, information technology; agriculture and manufacturing agro-processing, fresh fibres, horticulture and marine products; manufacture - apparel, other light manufacturing; and minerals - caustic soda, chemicals and ceramics.

The industrial policy framework therefore provides a clear signal to the priority growth areas for both local and international investors. So as to provide fast track implementation and remove bureaucratic delays, a Development Council headed by the Prime Minister and all the key sector Ministers has been established so that critical decisions can be made quickly. Because this is a new policy thrust established only in the past year, it is too early to measure the impact.

The Government intends to expand the incentives in areas consistent with the industrial policy objectives.

Lessons from the Recent Jamaican Experience

Perhaps the most important lesson learnt since the 1970s has been the need for macro-economic stability, which should include exchange market stability, adequate international reserves, low inflation, competitive interest rates and transparent and predictable policies, to promote confidence and create an environment conducive to enhance private flows. These objectives cannot be achieved without the proper mix of policies especially in the monetary, fiscal and exchange rate areas.

Jamaica has been fortunate to date that the private capital flows have not proven to be as volatile as that experienced by other countries. At all times, the Central Bank has enquired of financial institutions the sources of foreign exchange, and to a great extent the short-term flows, though significant, have not been volatile. The Jamaican Government has had to actively use a combination of monetary and fiscal policies not to permit a significant appreciation of the exchange rate which would erode the competitiveness of its exports, as Jamaica's inflation is still higher than that of its trading partners.

The cost of sterilisation has been a constraint on the fiscal budget and more specifically the non-availability of resources to finance government's capital projects which are essential to foster private sector led growth. The monetary and fiscal policies and the related interest rate cost have contributed to a significant increase in the domestic debt. It has increased from J$6.8 bn at the end of 1981/82 fiscal year to J$7.6 bn at the end of the 1995/96 fiscal year, with most of the increase taking place in the 1991/92 to 1995/96 period.

The management of capital inflows is critical to earning the confidence of international investors in the medium- to long-term prospects of the economy. A key challenge is to encourage and entice savings into longer term domestic debt instruments and into domestic equity instruments that would allow the economy to utilise it in its medium-term planning.

Jamaica, following graduation from the IMF, is about to access funds from the international capital markets, which will provide the government with greater flexibility in carrying out its economic reforms and programme. There are two critical factors working in Jamaica's favour.

- First, Jamaica is now reaping the fruit of a complementary fiscal and monetary policy, with inflation at its lowest point since the last quarter of 1989, and interest rates are now firmly following a credible downward path. The attaining of the inflation objective should strengthen the case for a Social Partnership which will serve to promote industrial peace. Many projects, in addition, will now become more attractive given the reduction in the cost of capital.
- Second, the general slow-down in economic activity and the corresponding decline in inflation and market rates in industrial economies should make portfolio investments in developing countries like Jamaica, more attractive. It is expected that increasingly private sector firms, especially those in the export sector, will be approaching the international capital market. One firm has recently obtained US$75.0 mn by way of a bond issue and more firms are expected to follow. This will, also require the attention of the authorities to minimise any possible harmful effects to its economic policies via exchange rate appreciation.

The Challenges Ahead

The challenges Jamaica face are multifaceted:

- make the transition to higher growth levels in the context of low inflation;
- continue to implement improvements in the monitoring and the regulation of the financial system which would serve to improve financial intermediation;

- mobilisation of domestic savings, including most importantly, reform of pension system;
- the management of capital inflows in a manner that will reduce the heavy cost on the fiscal budget by way of sterilisation;
- improve the data on capital inflows which would also assist in developing policies; and
- develop a simple investment code.

7 Malaysia

Background

Being an open economy with relatively liberal exchange control regime, Malaysia has been exposed to the phenomenon of international capital flows since its formation. However, the pattern and the magnitude of these flows have changed significantly in recent years and so are the benefits and risks. Prior to 1987, official long-term capital inflows in the form of borrowing was dominant as a source of financing capital formation particularly for infrastructure development. However, recourse to official long-term borrowing had exposed the nation to substantial debt-servicing problems and risks associated with fluctuations in exchange rate and interest rates. Consequently, voluntary structural adjustment measures were taken by the Government in the mid-1980s to reduce the exposure of the economy to external debt as well as to address the twin deficits of the current account of the balance of payments and Government's financial position. These adjustment measures, among others, entailed in the reduction of the role of Government and the provision of a more liberal environment for the private sector to assume the role as the engine of growth for the economy. Prudent fiscal management through stringent control on public consumption expenditure has generated substantial savings in Government operation in recent years that has allowed Malaysia to reduce its dependence on external borrowing with its accompanying pressures on the balance of payments.

Foreign Direct Investment

Since the mid-1980s, Malaysia has been able to attract substantial foreign direct investment (FDI). Gross FDI increased by 18 times from RM 1 billion in 1987 to an estimated RM 18 billion in 1996. Factors that have contributed to this increase include:

- a strong, stable, well focused and purposeful political leadership, that has successfully managed broad based growth and the transition from an agriculture based economy to an industrial country;
- a relatively non-interventionist policy of economic management that is supportive of private sector initiatives, which include the concept of Malaysia Incorporated and privatisation programme;
- an open and market oriented economy;
- well educated, disciplined and trainable labour force;
- good infrastructure;
- liberal foreign exchange policy, which allows free repatriation of profits and dividends;
- attractive investment incentives such as reinvestment allowance and granting of pioneer status or investment tax allowance;
- investment guarantees to protect foreign investors against non-commercial risks such as nationalisation; and
- transparent public policies.

As a result of the substantial inflow of FDI particularly in the manufacturing sector, the productive base and the volume of international trade of the economy have expanded rapidly and this has enabled Malaysia to sustain high growth since 1988. FDI currently forms a third of Malaysia's private sector capital formation.

While Malaysia continues to welcome foreign investment, it is also aware that over- dependence on FDI has also its downside effects on the balance of payments, particularly in the form of substantial repatriation of profits and dividends. These investments also lead to significant increase in the imports of capital and intermediate goods by multinational companies from their country of origin, given their lack of linkages with domestic industries. In the light of this, Malaysia has introduced policy initiatives to encourage investment from domestic investors and, at the same time, persuade multinational companies to enhance their linkages with local small and medium-scale industries to bring about increased multiplier effects of their investments on the economy.

Short term Speculative Flows

A major concern of macroeconomic management recently was the substantial inflows of short-term speculative funds into Malaysia in late 1993 and early 1994. The sharp inflows were induced by interest rate differentials between Malaysia and foreign rates, market perception that Ringgit was undervalued as well as the buoyant stock market. As a result of these inflows, growth in money supply accelerated from 20 per cent to a peak of 48 per cent in February 1994. During this period, broader M3 increased by close to 30 per cent. Such monetary growth was considered undesirable as it could potentially generate price pressures and contribute to a deterioration in the current account of the balance of payments.

Against a background of high monetary growth and an environment of volatility in the money and foreign exchange markets, priority was given in the immediate term to restore financial stability, with the objective of first, providing a predictable and stable economic and financial environment for the private sector to operate their business and, second, ensuring monetary policy measures achieved the medium and long-term objectives that had been set.

In managing the massive inflows of short-term capital, Malaysia had considered three options.

- Allow the exchange rate to appreciate. This would reduce the need for sterilisation operations to offset the impact of the inflows on domestic liquidity. This approach seemed appealing, given that an appreciation in the exchange rate would require those inefficient industries that have benefited from undervalued exchange rate to improve their productivity or relocate abroad and thereby help to ease the tight labour market prevailing in the economy. However, from a practical point of view, consideration had to be given to the length of time needed for the economy to adjust in order to enhance its international competitiveness that could be eroded by currency appreciation and the potential destabilising effect it might have. In considering this option, it was important to ascertain the nature of these inflows. In particular, it would not be desirable to base long-term policy on trends that were very short-term in nature.
- Maintain relative stability in the exchange rates and allow international reserves to increase accordingly. In this situation, high monetary growth could result with the potential for increased domestic demand leading to overheating of the domestic economy. To contain the monetary growth, sterilisation operations by open market operations to absorb excess liquidity would be undertaken. Other traditional tools for this purpose include adjusting the statutory reserve requirement and requiring Government agencies to place their funds with the Central Bank as opposed to the banking sector.
- Directly contain the short-term capital flows through administrative measures. These measures, however, have not generally been well received by the market as they create uncertainty with respect to the framework in which the market operates. It was also seen as a step backward in an environment which was moving towards greater liberalisation and deregulation.

