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CAPITAL ACCOUNT LIBERALISATION IN DEVELOPING COUNTRIES:
IMPLICATIONS FOR SOUTH AFRICA

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ABSTRACT

The purpose of this dissertation is to assess the desirability of controls on capital movements in South Africa. In line with the general international tendencies towards liberalisation, in recent years there has been increased pressure to lift exchange controls. Despite these pressures, some economists believe there is a need for the maintenance of controls. These arguments are based on issues relating to the inherent desirability of controls as well as the appropriate preconditions for liberalisation. The paper investigates the preconditions for capital account liberalisation, drawing on international experience, and considers whether or not they have been fulfilled in South Africa. In addition, the proper sequencing of capital opening itself is examined.

A literature survey is the main research method used, utilising the literature on financial reforms of some less developed countries. The countries of the Southern Cone of Latin America (Argentina, Chile and Uruguay) are used to illustrate examples of failed experiences.

In the light of the lessons learned from the above, the major results are that (1) South Africa's capital controls should be

abolished, although gradually; (2) macroeconomic stability is the key to successful liberalisation; and (3) a fairly liberal domestic financial system is a prerequisite for external liberalisation.

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PREFACE

This dissertation was undertaken as part of a larger study commissioned by the Macro-Economic Research Group (MERG). MERG was comprised of South African and foreign economists who were involved in economic research and policy analysis to support the ongoing policy formulation processes and socio-economic transformation in South Africa.

This part of the project looks at the current system of capital controls in South Africa and assesses its desirability and effectiveness in the light of economic and political instability associated with transition.

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Introduction

In recent years there has been a marked move in the developing countries towards greater liberalisation of both trade and capital accounts of the balance of payments. Despite the fact that there were failed attempts at capital account liberalisation in the Southern Cone of Latin America during the 1970s, many countries have now proceeded along this path, with different degrees of success. In South Africa there has been increased pressure for the relaxation of exchange controls and although the new government has in principle accepted the desirability of free flows of capital, there has been a reluctance to move too hastily in that direction. The major concern is with the impact effect of abolition as it is difficult to predict the precise effect of such a move on interest rates, prices, the exchange rate and/or foreign exchange reserves.

International experience with liberalisation has been mixed. There are many cases of successful liberalisation as well as failures. This paper will attempt to draw conclusions for South Africa on the bases of theoretical considerations as well as from learning from the mistakes of liberalising countries.

Capital account liberalisation is a complex issue because efforts towards capital account convertibility have usually occurred in the context of broader economic programmes which have incorporated extensive stabilisation efforts and structural reforms. For this reason, stabilisation efforts, sequencing of

reforms and other policy changes have to be addressed in a study of capital account liberalisation in developing countries.

In this thesis, the discussion focuses on the reasons for and against capital account reform; the sequencing of reform; and the experiences of the Southern Cone countries of Latin America with reform. Considerable attention is also given to the effects of capital flows on such key economic variables as exchange rates, foreign exchange reserves, interest rates, investment, and savings. The aim is to draw implications for South Africa.

The paper is structured as follows: chapter 1 explores the need for capital account liberalisation. Various arguments that support the opening of the capital account are discussed. Chapter 2 presents the arguments for the maintenance of restrictions on international capital flows, with an emphasis on the need to stem capital flight.

Chapter 3 surveys the literature on the sequencing of capital account reform. Sequencing raises numerous questions such as whether external (current or capital account) liberalisation should precede internal liberalisation (i.e. domestic financial reform), the appropriate sequencing of current and capital account liberalisation, and the preconditions for capital account opening.

Chapter 4 analyses the financial reform experiences of the Southern Cone of Latin America. The reform initiatives of these

countries constitute a significant portion of the literature on financial liberalisation.

Chapter 5 also looks at the need to maintain controls, but focuses mainly on the problems of capital inflows. This has become a cause for concern in Latin America over the past few years. This chapter will consider the reasons for these inflows, their implications and ways to deal with them.

Chapter 6 looks at the South African experience. The main dilemma in South Africa is the timing and sequencing of capital account liberalisation. The chapter therefore looks at the present nature of SA capital controls; the preconditions for a successful liberalisation; and how capital controls should be abolished.

CHAPTER 1Need for Capital Account Liberalisation

There is general agreement that the ultimate objectives of capital account liberalisation are in part to improve financial efficiency by increasing competition in domestic financial systems (Mathieson and Rojas-Suarez, 1993), and to stimulate growth. Numerous reasons why capital account convertibility is necessary are often cited. This chapter looks at (1) the economic arguments for capital account opening and (2) the ineffectiveness of controls arguments.

1.1 Economic Arguments for Openness

One of the arguments against capital controls is based on welfare considerations. Cuddington, for example, notes that "laissez-faire proponents maintain that unrestricted capital flows are welfare enhancing because, among other things, they increase the international pool of loanable funds." (Cuddington, 1986: 33). Furthermore, Pastor (1990) argues that orthodox economists contend that controls can actually encourage capital flight because of the negative signals such government interference sends to local investors.

Hanson (1992) emphasises the traditional welfare analysis of capital account liberalisation which pertains to the benefits of allowing foreigners to invest in the domestic economy. Such

foreign investment is seen to be financing needed capital goods and, simultaneously, resolving the transfer problem by taking away excess production. The country is left better-off because of the higher demand for labour that has been created in the process.

Fischer and Reisen (1992) assert that dismantling capital controls is generally presumed to generate economic benefits through increased opportunities for intertemporal trade and cross-border portfolio diversification in both assets and liabilities. The diversification allows the country's borrowers to find lower funding costs and its savers prospects for higher yields.

With respect to intertemporal trade, Hanson (1992) and Fischer and Reisen (1992) argue that intertemporal considerations enter only to the extent that differences in time preferences explain differences in saving and, ultimately, in factor proportions. An example of a benefit that results from intertemporal trade is when Southern Hemisphere producers export temperate zone products produced during their summer to the Northern Hemisphere during its winter. The situation is reversed during the next season.

Another argument raised by Hanson (1992) concerns the benefits arising from risk-bearing and risk-sharing in international financial markets. If the prices for sharing and bearing certain risks differ between countries, then there would be trade in the relevant international financial assets that involve the risks.

The inflow of new real capital in the domestic economy reduces the real interest rate and in that way helps reduce the capital market disequilibrium in relation to other world economies (Harberger, 1982).

Calvo, Leiderman and Reinhart (1993) hold that capital availability in the domestic economy is enhanced by capital inflows. These inflows enable the domestic agents to smooth out their consumption over time and investors to react timely to expected changes in their profitability. Furthermore, capital inflows can give important signals to participants in world financial markets. Agents can interpret an increase in capital inflows as reflecting an opportune investment climate in the receiving country.

Additional benefits of capital account liberalisation according to Williamson (1991) are:

* Portfolio Diversification from which the residents can gain. This is often defended on moral grounds as being a basic human right for people to protect their hard-earned assets by spreading them geographically.

* Investment Stimulus which is provided by the relaxation of capital controls.

* Administrative Economies because capital controls require public servants to administer them and thus their abolition results in a saving in public expenditure.

* Investment Duality is raised when, as result of the

abolition of capital controls, local investors have to compete with foreigners for international investments which are likely to have high yields.

1.2 Ineffectiveness of Capital Controls

Gros (1987) and Khan and Ul Hague (1987), amongst others, argue that capital controls work only for a short period before rational economic agents find ways to circumvent them. They cite various ways in which the controls can be evaded. One such method is trade misinvoicing. It happens in the following ways:

(a) Import Over-invoicing

An importer pays more than he or she should for the imported goods. The importer would pay the supplier, say, \$20 for a product that actually costs \$15. The difference is then deposited abroad.

(b) Export Under-invoicing

An exporter presents a fictitious invoice to exchange control authorities that reflects a good sold for, say, \$15 whereas the real price charged the buyer is \$20. The buyer abroad then places the difference into a foreign account.

Eaton (1987) observes that capital controls become self defeating in that they exacerbate the very defects that they sought to eliminate. For example, expectations of controls might induce **some** domestic investors to ship their funds abroad before they are instituted.

At times capital controls attack symptoms rather than addressing the underlying cause of the problem. According to Cuddington (1986), "[f]light capital might be a symptom of macroeconomic mismanagement thus the haemorrhage will be curbed by the application of sensible and credible policies (Cuddington, 1986: 33)."

Also, in an era of capital mobility, as more countries liberalise and as capital mobility increases, it becomes less feasible or desirable to maintain controls. If liberalised capital accounts are seen as the norm, foreign investors see controls as a negative signal and thus refrain from investing in that particular economy. Furthermore, increased capital mobility increases opportunities for arbitrage and therefore reduces effectiveness of controls on residents.

The reduced effectiveness of capital controls implies that the formulation of macroeconomic and structural policies may be more constrained (Mathieson and Rojas-Suarez, 1993). Despite unchanged external financial market conditions, for example, capital control evasion by domestic residents means that unstable domestic monetary and financial policies that result in a large differential between the expected real returns on domestic and external assets lead to capital flight, an increasing dollarisation of the economy, and a smaller domestic monetary system and domestic tax base. With a shrinking domestic financial system, the revenues accruing to the authorities from an inflation tax will also be reduced.

In addition, ineffectiveness of capital controls "can also make it more difficult for the authorities to tax financial income, transactions, and wealth." (Mathieson and Rojas-Suarez, 1993: 19). High taxes on financial income and wealth, for example, can create a strong incentive for domestic agents to hold a large proportion of their wealth in external assets which are less taxed or not taxed at all. New taxes and/or cuts in government spending will consequently be necessary as the ineffectiveness of capital controls leads to a reduction in real tax revenues.

CHAPTER 2

Arguments for Capital Controls

Restrictions on capital flows have been justified on four broad grounds (Mathieson and Rojas-Suarez, 1993): (a) to help control balance of payments crises or unstable exchange rates resulting from excessively volatile short-run capital flows, (b) to restrict foreign ownership of domestic factors of production and to help channel domestic savings towards financing domestic investment, (c) to enable the authorities to tax domestic financial activities, income, and wealth, and (d) to prevent the disruptive effects of capital flows on stabilisation and structural reform programmes. This chapter, expands on the above reasons for capital controls in the context of (1) the negative impacts of capital flight: its causes and consequences; (2) economic crises; and (3) the effectiveness of controls.

2.1 Economic Arguments Against openness

The traditional analysis maintains that there would be net capital outflows (capital flight) in some countries if the capital account were liberalised (Hanson, 1992). This would be even more acute in developing countries because of undeveloped financial markets, and the reduction of domestic capital in developing countries will result in lower returns per worker.

It is also argued that exchange controls are necessary on outflows of capital because holding foreign currency deposits abroad and the borrowing of domestic firms and individuals abroad **are** methods of escaping from the domestic inflation tax. [See Khan and Ul Haque (1985)].

Another argument mentions that the use of controls becomes justified in developing countries in situations of uncertainty about political and economic prospects. This uncertainty leads to large capital outflows. Consequently, macroeconomic policies on their own may not be sufficient tools for preventing capital flight.

