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Capital account liberalization: what options for developing economies

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Capital Account Liberalization: What Options for Developing Economies?

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I. Overview

Economic growth and development has continued to elude developing economies largely due to policy inconsistencies and confusion, arising from either lack of the courage or the handling capacity on the part of their policy makers, to address the problems. As well, most of them often "dub" policies from advanced economies or seemingly successful emerging economies, with little consideration to their peculiar situations. Consequently, the policies either get implemented poorly or cannot be implemented at all. In many cases, the outcomes make the economies worse than before. It is important therefore, that new policy considerations draw from other country experiences in order to avoid such pitfalls.

Liberalization is a policy of creating a level playing ground for all economic agents that are interested in a particular economic activity. It could be seen from two perspectives namely,

1. Opening up a sector or industry for new domestic entrants, thus creating competition, and

2. Opening up for international players to enter the sector, industry or market, for reasons including importation of capital, expertise, best practice or as eligibility condition for policy support facilities from development partners.

Liberalization is one of the ten planks of the "Washington Consensus", a

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terminology used by economist John Williamson in 1989 to describe the ten-point reform package that was impressed on the world as the route for poor countries to follow in order to become prosperous. There are however, similarities and differences across nations, which explain why economic reform packages have varied in content and pace of implementation over time and across countries such as Russia, Mexico, Argentina, South Korea, Brazil, Romania, South Africa, India and China, to mention just a few. Thus, the design and implementation of liberalization (as well as its outcome) varied with the circumstances of each country and the cocktail of supporting policies.

Just like economic reform, the mistakes observed to have been made by one country guides the others seeking prosperity along the same route. For example, the under-achievement of reform and collapse of the Mexican economy in 1994 was attributed to over-dependence on foreign direct investment (FDI) and weak domestic saving, while the 1997/1998 crisis in the Asian Tigers was adduced to "crony capitalism" where a few private sector players dominated the system and they were somehow related to the government in-spite of the sound macroeconomic stability and high domestic saving.

This explains why the argument has been made that capital account liberalization, as a stand-alone policy, is unlikely to produce the desired outcome unless certain environmental conditions prevail and it is complemented with other supportive policies. If it is not complemented with other supporting policies or the fundamentals are not right, capital account liberalization (CAL) can precipitate foreign exchange and banking crisis, as it did in the late 1980's and early 1990's in both Europe and some emerging economies. It is not the state of development of an economy that makes capital account liberalization to precipitate a crisis; rather, it is the environment in which liberalization is done.

The ultimate aim of capital account liberalization is to allow the free flow of FDI in particular, both inward and outward. However, it has been discovered that a large volume of FDI inflow can be injurious to an economy that lacks the absorptive capacity or has weak economic fundamentals. Depending on the state of that economy and its fundamentals, net outflow of FDI is equally not necessarily harmful to an open economy. Perhaps an important thing to note at this point is the need for consistency and robustness of policies, so as to retain investor confidence.

Prior to the Asian crisis, it was thought that contemporary economists had arrived at a good understanding of capital accounts, especially the challenges of its liberalization and how to handle them. In particular, sound macroeconomic policies were thought to be the critical factor for effective management of capital accounts. The Asian crisis made the importance of well-capitalized, well-managed and well-regulated financial system to come into sharper focus, according to Andre Icard (2003). He pointed out as well, the importance of shareholder discipline in a highly leveraged corporate capital structure.

This paper is in five sections dealing with, some basic facts about capital account liberalization, liberalization experiences, problems and prospects, policy options and recommendations, and conclusion, respectively. It is hoped that Nigeria, as a developing country, would have some useful lessons to draw from the conclusions.

II. Some Basic Facts about Capital Account Liberalization

Capital account is a familiar term in the discussion of the balance of payments (BOP). It is a vital component of BOP that treats both inflows and outflows of long and short term capital, which is often treated as the balancing item against the current account deficit or surplus. It consists of capital movements in the form of investments, loans and grants. New foreign investments are therefore, as important as divestments, while loan receipts and their obligations (principal repayment and interest payment) as well as grants and aids matter to policy makers.

Liberalizing the capital account to facilitate capital flows has been an important policy issue since the end of the Second World War. It was brought to the centre stage of policy formulation and implementation for individual countries that were seeking foreign financing for development projects and initiatives. Some countries have successfully liberalized their capital accounts, while others have had major foreign exchange and financial system crisis ensue from liberalization.