The monetary response Malaysia adopted to contain the sharp inflows of short-term funds in 1994 was a combination of the three approaches. As a result of these measures and assisted by rising international interest rates, monetary growth was significantly moderated. Inflation had slowed down towards the end of 1994 and continued to remain low since then, at less than 4 per cent per annum.

The lesson to be learnt from Malaysia's experience is that policies based on domestic considerations alone, such as maintaining relatively higher interest rates to contain inflation, cannot be sustained for any long period of time. Eventually, the market would make the adjustment, the consequence of which is usually increased volatility. In the case of using administrative measures to contain short-term capital inflows, they should be considered only for extreme situations and as a temporary intervention, given that these measures create distortions and uncertainties. The Malaysian experience also demonstrates the need to maintain strong economic fundamentals and sound macroeconomic policies backed by a strong reserve position, in order to reduce the vulnerability of countries to destabilising international developments, including capital flows.

8 Mauritius

Over the last few decades the economy of Mauritius has passed through several distinct stages. From being a monocrop economy, based on sugar, which accounted for over 75 per cent of its export earnings and for the bulk of its employment, the economy is now well diversified with the sugar sector falling in second place in terms of export earnings and employment. The country has now a strong export manufacturing sector, predominantly based on textiles and clothing, and a flourishing tourism sector. The financial services sector is fast becoming an important pillar of the economy.

Mauritius has an extremely open economy and private capital inflows have played a significant role in its economic development. During the 1970's and 1980's such inflows were in the form of direct investment in manufacturing and hotel industries. The package of incentives offered to investors under the Export Processing Zone (EPZ) scheme, included import of duty free raw material and capital goods, tax-free dividends and a ten-year tax holiday. Additional attractions were availability of cheap labour in Mauritius and duty free access to the EU. The EPZ sector attracted foreign investors from France, Netherlands, Germany, Singapore, Hong Kong and India. The growth in the EPZ was largely drive by the creation of joint venture companies. However, with the internationalisation of the Stock Exchange, portfolio investment has also started assuming importance. In 1996/97, it accounted for about 59 per cent of total private capital inflows as compared to 19 per cent in 1994/95.

In recent years the country has been confronted with a number of challenges. Domestic labour costs have been rising. The economy, moreover, has been confronted with an increasingly competitive international environment with real dangers of dilution of access to preferential markets. In view of these challenges, the policy emphasis has been to diversify into higher value-added activities, move up-market and modernise the economy. Efforts are also being pursued to improve productivity and the competitiveness of the economy. These require massive investments in modern technology as well as skills development programmes. However, domestic savings alone are not enough to finance the large investment requirements. Thus continued inflow of foreign capital assumes critical importance in sustaining the growth process.

Strategy to Attract Private Capital Flows

A multi-pronged strategy is being pursued with a view to attracting larger inflows of private capital. The various components of the approach are designed to maintain an investor and business-friendly environment and provide profitable investment and business opportunities. As part of this strategy we are also undertaking a wide-ranging reform of the financial sector. These are outlined in the following sections.

(a) Investment and Business-friendly Environment

Effective policies are being pursued to ensure sustained macroeconomic stability. Under the medium-term economic policy of Government, budget deficit is targeted to be reduced to 2 per cent of GDP and the annual rate of inflation to fall below 5 per cent.

Processing of investment proposals is being expedited in a transparent manner by minimising bureaucratic red-tape and delays.

Infrastructure is being expanded and modernised so that state-of-the-art infrastructure services in sectors such as telecommunications and transport are provided at competitive rates to the investors.

The grant of work and residence permits to foreign businesspersons/investors/and workers are being further streamlined to reduce administrative bottlenecks and delays. Government has agreed to introduce a Permanent Residence Scheme to attract investors.

The Double Taxation Avoidance Treaty (DTA) network is being expanded so as to tap business opportunities in the region especially within the Indian Ocean Rim - Association for Regional Co-operation countries. As to date, some 18 such treaties have been ratified. Mauritius is also signatory to Investment Promotion and Protection Agreements with China, Germany, Indonesia, Mozambique, Pakistan and UK with a view to enhance investor's confidence.

To facilitate trade, the processing of customs trade documents using EDI has been introduced and will be further enhanced with the full implementation of the Tradenet - a nation-wide EDI trade application. This will significantly reduce the administrative bottlenecks to trade.

The laws on copyright, trademark and patents are being amended to bring them in conformity with the international obligations on intellectual property rights.

(b) New Investment and Business Opportunities

Policy initiatives have been taken to further create profitable investment and business opportunities.

To meet the constantly rising infrastructure needs, recourse is being made available through private financing and direct involvement of the private sector in this area. Legislation for the implementation of Concession Projects has recently been enacted. This provides the legal framework for the execution of Build-Operate-Transfer (BOT) type projects. Major projects in inland transport, energy generation and construction through BOT schemes are planned for the next few years. Infrastructure development in the Freeport is already being implemented on this basis.

A comprehensive policy regarding privatisation of state-owned enterprises is being formulated. A White Paper on Privatisation and Workers' Participation has been released recently.

The increasing business and investment opportunities in the region, arising from membership of Mauritius in various regional organisations, the renewed international interest in the region and the promising prospects for the long awaited economic take-off of many African countries, are being actively pursued. A Special Economic Zone in Mozambique covering 100,000 hectares has been put at the disposal of Mauritius for investment and development purposes. Similar opportunities exist in Madagascar, Zanzibar and Zambia. A Regional Economic Zones Fund is being set-up to help the exploitation of such potential opportunities.

Freeport

In order to attract foreign enterprises to use Mauritius as a platform for trading with the African and Asian countries, a freeport has been established. This Freeport aims at positioning Mauritius as the regional warehousing, distribution and marketing centre as well as the main transhipment port for the Indian Ocean, Southern and Eastern African regions. Companies registered in this sector are primarily in trading, minor processing and assembling, and ship repairing and servicing activities.

The Freeport legislation provides for a liberal and comprehensive incentive package for companies looking for a cost effective storage, assembly and redistribution location. The Mauritius Freeport is rapidly gathering momentum. The total trade in value terms reached US$ 95 mn last year and is expected to be US$ 200 mn this year. Additional warehousing space of 40,000 sq. metres, most of which will be put up by private consortia, will be available by the end of the current year. An International Exhibition Centre will also be completed this year. This will enable Freeport operators to promote their products.

(c) Financial Sector Reforms

Financial sector reforms have also been in progress with the aim of further integrating Mauritius in the world financial system. These reforms are an integral part of the strategy to diversify and modernise the economy, make it more market-oriented and create an investment and business-friendly environment.

Stock Exchange

Mauritius has also given high priority to the development and modernisation of its Stock Exchange as part of its efforts to attract private capital flows from abroad.

The Stock Exchange of Mauritius (SEM) was established in July 1989 with significant opportunities for remunerative portfolio investment. There are currently 49 securities listed on the Official Market with a market capitalisation of around US$ 1.7 bn and price-earnings ratios which are attractive compared to the mature as well as many emerging markets. The Stock Exchange is being fast modernised, with the recent setting up of a computerised Central Depository System. Such a depository system is one of the first of its kind in the region. Mauritius is also in the process of modernising the legislation related to the securities market to revamp the regulatory and institutional framework governing the financial services sector.