In short, therefore, the main reason for the existence of capital controls is to eradicate or alleviate the negative consequences of capital flight (which are discussed in section 2.1.3 below).

2.1.1 What is Capital Flight?

There are conflicting views about the definition of capital flight among economists. Khan and Ul Haque (1987) assert that different writers use different concepts when discussing capital flight, and particularly when measuring it. Most definitions of capital flight are determined to a large extent by the author's views on whether capital flight is "good" or "bad". "It is difficult - perhaps impossible - to make a rigorous definition of capital flight for the purpose of devising policies to cope with it," Kindleberger (1987: 7).

Cumby and Levich (1987) hold that the definition of capital flight requires some arbitrary distinction between normal capital outflows and those labelled as capital flight (abnormal outflows). This distinction is one of the reasons that make it difficult to come up with a single definition.

Walter (1987) defines capital flight as a subset of international redeployments or portfolio adjustments that occur in the presence of conflict between the objectives of asset holders and governments. Mathieson and Rojas-Suarez (1993: 15), however, assume capital flight to be a proxy' "for the portfolio decisions of domestic residents regarding the proportions of their wealth that they hold in domestic or foreign assets." The proportions held in these assets depend on the expected real returns and risks associated with holding each type of asset.

Other definitions of capital flight include:

- * All private capital outflows from developing countries, be they short-term or long-term, portfolio or equity investments. (Khan and Ul Hague, 1987)
- * The difference between total private capital outflows and the part for which income is identified and reported. (Khan and Ul Hague, 1987)
- * Resident outflows that flee abnormal risk. (Lessard and Williamson, 1987; Smit and Mocke, 1991)
- * All resident capital outflows. (Pastor, 1990)

'This, however, is not necessarily a definition , but another way of looking at capital flight.

A further point raised by Pastor (1990) and Cuddington (1986) is that capital movements from developing countries are called "flight" whereas those from industrialised countries are termed "foreign investment". This further complicates the question of definition. Also, as a caveat, capital flight should not be restricted to illegal resident capital outflows as this would exclude the possibility of capital flight from countries which do not have exchange controls.

2.1.2 What Causes Capital Flight?

According to Pastor (1990), capital flight occurs when individuals decide to reallocate their assets from domestic to foreign assets. Three basic forms of assets are available; (a) holdings of money or currency, (b) savings in the domestic financial system, or (c) investment in real productive activity.

Regarding the reallocation of assets, when financial reform is contemplated in developing countries, cognisance should be taken of their legacy of widespread controls, the need for domestic savings to finance new investment, and the often high degree of political instability. Since exchange controls have for a long time featured prominently in LDCs, investment decisions have been dictated by this fact. As a result, a sudden lifting of exchange controls would result in a significant portfolio reallocation. The domestic capital markets and interest rates could be severely

affected.'

Khan and Ul Hague (1987) cite the following five causes of capital flight:

* Overvaluation of the Exchange Rate

There is consensus that one of the principal causes of capital flight is the likelihood of a change in the exchange rate. The expected depreciation of the domestic currency causes residents to switch to foreign currencies.

* Financial Sector Constraints

In a number of developing countries there are extensive controls on interest rates and other aspects of the financial market. Often these practices result in nominal interest rates that are below the rates on comparable foreign financial instruments as well as in negative real rates of interest. In such a situation it is rational for the domestic investor to seek foreign assets that have higher yields. The higher interest rates in receiving countries such as the US are therefore some of the external incentives that encourage capital inflows from the developing countries.

* Fiscal Deficits

In many instances, particularly in Latin America, capital flight has been associated with growing fiscal deficits. A widening fiscal deficit financed by printing money creates

'Although it is generally expected that capital outflows would follow liberalisation, the possibility of net inflows cannot be ignored. Capital inflows could cause an appreciation of the currency, which undermines the competitiveness of the tradable goods industries, and thus brings export-led growth to a halt (See chapter 5 on capital inflows).

inflationary pressures. Consequently, residents reduce their domestic money balances to avoid an erosion of the value of their assets. As one alternative, they purchase foreign currency to avoid this "inflation tax".

* The Risk Factor

It can be argued that there are relatively higher perceived risks associated with investments in developing countries, and that this difference in relative risks stems from the characteristics of developing countries that distinguish them from the developed economies.

Alesina and Tabellini (1989) and Cuddington (1986) mention widespread political uncertainty about future governments in developing countries as the reason for high economic uncertainty about future economic policies. Capital flight, therefore becomes an insurance against the risk of future taxation or expropriation.

In developing countries the domestic resident faces the possibility of losing the value of his or her assets without compensation [see Khan and Ul Hague (1985)], whereas the risk on similar assets held abroad is significantly lower.

2.1.3 The Consequences of Capital Flight

Short- and Long-Run Effects

Capital flight has both short-run and long-run effects that can create serious economic problems for the domestic authorities, and these are:

* Short-run Effects

A sudden increase in the outflow of capital has destabilising effects on the domestic interest rates, exchange rates, and the country's international reserve position (Hanson, 1992; Cumby and Levich, 1987).

* Long-run Effects

If capital flight is permanent, that is, the resources are lost by the home country, then there are several long term effects on the economy such as a reduction in available resources to finance domestic investment.

Pastor (1990) cites three major consequences of capital flight:

- * A reduction in growth potential
- * An erosion of the tax base
- * A redistribution of income from poorer to richer groups.

(a) The Growth Cost of Capital Flight

There are two ways in which capital flight can limit future growth:

- (i) Capital shipped abroad does not contribute to the

domestic investment required for development. If domestic residents invest abroad, such investments contribute more to the development of receiving countries than they do for the source country. This reduces both current and future domestic investment and, consequently, current and future growth.

In addition to the impact on growth, Rodriguez (1987) argues that investment abroad results in the transnationalisation of domestic capital whereby the investors from developing countries obtain substantial holdings in corporations in OECD countries. This makes it difficult for domestic funds to return to source countries because of the nature of these investments. Capital mobility is reduced when funds have purchased firms or corporations than the case would have been had they been held in the form of financial assets. This makes it highly unlikely that capital flows will return once the causes of capital flight have been removed.

(ii) Reduction of growth potential via imports. Capital invested abroad could be used domestically to produce importables that would bring in foreign capital that is essential for growth.

(b) Erosion of the Tax Base

Capital flight removes both stocks of wealth and earnings from the economy by making it easier for residents to transfer their capital to foreign institutions beyond the reach of local authorities. This creates problems for domestic authorities by shrinking the taxable assets and income of those most able to meet the government revenue requirements.

According to Hanson (1992) and Gros (1987) open capital markets are an impediment to the effectiveness of monetary and fiscal policies. This assertion, as it applies to fiscal policy, is based partly on the possibility of avoiding taxes when the capital account is open.

Furthermore, as a result of the reduced tax base because of capital flight, social infrastructure projects which might otherwise have been financed through tax revenues would have to be financed by borrowing from abroad to finance the increased fiscal deficit. These projects may generate high social returns which are also enjoyed by holders of assets abroad who escape taxes. The required additional foreign borrowing generates an additional debt burden and possible future debt-servicing problems

(c) Distributional Consequences

While the poor suffer austerity so that their governments can service debt, a substantial portion of these hard-earned interest payments to international creditors makes its way back to those in developing countries who are wealthy enough to hold foreign assets (Diaz-Alejandro, 1984).

Debt Accumulation and Simultaneous Borrowing and Lending

Often the existence of capital flight is concealed by the fact that it is financed by capital inflows. On the face of it, simultaneous inflows and outflows should not be a problem. But if capital inflows are simply financing resident outflows and

if a crisis (political or economic) occurs, foreign capital will go out but resident capital will not come back. The result is a debt crisis. Therefore, the simultaneous existence of capital inflows and outflows in this situation leaves the developing economies vulnerable to macroeconomic shocks. This phenomenon has been analysed in detail by Khan and Ul Hague (1987).

Than and Ul Hague's model tries to explain why residents in developing countries often choose to invest their savings abroad at the same time that they are seeking external finance. The authors maintain that there are two separate agents - the government and private individuals - engaged in such operations. That is, it is the government that borrows in external markets for its financial needs, while at the same time private individuals invest their funds abroad.

To explain this phenomenon of simultaneous borrowing and investing in international capital markets, the authors introduce uncertainty into the analysis and assume that the domestic and foreign environments are characterised by different sources of uncertainty. They argue that, once this asymmetry is established, it is possible to show that it is rational for domestic residents to borrow abroad, use the proceeds of such borrowings to finance domestic investment, and at the same time invest their domestic savings abroad.

The analysis is based on the view that there are relatively larger perceived risks associated with investing in developing

countries than in investing in developed countries. This difference in relative risks is due to characteristics of developing countries that distinguish them from developed economies. Most developed economies have well-established political systems with constitutional arrangements that provide an institutional infrastructure for efficient market transactions, developing countries are generally lacking in this regard and generally have a high expropriation rate. As a result, the pattern of simultaneous borrowing and investing abroad is theoretically justifiable.

Behind Than and Ul Hague's paper is the view that the rapid rise in the foreign debt of many developing countries has financed capital flight rather than productive investments.

Domestic residents are aware of the relative higher risks involved in investing at home rather than abroad. Hence, residents of developing countries choose to invest domestic savings in the international capital markets while using foreign financing for domestic investment.

In order to increase the incentives to invest domestically, the following policy options are suggested:

- * Adopting sound macroeconomic policies can be a key element in reducing resource transfers abroad and avoiding the attendant problems this phenomenon creates for capital-scarce economies.
- * Full compensation to domestic investors in the event of government expropriation is another policy possibility. But this is tied to credibility and confidence which are issues that are

hard to assess objectively. Whether domestic investors will believe that they will be compensated, particularly when there is a change of regimes, is difficult to determine.

* Guarantees against expropriation and against the imposition of exchange controls provided by an international agency may encourage domestic residents to repatriate funds held abroad

* Since one of the reasons for the continual outflow of capital from developing countries is often the lack of suitable financial assets, the provision of such assets at attractive terms may also serve to keep capital flight in check.

* The imposition of capital controls is another policy that can be implemented. Khan and Ul Hague mention that there is evidence that the amount of capital flight from several countries depend to some extent on the degree of capital controls.

2.2 Economic Crises

Controls are often used to overcome particular economic crises. This is illustrated in Wyplosz (1986) model which focuses on the fixed exchange rate system. This model is an adaptation from Flood and Garber (1984) in order to introduce capital controls. Despite the fact that the ineffectiveness and inefficiency of exchange controls have been widely documented in the literature, most countries continue to have or enforce some form or another of restrictions on capital flows. Observations show that restrictions are strengthened when the pressure builds up on a currency, and are subsequently relaxed when tranquillity

prevails. The implication is that controls are useful mainly during crisis periods.