Liberal economists have argued against capital restrictions for years. This notwithstanding, they appreciate the dangers of badly handled liberalization, as reflected in the financial crises that erupted in most of the emerging economies that attempted capital liberalization without the supporting initial conditions. In the developed economies, with deep and diversified financial markets, honest and competent regulators, and macroeconomic policies that keep public borrowing and inflation in check, liberal regime for capital flow works best. Indeed, it works so well that the policy virtually elicits no debate. But this is not the case in the developing economies.

For developing economies, liberalization of the capital account has tended to prove very costly when combined with interest rate liberalization against the backdrop of weak macroeconomic policy environment and financial markets. The usual pattern is that when interest rates are deregulated, the rates tend to rise significantly, as has been the case in Nigeria. Domestic interest rates will, therefore, be significantly higher than international interest rates, producing a gap that ordinarily should encourage capital inflows (Table 1). Where liberalization induces large capital inflows, the local currency may appreciate while domestic liquidity may expand, generating inflationary pressure. Under the circumstances, liquidity management becomes a difficult task.

An important initial condition for CAL is ratio of current account deficit to the Gross Domestic Product (GDP). Where this exceeds the benchmark maximum of 5%, it can become injurious to the economy, as other conditions might encourage pent-up outflows (especially at commencement of liberalization) and further worsen the deficit. This will raise domestic (deregulated) interest rates, in an attempt to reverse the outward flows and make domestic currency denominated financial instruments more attractive.

Some types of capital flows are preferred to others. Capital flows of the "hot money" type, particularly short-term bank loans, are risky and least preferred. Apart from the volatility risk, it is associated with the phenomenon of reversibility and domestic financial crisis. Though, difficult to attract and retain, FDI seems to be the best and most desirable form of capital inflow in relation to bank loans (often short-term), bonds and equities. So countries, whether advanced or emerging, are often encouraged to attract FDI and other long-term flows.

A common feature of international trade in both goods and capital is the wide range of choices. Trade in goods makes it possible for consumers in a country to access goods that they have not produced, and pay for them by producing and selling goods they do not wish to consume. In the same way, trade in capital makes it possible for countries to separate their savings and investment choices. They can invest more than they save by borrowing the difference from abroad; or they can invest less than they save by lending out the surplus. This is in line with the simple theory of international capital flows, by which the poor-country capital importers would invest more and produce more, while the rich-country capital exporters would invest less, but the income loss through this way would be more than outweighed by the additional income they receive from investments abroad. Thus, in the poor countries where domestic resources tend to be short in supply, capital inflows can be highly beneficial as they provide opportunities to accelerate capital formation and fuel growth.

In reality however, capital flows have both benefits and costs. Indeed, a flood of capital into economies with immature and poorly regulated financial institutions had tended to do more harm than good. This is one of the pitfalls of capital account liberalization.

There is a tendency in developing countries to seek to attract FDI at all cost, not minding that certain initial conditions must prevail, and their absence precipitates crises. Some of these initial conditions include:

1. Macroeconomic stability

2. Fiscal discipline

3. Strong and liquid financial system, both the money and capital markets

4. Minimal interest rate differential

5. Flexible exchange rate management regime

6. Robust external reserves

7. Fast growing GDP

8. Effective and efficient financial regulatory and supervisory framework

According to Bhagawtti (1998), "substantial gains [from capital account liberalization] have been asserted and demonstrated…", and Rodrik (1999) warned "Openness to international capital flows can be especially dangerous if the appropriate controls, regulatory apparatus and macroeconomic frameworks are not in place." Even the International Monetary Fund (IMF) in one of its reports in 2000 stated "… has emphasized the substantial benefits of capital account liberalization, but stressed the need to carefully manage and sequence liberalization in order to minimize risks." Rogoff (2002), "These days, everyone agrees that a more eclectic approach to capital account liberalization is required."

Cobbam (2001) was very specific in concluding that evidence does not support the theoretical arguments on the benefits of capital account liberalization, especially the linkage between the policy and poverty reduction. According to him, "CAL may contribute to reduced levels and stability of government finances, and hence reduced provision for the poorest and reduced investment. CAL and domestic financial liberalization may increase unemployment as finance is diverted away from rural areas and from smaller firms in search of higher investment gains."