There are no restrictions on foreign investment in Mauritius. Interest, dividends and capital gains on listed securities can be repatriated tax free from Mauritius. Since 1994, foreigners have been allowed to invest and trade freely in securities listed on the official market. This has resulted in increasing inflows of foreign capital.

In recent years, Government has opened to the public its shareholding in major state-owned enterprises such as Air Mauritius the national airline, and the State Bank of Mauritius, the second largest commercial bank, both of which are listed on the Stock Exchange. Part divestiture in other state-owned enterprises like the Cargo Handing Corporation and SICOM, the state-owned insurance company, is being undertaken in the context of the Port Louis Fund.

To encourage secondary listings on the stock exchange, it is envisaged that foreign companies, including offshore funds will pay only 50 per cent of the current listing fees. Furthermore, offshore companies will be allowed to invest in listed securities as well as in non-listed debentures.

Monetary Sector

The monetary sector has also undergone major reforms. The Bank of Mauritius has over a number of years removed quantitative control on bank credit to the private sector as well as selective credit control and interest rates. It has gradually shifted to a monetary policy that relies on market-based instruments. Interest rates have thus been fully liberalised.

Open-market operations began in November 1991 with the first issue of Treasury Bills. Since July 1994, the determination of the Bank Rate is linked to the Treasury Bill auction rate. The Bank of Mauritius now focuses on the control of bank liquidity through a reserve money programme. The overall stance of monetary policies is determined by a High-Level Monetary Policy Committee, comprising of very senior officers of the Ministry of Finance and the Bank of Mauritius.

Foreign Exchange and Payments System

Foreign exchange control has also been removed. This has been done in stages. In 1993, all current account transactions were fully liberalised. In the following year restrictions on capital account transactions, in respect of both inward and outward investment, were completely lifted.

Efforts are also actively being pursued by the central bank to modernise the payments and clearing systems. An electronic payments system with real time gross settlement for larger value transactions is currently under implementation.

Since July 1994, a foreign exchange market in US dollars has been established and the Bank of Mauritius intervenes in foreign exchange market by buying and selling US dollars. As regards management of foreign exchange, the policy of the Bank of Mauritius is to ensure that the value of rupee vis-à-vis major currencies reflects the macroeconomic fundamentals of the country.

In order to promote greater competition in the foreign exchange market, foreign exchange dealing licenses are also issued under the Foreign Exchange Dealers Act.

Offshore Sector

With a view to further increasing the number of foreign companies incorporated locally for carrying out financial activities in the region, regular promotional campaigns are carried out. Activities that can be conducted in the offshore sector include banking, insurance, funds management, international trading, international consultancy and financial services. Since the enactment of the Mauritius Offshore Business Activities Act five years ago, Mauritius has attracted a growing number of offshore entities. From only 813 in June 1994, the number of offshore businesses registered has soared to over 5,580 by the end of July 1997. There are currently some 120 investment funds promoted by leading international fund managers, with an asset base of about US$ 3.1 bn.

Conclusion

From our own experience in tapping foreign capital flows, the following lessons can be drawn:

(i) Both a sound macroeconomic environment and political stability are essential for attracting capital flows.

(ii) Consistency in economic policies is necessary for maintaining the credibility of the Government, thereby inspiring confidence among the investors.

(iii) For a small developing country, it may be more prudent to liberalise the economy gradually with proper sequencing and co-ordination among the different components of the reform programme.

(iv) Proper investment in human resource development is essential especially when a country is moving to a higher stage of economic development.

9 Pakistan

Pakistan was among the first South Asian countries to develop an open-door policy for foreign investment in the early sixties. Even in the early seventies, when banks and some key industries were nationalised, the units with foreign investments were not affected by the nationalisation policy. During the late seventies and eighties, a de-nationalisation policy was initiated and domestic foreign private sector was encouraged to invest in industry and infrastructure. In the late eighties, the ambitious Hubco Power Project, was conceived as the first and largest private sector power project in Asia. It opened the door to large scale investments from abroad.

In early 1991 Pakistan launched a programme of economic reforms. The thrust of the programme was on deregulation and liberalisation of the economy, privatisation of public enterprises, tariff and tax reforms and the development of infrastructure. It also focused on ambitious banking and financial sector reform. It envisaged the opening up of areas so far reserved for the public sector to the private sector. Under this programme, over 85 industrial units and two banks were privatised and a number of commercial and investment banks were set up in the private sector. Foreign exchange regulations were liberalised, and fiscal and other incentives extended to facilitate foreign direct and portfolio investment in the country. On the basis of these reforms, the capital account was virtually opened up and liberalised.

The present government assumed office in February 1997 and immediately launched a programme of economic revival aimed at restoring stability, accelerating economic growth and enhancing human development. This programme built on the reforms introduced in 1991.

On the fiscal front, the government has taken a number of steps to remove fiscal distortions, rationalise tariffs, reduce tax rates and broaden the tax base. Simultaneously, it has drastically contained government expenditures with a view to bringing down the budgetary deficit. These measures have been backed up by deeper banking and financial reforms which inter-alia provide laws for the quicker recovery of bank loans, improvement in public sector bank management and greater autonomy for the State Bank in conducting monetary policy and supervising the banking sector. They also envisage the privatisation of public sector banks and financial institutions. The capital market has been strengthened with the setting up of an autonomous Securities and Exchange Commission and the provision of an even playing field for public and private mutual funds. The Central Depository System has been put in place to facilitate portfolio investment.

The process of privatisation is being speeded up and public sector institutions in banking, finance, energy and transport and communications sectors have been offered for disinvestment. The Pakistan Telecommunications Corporation has been partly privatised and its management given in to the professional hands. The regulatory mechanism in key sectors, such as energy and communications is being strengthened by establishing regulatory authorities to protect the interests of consumers and small investors. The proceeds from privatisation have been earmarked for the retirement of debt.

In the last four years, Pakistan has attracted foreign investment worth $4 billion. The United States and the UK are the largest investors in Pakistan closely followed by Korea, Japan and Hong Kong. Investments have been flowing in the energy, oil, gas and communications sectors.

Pakistan has had difficulties in common with other developing countries relating to the volatility of portfolio investment. However, the situation has proved to be less volatile than was feared at one time. The privatisation process, now being geared up will help to bring in industry-related investments on a large scale. The implementation of the far reaching banking and financial reforms and steps taken for the development of capital market have helped in the stabilisation process, especially at a time of instability in the Far Eastern Financial Markets.

In the past four years economic growth in Pakistan slowed down to about 4 per cent per annum, compared with around 5.5 per cent in the last three decades. The reasons for the slowdown are being analysed: a preliminary view is that this is due to weak and inconsistent macroeconomic policies. The present policy thrust on the fiscal, financial and sectoral fronts is expected to revive GDP growth to the levels of previous decades and to promote export growth. Simultaneously, the environment for investment, domestic as well as foreign, is being improved.

10 South Africa

Before 1990 private capital flows to South Africa had been following developments in the political arena. The massive outflows prior to the political transition reflected partly the success of the pressure of sanctions against the country. This paper analyses private capital flows during the period 1990-1996. It examines the scale and composition of private capital flows; the cause of these flows; their sustainability; their macroeconomic impact; and the measures taken to cope with them.