Wyplosz, therefore, models the balance of payments crises in the presence of exchange restrictions. He considers the case of a country facing the prospect of a devaluation of its currency; where outflows of speculative funds might result as a consequence of this devaluation. He asserts that the capital controls that are aimed at restricting this potential amount of speculative funds should target the domestic currency assets which can be easily transferred offshore in a crisis situation. The crisis he considers is the one in which there exists an inflation differential between the country under study and the rest of the world.

Wyplosz concludes that if exchange market operators are endowed with perfect foresight, a fixed exchange rate system cannot sustain a balance of payments crisis. Therefore, he suggests that in the short-run, exchange rates must be allowed to float. Exchange controls are a way of maintaining the principle of fixed parities at the cost of periodic distinct changes. Two other solutions can be entertained:

the introduction of enough uncertainty (regarding the timing and the size of the parity changes, the level of reserves, the course of monetary policy, and other factors); or

the introduction of a tax on all international financial transactions.

In all, the choice of the best tool to use (assuming that a fixed exchange regime is necessary) should be based on welfare considerations.

2.3 Effectiveness of Controls Arguments

Although it is generally accepted that controls are not completely effective, proponents of controls contend that the existence of leakages negates the usefulness of controls. Referring to LDCs where capital controls are widespread, Pastor (1990) argues that developing countries with capital controls have tended to exhibit lower levels of capital flight. Korea is one case in point. It maintained tight capital controls throughout her financial liberalisation process and the result was phenomenal economic growth with minimal loss of capital.

Similarly, Brazil and Columbia, which maintained exchange controls, experienced proportionately less capital flight than other major Latin American countries. This can be attributed to the capital controls themselves or the macroeconomic policies made possible because of the controls. Therefore, although not 100 percent effective, capital controls do provide some insulation by increasing the cost of flows.

Khan and Ul Hague (1987) and Williamson (1991) argue that capital controls may curb capital flight by increasing the costs of moving funds abroad. Tax information-sharing agreement is an example of such controls. In the presence of these agreements

agents who want to invest abroad would have to consider the legal repercussions of doing so. They will have to seek legal counsel before embarking on tax evasion thus incurring extra costs than the case would have been in the absence of international tax information-sharing agreements.

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CHAPTER 3

The Sequencing of Capital Account Liberalisation

As argued by Edwards (1984), many of the liberalisation attempts in Latin America in the late '70s and '80s failed not because liberalisation itself was inappropriate, but because of the nature of the reform process itself. Chapters 2 and 5 highlight some of the problems of opening the capital account. This chapter considers the problems that may arise in the process of liberalisation.

The reform process is a difficult task that requires appropriate and well-thought planning. What makes it even more complicated is that there are no specific rules or formulae that should be followed. Each reform process requires its own particular solution that is partly dictated by the relevant country's initial conditions. As Choksi and Papageorgiou (1986: 1) note, "...the desirable transitional path to follow will depend on the specific institutions and economic situation of the individual countries." As a result, there are still no definite answers about the sequencing and speed of financial liberalisation.

3.1 Before Liberalising the Capital Account

Fischer and Reisen (1992) address the question of the appropriate indicators available to the policymaker with which to judge the

appropriate moment for opening up the capital account. They assert that stabilisation, both fiscal and monetary, as well as domestic financial liberalisation should precede external liberalisation.

3.1.1 Stabilisation

Stabilisation programmes in the developing countries are often embarked upon after the pernicious policies of populist regimes. Often, with the help of the International Monetary Fund (IMF), the government would initiate a stabilisation programme (Diaz-Alejandro, 1981) Such a programme usually includes:

- * a restoration of balance-of-payments equilibrium (This is where the stabilisation plans achieve their clearest and quickest success.);
- * the orderly servicing of the foreign debt;
- * the control and elimination of inflation;
- * the creation of a structure of relative prices conducive to an efficient allocation of resources; and
- * reducing fiscal deficits to sustainable levels.

According to Cho and Khatkhate (1989: xvi), macroeconomic stability is the "linchpin" of successful liberalisation.

There are, however, numerous cases of failed stabilisation episodes in developing countries, in the Southern Cone in particular (Diaz-Alejandro, 1981). The basic failures are the inability to bring inflation down to acceptable world levels, and to avoid disequilibria in the balance of payments.

Also, when dealing with stabilisation, it is difficult to distinguish between economic and political considerations. As Black (1981:47) notes, "[p]olitical instability is a noneconomic factor that maybe very important in causing economic instability in specific countries at specific times."

3.1.2 Domestic Financial Liberalisation

Domestic financial reforms are a prerequisite for successful external liberalisation. These reforms also help enhance the competence of domestic institutions. Krueger (1984: 403) notes that "[t]he highly successful developing countries have generally had liberalized trade and payments regimes, which in turn have been feasible only with relatively liberal domestic economic policies" (my emphasis).

The experiences of the Southern Cone countries attest to this (see chapter 4). The reform initiatives of the Southern Cone countries were disastrous partly because they liberalised their capital accounts before a significant number of their financial institutions had attained international competence. Financial repression also meant that when the capital account was opened, substantial capital outflows resulted. The liberalisation attempts of some Asian countries such as Korea and Malaysia, on the other hand, were relatively successful because their financial institutions were already fairly competitive before they embarked on external reforms.

3.2 External Liberalisation

3.2.1 General Pointers About External Liberalisation

Sequencing External Liberalisation

An extensive body of literature focuses on the question of sequencing external liberalisation, i.e. whether the capital account or the current account should be opened first.

Hanson (1992) quotes McKinnon (1973) as saying that the initial view on sequencing was that the capital account restrictions should be relaxed only after trade reform (see section 3.2.2 for more discussion). This is a widely accepted proposition. The minority view among economists is that the capital account should be opened first, or simultaneously, with the trade account.

Some proponents of the capital-account-first view are Paul Clark (1986) and Anne Krueger (1988). This view holds that financial assistance during transition is necessary because an increased availability of funds can help reduce the adjustment cost associated with micro reforms (Edwards, 1989).

According to Edwards (1987), frequently (due to political or other problems) it is not possible to pursue the liberalisation of both the trade and capital accounts simultaneously, and from the efficiency stand point it may not even be desirable to do so. As mentioned elsewhere, in situations where there is political

instability and the consequent uncertainty about the future economic prospects, there are high probabilities of damaging capital outflows which may undermine the liberalisation initiatives. Therefore, for the sake of prudence, it might be necessary to delay abolishing capital restrictions on outflows whilst restrictions on inflows have been lifted.

Sequencing Capital and Current Accounts Themselves

Fischer and Reisen (1992) note that, since there are a variety of capital flows on which controls are often imposed, the policymaker can also sequence the process of capital account liberalisation itself.

Similarly, Anjaria (1987) states that trade liberalisation itself needs to be sequenced. The first concern is the optimal speed of this liberalisation. However, the experiences of the developing countries give no indication of whether or not trade liberalisation should be massive and quick or gradual.

Capital Account Convertibility: Preconditions

According to Mathieson and Rojas-Suarez (1993), it is highly possible to sustain capital account convertibility if countries implement certain policies before initiating capital account reform. The first such key macroeconomic precondition is a fiscal reform that drastically reduces the fiscal deficit and finances the remaining deficit in a non-inflationary manner.

The second concerns the strengthening the prudential supervision of financial institutions as well as carefully formulating financial policies that establish more flexible interest rates, restructure and recapitalise domestic financial institutions, and more succinctly define the scope of the protection offered by the official safety net that underlies the domestic financial system.

The third is a strong domestic financial system that can compete effectively with external financial institutions and withstand the effects of high asset price variability.

The fourth is that the authorities must take steps to curb the moral hazards associated with maintaining an official safety net under a financial system with an open capital account in order to avoid the likely fiscal costs associated with maintaining such a safety net.

The fifth is to remove capital controls and establish capital account convertibility which will bring new financial techniques and instruments, new sources of funds and new participants in the domestic economy.

3.2.2 Current-Account-First View

As mentioned above, the widely accepted view is that trade account liberalisation should precede the opening of the capital account. Some proponents of this idea are Mckinnon (1973, 1982), Frenkel (1982) and Rodrik (1987). The rest of this section gives some reasons for the current-account-first notion.

The trade-account first idea is based on the fact that there is a fundamental difference between the goods and asset markets. The speed of adjustment in the asset markets is much faster than the speed of adjustment in the goods markets. Asset markets are more sensitive to speculative considerations or to expectations concerning the distant future. New information which alters expectations is reflected in asset prices much faster than in the prices of goods and services. This basic difference in the fundamental characteristics of goods and assets contains several implications that support the trade-account first argument.

Firstly, in economies which have been distorted for some time nobody can safely predict the paths that the various sectors will follow after liberalisation. The trade-account first approach has the advantage of providing the policymaker with time to monitor the market's reaction and to rectify errors if need be. The capital-account first idea, because of the speed with which asset markets adjust, lacks this advantage. Once the capital account is opened up, the initial reaction is likely to be very fast and the resulting flows are likely to be huge. In addition it could

result in inappropriate resource allocation effects.

Secondly, from the social viewpoint, it is easier to reverse wrong portfolio decisions than to reverse real investment decisions. When the distortions are removed in the commodity markets and the current account is opened, real investment in the economy will be based on the undistorted environment. Portfolio investments will continue to be based on the distorted capital market as long as the capital account is not opened. Once the capital account is liberalised, some of these portfolio decisions will have to be reversed. On the other hand if the capital account is being opened first, portfolio decisions are likely to correspond to the long-run undistorted conditions, but real investment will take place in a distorted environment as long as the trade account is not opened. Due to the distortions, the social cost of the investment is likely to exceed the private cost. As a result of the difference between the private and social costs, it is likely that the first order will be preferred.

Thirdly, when the trade account is opened up first, the cost of the remaining distortion, i.e., of the closed capital account, is proportional to the volume of trade which, due to the slow adjustment of the market for goods, is likely to be relatively small. On the other hand when the capital account is opened up first, the cost of the remaining distortion, i.e., of the closed trade account, is proportional to the volume of capital flows which, due to the swift adjustment of the asset market, is likely

to be large. This comparison therefore suggests that the trade account should be liberalised first.

3.2.3 Sequencing Capital Account Opening

In reality, the "current-account-first" idea does not necessarily mean that the opening of the capital account should be strictly undertaken after the trade account reforms have been totally completed. It is a question of degree. That is, it is only after some major distortions in the current account have been removed that capital account liberalisation can be initiated.

Having accepted the "current-account-first" view, the issue is that the capital account liberalisation itself might need to be sequenced. This is particularly relevant to countries with a long tradition of controls such as South Africa where residents could not invest abroad.

In South Africa, for example, lifting controls could cause major outflows from such institutions as insurance companies and pension funds and result in real exchange rate overshooting. Therefore, this might provide a case for sequencing capital account liberalisation. That is, lifting controls on non-residents first, then on certain categories of residents, and phase in to avoid major impacts on interest rates and exchange rates (or foreign reserves). [This is discussed further in chapter 6].