Klein (2004) examined the relationship between capital account liberalization, institutional quality and economic growth in the context of theory and evidence, and wrote that "..this research typically fails to find consistent evidence of a beneficial effect of open accounts on economic growth." He concluded that, following the warnings of Rodrik and Rogoff along with his own evidence-based research, "the environment in which capital account liberalization occurs is a potentially important determinant of its consequences."

Most of these facts evolved from the theoretical arguments and evidence-based research on capital account controls and restrictions vis-à-vis liberalization of capital accounts, as well as the particular experiences that many countries have had with these two policy extremes. In particular, countries such as China, Japan, Singapore, South Korea, Italy, France, South Africa, Philippines, Malaysia, India and Taiwan were surveyed recently (2003), when China was considering liberalizing capital accounts. The experiences of some of these countries are summarized in the next section. In its evaluation report for 2005, titled "The IMF's Approach to Capital Account Liberalization", the IMF admitted that there are several gaps between the theoretical arguments for CAL and the evidence, and argued for the mandate of the IMF to be expanded to include CAL at present, it is restricted to current account, even though its staff have been allowed to research into and offer advice to member countries on capital account issues.

III. Capital Account Liberalization Experiences

Capital account liberalization is a parameter used in measuring the degree of openness of an economy, signalling the rate of inflow and outflow of capital from one economy to another without undermining its territorial integrity and independence. The extremes of the continuum are strict controls, which come in some variety, and liberalized markets, where economic agents freely interact under commonly applicable rules to clear the markets.

Capital account liberalization has worked better for currencies without history of capital controls and/or that are convertible. Ready examples are the Deutsche Mark, US Dollar and Hong Kong Dollar. This does not in any way suggest that these currencies have not had their share of trouble in the course of time. Rather, the observation is that such troublous times have been easier to manage, in spite of what would appear to be out of sync with certain initial conditions for capital account liberalization.

During the late 1980s and early 1990s, attempts to combine exchange rate stability with the progressive liberalization of capital accounts in Europe ran into a series of foreign exchange crises. In Scandinavia, Latin America and East Asia, capital account liberalization gave rise to capital inflows too large for the domestic financial system to absorb. The financial crises associated with capital flows that Latin America experienced in the 1980s (Mexico in 1994 and East Asia in 1997-98) caused recession that was equivalent to years of economic growth. The Economist (2003:9) and Obadan (2002) estimated the financial crises of the 1980s to have cost Latin America an average of 2.2 per cent of GDP each year of that decade. Similarly, East Asia's financial crisis cost some 1.4 per cent of GDP a year.

The main features of this boom-bust cycle are as follows. Owing to faster growth, higher inflation or both, interest rates tend to be higher in the liberalizing economy than the international market levels[2]. This interest rate gap combines with the new opportunities offered by liberalization to lead to surging capital inflows, mostly in the form of short-term bank claims or portfolio inflow. The influx of foreign capital in turn provokes currency appreciation under a more flexible exchange rate regime, or to even larger capital inflows under a more stable exchange rate, which falsely implies that there is little risk to foreign currency borrowing. Either way, the recipient economy can experience rapid monetary and even more rapid credit growth, asset price bubble, and booming consumption and investment. The specific experiences of selected countries that have liberalized capital accounts and the lessons are as follows.

Japan

The Japanese situation was succinctly captured by Mitsuhiro Fukao (2003) in the summary below:

- Regime of administrative control and multiple exchange rates between 1945 and 1949, which allowed Japanese enterprises to export freely, but imports strictly controlled.

- Massive official borrowing from the international market to finance post-war infrastructure renewal.

- Unified exchange rate between April 1949 and 1971, while inflation was brought under control and price controls and rationing were discarded altogether.

- In July 1960, non-resident free yen accounts were allowed.

- Japan joined the Organization for Economic Cooperation & Development (OECD) in 1964, which required her to liberalize international finance transactions.

- Current account surplus triggered policy shift from restriction of capital outflows to active encouragement of it. The growth in trade surplus pushed external reserves to $4.4 billion in 1970 (or above 4.0 per cent of GDP) and $7.9 billion in July 1971. Prepayments for exports of $4 billion between 16th and 27th August 1971 took reserves to $12 billion, encouraging Japan to adopt the floating exchange rate system.