Scale and Composition of Private Capital Flows

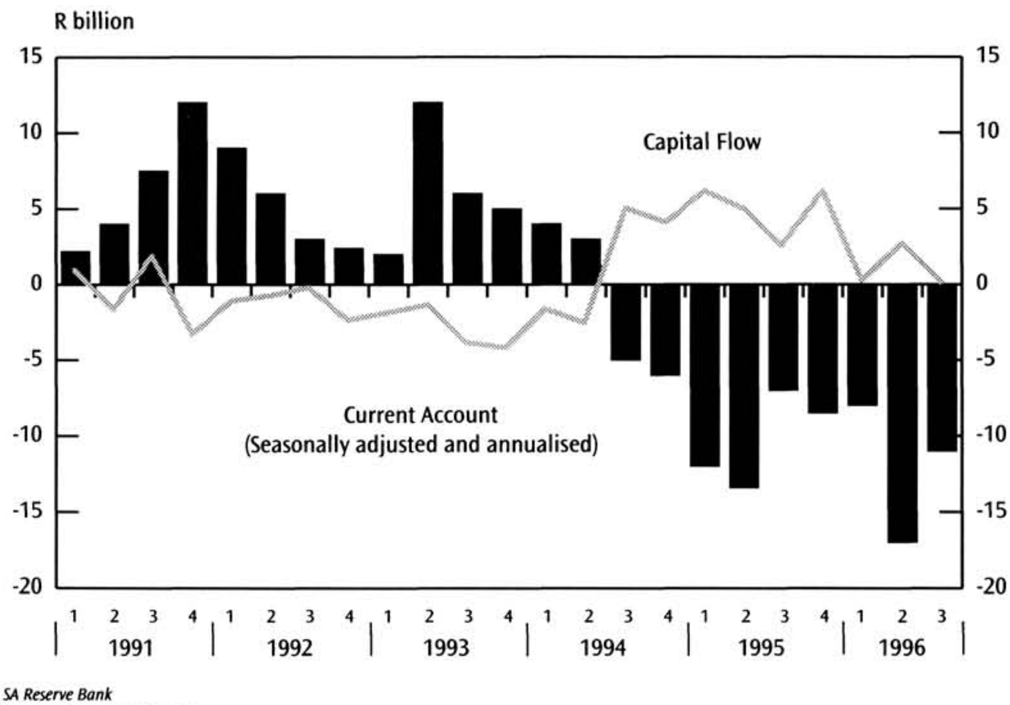
During the period 1990-93, South Africa experienced net capital outflows of some Rand 23-29 billion. Both long-term and short-term capital movements were negative. The biggest contributor to the outflows was chiefly the volatile structure of the capital flows. The capital outflows were financed mainly by running a current account surplus. However, from 1994 until the third quarter of 1996, South Africa experienced net capital inflows of Rand 26.2 billion, which was termed 'post apartheid dividends' (see Graph 1). During the first quarter of 1996, at the height of the inflow, the Rand appreciated against the basket of major currencies. In the first ten months of 1996, there was a net equity inflow of Rand 4.4 billion, with foreign purchases in the stock market of Rand 33.7 billion and net inflows of around Rand 2 billion in the bond market.

Causes of the Flows

No attempt has been made, econometrically, to pin down the cause of the inflows that South Africa experienced. The following, however, have been generally accepted as strong possible causes:

- Political reform: In the period 1990-93 South Africa was undergoing delicate political negotiations which led to uncertainty about the future of the country and investors were adopting a wait-and-see attitude. Once the transition to democracy was on course in 1994, massive capital inflows were experienced. These inflows were termed a "post apartheid dividend", as many investors who were initially wary started to invest in the country.

Graph 1 **Current Account and Net Capital Flow**



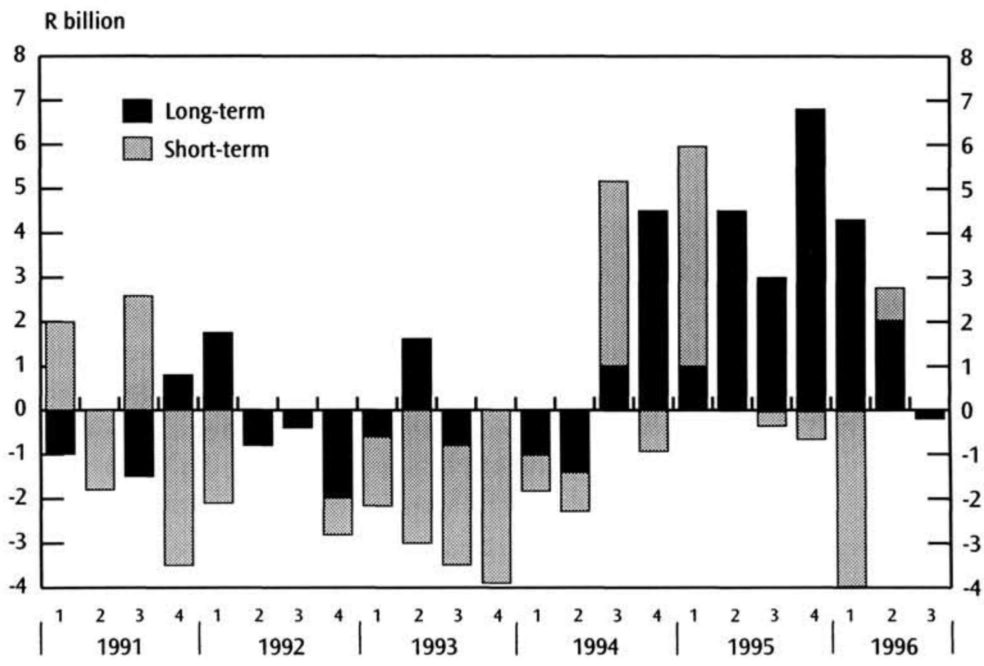
Source: SA Reserve Bank
Compiled by Department of Finance

- "Liberalisation" of the foreign exchange market: The abolition of the dual currency system in 1995 added to already positive investor sentiment about the country and capital inflows. A unified currency enabled foreign investors to invest freely in the bond and equity markets without the discrimination of a dual currency system. However, the benefits of a single currency brought with it new challenges, since the South African currency was exposed to volatile international capital flows.
- New borrowing opportunities for South African corporations: With a stable and even appreciating local currency and the re-entry of South Africa into the international arena, South African corporations and monetary institutions started borrowing off-shore, initially for short-term trade finance and money market lines and, subsequently, to raise capital through international equity placements.
- High positive real interest rates: The real interest rate differential between South Africa and its major trading partners attracted yield-hungry portfolio investors to the South African bond markets. South Africa even experienced a rise in non-resident bond deposits with domestic financial institutions.

Sustainability of the Flows

Graph 2 on capital movements indicates that whereas short-term capital flows were erratic and sometimes even negative, long-term capital flows remained positive between 1994 and the second quarter of 1996. This was because the Government continued to implement its macro-economic strategy, thereby creating an environment conducive to continued capital inflows in general, and foreign direct investment in particular. The sustainability of these flows is further demonstrated by the fact that even at the time of the Mexican crisis in 1994 and the

Graph 2 **Balance of Payments: Capital Movements**



Source: SA Reserve Bank
Compiled by Department of Finance

sharp decline of net capital flow in February 1996, the long-term capital flows remained positive.