3.3 Alternative Sequencings

Other economists have proposed alternative sequencings. These economists are divided into the "liberalise first" and "stabilise first " camps. The former is mainly represented by Krueger (1981); the latter consists of McKinnon (1984), Fischer (1986, 1987) and Sachs (1987, 1988).

The "liberalise firsts" argue that there is little connection between disinflation and liberalisation policies, and that the costs of trade restrictions are too high to justify the postponement of liberalisation until the macroeconomy has regained equilibrium. In addition, they maintain that, irrespective of macroeconomic instability, the opening of both trade and capital accounts should proceed. The real contention will be on the sequencing of the liberalisation of these accounts.

The "stabilise firsts" have based their arguments on such considerations as the historical difficulty of avoiding overvaluation in countries with high fiscal deficits and the relationship between inflation, relative price variability and resource allocation. Pertaining to capital account reform, they contend that if macroeconomic instability is unresolved it could make the liberalisation of both trade and capital accounts ineffectual. Therefore it is sensible to stem instability first.

A shortcoming of this alternative sequencing literature is that

it is very general and no systematic attempt has been made to analyse the historical evidence (see Edwards, 1989). Moreover, most of these studies have not made a clear distinction between different degrees of trade reform (as it has been done with capital account reform), or between different initial types of macroeconomic disequilibria.

CHAPTER 4The Southern Cone Experience

An analysis of examples of some countries' experiences with financial reform is a logical progression from a discussion of the sequencing of liberalisation. The primary purpose is to examine the role of the capital account in these reform initiatives. The aim of this analysis is to help in determining South Africa's economic prospects in chapter 6. The assertion that there are no ready-made rules that are applicable to all reform processes will be supported. One basic conclusion that does emerge is the need for appropriate macroeconomic policy.

A group of countries has been used in this analysis: the Southern Cone of Latin America (Chile, Uruguay and Argentina). The Southern Cone is important to LDCs' observers and policymakers who seek to initiate financial reform because they fear the repetition of the type of economic disasters which occurred in the Latin American countries. As a result, an understanding of what happened there might help in determining which measures should be avoided. The structural reforms of the Southern Cone constitute much of the emerging literature on the sequencing of financial reform including capital account liberalisation.

The discussion of this group of countries in this chapter looks at the situation before the reforms, during the reform, and the reasons for the failures.

4.1 Conditions on the Eve of Reforms

Uruguay, Chile and Argentina had largely similar macroeconomic backgrounds, social structures, cultural heritage and historical circumstances. As Corbo, de Melo and Tybout (1986) observe, for decades these countries pursued inward-looking development strategies that relied heavily on government intervention. They all had extensive capital controls. On the eve of reforms, the main macro imbalances facing the Southern Cone were the surging inflation and the debilitating external account deficit.

During 1971-73, in Chile, the capital account surplus of the balance of payments in relation to the GDP was at an average annual rate of 2.8%, whereas the current account deficit was at 3.2% (Cho and Khatkhate, 1989). The annual growth rate of GDP was 0.7% during 1971-73; and the fixed investment growth rate was minus 9.8%. The average annual rate of inflation was 150%; it was exacerbated by average fiscal deficits of 12.5% of GDP and was financed chiefly by borrowing from the Central Bank.

In Argentina, during 1971-73, the balance of payments was also under pressure (no conclusive data is available). The average rate of growth of real GDP was 2.8% during 1971-75. The rate of inflation was around 82% in the same period. The fiscal deficit was at 12% of GDP.

In 1971-73, in Uruguay the capital account surplus was at an annual average rate of 2.00% of GDP and the current account

surplus was at 0.52% of GDP. The average growth rate of GDP during 1971-75 was only 1.6% in Uruguay. The gross fixed investment as a percentage of GDP was at an average of 10.8%; whilst the domestic savings were at an average of 12.3% of GDP. The fiscal deficit was relatively low at 3.5% of GDP.

In the early 1970s all three countries began the liberalisation of their markets although in various degrees and approaches.

4.2 Conditions During the Reforms

At the beginning of the reforms, in all three countries, some efficiency gains were made. With the stabilisation policies in full swing, for example, the rate of inflation declined: in Chile to 40.2% in 1978 from 600% in 1974; in Argentina to 171% from 444% in 1976; in Uruguay to 44.6% from 51% in 1976. Although in each case the rates were reduced, they still remained high by international standards.

Also, the overall balance of payments position improved in each country. In Chile, the capital account surplus as a percentage of GDP moved from 1.85 in 1974 to 12.74 in 1978, whereas the current account deficit to GDP moved from 2.64 to 7.06. In Argentina, the capital account surplus in relation to GDP moved from 1.04 % in 1976 to 0.47% in 1978, the current account surplus, on the other hand, moved from 1.50% to 2.86%. In Uruguay, during 1976-78, the capital account surplus as a percentage of GDP was at an annual average rate of 4.42%, whereas

the current account deficit was at a yearly average of 2.73%.

The fiscal deficit in Chile was almost eliminated in 1978, decreasing from an average of 10.6% during 1971-73 and there was eventually a surplus beginning in 1979. In Argentina, the fall in fiscal deficit was from 12.5% in 1976 to 3.8% of GDP in 1978. In Uruguay in 1978 it dropped to 0.9% from 3.5 % of GDP on the eve of reform; and it was eliminated in 1979.

However, the initial efficiency gains were eventually overshadowed by problems with policy inconsistencies, implementation difficulties, and overlooked market frictions. In all three countries, very high interest rates and the continuous overvaluation of the pesos eventually led to bankruptcies.

4.2.1 Uruguay

In Uruguay after the military take over in 1973 the authorities embarked on the liberalisation of their economy's tightly regulated financial system (de Melo and Tybout, 1986). The Uruguayan financial reforms were accompanied by major macro-stabilisation programmes. According to Hanson and de Melo (1985), restrictions on private capital flows were almost eliminated in late 1974 and Uruguayan residents were allowed to hold foreign exchange.

By the end of 1976, directed programmes had been largely dismantled and interest rate ceilings had been phased out. In

1977, the authorities embarked on the elimination of reserve requirements and numerous other regulations, leaving the Uruguayan central bank virtually free of government controls.

In October 1978, however, the government adopted the policy of announcing in advance the future values of the exchange rate (the tablita) as an anti-inflationary tool. The financial reforms, and the macro-stabilisation programmes and policies (including the tablita) eventually combined to generate serious problems.

In the early 1980s, difficulties started to arise in connection with the implementation of the anti-inflationary (tablita) programme. The result was a gradual loss of confidence in the schedule of preannounced devaluation, which eventually undermined the stabilisation plan and endangered the liberalisation. The tablita was abandoned in November 1982, and the reforms were eventually aborted.

Besides the advent of the tablita, there is no general explanation for the causes of the reform failure. However, a few issues need to be emphasised particularly with respect to the capital account.

Restrictions on capital movements were immediately removed at the beginning of the reforms. Capital account liberalisation preceded stabilisation, which is not conducive to a successful liberalisation programme, according to the "stabilise-first" economists. The stabilisation reform policy itself was not

successful. It was aimed at clamping down on inflation through a reduction of aggregate demand, and reducing real exchange rate fluctuations, but it resulted in an adverse reduction in output, increased unemployment and appreciation of real exchange rates.

4.2.2 Argentina

In 1976, the military government was faced with an economy fraught with relative price distortions, on the brink of hyperinflation and default, with seriously deteriorated public sector finance and a highly disorganized financial system.

The main goals of the economic authorities in 1976 when they undertook reform were to open the economy to foreign trade and to reduce inflation (Fernandez, 1985). As in Uruguay, Argentina followed the "liberalise-first" strategy: Stabilisation was preceded by the opening of the capital account.

As in Uruguay and Chile, early in 1978, the authorities introduced published schedules of future exchange rates that implied daily rates of depreciation for their exchange rates that were below the existing difference between domestic and foreign rates of inflation (Mathieson and Rojas-Suarez, 1993).

The stabilisation policy objective, to control inflationary pressures, was not accomplished. The plan was eventually abandoned in the first quarter of 1981 for two reasons. First,

an important financial crisis had developed during the second quarter of 1980 (Corbo, de Melo and Tybout, 1986). Second, a deterioration of fiscal discipline that could no longer assure coherence between the deficit and the preannounced schedule. With the abandonment of the stabilisation schedule, new commercial and exchange rate measures were gradually introduced, reversing the policy of opening the economy to foreign trade. The financial reform (and capital account liberalisation) was reversed in 1982 with virtual nationalisation of deposits.

The failure of the Argentine stabilisation plan gives credence to the idea that any attempt to cure inflation needs a sound programme of fiscal discipline as a fundamental prerequisite. In a country like Argentina with a long history of fiscal irresponsibility, credibility in government is one of the scarcest resources of all and a programme of stabilisation should not rely on credibility.

The preannouncement of future exchange rates in particular is a highly risky policy because it requires commitments from the government that might delay quick correction of policy mistakes.

4.2.3 Chile

After Allende's election in 1970, government directly or indirectly took control of a substantial part of the financial sector. The economy was shielded from foreign competition through innumerable tariff and non-tariff barriers.

Policies changed dramatically when the military government took over in 1973. During the ensuing two years the government liberalised domestic commodity markets and started to liberalise the domestic financial market. Capital controls were phased out over a period of five years. Contrary to both Uruguay and Argentina, Chile adopted the simultaneous liberalisation and stabilisation approach.

A major turning point was in February 1978, when the exchange rate became the main instrument of stabilisation and an active (preannounced) crawling peg was introduced. Three reasons were behind the introduction of the active crawling peg system with a decreasing rate of crawl.

* First, the system was supposed to reduce the expected rate of inflation in the small open Chilean economy.

* Second, it was supposed to provide downward pressure in the rate of increase in the price of tradeables and thus to help reduce the stubborn inflation.

* Third, it was going to integrate capital markets further and reduce domestic interest rates by reducing the expected rate of devaluation.

As in Uruguay and Argentina, the stabilisation programme failed. The reforms were abandoned in the early 1980s.

According to Corbo (1985), two major mistakes were made. The first occurred at the beginning of 1978 when the exchange rate was used as a normal anchor to stabilise prices (the tablita)

without due regard to the incentives for large capital inflows that arose from this policy at a time when international capital markets were very liquid.

Unlike Argentina and Uruguay, Chile had vast restrictions on the capital account at the time of the introduction of the tablita. Chile abolished capital controls in the belief that a freer inflow of foreign funds would help bring down real interest rates. However, high interest rates persisted. The tablita-induced inflows increased absorption and drove up the prices of nontradeables, thus raising the real exchange rate.

The second mistake occurred in the second half of 1981. The persistent rise in the exchange rate, and the deterioration in trade balances, led to expectations that the tablitas would not be sustainable. This led to capital flight. After a large drop in capital inflows, the authorities relied on an automatic adjustment mechanism, by which the monetary squeeze from the reduction in capital inflows would improve the exchange rate.