- Financial market internationalization, both the money and capital markets.

- Internationalized business sector.

- Controls on interest rates on deposits.

- Troubled state-owned enterprises (SOEs).

Obviously, the outstanding motivations for capital account liberalization by Japan were macroeconomic stability (fiscal discipline plus tamed inflation), membership of OECD, huge current account surplus (strong manufacturing and export orientation) and robust external reserves, and internationalization of the financial markets. Obviously, Japan did not liberalize because of external pressure (as China started experiencing about 2003), as most advanced economies were liberalizing just about then. Also, the problems with the SOEs were not so deep as those observed in China.

All these became irrelevant during the financial crisis of 1997/1998 simply because of a weak financial system the banks were big, but carried huge non-performing loans from a corporate sector that borrowed heavily and had substantial equity stake from the international market, coupled with poor corporate governance.

Fukao (2003) went on to state that, it is well known that it is not possible to achieve all three of the following desirable objectives of international monetary arrangements:

- Maintaining an independent monetary policy.
- Allowing free international transactions.
- Keeping exchange rate pegged to an anchor currency.

Korea

Yoon Je Cho and Robert N. McCauley (2003) highlighted the importance of current account deficit as one of the initial conditions for liberalization of capital accounts. They stated that it must not exceed the benchmark maximum of 5.0 per cent of GDP, and identified the following as issues in capital account liberalization, especially in Korea.

- "Crony capitalism" is a problem associated with liberalization, being the political angle to it. There are always beneficiaries from liberalization that some checks are required to temper their appetite for profit and temptation to stretch the liberty conferred by liberalization.

- Monetary policy must be consistent with other policies over time. The presence of interest rate regime and corporate finance, as well as monetary aggregates that are moderated along well-defined targets.

- Disciplined fiscal operations.

- Korea accelerated capital account opening in 1994, resulting in corporates preferring to take dollar-denominated loans, at a time that non-residents were prevented from investing in won-denominated domestic equity and debt.

- Liberalized interest rates resulted in large corporates (chaebol) shifting their funding demand to the non-bank financial institutions, which were not under sharp/close surveillance by the regulatory authorities. Dependence on commercial papers rose from 2.5 per cent in 1990-1992 to 13.1 per cent in 1993-1996 and peaked at 17.5 per cent in 1996.

- External reserves quantum compared to short-term corporate debts from abroad. Borrowing from abroad rose from 20.0 per cent in 1992 to 28.0 per cent in 1996.

- Strengthening of the supervisory capacity of financial system by the regulatory authorities. This was necessary to preclude unreasonable risk taking and obvious skill gaps that made Korean merchant banks to use short-term dollar deposits to finance long-term dollar loans.

- Capital market opening, i.e. internationalization, with restriction on corporate sale of equity abroad.

Cho and McCauley, drawing from the Korean experience made the following recommendations to China, which are also relevant to developing countries aiming at capital account liberalization:

- Develop framework for strengthening corporate governance, especially as large corporate debt expands.

- Strengthen supervision and regulation of the financial system.

- Long-term instruments should be liberalized before short-term instruments.

- Maturity matching and types of financial institutions matter. In particular, the treatment of banks should be similar to that of non-banks.

- Limit external corporate borrowing because of externalities of short-term foreign debts.

- Maintain constant surveillance on the offshore financing activities of banks, the corporate sector and non-bank financial institutions.

South Africa

South Africa was a pariah state, faced with severe financial sanctions in the 1980s because of its apartheid policy. This forced the South African authorities to impose a debt standstill in September 1985, as several foreign trade creditors refused to rollover and there ensued massive outflow of private investments. The nation suffered dearth of foreign exchange. From mid-1985 to mid-1994, the average outflow amounted to 2.5 per cent of GDP and 13.0 per cent of gross domestic fixed investment. For the nine years to 1994, the country was forced to depend on current account surpluses, bringing its foreign debt profile down from 126.1 per cent of annual exports of goods and services in 1985 to 89.2 per cent in 1993, and from 42.9 per cent of GDP to 21.6 per cent over the same period. At the same time, the South African Reserve Bank created the Forward Book[3] that allowed them to provide forward cover for private sector and government corporations to use trade credit. This became necessary because South Africa had no access to IMF and other official sources for financing trade deficits. The forward book reduced over time, as capital inflows increased.