Macroeconomic Impact

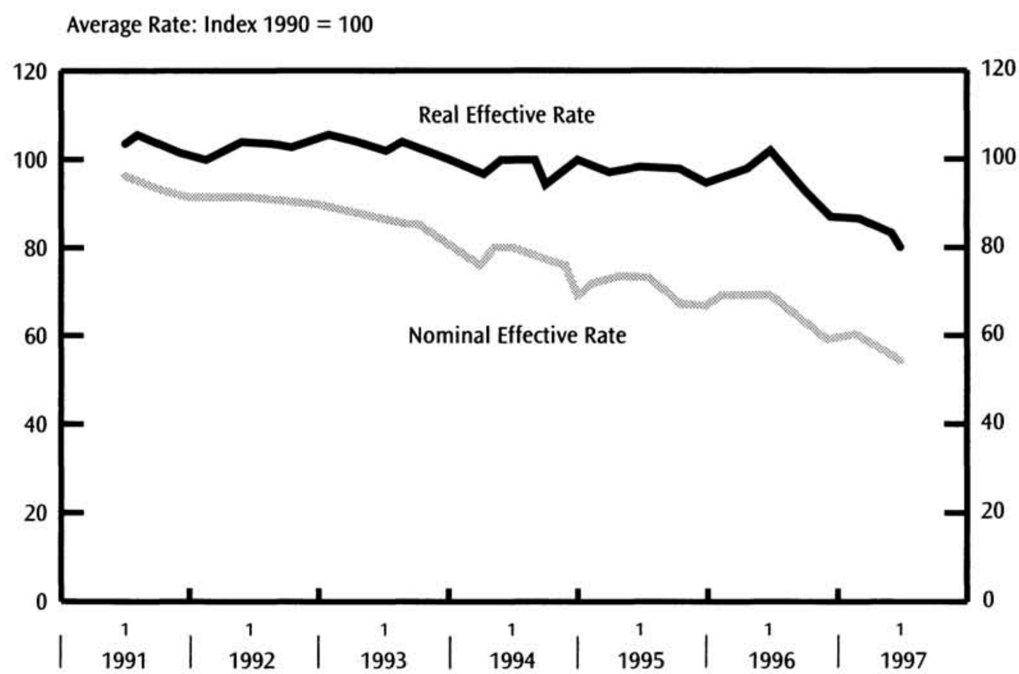
The inflows that South Africa experienced, though sustainable, brought with them new macroeconomic challenges. Given the existence of capital controls on residents, the capital inflows could not be countered by residents' outward investment. The inflows were bound to reflect themselves somewhere and this was in the effective exchange rate of the currency. Graph 3 shows that while the effective exchange rate was relatively stable for the best part of 1991-1995, it appreciated quite significantly in real terms upto the first month of 1996. This contributed to the deteriorating current account deficit. It was clear that a correction was bound to take place given the inflation differentials with South Africa's major trading partners. The correction took place on 14 February 1996 and unfortunately created a lot of uncertainty, contributing to negative investor sentiment and, ultimately, led to volatility in the foreign exchange market.

The positive impact of the capital inflows was that it enabled the South Africa Reserve Bank (SARB) to build-up its reserve level and reduce its net oversold position. Unfortunately, these valuable reserves were lost during the currency crisis as the short-term flows were being reversed. In the process of building-up the SARB's reserves, money supply and domestic credit expansion accelerated leading to inflationary fears, and thus necessitated counter-inflationary measures. Despite the depreciation of the nominal exchange rate, inflation is still low, due mainly to tariff reform.

Policy Measures and Lessons

The impact of the capital flows on key macroeconomic indicators necessitated the adoption of various policy measures to cope with the flows

Graph 3 **Effective Exchange Rate of the Rand**



Source: SA Reserve Bank
Compiled by Department of Finance

and influence their composition:

- Sterilised interventions: In the process of attempting to reduce the currency's appreciation, liquidity was created in the domestic money markets and, thus, the SARB had to undertake open market operations to sterilise the inflows.
- Capital account liberalisation: South African corporations were given permission to invest in SADC and other African countries. This contributed, to some extent, as an instrument to cope with the flows and influence their composition. Previous measures to extend the maturity of the flows by providing cheap forward cover, proved to be too costly to the Treasury and this is a route that other countries should not follow. The Growth Employment and Redistribution strategy (GEAR) intends to increase and extend the maturity of these flows by providing tax holidays to new and expanding investors, and through the restructuring of state owned enterprises. This strategy also creates an environment conducive to long-term investment by putting in place prudent fiscal and monetary policies.

Conclusion

From 1994 onwards, South Africa experienced massive capital inflows, composed mainly of short-term flows. Although short-term flows were reversed, long-term capital flows remained positive. The possible causes of these flows were: political transformation, abolishment of the dual currency system; re-entry of South Africa into the international arena; and positive real interest rates.

The capital inflows were sustainable and had an impact on key macroeconomic variables such as the current account deficit, reserves, money supply and the real effective exchange rate. The measures adopted to cope with the flows included sterilised intervention and relaxation of capital account controls; measures to attract flows included investment promotion measures and restructuring of state owned enterprises.

11 Uganda

Overview

In Uganda unrequited private transfers are the driving force behind recorded inflows. If private transfers are excluded from the picture, capital inflows are actually negative as of 1990, owing in part to IMF ESAF repayments. Most analysts in Uganda conjecture that private transfers translate relatively quickly into real investment, though the data constraints prevent precise quantification. Foreign Direct Investment inflows have been feeble, at about 0.1 per cent of GDP, while inflows of portfolio equity have been virtually non existent. On the other hand, private transfers have surged. Total private transfers for 1995/96 alone were nearly 90 per cent of the total recorded for the years 1990-93. Even though official FDI has been small, it is believed that a significant chunk of the large and increasing private transfers includes large amounts of FDI.

A number of related explanations can be posited for the rising level of inflows into Uganda.

- First, the performance of the Uganda economy over the last 9 years has undoubtedly increased investor confidence and thus acted as a major pull factor. The control and reduction of inflation has been a crucial achievement, made possible by the prudent monetary and fiscal policies Uganda has followed. Since 1987, the annual rate of growth of real GDP has been 6.5 per cent, it was 5.2 per cent per annum between 1987-1992, but since 1992, when macroeconomic stability took hold, growth has increased to 8.1 per cent per annum and in 1994/95 the rate was 10.7 per cent per annum. Also, before 1992 domestic financing of the budget was equivalent to an average of 1.2 per cent of GDP. Since then Government has generated fiscal savings of the order of 1.5 per cent of GDP per annum which had led to a massive build up of Government deposits in the Central Bank. This has built up public confidence in macroeconomic management and economic policy generally.

- Following dramatic deregulation of coffee marketing and the scrapping of surrender requirements for export earnings, there was not only a surge in coffee exports but foreign pre-financing of coffee procurement became significant. Inflows associated with financing coffee procurement were magnified by the boom in coffee prices on the world market in 1994/95.
- There have also been reductions of the debt stock as a proportion of GDP and an improvement in reserve cover in terms of months of imports. The country risk rating for Uganda has improved, though the contribution of reserve cover to this development cannot be quantified.
- Contrary to expectations of massive capital outflows, the policy of financial deregulation (especially the liberalisation of the exchange rate, the establishment in 1993 of the foreign exchange interbank market and Uganda's acceptance in 1994 of the obligations of Article VIII of the IMF Articles of Agreement, expressing its commitment to an open and free payments and exchange system) in fact led to a massive return of flight capital. The new Investment Code contains highly liberal provisions on repatriation of capital and dividends. Whilst Uganda has not yet formally implemented capital account liberalisation, one might speak of "de facto" liberalisation as many capital account transactions can be conducted through exchange bureaux. Capital account has been liberalised completely since 1st July 1997.
- High real interest rates which have prevailed over the last three years may also have contributed to increased inflows. Real interest rates swung spectacularly from minus 20 per cent in 1992 to plus 13 per cent in 1993, and have since averaged 13.5 per cent over the last two fiscal years, with peaks at 17 per cent. These high rates are a consequence of a reduction in inflation, but also persistent inefficiencies in what is still an underdeveloped banking sector. It is unclear as to the extent to which interest rate differentials are liable to attract capital into sub-Saharan Africa in general, given the risk premia attached by investors to the area as a whole.

Consequences, Problems and Policy Response

The sustainability of capital inflows has become an issue of concern over the last two years, particularly due to the transient nature and reversibility of non-FDI capital inflows and the drastic effect a reversal could have on domestic absorption and income. Data scarcity make the assessment of sustainability a difficult proposition. One crude indicator[1] policy makers in Uganda have suggested pursuing is to measure net liabilities (here defined as the current account deficit excluding private transfers) as a percentage of exports, with a benchmark of 200 per cent.