One of the lessons from the Chilean experience is that trade liberalisations should be co-ordinated with other macropolicies to avoid undue swings in real exchange rate. In particular, it is too dangerous to use the exchange rate for stabilisation because it soon works at cross purposes with the trade liberalisation. In Chile the lack of basic rules for financial intermediaries was important in accounting for the high real interest rate.

4.3 General Reasons for the Failures

The above case studies emphasise the point made at the beginning of this study: capital account liberalisation cannot be dealt with in isolation from other intimately related phenomena. In Uruguay and Argentina capital controls were abolished at the beginning of the reforms with stabilisation following thereafter.

The cases, therefore, suggest that it is necessary to deal with the status of macroeconomic stability before opening the capital account. The main reason for the reform failures in all three countries, however, is the introduction of the tablita (a preannounced exchange rate).

The adoption of the tablitas was resorted to after the basic objective of the stabilisation policies, the control of inflationary pressures, was not attained. The tablitas were viewed as a mechanism for conveying the governments' commitment to reduce inflation and, thus, influence expectations about inflation (Mathieson and Rojas-Suarez, 1993).

The rate of depreciation of the exchange rate declined with the introduction of the tablitas. This resulted in the spread between domestic interest rates (adjusted for the preannounced rate of depreciation of the exchange rate) and external interest rates widened, which increased domestic residents' incentive to borrow external funds to finance domestic expenditures. The resulting inflows of foreign capital, in all three countries, were

accompanied by comparatively slow declines in inflation and real exchange rate appreciations.

The real exchange rates, by the end of 1980, in Uruguay, Argentina, and Chile had appreciated by 67%, 74%, and 37%, respectively relative to their values before the tablitas were introduced. The trade balances deteriorated further with the appreciation of the real exchange rates, which resulted in expectations that the preannounced exchange rate regime would not be sustainable (Corbo, de Melo and Tybout, 1986). These developments eventually undermined the credibility of the reform programmes, "which was manifested in capital flight; in the abandonment of the tablitas by Argentina in early 1981, by Chile in June 1982, and by Uruguay in November 1982; and in a series of financial crises in the early 1980s" (Mathieson and Rojas-Suarez, 1993: 25).

The above experiences have led some analysts to attribute the ultimate unsustainability of the capital account liberalisations to inconsistencies between the tablitas and other macroeconomic, incomes, and financial policies. As the inconsistencies between the macroeconomic policies became more progressively apparent, capital flight, a balance of payments crisis, and the abandonment of the stabilisation plan resulted.

Other reasons for the failures as pointed out by Cho and Khatkhate (1989) are: First, the authorities did not recognise that financial liberalisation in imperfect and oligopolistic

financial markets had certain inborn limitations. Second, the abolition of restrictions on the capital account were premature. Third, the importance of the supervision of financial institutions was ignored.

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Chanter 5Problems of Capital Inflows: Case for Controls

Although it is usually assumed that developing countries will be net capital exporters in the absence of controls, recent experiences in Latin America have shown that even highly indebted countries can experience capital inflows which can in turn create problems (see e g Calvo et. al, 1993).

5.1 General Observations on Problems of Inflows

Harberger (1982) observes that (by definition) the arrival of new real capital from abroad increases the current account deficit. This is not necessarily a problem depending on what the inflow is financing. If it is used for consumption only, then it can have negative consequences. But the inflow that is channelled to productive investment is not necessarily problematic because the resulting returns can be used for debt servicing.

Edwards (1987), on the other hand, contends that if major capital inflows are allowed, there is a possibility that the liberalisation episodes will be aborted. This can happen when the flow of capital adjusts "perversely" to the state of the economy (Williamson, 1991). That is, when capital flows exacerbate cyclical instability. In the South African case, for example, a fall in the gold price would erode confidence and so prompt a capital outflow that would worsen the recessionary impact of the

low price of gold. Clearly, since this is not palatable to the objectives of capital account liberalisation (i.e. increased growth and efficiency), a reversal of the whole episode could occur.

5.2 Recent Developments in Latin America

Chapter 4 focuses on the failures of the '70s and '80s reform initiatives of the Southern Cone. However, recently there have been some potentially positive developments in Latin America. This section looks at some of these developments, the reasons behind them, and the prospects for the future. The idea is to highlight the possible harmful effects of the inflows and thus the possible need for capital controls.

5.2.1 The Nature of Recent Developments

In 1990 the economies of Latin America were still in serious crisis, with widespread macroeconomic imbalances that involved large budget deficits, very high inflation and even hyperinflation. In 1994 growth is up, and inflation and budget deficits are down. As a result, there is a feeling that the crisis is over. There are two significant developments that have contributed to this scenario.

First is a sudden and marked reversal of capital movements. There have been a large increase in financial flows to Latin America. The total net external financial flows to the region are

estimated to have increased from \$40 billion in 1991 to about \$57 billion in 1992 (UNCTAD, 1993). These inflows consisted not only of external financing from non-residents but also of substantial amounts of repatriated flight capital. The inflows, accompanied by trade liberalisation, have caused imports and domestic absorption to increase substantially. From 1990 to 1992, imports of Latin America grew at an annual rate of 17.4 percent in value and 14.9 percent in volume

As noted in Calvo et al.'s (1993) study, in most countries, the capital flows have been accompanied by booming stock and real estate markets, an accumulation of international reserves, a strong recovery of secondary-market prices for foreign loans, and faster economic growth. Since the beginning of the 1990s growth has accelerated in Latin America, averaging 2.3 percent annually for 1990-1992 (UNCTAD, 1993). However, this growth is still relatively slow. It implies a small increase in per capita income.

Also, capital inflows are often associated with an upward push in inflation because they raise the money supply and spending. This, however, did not happen in Latin America in part because of the sterilisation of the effect of capital inflows on the stock of money.

Second, although domestic reform partly explains the forceful return of Latin America to the international financial markets, Calvo et al.'s (1993) analysis maintains that some of the

renewal of capital flows to Latin America is due to external factors, external shocks common to the region. Some of these shocks were such conditions as the recession in the United States, and the interest rate arbitrage between the United States dollar rates and generally substantially higher ones in the Latin American countries' markets (UNCTAD, 1993). A significant fall in the interest rate bill resulted in annual interest rate payments on external debt from the region falling from \$28.5 billion in 1988-1989 to around \$23 billion in 1991-1992.

5.2.2 Some Problems with the Inflows

Although the external financial inflows have been associated with reductions of financial costs, they have also complicated monetary, fiscal and trade policy. These inflows have exerted upward pressure on the exchange rate, with a gradual loss for the countries' competitiveness and their capacity to attract foreign direct investment (FDI) in sectors producing tradeables.

Moreover, a worsening of the external accounts poses a risk of a further deterioration through financial outflows as arbitrage profits, dependent in part on high domestic exchange rates, are eliminated. In these circumstances the government may find that it is losing its control over key economic variables such as exchange and interest rates, and may also be confronted with a devastating loss of international creditworthiness.

5.2.3 Prospects for the Future

It is unlikely that capital inflows will continue at their recent pace. Since lower interest rates in the United States have played a major role in capital inflows to Latin America, their expected rise would therefore discourage these flows, particularly to countries with close financial relations with the United States. In addition, the current composition of exchange rates, interest rates and stock prices behind the recent capital influx cannot be expected to last (UNCTAD, 1993).

Clearly, capital inflows have played a much smaller role in stability and growth in some Latin American countries than in others. In Chile, for example, growth and stability had been achieved by the mid-1980s, i.e. before the advent of the capital inflows. Therefore, what happens to inflows in future will have a minimal impact on these countries. In countries such as Brazil, on the other hand, where capital flows have had a significant role, a decline in capital inflows may be expected to facilitate fiscal adjustment and disinflation since foreign exchange has never been a major constraint since the mid-1980s.

5.3 Policy Implications: Measures to Reduce the Inflows

The concern in this section is the form and timing of appropriate policy responses to capital inflows. Calvo et al. (1993) mention three types of concerns that policymakers tend to have about capital inflows:

(1) the adverse effects of capital inflows on the export sector;
(2) massive capital inflows in particular may not be properly intermediated and may therefore lead to a misallocation of resources; and

(3) the "hot money" variety of capital inflows may be reversed on short notice and possibly lead to a domestic financial crisis.

The rest of this section therefore explores the grounds for these concerns and their policy implications.

5.3.1 Reasons for the Concerns

Export Sector

The export sector is important in most Latin American countries because its development has laid the foundations for technological advancement and economic growth. Moreover, the creditworthiness of highly indebted countries has been indicated by the behaviour of exports. As a result, changes in exports associated with capital inflows might have economywide effects which cannot be internalised by the private sector and thus warrant policy intervention.

Improper Intermediation

Calvo et al. note that improper intermediation could be the result of speculative "bubbles", lack of policy credibility, market failure (such as externalities, economies of scale and

nominal wage or price rigidity), or some combination of the above.

Quick reversal of the Inflows

A reversal of the inflows may exacerbate the negative effects of improper intermediation, or actually give rise to improper intermediation. Because of asymmetric information, a sudden capital outflow may lead lenders to conclude that the country has suffered a negative supply shock, even when none has occurred. Such a sudden capital flight might result in the termination of important investment projects.

5.3.2 Interventionist Policies

Based on the above concerns, Calvo et al. (1993) explore five interventionist policies: (1) a tax on capital imports; (2) trade policy; (3) fiscal tightening; (4) sterilised and nonsterilised intervention by the central bank; and (5) a rise in the marginal reserve requirements on bank deposits and more regulated bank investments in equity and real estate markets.

Israel (1978) and Chile (1991) are some of the countries that have used taxes on short-term borrowing abroad. This method is effective in the short-run. In the long-run private agents find ways to circumvent it.

Trade Policy

Trade policy measures can also help insulate the export sector from real exchange rate appreciation by ,for example, paying higher export subsidies. As an example of this in the South African context, the General Export Incentive Scheme (GEIS) formula includes the compensation to exporters for adverse real exchange rate changes.

Tightening Fiscal Policy

Another policy reaction to massive capital inflows is to tighten fiscal policy through higher taxes or through lower government expenditure. This policy is unlikely to stop the capital inflow, but it may lower aggregate demand and curb the inflationary impact of capital inflows.

Lower government expenditure - particularly when directed to the purchase of nontraded goods and services - has a direct impact on aggregate demand, which is unlikely to be offset by an expansion of private sector demand. A contraction of government expenditure, however, is a sensitive political issue.

Sterilised Intervention

This has been the most popular policy response to the episode of capital inflows in Latin America. With capital inflows, this type of intervention amounts to the sale of government bonds by the

central bank in exchange for foreign currencies and securities. This policy does not necessarily stop private agents from engaging in international loan transactions, but, if successful, it does insulate the stock of domestic money from variations associated with capital mobility.

Nonsterilised Intervention

Here, the central bank purchases the foreign exchange brought in by the capital inflow in exchange for domestic money - as under a fixed exchange rate. This policy can help avoid nominal exchange rate appreciation and is likely to narrow the domestic-foreign interest rate differential; however it is likely to generate an increase in the domestic monetary base beyond the central bank's target.