The situation reversed in May 1994, as soon as President Mandela was sworn in there was a massive inflow of foreign investments and trade credit windows opened afresh. The Government was also able to raise funds from the international capital markets. The scrapping of foreign exchange control on non-residents in March 1995 did not cause massive outflow as envisaged by several analysts, and the subsequent (in February 1996) rate correction was adduced to other factors and rumours. The country was forced to adopt the floating exchange rate system and commenced inflation targeting in 2000, about the same time that the open economies of Australia, New Zealand, Sweden, Canada and the United Kingdom adopted this monetary policy framework.

The specific components of the policy on capital account liberalization in South Africa were as follows:

- Abolition of capital controls on non-residents in March 1995.

- South African companies were allowed to make offshore investments and to raise foreign capital against their domestic balance sheets. Limits of ZAR500 million for outside Africa and ZAR750 million within Africa.

- Qualifying institutions (pension funds, long-term insurers and unit trusts) are allowed to make offshore portfolio investments - up to 15.0 per cent for pension funds and insurers, and 20.0 per cent for unit trusts.

- In July 1997, exchange controls on private individual investments offshore were lifted, and limit of ZAR750,000 imposed.

- Also in July 1997, residents were allowed to retain foreign income earnings abroad.

Some of the obvious factors in favour of capital account liberalization in South Africa were:

- Framework that was conducive to macroeconomic stability had been maintained. Government was committed to financial stability, including fiscal prudence.

- Monetary policy had been firmly anti-inflationary since the late 1980s, resulting in the inflation rate being brought down from double (peak of 21.0 per cent in 1986) to single digit, in spite of exchange rate volatility.

- Budget deficit in fiscal operations reduced from 8.5 per cent of GDP in 1992/1993 to 2.0 per cent in 2003.

- Healthy financial system - the banks were big and well capitalized.

- Liquid financial system.

- Strong financial infrastructure, especially the payments system.

- Improved internal political environment.

- Strong capability to handle external shocks.

India

India had a financial crisis in 1991 and liberalized her capital accounts in the aftermath and as part of its economic reforms package. By 1993/1994, she had started to see its impact on the inflow of FDI. The net inflow from all sources (excluding IMF) averaged about $8.89 billion per year over the seven years from 1993-94 to 1999-2000, strengthening and making the capital account of the BOP more resilient. Despite the exchange rate volatility in 1995/1996 that caused massive net outflows, the annual average came to $9.69 billion from a mere $3.9 billion during the previous two years, 1991/1992 to 1992/1993. Much of this had been in favour of non-debt creating foreign investment flows. More recently, the Indian monetary authorities introduced the following measures to further encourage FDI:

- Foreign investors needed only inform the Reserve Bank of India of new investments after 30 days of bringing their investments and 30 days of issuing shares.

- Non-bank financial companies can hold up to 100.0 per cent foreign equity if they are holding companies.

- Foreign investors can set up 100.0 per cent owned subsidiary (no limit on number of subsidiaries), subject to capital importation of $50 million, $7.5 million upfront and the balance in 24 months.

- FDI of up to 49.0 per cent is permitted in banking, subject to the guidelines of the Reserve Bank of India (RBI).
- Changes made to remove restrictions included:

  i. 100.0 per cent FDI permitted for B to B e-commerce

  ii. Dividend balancing on 22 consumer items removed

  iii. Cap on foreign investment in the power sector removed

  iv. 100.0 per cent FDI permitted in oil refining.

- Automatic route of FDI allowed for proposals in Information Technology and manufacturing activities in Special Economic Zones except for some items[4].

- 100.0 per cent FDI allowed in the Telecom sector and several other sectors, with conditions applying to certain sectors because of their state and/or strategic importance.

The country experiences reviewed above show clearly that liberalization of capital accounts is not a bed of roses. There are problems and pitfalls, which should guide policy options for developing economies that are seeking a faster route to prosperity, especially taking advantage of the global financial markets. These are examined in the next section.

IV. Problems and Pitfalls

Problems usually arise with capital account liberalization when it is unplanned and/or it is not properly guided. Recall the argument that where liberalization induces large capital inflows, the local currency has a tendency to appreciate, along with expansion in domestic liquidity, which generates inflationary pressures. In such circumstance, liquidity management becomes a difficult task.