Due to the dearth of money market instruments, it has been problematic in Uganda to use sterlisation to deal with the monetary consequences of large capital inflows. As such, fiscal policy has had to bear the burden of adjustments required to maintain monetary stability, through reductions in planned or budgeted expenditure. This in turn has lead to lumpiness in the implementation of planned fiscal programmes, with real sector effects. Also the main instrument at the disposal of the Central Bank of Uganda is the government treasury bill, though this is now

1 It is crude primarily because it does not make fine-grained distinctions between different types of inflows.

complemented by the new Bank of Uganda Bill. The issuance of Treasury Bills for sterilisation purposes incurs a cost to government which could otherwise be avoided, given that the government is currently a net depositor with the banking system and has no real need to issue bills in order to meet its financing requirements. There is also the added danger that by increasing the yield on domestic paper, sterilisation policies might have the perverse effect of attracting further capital inflows.

Capital inflows are typically associated with an appreciating real exchange rate, though this is perhaps less of a problem where the nominal rate is freely floating. In the Ugandan case, the increase in inflows from abroad coincided with increased earnings from coffee exports following the 1994-95 boom in world market prices for coffee. The consequences for real exchange rate appreciation have been all the more pronounced, an appreciation of roughly 20 per cent being recorded over the fiscal year 1993/94. The overall appreciation to date from January 1992 is the order of 30 per cent.

The mechanics of Dutch Disease associated with increased inflows of foreign exchange were evidenced in a boom in the construction sector, which grew at 28.6 per cent in 1994/95 and 1995/96 respectively, compared to 12.4 per cent in 1993/94. However, it is not possible to state how much of this resulted from increased inflows and how much from the coffee boom.

One peculiar consequence of foreign inflows and their associated positive impact on reserves and the overall current account is that donors are led to question the rationale behind fast-disbursing balance of payments support and are thus motivated to switch funds to slower disbursing project support. This is liable to be problematic were inflows to be reversed, and would precipitate a swift drop in reserves and a foreign exchange crisis. This scenario has led some[2] to coin the word "Uganda Disease", to denote the possibly perverse effects of large capital inflows. Policy makers and donors should therefore avoid succumbing to misplaced feelings of euphoria, policy-makers remembering that there is no substitute to getting the fundamentals right, and donors remembering the fragile state of many economies such as that of Uganda, and avoiding jumping to hasty and over-optimistic conclusions.

The level of Foreign Direct Investment undertaken in Uganda is relatively feeble. This is attributed to the unfavourable political and incentive regimes that have prevailed in the past, the poor state of vertical and horizontal linkages and persistent inadequacies in infrastructure. Furthermore, while achieving macroeconomic stability is a necessary condition for attracting FDI, it is not in itself sufficient in influencing the locational decisions of investors. Overall country risk rating, as measured by Institutional Investor International, improved by 60 per cent over two years between 1994 to 1996, but remains very low by international standards. Efforts to attract FDI are undertaken by the Uganda Investment Authority, which is setting up offices in embassies in South Africa, USA and the UK. It has eight primary target sectors, though no individual firms have been targeted. The UIA was voted best Investment Agency in Africa in 1995 by the periodical *Corporate Location Magazine*. A further boost to FDI might come from the implementation of the Cross Border Initiative, which seeks to eliminate tariffs between Kenya, Tanzania and Uganda, and to rationalise external tariffs to within a 20-30 per cent band, and emphasises the importance of regional integration as well as reducing the anti export bias of trade tariffs.

12 United Kingdom

The UK has probably had more experience than most of uncomfortably large capital inflows and outflows, both in recent years and during the

2 L. Kasekende, D. Kitabire and M. Martin, amongst others

forty year period from 1939 to 1979 when formal exchange controls were in place:

- In 1976, for example, investors' concerns about the sustainability of domestic economic policies led to massive outflows of capital, and led to the UK's IMF programme.
- In 1977, with confidence in sterling restored, large reflows of funds into the UK generated upward pressure on the exchange rate, and pressure for weaker monetary policy.
- More recently in 1987 and 1988, large inflows again complicated macroeconomic management. Monetary policy was loosened by more than would have been warranted by developments in the domestic economy alone. But neither this, nor heavy intervention in the foreign exchange markets failed to prevent a sharp rise in sterling.

Exchange controls

At various points in recent years, the UK authorities have thought about countering inflows by re-introducing controls of various kinds. On each occasion, the authorities concluded that controls simply would not work. Capital controls were introduced in the UK over fifty years ago. The original unifying rationale behind them was to conserve foreign exchange and to assist the balance of payments. By 1979, exchange controls had only limited effectiveness. Investors could find ways around the controls. It was not possible to open up an interest rate differential between onshore and offshore sterling rates of any more than about 1.5 percentage points, on average.

The UK removed controls in 1979, over a very short period of time. Controls were relaxed in June and July 1979, and then abolished in October of that year. The decision was not taken with a view to influencing the exchange rate, but to remove some of the restrictions that had remained on investment decisions by UK residents, and so improve the functioning of the capital markets. As such, capital account liberalisation was only one element in a series of major structural economic reforms introduced at around the same time.

Exchange controls were removed at the outset of a very turbulent period for the UK economy. It is very difficult, therefore, to disentangle the precise effects of abolishing controls from other changes that were taking place:

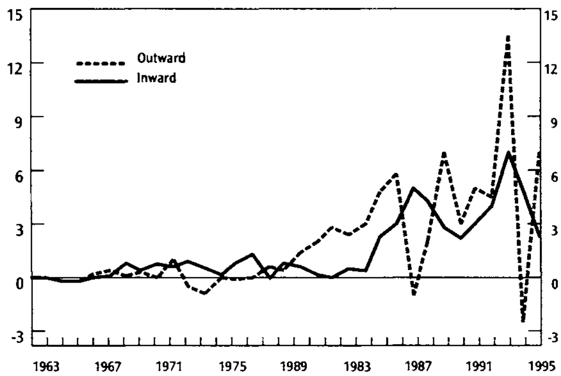
- Nominal interest rates rose sharply to 18 per cent, fiscal policy was tightened, and a new framework for monetary policy was established.
- The real exchange rate appreciated by almost 50 per cent in three years.
- The second oil price shock in 1979 coincided with the transition of the UK from net importer to net exporter of oil.

Although the exchange rate was very strong at the time, the effect of removing exchange controls in the short run was probably to push sterling lower than it would otherwise have been.

- Pension funds and other financial institutions invested more abroad: portfolio outflows rose from around £1 billion in 1978 to £4.5 billion in 1981 and over £7 billion in 1983.
- Direct investment was not affected, but its financing was.
- Foreign currency deposits held by residents rose from £5 billion at the end of September 1979 to £10 billion at the end of June 1981[3].
- Sterling lending abroad by UK banks rose from around £6 million a month in 1979 to around £300 million per month (following the end of the supplementary special deposits scheme) in 1981.

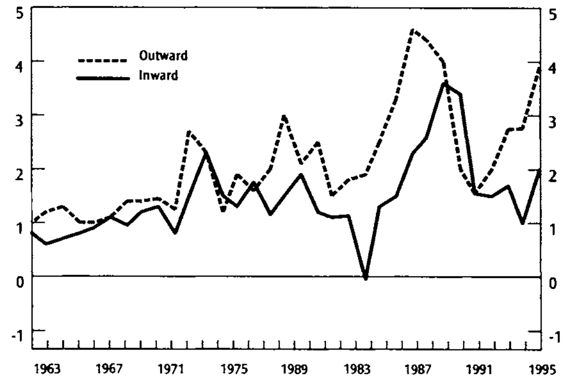
3 Source: Bank of England Quarterly Bulletin, September 1981

UK Portfolio Investment
% of GDP



Source: ONS

UK Direct Investment
% of GDP



Source: ONS

- There was an increase in inward investment, but net identified capital outflows (including net errors and omissions) moved from broad balance in 1979 to a net outflow of around £7 billion in 1981.