Marginal Reserve Requirements

Marginal reserve requirements could be sharply raised such that they become higher as the maturity of deposits shortens. A 100 percent required reserve ratio could be imposed on deposits with the shortest maturity. Although this method would impose a burden on the banking system and could result in some disintermediation of the capital inflows, it has the advantage of decreasing banks' exposure to the risks of capital flow reversals.

5 3 3 Conclusion

Based on the analysis and the above policy recommendations, Salvo et al. (1993) conclude that there are grounds to support a mix of policy intervention based on the imposition of a tax on short-term bank deposits. Furthermore, they argue that the likely fiscal costs make it hard to argue for sterilised intervention, unless countries exhibit a strong fiscal stance and capital inflows are expected to be short-lived. Moreover, the authors believe that none of the aforementioned policies will drastically change the behaviour of real exchange rates or interest rates.

5.4 Suggestions for International Collaboration in Reducing Inflows

As an additional measure to stem detrimental inflows into developing countries, Felix (1993) has proposed that there should be collaboration from the advanced economies in reducing destabilising effects of international capital mobility on the developing countries. This is further necessitated by the fact that these destabilising effects also affect the developed countries albeit to a lesser degree.

Felix's proposal for international co-operation outlines new mechanisms and changes in existing ones (see Appendix 1). He suggests using collaborative bank supervisory mechanisms such as an internationally uniform transaction tax on foreign exchange transactions and the exchange of tax information agreements to

reduce capital flight and tax evasion on foreign assets. Developing countries should join such initiatives as the agreements of the Basle Committee on Banking Regulation and Supervisory Practices (the Basle Committee).

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CHAPTER 6

The South African Experience

The previous chapters have indicated that the lifting of capital controls is not a straightforward issue. Policymakers have to choose among various alternative paths. The "correct" sequencing is central in making a decision. However, establishing capital account convertibility is important especially for a developing country like South Africa. The benefits in terms of employment, technology transfers and access to foreign markets are enormous.

In an attempt to determine the suitable sequence of capital account reforms, whether capital controls should be phased out or abolished instantly, this chapter first looks at the nature of controls that exist in South Africa; the Financial Rand Mechanism is discussed in this part.

After establishing the importance of capital account convertibility, the conditions necessary for a successful liberalisation are discussed, and whether they have already been accomplished in South Africa. Here the status of the current account and the financial sector is presented. In addition, other preconditions are examined.

6.1 The Nature of the Controls'

In South Africa there are mainly two forms of controls on capital movements: quantitative controls (which mainly affect residents) and the financial rand mechanism. By and large, they affect residents, non-residents, emigrants and immigrants in different ways (Garner, 1994).

Regarding residents, direct outward investment by companies, for example, is considered by Exchange Control in the light of national interest. Annual financial statements are to be submitted. All net income is to be repatriated except with special permission, and all share capital is to be transferred through the financial rand.

Concerning portfolio investment, new purchases of foreign currency by South African residents, like all other purchases of foreign capital assets, are subject to Exchange Control approval, which is usually denied. Interest on existing holdings must be repatriated.

Pertaining to non-residents, direct investment may be made and disinvestment must be made using the financial rand which requires Exchange Control approval. Purchases of residential property, farms and items other than fixed assets are forbidden. Profits and dividends are transferred with the commercial rand.

³ Appendix 4 lists some of South Africa's capital controls.

Also, foreign companies have stipulated gearing requirements.

Portfolio investment by non-residents, such as purchasing quoted securities, may be done with the financial rand without Exchange Control approval, and quoted securities are endorsed "non-resident" to prevent their sale outside the financial rand mechanism. When they are sold funds must be deposited in a financial rand account; and dividends and interest are paid in commercial rand.

6.2 The Financial Rand Mechanism'

This is a two-tier exchange rate system that consists of the Commercial Rand and the Financial Rand. The commercial rand is used mainly for current account transactions while the financial rand is used by non-residents for certain categories of capital account transactions. It is a freely floating exchange rate (apart from limited SARB intervention) determined by the supply and demand for capital flows. [See Garner (1994) for fuller discussion].

The finrand mechanism is a form of exchange control on the movement of investment capital to and from South Africa. This arrangement is part of a whole group of rules and regulations designed to monitor and/or restrict the outflow of capital. The crucial difference between the commercial rand and the finrand is that payments through the former reduce foreign reserves,

'Appendix 3 gives some options for financial rand reform.

whereas because finrand transactions are transactions between non-residents, payments through this mechanism do not affect South Africa's reserves.

Apart from insulating the capital account from outflows of foreign exchange, the financial rand also has the effect of partially insulating domestic interest rates (Kahn, 1994; Garner, 1994).

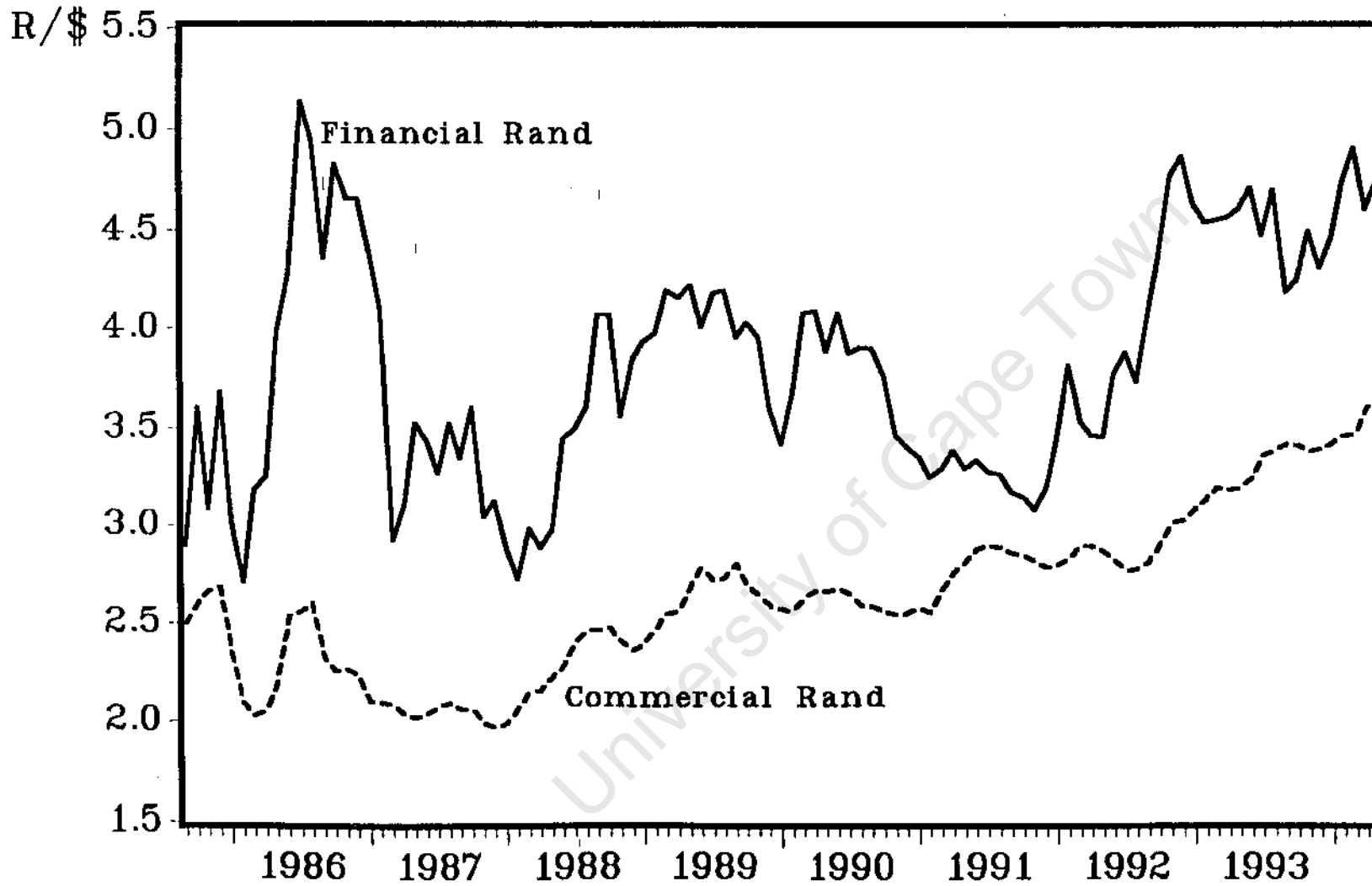
The finrand rate is largely influenced by the level of foreign investor confidence in South Africa's economic prospects. Over the years, this confidence has fluctuated with political shocks. In the 1980s, for example, political disturbances led to large foreign disinvestment from South Africa. The current uncertainty about the state of the country after the April 27 elections has left foreign investors quite ambivalent. They are unsure whether the present political stability will last, and thus are not willing to make long-term investments lest the country reverts back to political instability.

The dismantling of apartheid legislation since 1990 helped to slightly increase the foreigners interest in South Africa. The renewed confidence began to decline as violence escalated in the past four years. Hence, new investments subsided.

The above discussion clearly indicates that the financial rand market is volatile (see Figure 1). The Reserve Bank sought to reduce this volatility in 1992 by announcing its aim to intervene in the market. At first sight, this decision suggested that the

Figure 1

Financial Rand and Commercial Rand Exchange Rates



Source: SARB Quarterly Bulletins

system was ultimately being discarded; a perception which would have encouraged foreign investment into the country.

However, the downside to the interventionist strategy is that such intervention is at the expense of foreign exchange reserves if the SARB is intervening to prevent a depreciation of the rate.

6.3 The Importance of Liberalisation

One of the important benefits of liberalisation is increased trade and foreign investment (Mathieson and Rojas-Suarez, 1993). Capital account opening, in particular, will not only improve integration into the international financial system, but it will also send a strong signal to foreign investors to invest in South Africa. Also, the general international trend including African countries is towards liberalisation in order to remove the negative signal that controls give for foreign investment. However, as seen in chapter 3, there is a need to sequence liberalisation.

6.3.1

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Having noted the need for the elimination of SA capital controls, the challenge becomes the sequencing and timing of the liberalisation process. In chapter 3 the following general sequencing is recommended: the current account first, followed by the domestic financial sector, and then the capital account. The capital account opening itself needs to be sequenced since

there are controls on various capital account transactions. Below, the status of the current account and the domestic financial sector is considered to assess whether capital account opening can be undertaken.

6.3.1.1 Current Account

The current account in South Africa is less controlled than the capital account. During 1984-93, the current account surplus as a percentage of GDP was at an average annual rate of 1.94, whilst net capital inflows were -1.71% of GDP [Appendix 2(a)]. Although South Africa does have very high tariffs for certain narrow categories, the average tariff is not excessively high by international standards.