Hitch free and minimal risk capital account liberalization is hinged on stable macro-economy, characterized by high and sound macroeconomic and trade policies, strong financial systems cum supervisory infrastructure, sound private sector corporate governance and flexible exchange rate regime.

The lessons from the financial crisis that engulfed the Asian countries in 1997/1998, the much earlier Mexican and Russian experiences, and the peculiar situations of Scandinavia and South Africa are instructive to developing economies. Prior to the Asian crisis, it was well understood that sound macroeconomic policies are needed to minimize the risk involved in a liberalized capital account. After the crisis however, it became clear that a well-capitalized, well-managed and properly regulated financial system plays a critical role in stability. Equally important is the structure of corporate finance. For example, a highly leveraged capital structure without effective shareholder discipline can result in reckless borrowing and maturity mismatch that can easily precipitate financial crisis.

The benefits of properly designed and well-implemented capital account liberalization policy are many. The obvious ones include making funds available through foreign capital inflow (FDI type) to serve as gap-fill between domestic saving and investment. It makes the economy more competitive and open to global best practices. Also, it is a policy that demonstrates “political correctness” and therefore, will readily attract international support if crisis arises! To the foreign participants, it provides valuable opportunities for portfolio diversification, risk sharing, and inter-temporal trade, according to Eichengreen and Mussa (2004).

V. Policy Options and Recommendations

The policy options and recommendations derive from the basic facts and country experiences reviewed in previous sections. In order to avoid listing too many issues for the attention of policy makers, the recommendations are restricted (in pursuit of liberalization!) to the following six key issues.

- First pursue *macroeconomic stability*, especially proper coordination of fiscal and monetary policies. In particular:

    i. Maintain fiscal discipline, which is one of the ten planks to the Washington Consensus, as mentioned earlier. Keep overall fiscal deficit at a maximum of 3.0 per cent.

    ii. Ensure consistency between monetary and exchange rate policies. See relationships between variables in Table 4.

- Strengthen *prudential measures* to check indiscriminate short-term, foreign-currency denominated borrowing.

    i. Limit banks' open net foreign currency position.

    ii. Tax short-term capital inflows to discourage excessive foreign exposures by non-financial companies and banks.

    iii. Adopt flexible exchange rate management system.

- Make *monetary policy* proactive and flexible enough to deal with market developments as they unfold.

- Strengthen *supervisory and regulatory structure* and *infrastructure* of the financial system, maintaining surveillance on maturity matching in external transactions of banks, non-bank financial institutions and the corporate sector.

- Limit the *variety of financial institutions*, to avoid regulatory arbitrage and go for *strong capitalization*.

- Strengthen corporate finance and *corporate governance*.

- Liberalize *long-term instruments* before short-term instruments.

- Target FDI for *sectors that offer fast growth opportunities* and development prospects.

- Ensure stable *political environment*, in order to retain FDI, especially the portfolio investments.

- *Privatize* as many of the SOEs as possible, perhaps except those considered strategic to the well being of the national economy.

- Make *sequencing* a function of the degree of resilience of the domestic financial system to external shocks and its ability to deal with larger flows of foreign capital. In particular, Eichengreen and Mussa (2004) recommend as preconditions:

    i. Accounting, auditing and disclosure requirements in the corporate and financial sectors to strengthen market discipline.

    ii. Remove implicit government guarantees.

    iii. Strengthen prudential regulation and supervision.

VI. Conclusion

There is no doubt that contemporary economies, especially the developing economies, need to be reformed periodically in order to remain competitive and be able to attract foreign participation in their domestic economies. Such external participation creates a balance and needs to be properly managed.

Capital account liberalization is a route that many countries have gone in strengthening their economies, and indeed is seen today as the "politically correct" approach to managing the external economy. As attractive as its prospects and promises are, it requires some caution and a measure of pragmatism as well as keeping within prudent limits. It is obvious that capital account liberalization needs to be tempered with some measure of control in some aspects of the economy, to reflect the flexibility that competitiveness demands.

Proper sequencing of the different aspects of the liberalization policy is as important as the widely discussed capital account liberalization. As such, it is advisable that liberalization of the domestic financial system should always precede the opening up of the economy to foreign investors, while the current account should be liberalized before the capital account. Even within the capital account, the order should be inflow before outflow, and FDI rather than portfolio investment.