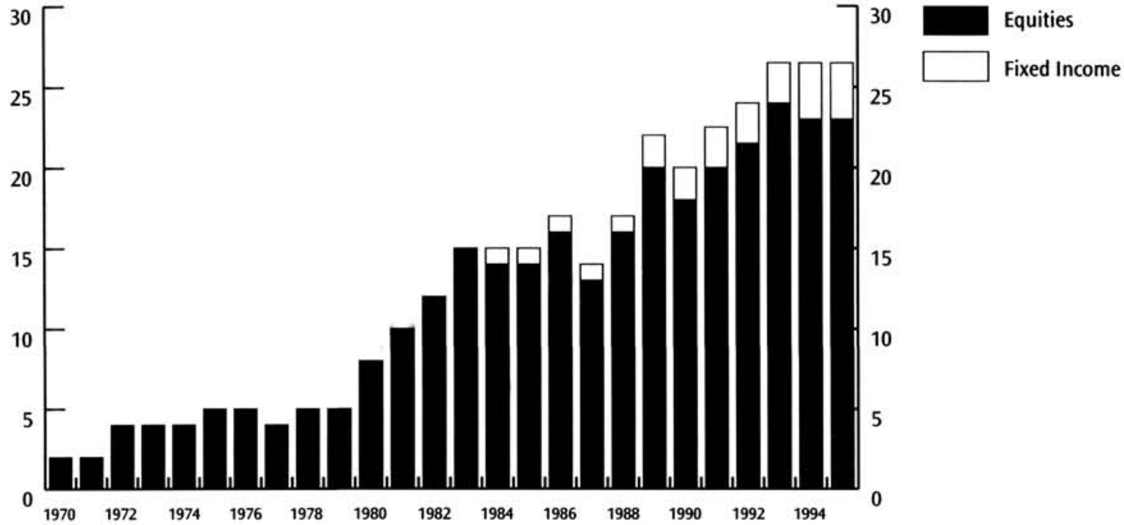
In the longer term, the impact will have been to strengthen the performance of the UK economy, and will have contributed to making the UK a more attractive place to invest. The removal of controls also led, inexorably, to the abolition of quantitative banking controls.

Eventually (in the late 1980s and 1990s), the UK experienced a huge increase in inward investment compared with the 1970s. The UK economy is exceptional, in comparison to other major economies, in the degree of both inward and outward investment that takes place. In relation to the size of the economy, the UK is, by some way, the largest overseas direct investor in the world - and second only to the US in absolute terms:

- The UK's direct and portfolio assets combined to almost £700 billion in 1995 - equivalent to nearly 100 per cent of GDP, more than any other G7 country.
- The stock of inward direct investment in the UK was around £150 billion in 1995 - by far the largest as a percentage of GDP than any other G7 country.
- Earnings (net of losses) on UK direct investments in 1995 were more than twice as great (£24 billion) as UK oil exports.
- Total earnings (net of losses) on direct and portfolio investment (£42 billion) were equivalent to more than 6 per cent of GDP in 1995. Allowing for revaluation effects, this rises to more than 12 per cent of GDP. To put this figure into context, earnings on visible exports were equivalent to about 22 per cent of GDP in 1995.
- Inward and outward flows of direct investment, as a percentage of GDP, are greater for the UK than for any other major economy.

The UK has benefited greatly from this inward and outward investment. Inward investment has led to domestic productivity improvements. Overseas companies have introduced new management and technological methods to UK firms. Greater competition has also prompted UK firms to respond in order to compete more successfully in both domestic and overseas markets. The clear benefits of the UK's involvement in international investment activity have created a relaxed attitude to foreign ownership within the UK. Recent estimates suggest that at least 35 per cent of total UK manufacturing exports are produced by

UK Overseas Pension Fund Assets
% of total assets



foreign owned companies. In manufacturing, nearly one job in five is in a foreign-owned company and foreign firms account for nearly one third of all manufacturing investment.

Outward investment has enabled UK firms to expand and develop their markets overseas. Overseas investment has also produced better returns and reduced risks for UK savers. UK pension fund investments, for example, are considerably more internationally diversified than in most other countries.

13 Vanuatu

Background

The Republic of Vanuatu is a very small country located in the centre of the Pacific ocean, distant from its main markets. In 1994, the population of Vanuatu was about 165,000. Total GDP was of the order of US$ 189 million resulting in a GNP per capita of US$ 1,145. Vanuatu is one of the five least developed countries in the Pacific region. About 80 per cent of its population depends upon the subsistence sector for its livelihood. The services sector includes tourism and a thriving offshore banking sector. The public sector contributes more than 66 per cent of the total GDP. Tourism, beef, copra, coffee, kava, squash and other agricultural items are Vanuatu's main sources of foreign exchange receipts. Its industrial sector is relatively small, producing simple manufactures, and accounting for less than 10 per cent of total GDP. Given appropriate supportive policies, this sector will increase in importance during the coming years.

Vanuatu is exposed to external and domestic economic shocks over which it has no control. Hurricanes affect the country frequently during the months of November to April each year. The negative impacts of external economic shocks are regularly transmitted to Vanuatu's economy through the goods and capital markets.

Vanuatu enjoyed economic growth in excess of 4.5 per cent per year from 1989 to 1991. But growth has decelerated to about 1 per cent per year since then. Inflation rates are generally low, hovering around 5 per cent during the last six years. The balance of payments position has been relatively stable and foreign exchange reserves are traditionally high. Including grants, Vanuatu has experienced surpluses in the current account of the balance of payments in 5 of the last six years. Holdings of external reserves by the Reserve Bank vary from 6 to 8 months of imports. As there are no exchange controls, the bulk of the country's external reserves, equivalent to a further 10 to 12 months of imports, are held by the banking system. Vanuatu's external debt to GDP ratio has increased from 15 per cent in 1989 to about 23 per cent at present. The country's external debt service ratio, which is currently 1 per cent, is low. Traditionally, Vanuatu has adopted a conservative approach to fiscal policy. The Government attempts, not always with success, to maintain balance in its operating budgets. The bulk of development expenditure is financed through aid or borrowings with soft terms and conditions from multilateral financial institutions.

Vanuatu's domestic tax base is somewhat narrow. It relies heavily upon indirect taxes, such as customs duties, which yield some 80 per cent of total revenue. There are no personal income and company taxes. But there is a system of business licences which has helped to maintain the total yield of government revenue. Vanuatu is keenly aware of the need to ensure that the elasticity of its tax system is maintained or enhanced. Its proposed commitment to WTO membership will clearly have a direct impact upon the yield of indirect taxes. In this context, it is having to examine the structure of the tax system not only to ensure that the revenue needs of the Government are protected, but also to promote economic efficiency, domestic savings, risk taking and investment activities.

Industrial countries, private investors, and multilateral financial institutions are increasingly focusing upon Eastern Europe and the former Republics of the USSR as well as other strategically and economically important developing countries. Hence, future aid and private capital flows to small countries in the South Pacific are coming under some strain.

Attraction of Private Capital Flows

Given Vanuatu's status as a reputable offshore finance centre, the Government has embarked on a much broader policy of attracting private capital flows through a systematic process of foreign direct investment (FDI). New foreign investments are to be encouraged through a Vanuatu foreign investment code. Within the framework of the code, it is envisaged that the investment environment could become more transparent and more conducive to economic growth, particularly in sectors having the greatest potential for enhancing joint-venture capital finance between potential investors and locals. The putting in place of sound and appropriate policies for investment will act as a catalyst in attracting private capital flows into the economy.

Investment Incentives

While Vanuatu is free of corporate and personal income taxes (which can be considered to be non-distortionary systems of direct taxation), and this is a significant investment incentive, other government revenue raising measures, e.g. the business licence fee, impose significant costs on investors and can induce distortions or disincentives for some industries. The Government is giving particular consideration to the impact on investment of the various current forms of indirect taxation, and to possible changes in them under the comprehensive reform programme being undertaken.