However, complexity is one of the main problems with South Africa's trade regime. Of thirty-two developing countries for which the World Bank has comparable data, South Africa has most tariff rates, and the widest range (Belli et al., 1993).

The recent SA offer to the General Agreement On Tariffs and Trade (GATT) promises even more liberalisation of the trade account (Hirsh, 1994). Therefore, as discussed in chapter 3, the SA current account might already be liberalised enough to permit capital account liberalisation to proceed.

6.3.1.1 The financial sector

Significant liberalisation in the South African financial sector has already taken place during Dr. Gerhard de Kock's term as Governor of the South African Reserve Bank (SARB). As shown in table 1, especially since 1988, real interest rates have been positive which implies that no real financial repression exists. No interest rate ceilings exist. Interest rates are market determined although SARB still sets the bank rate.

6.3.2 Other Preconditions for Liberalisation

According to the Normative Economic Model (NEM), four preconditions need to be met before capital account opening:

- (a) the building up of gold and foreign exchange reserves to adequate levels;
- (b) the attainment of domestic financial stability, including low inflation;
- (c) the replacement of interim debt arrangements with normal arrangements; and
- (d) the further development of a flexible South African foreign exchange market, by allowing and expanding controlled wider ownership of foreign exchange in the hands of accredited domestic financial institutions and corporations. (Kahn, 1994).

Table 1

**South African Real Interest Rates (Discount) Compared with those
of Some Industrialised Countries**

	SOUTH AFRICA	UNITED STATES	UNITED KINGDOM	GERMANY	JAPAN
1975	-7.36	-2.90	-13.17	-1.47	-4.34
1976	-3.73	-0.22	-5.01	-1.04	-2.94
1977	-3.45	-0.95	-8.32	-0.42	-2.99
1978	-2.34	0.07	0.30	0.37	-5.20
1979	-7.82	-0.83	-0.41	0.35	1.59
1980	-9.04	-1.78	-2.96	1.77	0.15
1981	-5.45	2.95	1.15	1.60	1.42
1982	0.81	4.65	2.26	1.73	2.85
1983	0.99	5.30	5.11	1.17	3.45
1984	7.70	3.72	4.34	1.89	2.72
1985	-3.20	3.90	4.87	1.80	3.00
1986	-7.10	3.60	7.69	3.70	2.40
1987	-6.60	2.30	4.87	2.20	2.50
1988	1.60	2.50	5.77	2.30	1.80
1989	3.30	2.20	3.42	3.20	1.95
1990	3.60	1.10	1.49	3.30	2.90
1991	1.70	-0.70	3.99	4.50	1.20
1992	0.10	0.00	3.69	4.25	1.55
1993	2.70	0.20	5.02	2.55	0.60

Source: IMF Financial Statistics, various issues

The NEM seems to suggest that the main stumbling block towards liberalisation is getting the adequate level of foreign exchange reserves. It further asserts that substantial progress towards meeting this precondition has been made. But this assertion is highly debatable.

Caution is necessary when determining the "adequate" level of foreign exchange reserves. As Garner (1994) argues, one of the reasons the finrand was reintroduced in 1985 was the fact that the authorities undermined the level of reserves that were necessary to defend a unitary exchange rate in the case of political instability. Undertaking radical reform in a weak net reserve position left the SARB unable to defend the rand from attack during political instability.

The current South African net reserve position as shown in Table 2 is not strong. Therefore, according to Garner (1994), if a significant amount of reserve losses is experienced net reserves would immediately fall to zero.

account and financial sector reforms will enable the open capital account to be sustainable.

6.4 Sequencing Capital Account Reforms

Since capital account controls can be various, e.g. on residents and non-residents as in South Africa, capital account liberalisation might have to occur in stages (phased out). However, there is a possibility of removing all controls simultaneously; the "Big Bang" approach.

6.4.1 Phasing out Capital Controls

The main problem of capital account reform in South Africa are major capital outflows that can result particularly from institutions such as pension funds and insurance schemes who control most of the domestic savings in the country (Kahn, 1994). Their investment in the South African economy has been enforced by controls. Had the controls to be lifted, these institutions would reallocate their funds and thus drain the country of the much sought finance.

Therefore a gradualist policy of sequencing this liberalisation could be implemented to mitigate the impact of the outflows. The sequencing of the capital account could take the form of each year increasing the percentage that domestic residents can invest abroad with the hope that there will also be reciprocal inflows to offset these outflows.

The abolition of capital controls should be on non-residents in order to encourage them to invest in the country. As discussed in section 6.1, non-residents are subject to the financial rand mechanism in their direct and portfolio investments (Garner, 1994). But the financial rand mechanism, insofar as portfolio investments are concerned, serves to increase the returns because all dividends and interests are repatriated freely at the commercial rand rate, thus increasing the effective return to non-residents by the amount of the discount between the commercial rate and the financial rate.

6.4.2 Simultaneous Lifting of All Controls

What of the proposal that all controls could be lifted simultaneously (the "Big Bang" approach)? Given the current uncertainty and instability in South Africa, it is unlikely that the scrapping of all controls will change the current level of capital inflows. The SARB reported on 8 April 1994 that the gold and foreign reserves declined by almost R900-million in the previous month to R7,93-billion from R8,8-billion in February 1994. The large net outflow of short-term funds from South Africa can be ascribed to unfavourable leads and lags in foreign payments and receipts, as a result of the strength of the US dollar on international foreign exchange markets and sustained downward pressure on the value of the rand (SARB Quarterly Bulletin, March 1994). Domestic unrest, political and social uncertainty also contributed to the persistent outflow of short-term capital.

Given the current rate of outflows from South Africa, it is highly conceivable that if capital controls were to be suddenly lifted, there would be a net outflow of capital resulting in abandonment of the reform as it happened in the Southern Cone of Latin America.

Also, the influence that external incentives, such as high US interest rates, would have on South Africa is to exacerbate capital flight. As mentioned in chapter 2, incentives in industrial countries would encourage South African residents to invest their assets in these recipient countries.

6.5 Conclusion

Having established the need for capital account liberalisation, and accepting the "current-account-first" approach of sequencing, then there is an option of either phasing out the opening of the capital account itself, or opting for the "Big Bang" approach.

In trying to choose between the gradualist and the "Big Bang" approaches what will happen to domestic savings in the process needs to be considered. If the gradualist approach is chosen, domestic capital must be retained by firstly phasing out restrictions on non-residents in order to attract foreign investment, and then removing restrictions on residents in the long-run after the stability (political and economic) has been restored.

However, if the simultaneous approach is chosen, there is no guarantee that the inflows will offset outflows. The outflows might outweigh inflows, prompting perhaps a reversal of the whole capital account liberalisation. On the balance of probabilities, therefore, the gradualist approach is more reasonable, and it is recommendable for South Africa particularly during the transitional period.

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Appendix 1⁵**Some Mechanisms to Increase the Net Benefits to Developing Economies from International Capital Mobility by Curbing its Destabilising Effects****A. An international uniform transaction tax on foreign exchange transaction**

This was proposed by James Tobin⁶ 16 years ago, and the tax would be structured as follows:

- (1) It would have a uniform rate and at least be applied by all the key currency countries.
- (2) The tax would be administered by each government on all payments by residents within its jurisdiction that involve a spot exchange currency.
- (3) Proceeds from the tax would be paid into a central fund, controlled by the IMF or World Bank.
- (4) With IMF consent, small industrialised countries and developing countries that are formally part of currency areas, or have tied their currency to one of the key currencies, could be exempted from the tax.

Apart from the favourable spillovers to the developing countries from the greater macroeconomic stability that a tax such as the one proposed by Tobin might bring to the industrialised countries, the tax offers the following direct benefits to the developing countries:

- (1) It would help discourage capital flight by increasing its transactions costs.
- (2) The tax receipts centralised in the IMF or World Bank could, if channelled properly as credits to developing countries, be a welcome offset to the slackening of other official loans and transfers from the industrialised countries.
- (3) It would mitigate the "financial Dutch disease"⁷ that occasionally afflicts developing economies.

⁵**Source: Felix (1993)**

⁶ This international transaction tax was seen by Tobin as a restriction to the rampant international financial mechanism.

⁷ Financial Dutch Disease refers to a situation in which excessive short-term financial inflows appreciate the real exchange rate to the extent of undermining the government's export-oriented growth strategy, whilst also increasing the money supply to the extent of undermining its stabilisation strategy.

Annendix 1^a (continued)B. Using collaborative bank supervisory mechanisms to reduce

Felix (1993) maintains that collaborative bank supervision is particularly beneficial to developing countries in order to gain better control over two interrelated problems of their own with international banks: their inadequate "governability" over the local branches and subsidiaries of large multinational banks, and the ease with which these local affiliates function as conduits for capital flight and other evasitory activities. The following are some of the proposals that could enhance collaborative bank supervision between the industrialised and developing countries:

The following are some of the proposals that could enhance collaborative bank supervision between the industrialised and developing countries:

- (1) The developing countries that are pressed by major industrial countries to remove restrictions on the entry of multinational banks should insist that all such entries be conditional on
 - (a) that each petitioning bank formally contract to adhere faith fully to the Basle Committee's December 1988 recommendations on bank ethics in all its host country activities, the contract also authorising that
 - (i) the supervisory authorities of the host developing country may apply penalties, including closure, for contract violations;
 - (ii) the bank and/or its home country may appeal the penalties to the World Court, but may accept its judgement as final, and agree not to engage in any unilateral retaliation against the host country prior to or after the Court's ruling.
 - (b) In accordance with the Basle Committee's July 1992 recommendations on the exchange of information between home and host bank supervisory authorities, the home country shall agree to make best effort responses to all requests for information about the activities of the multinational bank from the host developing country's supervisory authority that it deems needed for adequate supervision of the activities of the bank's local affiliate.
- (2) The Basle Committee should extend its 1988 and 1992 recommendations:
 - (a) to cover tax fraud;
 - (b) to cover the activities of existing as well as new

^aSource: Felix (1993)

Appendix 1² (continued)

- cross-border operations of multinational banks;
- (c) to expand the committee to include representatives of regional developing country supervisory groups, such as the South-East Asia, New Zealand and Australia group and the Commission of Supervisory Authorities of Latin America and the Caribbean.
- (3) These regional groups should develop coherent group positions on how to improve their members' governability of the cross-border banking affiliates they host. The purpose is to:
- (a) educate members on using the existing international facilities to strengthen governability;
 - (b) to instruct their representatives on the Basle Committee.
 - (c) negotiate with the Basle Committee on governability matters on behalf of their members, should formal membership be rejected.

C. Usina the exchange of tax information agreements

To promote the exchange of tax information among the developing countries, and between them and the developed countries, Felix suggests:

- (1) the current developing country signatories should strengthen their existing laws on the taxing of foreign assets as required in order to make full use of the opportunities to collect such taxes provided by the Agreement.
- (2) The agreements should be amended to specifically enjoin the signatory governments from issuing bearer bonds or other instruments that facilitate tax evasion.
- (3) Other developing countries within the United States orbit should seek similar agreements with the United States, strengthening their tax laws appropriately to maximize fiscal benefits.
- (4) There should be a proposal of a convention to multilateralise the tax agreements, with convention signatories - industrial and developing country - agreeing to negotiate a standardised agreement with one another.