An orderly liberalization of the capital account must meet the pre-conditions (also termed 'initial conditions') of improved standards of monetary and fiscal policies, a robust financial system supported by effective regulation and supervision of financial institutions, strong corporate governance and political stability.

Notes

1. No capital exportation of any kind without official approval; restrictions on corporate borrowing abroad, either requiring approval or prohibited as for companies in the Free Trade Zone in Nigeria; no foreign currency denominated deposits in the domestic market; foreign currency purchases only available for travelers; foreign currencies purchased from official sources have list of eligible items; etc.

2. The interest rate differential in Nigeria is so significant that a liberalized policy environment should encourage the influx of foreign capital, (Table 1). The argument is that this situation will persist until inflation is

tamed and other macroeconomic fundamentals become internally consistent.

3. Forward Book is the foreign currency guarantees issued by the South African Government. It is oversold when greater than the external liquidity. The key instrument is the net open forward position (NOFP), which is the oversold Forward Book minus the net gold and foreign exchange reserves of the South African Reserve Bank. The IMF insisted that this must be brought down to zero in order to reduce the Government's foreign currency risks, which is simply the sum of government's external borrowings, the position of the central bank and derivatives outstanding. NOFP is naturally part of this.

4. Arms and ammunition, explosives and allied items of defence equipment, defence aircraft and warships; atomic substances; narcotics and psychotropic substances and hazardous chemicals; distillation and brewing of alcoholic drinks; cigarettes/cigars and manufactured tobacco substitutes.

5. Article VIII of the IMF's Articles of Agreement, which defines current account convertibility as freedom from restrictions on the making of payments and transfers for current international transactions and makes

Table 1: **Interest Rate Differentials** (%)

Year	Nigeria	Europe	USA	Japan	UK
2000	14.0	4.9	6.4	0.5	5.9
2001	20.5	3.2	2.4	0.1	4.1
2002	16.5	2.2	1.6	0.0	4.1
2003	15.0	2.2	1.3	0.0	4.4
2004	15.0	2.2	2.9	0.0	4.9
2005	13.0	2.7	4.8	0.1	4.7
2006	14.0	3.7	5.4	0.5	5.3

Note:Minimum Rediscount Rate (MRR) and LIBOR.

Table 2: Nigeria: Maximum Lending Rates (%)

Year	%_1/
2000	26.20
2001	31.20
2002	25.70
2003	21.60
2004	20.40
2005	19.50
2006_2/	20.50

Notes:
_1/For merchant banks in 2000 and universal banks thereafter.
_2/Based on independent market surveys.
Source: Central Bank of Nigeria Annual Report of 2005 and Statistical Bulletin of December 2004.

Table 3: Structure of Corporate Finance in Nigeria, 2004 _1/

Source	₦'billion	%
Bank Loans & Advances	149.2	60.38
BA's & CP's	55.2	22.34
Foreign Trade Credit_2/	28.0	11.33
Equities	14.7	5.95
Total	**247.1**	**100.00**

Notes:
_1/ The excess of gross capital formation over gross savings, being deficit that needed financing. Where the total exceeded the gap, the corporate sector invested in bank deposits and other financial assets.
_2/ Nigerian companies rely on foreign trade credit only to the extent of 11.3% of their external financing need, obviously because of capital account restrictions.
Source: Annual Report of the Central Bank of Nigeria (2005).

Table 4: Summary of Rate Movements

Economic Event/Indicator	Effect on Interest Rate	Effect On Exchange Rate ($/₦)
BOOM	↑	↑
SLUMP	↓	↓
BOP SURPLUS	↓	↑
BOP DEFICIT	↑	↓
MONEY SUPPLY ↑	↓	↓
MONEY SUPPLY ↓	↑	↑
CAPITAL OUTFLOW	↑	↓
CAPITAL INFLOW	↓	↑

Table 5: Nigeria: Capital & Financial Account Balance (% of GDP)

Year	%
2001	-1.1
2002	-3.6
2003	-6.4
2004	-7.9
2005	-13.5

Comment: Obvious net outflows that signal need to consider seriously liberalization, as vehicle for reversing the trend.

Table 6: Nigeria, Overall Fiscal Balance (% of GDP)

Year	%
2001	-4.3
2002	-5.5
2003	-2.8
2004	1.5
2005	-1.1

Comment: Nigeria has done well in this to warrant capital account liberalization.

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