Investment Promotion

In order to encourage private sector investment and private capital flows, the Government is giving consideration to the establishment of an investment promotion agency. Such an agency would have the following primary functions:

(a) To initiate investment policy dialogue and propose investment policy changes;

(b) to build the international image of Vanuatu as an investment location;

(c) to undertake investment generation and promotion activities; and

(d) to provide investment facilitation services

Broad Investment Policy

Vanuatu has relied heavily upon its tax haven status to attract foreign capital and private flows as part of its long term investment programme. It believes that tax incentives can influence the level and pattern of investment but, more important, are the overall business climate, the ease of entry and exit, and the freedom to repatriate profits. A major difficulty with tax incentives is that any tax advantages in Vanuatu are often off-set by taxation on repatriated earnings. Present global trends in capital flows and investment have a direct bearing on Vanuatu's existing legislation and policies. The Government is committed to ensure that fundamental reforms are put in place to respond to these trends.

People, firms and investment are becoming increasingly mobile. This development has intensified the search for the best environment for making sustained profits. Enhanced mobility has been facilitated by rapid improvements in transport and communications. This mobility is especially evident in the services sector where firms and corporations can be more easily spread over several countries. The offshore finance centre in Vanuatu is an example of the effects of the increased mobility of firms, people and investment capital.

De-regulation

As part of the concerted effort to mobilise financial resources and technology, it has become imperative for the Government to take stock of existing policies and requirements. Vanuatu believes that with the integration of the world economy and with the rapid evolution of the monetised sector, fundamental changes are crucial to the continuous development and promotion of its foreign direct investment regime. The Government is fully committed to undertake a comprehensive reform programme, both for the economy and public enterprises, with a view to increasing economic efficiency and attracting greater foreign capital flows into Vanuatu's economy.

Membership of WTO

The Government is committed to accede to membership of WTO, as part of its efforts to streamline existing policies and become part of the global liberalisation process. Membership of WTO will require Vanuatu to introduce/re-define laws and policies to be consistent with the Agreement on trade-related-investment measures (TRIMS) and other WTO rules.

14 Zimbabwe

Background

Zimbabwe attained independence in 1980. Because of the political system that was in place, the new Government inherited a system which was full of inequities in the areas of health, education, infrastructure provision and opportunities for participation in economic activity. Government sought to redress this situation through massive programme in social spending in these areas. Phenomenal progress was achieved in the areas of health, education, small holder agriculture and provision of infrastructure in the rural areas where approximately 70 per cent of the population reside.

The success was however achieved at the expense of the productive sector. Investment in this sector was largely ignored during the period from 1980 to 1990. Gross fixed capital formation declined to 15 per cent of GDP in the mid 1980s. Private investment fell from 12 per cent of GDP in 1985 to less than 8 per cent in 1987. Coupled with this, Government adopted a number of protectionist and inward looking policies which saw the introduction of extensive price controls, labour controls, foreign currency allocations, import licensing, stringent exchange controls on both the capital and current accounts and there were long delays in processing of import and investment applications. The net effect was to create a very unconducive investment environment. On the macro-economic side, Government chalked up a high budget deficit as a result of the large social expenditure which was financed primarily by domestic borrowing. This was translated into high interest rates on the money market, high inflation and decline of investment in the economy.

Against this background, in 1991, the country embarked on structural adjustment programme whose essence was to re-launch the country on a road to economic recovery through the stimulation of investment and removing impediments to growth. The main areas of reform were:

- reduction in fiscal deficit (which in 1991 was 10 per cent of GDP) through introduction of cost recovery for services provided Government; elimination of subsidies to public enterprises and privatisation of these enterprises; civil service rationalisation, and increased efficiency in revenue collection;
- deregulation through the removal of controls to increase domestic competition and provide entrepreneurs with the freedom to respond to emerging market opportunities and pressure; and
- trade liberalisation through the movement away from the foreign exchange allocation system to a market based system.

In recognition of the role that foreign investment was to play in economic development, the country established through an Act of Parliament, the Zimbabwe Investment Centre in 1993 as a "one stop shop" for investment promotion and facilitation. Since its inception, the Centre and Government have actively sought to promote investment into the country and this has borne some fruit. The following table gives a breakdown of the investment approved to date by value, jobs created, and exports to be generated.

Of this, the total foreign investment amounted to Z$13,83 billion or approximately US$ 1.38 billion.

Lessons from Experience

In Zimbabwe's experience, the enabling environment plays a crucial role in the promotion of capital flows, as it is the barometer used by investors in assessing a country's potential for business. The decline in investment that occurred in Zimbabwe during the period 1985 to about 1991 was due to the risks associated with unsustainable fiscal deficits, uncertainties and high cost associated with the forex allocation system affecting access to investment and intermediate goods and spares, and the relatively high cost of doing business in Zimbabwe's highly regulated business environment as a result of price controls, labour market restrictions and investment control procedures.

Zimbabwe's experience shows that special incentives only work in attracting investment in an environment that is already conducive to investment. Sound infrastructure in the form of roads, telecommunications, reliable power supplies and sound banking and financial infrastructure are also essential. Special incentives can play an important role in reducing the cost of the initial capital outlay to the investor as well as removing impediments, and demonstrate the host country's commitment to promote investment thereby giving the investor added confidence and security. In Zimbabwe the incentives that are available are: reduced corporate tax rates for companies engaging in infrastructure projects and for investments in growth points; free importation of capital goods; low rates on imported raw materials etc., depreciation allowances, and special initial allowances for establishment expenses. Zimbabwe has recently established Export Processing Zones and these have their own

	No. of Projects	Value	Jobs Created	Exports
1993	266	Z$1,5 billion	2,488	Z$220 million
1994	365	Z$5,5 billion	9,932	Z$1,85 billion
1995	448	Z$3,8 billion	12,442	Z$1,86 billion
1996	415	Z$9,6 billion	12,147	Z$2,26 billion

incentive regime which is similar to what most countries provided.

Zimbabwe has tended to hold general promotions of the country as a viable investment location and develop contacts from such promotions. It has tended to rely primarily on Britain as the prime source of investment due to former colonial links and British companies have been targeted for increased investment. The established companies have been used at promotional conferences to speak about the changes that have taken place in the country and their experiences, as it was felt that such presentations would carry more weight in the eyes of potential new investors than presentations by politicians. Investment conferences have also been held in other countries which have investments in Zimbabwe as well those with which Zimbabwe has good political relations (e.g. Germany, Malaysia, China, Singapore, and Australia while plans are afoot to visit the USA and Japan). Inward missions have also been held but this has also followed the same trend i.e. missions from the same category of countries. Zimbabwe has not developed strategies for targeting particular types of investment. This is due to the lack of information on the sectors in which it has comparative strengths and the opportunities that are available within these sectors. The Zimbabwe Investment Centre has commissioned work on Sectoral Studies which are expected to provide the requisite information to undertake targeted promotion.

In Zimbabwe the Constitution guarantees security of individual property. In addition it has signed bilateral investment protection agreements with the UK, Germany, Netherlands, Switzerland, Denmark, Malaysia, Portugal, China, Yugoslavia, Mozambique; those with France, Sweden and Italy will be signed shortly. To enforce these agreements Zimbabwe acceded to, and ratified the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and the 1965 Washington Convention establishing the International Centre for the Settlement of Investment Disputes. Zimbabwe is also signatory to the Multilateral Investment Guarantee Agency (MIGA) which covers commercial risk on the part of investors.

Zimbabwe has not yet been adversely affected by surges in large capital inflows as these have been restricted. Capital inflows on the money market remain prohibited while foreign inflows on the Stock Exchange only started in 1993. Temporary capital inflow surges have been experienced especially following receipt of tobacco proceeds and foreign loan inflows. The intervention by the monetary authorities has however been determined by Zimbabwe's exchange rate policy which has been to maintain an exchange rate that promotes exports and competitiveness with trading partners. When there have been capital inflow surges, the Central Bank has intervened to keep exchange rate at a desired level. To counter the negative impact, the monetary tools the Central Bank has employed include: increase in the reserve ratio to mop up excessive liquidity; increase in the discount rate at which the Reserve Bank lends to the commercial banks; and open market operations.

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