²Source: Felix (1993)

Appendix 2(a)Current Account Balance and Capital Flows in South Africa
(In percentage of GDP)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Trade Balance	2.7	10.0	10.8	9.0	6.0	6.0	6.2	5.2	3.9	4.3
Current Account	-2.4	4.1	4.3	3.6	1.4	1.3	2.2	2.1	1.2	1.6
Net Capital Inflow	1.2	-6.8	-3.6	-1.7	-3.1	-1.9	-1.1	-0.7	-1.1	-4.5
Change in Net Reserves	-1.3	-2.6	0.7	1.9	-1.8	-0.5	1.1	1.3	0.1	-2.8

Source: SARB Quarterly Bulletins

Appendix 2(b)

South African Structure of Protection in 1990

Tariff (in percent)	Number of Tariff lines	Percent of total tariff lines	Imports (in millions of rand)	Percent of total imports
0	2,832	29.5	13,015	56.0
1-10	2,466	25.6	4,954	21.3
11-15	922	9.6	1,224	5.3
16-20	1,956	20.3	2,484	10.7
21-25	743	7.7	664	2.9
26-30	505	5.3	544	2.3
31-35	75	0.8	77	0.3
36-40	100	1.0	253	1.1
40+	16	0.2	27	0.1
Total	2,615	100.0	23,242	100.0

Source: Lachman and Bercuson (1992)

Appendix 2(b)**South African Structure of Protection in 1990**

	Weighted Nominal Tariff	Weighted Import Surcharge	Total Tariff Plus Surcharge
Primary products	2.5	0.6	3.1
Processed Primary products	12.0	2.5	14.5
Material-intensive products	28.3	5.7	34.0
Manufactured products	26.9	13.4	40.3
Capital goods	9.8	10.0	20.2

Source; Lachman and Bercuson (1992)

Appendix 3

**Some proposed options for the reform of the financial rand
mechanism**

1. Unify the exchange rates. Allow full convertibility of all current and capital transactions for residents and non-residents.
2. Unify the exchange rates. Allow full convertibility for all current and capital transactions for non-residents, and liberalize existing controls on residents. For example foreign direct investment could be allowed, but portfolio investment disallowed.
3. Unify the exchange rates. Allow full convertibility for all current and capital transactions for non-residents, but maintain existing controls on residents.
4. Convert the current dual exchange rate system into one where all capital flows take place in one currency, which is purely market determined, and all current flows take place in another, in which SARB intervenes. Liberalize existing capital controls on residents and non-residents.
5. Unify the exchange rates. Allow full convertibility for all current and capital transactions of non-residents, but tighten existing controls on residents. For example limit foreign direct investment overseas.
6. Convert the current dual exchange rate system into one where all capital flows take place in one currency, which is purely market determined, and all current flows take place in another in which the SARB intervenes. Maintain existing capital controls.
7. Unify the exchange rates. Allow full convertibility for all current transactions of non-residents, but introduce other controls on non-resident capital flows, and tighten existing controls on residents.
8. Maintain the current dual exchange rate system, including the need for approval to use the financial rand mechanism for disinvestment. Undertake a phased removal of the provision allowing non-residents to earn interest in commercial rand on government bonds purchased with financial rand.

Source: Garner (1994)

Anoendix 3 (continued)**Some proposed options for the reform of the financial rand
mechanism**

9. Maintain the current dual exchange rate system. Keep the rules governing non-residents the same, but allow residents access to financial rand only for capital outflows to neighbouring countries without approval.

10. Maintain the current dual exchange rate system unchanged.

Source: Garner (1994)

University of Cape Town

Appendix 4(a)**A simplified view of South Africa's capital controls**

Direction of original flow / type of capital transfer	From residents
(1) Direct investment	<p>i) No outward investment allowed for individuals.</p> <p>ii) Outward investment by companies is considered by Exchange Control in the light of national interest. Annual financial statements are to be submitted. All net income is to be repatriated except with special permission. All share capital is to be transferred through the financial rand.</p>
(2) Portfolio investment	<p>i) No outward investment is allowed, except a small allowance in financial rand to take up rights on shares already owned.</p> <p>ii) New purchases of foreign currency bonds by South African residents, like all other purchases of foreign capital assets, are subject to Exchange Control approval, which is not normally given. Interest on existing holdings must be repatriated.</p>
(3) Bank loans	<p>i) Bank loans from residents to non-residents are subject to Exchange Control approval, which is usually only given if related to approved inward investment by a non-resident company. All flows take place in commercial rand.</p> <p>ii) See the discussion of trade finance below for rules affecting bank's provision of loan relating to trade flows.</p>

Source: Garner (1994)

Appendix4(a) (continued)

A simplified view of South Africa's capital controls

(3) ... (contd)	iii) Non-resident wholly owned subsidiaries may borrow locally up to 50% of their shareholders investment (equity, profits, and loans from abroad). Where the company is not wholly owned, the greater the local interest is in the company the more can be borrowed. This regulation applies also where guarantees are given by non-residents. However, Exchange Control will allow excess facilities under some circumstances and if local interest is more than 75%, the company is no longer affected by this regulation. Loans can be made by authorized dealers but must be reported to Exchange Control. All flows take place in commercial rand.
(4) Bank Deposits	South African residents are allowed to hold overseas bank deposits, but all interest must be transferred to the CMA. All new acquisitions of capital assets, and hence new bank deposits, outside South Africa require Exchange Control approval.
(5) Other loans	Are mainly covered by the same restrictions as bank loans.
(6) Migrant flows	i) Emigrants are permitted a small cash allowance (R15,000) in commercial rand, equal to the annual travel allowance, and a settling in allowance (R100,000) in financial rand. They are also allowed to export certain items, with value up to R100,000, as long as they have been held for one year. ii) If an emigrant's net declared total assets in South Africa, excluding allowances, are more than R200,000, or application to export further assets is made, approval must be sought from Exchange Control.

Source: Garner

4(a) [continued]

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(6) ... (contd)	iii) Remaining assets are held in a "blocked account" with an authorized dealer, and may only be used for expenses incurred in South Africa. Income from these assets can be remitted overseas up to a maximum of R300,000. Transfer can be in Commercial or financial rand at Exchange Control's discretion.
(7) Trade finance	i) A South African exporter requires approval from an authorized dealer to provide a trade finance facility with a maturity of more than 6 months. Approval from Exchange Control is required for facilities of more than 12 months. All flows mainly take place in commercial rand ii) Banks making loans to overseas importers and exporters are subject to the same regulations.

Source: Garner (1994)

Appendix 4(h)**A simplified view of South Africa's capital controls**

Direction of original flow / Type of capital transfer	From non-residents
(1) Direct Investment	<p>i) Investment may be made and disinvestment must be made using the financial rand. Exchange Control approval is needed. Purchases of residential property, farms and items other than fixed assets are forbidden. Profits and dividends are transferred with commercial rand. Foreign companies have stipulated gearing requirements.</p> <p>ii) Investment in other CMA countries with financial rand is allowed, but a detailed application must be made to Exchange Control</p>
(2) Portfolio Investment	<p>i) Quoted securities may be purchased with financial rand without Exchange Control approval. Quoted securities are endorsed "non-resident" to prevent their sale outside the financial rand mechanism. When they are sold funds must be deposited in a financial rand account. Dividends and interest are paid in commercial rand.</p> <p>ii) Purchases of unquoted securities need Exchange Control approval. For those in new companies, the expansion of manufacturing capacity and low gearing will be viewed favourably. Profits and dividends are paid through the commercial rand.</p> <p>iii) Switches from quoted to non-quoted securities are not allowed. Sales of securities must be credited to a financial rand account.</p> <p>iv) Public sector foreign currency bond debt was excluded from the Debt Standstill of end August 1985. Repayments of principal and interest have been made normally</p>

Source: Garner

A simplified view of South Africa's capital controls

<p>(3) Bank loans</p>	<p>i) Repayment of all bank loans outstanding at end of August 1985, and not guaranteed by a foreign government or export credit agency, were halted and have been subjected to the Debt Standstill. Under various interim arrangements, some repayments on these loans have been made, and at the creditors option, some loans have been converted to long term loans not subject to the Debt Standstill, and some have been paid in financial rand. Interest has always been paid on time in commercial rand.</p> <p>ii) New non-resident bank loans to South African residents require prior approval from Exchange Control (except for trade finance) to avoid bunching of loan maturities, but are normally approved. Longer maturity loans are welcomed, and early repayment is not generally allowed. Working capital loans of less than 3 months are not approved. Facilities may not be extended without approval. Capital and interest flows are made in commercial rand</p> <p>iii) Repayments of loans from a foreign bank to finance a South African firm's overseas subsidiary must be made with financial rand if they were for capital expenditure; if they were for current expenses they should be paid with profits generated overseas, or with Exchange Control approval from the parent using commercial rand</p>
<p>(4) Bank Deposits</p>	<p>Investments with authorized South African banks can be made with financial rand without Exchange Control approval. Interest is mainly payable in commercial rand.</p>

Source: Garner (1994)

Appendix 4(b) [continued]**A simplified view of South Africa's capital controls**

<p>(5) Other loans</p>	<p>i) Loans made before end August 1985, which were not from or guaranteed by a foreign government or export credit agency, have been subject to the Debt Standstill.</p> <p>ii) Loans from non-resident shareholders to South African companies may not be made without Exchange Control approval. Equity must generally exceed 1/3 of borrowings where the company is non-resident controlled. Loans from non-residents increase local borrowing capacity of company.</p> <p>iii) Loans from other non-residents are largely treated as bank loans</p>
<p>(6) Migrant flows</p>	<p>i) Immigrants taking up permanent residence in South Africa must declare to an authorised dealer any foreign currency and assets which they own, and must keep Exchange Control informed of their ownership of foreign assets.</p> <p>ii) Immigrants arriving since Sept. 1990 are allowed to dispose of or invest their foreign assets for a period of 5 years before become subject to Exchange Control as residents. Within one year of arrival they are allowed to introduce a maximum of R500,00 of capital via the financial rand mechanism, to be used for the purchase of property or a motor vehicle. Other inflows are subject to the rule governing foreign investors. All income from foreign assets must be transferred to the CMA</p>

Source: Garner (1994)

Appendix 4(b) [continued]**A simplified view of South Africa's capital controls**

<p>(7) Trade finance</p>	<p>i) Trade finance originating directly from the supplier, or which was guaranteed by a foreign government or export credit agency, was not subject to the Debt Standstill of end August 1985.</p> <p>ii) Foreign bank facilities for periods of not more than 12 months for financing exports from and imports to South Africa are classified as trade finance, and do not require Exchange Control approval</p>
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Source: Garner (1994)

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