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Capital Flows, Capital Control and Exchange Rate Regimes

*Jonathan A. Aremu, Ph.D**

I. Introduction

Over the years, economists have debated about the optimal choice between the speed and sequencing of economic reforms. One of these debates relates to easing of capital account controls as it affects the capital account of the balance of payments (BOP). While some economists view liberal cross-border movement of capital as welfare enhancing, others deem it damaging, especially for developing countries. According to the latter group, free capital mobility heightens macroeconomic volatility and the vulnerability of developing countries to external shocks. Thus, liberalisation of the capital account should be gradual and should be undertaken after other reforms and market liberalisation have been concluded. On the other hand, proponents of liberalisation see no reasons to delay the ease capital mobility as restrictions result in serious economic costs, inefficiencies and resource misallocation.

Whereas capital controls were seen as “orthodox” necessity by the conveners of the Bretton Woods (BW) system, their ideas were discarded during the neo-liberal era that began in the late 1970s. What was once fulcrum of the international monetary system—regulating capital flows to maintain policy autonomy and stabilise exchange rates—became heresy. However, following the array of the financial crisis since the late-1990s, there is an emerging consensus that capital controls can play a legitimate role in promoting financial stability in domestic and international environments (Akyuz, 2012). In fact, the World Bank (2013) stated that the recent financial crisis has challenged conventional thinking of financial policies and consequently capital flows, and has given greater credence to the idea that active state involvement in the financial sector can help maintain economic stability, drive growth, and create jobs.

In the immediate aftermath of the global financial crisis, the world economy was characterised as undergoing a “two-speed” recovery. The industrialised nations, where the crisis started, experienced slow growth whereas many emerging market and developing countries grew significantly. The growth asymmetries reinforced by wide interest rate differentials across the globe, triggered significant flows of financial resources, based on the perceived relative higher marginal

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productivity of capital in emerging and developing economies in congruence with economic theory. The concurrence of low interest rates and slow growth in the global north with relatively high interest rates and fast growth in the global south, encouraged divestment from the rich economies of the north, and to the south.

However, without government intervention, accelerated capital flows may have adverse consequences both for the source and the recipient economies. It is believed that large surges of short-term and potentially reversible capital that flows to developing countries can have negative effects. Firstly, these surges can pose complex policy dilemmas for macroeconomic management, as they can initially push key macroeconomic variables, such as exchange rate and prices of assets like property and shares, away from what could be considered their long-term equilibrium. Secondly, and more important, these flows can pose the risk of very sharp reversals with little or no notice. Such reversals – particularly if they lead to currency and financial crises – can result in very serious losses of output, investment and employment, as well as increases in poverty.

On this basis, economies of the south fear that the flood of capital from the north may affect their exchange rates, while stirring current account deficits and asset bubbles, if appropriate policies are not put in place. With such surge in capital inflow, the value of their currencies could appreciate – making it harder for companies and farmers in these economies to export, and thus causing job losses and a general lack of competitiveness. Furthermore, unfettered speculation of capital flows could also raise the price of stock, bond and real-estate markets – threatening to create bubbles such as the one that was started in the US in 2008.

Therefore, the movement to outlaw capital controls began to lose popularity given that premature capital account liberalisation in part caused the Asian Crisis of 1997-8. However, nations, such as Malaysia that used capital controls to avoid the worst of that crisis were better off. The fears of the emerging and developing countries have equally attracted the attention of the International Monetary Fund (IMF) to take steps to address the issue; making the Fund to change its mind in favour of the capital restrictions. This new position of the IMF's was based on findings which suggested that borrowing in a low-interest economies coupled with loose capital controls brought about the Great Depression in 1929.

The '*explanandum*' from these premises points to the fact that regulatory controls of cross-border capital flows can complement both the macroeconomic policy. Indeed, since it was shown that countries that used such regulations were less affected during financial crisis, the objective of this presentation is to examine the

importance of capital controls on the flow of foreign capital under the current circumstance for the benefit of the Nigerian economy. Part II of the paper will look into some critical issues in the global capital flows by identifying the principal agents; structure and trends of the flows; effects; and policy options in managing the flows. In Part III, an attempt is made to review the historical developments of global governance of capital controls since the pre-World War I, while Part IV examines the policy challenges in capital control management strategies. Part V examines the on-going ECOWAS financial integration among its Member States, coming at a time of increasing voice for a return to the Bretton Woods's ideology. Part VI concludes the paper with charting a framework for increasing the resilience of the Nigerian capital flow system.

II. Issues in Global Capital Flows

The integration of a country's local financial system with the international financial markets and institutions typically requires that governments liberalise the domestic financial sector and the capital account. Although developed countries are the most active participants in the process, developing countries, like Nigeria as well, have also been participating. While the integration of developing countries with the international financial system is not a new phenomenon, the depth and breadth of it today are unprecedented. Hitherto, capital flows tended to follow migration and were directed towards supporting trade flows under the gold standard (in which gold backed national currencies). The main benefit of financial globalisation for developing countries is the development of their financial system (more complete, deeper, more stable, and better-regulated financial markets). To Levine (1999), there are two main channels through which financial globalisation promotes such financial development. First, financial globalisation implies that a new type of capital and more capital is available to developing countries. Among other things, this new and more capital allows countries to better smooth consumption, deepens financial markets, and increases the degree of market discipline. Second, financial globalisation leads to a better financial infrastructure, which mitigates information asymmetries and, as a consequence, reduces problems such as adverse selection and moral hazard.

It must, however, be pointed out here that capital account liberalisation is neither necessary nor sufficient to attract foreign capital. China is held as an example of a country that was receiving large amounts of Greenfield foreign direct investment (FDI) without pursuing an open capital account regime, while many African countries were receiving very little despite a rapid liberalisation of their capital account. Thus, for successful integration, economic fundamentals need to be and remain strong, and local markets need to be properly regulated and

supervised. The need for these strong fundamentals is key since financial globalisation tends to intensify a country's sensitivity to foreign shocks. Moreover, international market imperfections, such as herding, panics, and boom-burst cycles, as well as the fluctuating nature of capital flows can lead to crises and contagion, even in countries with good economic fundamentals.

II.1 Agents of Global Capital Flows

There are three main agents of financial globalisation: governments, borrowers and investors, and financial institutions.

1. Governments

Governments could allow capital flows by liberalising restrictions on the domestic financial sector and the capital account of their BOP or impose controls on cross-country capital movements. Six possible reasons explain the wave of financial liberalisation during the Washington Consensus era by various countries across the world. First, governments found capital controls to be increasingly costly and difficult to maintain effectively. Second, policymakers have become increasingly aware that government led financial systems and non-market approaches have failed. Third, the importance of foreign capital to finance government budgets and smooth public consumption and investment became understood as foreign capital has helped governments capitalise banks with problems, conduct corporate restructuring, and manage crises. Fourth, opening up the privatisation of public companies to foreign investors has helped increase their receipts. Fifth, although governments can also tax revenue from foreign capital, they might find this harder to do than with other factors of production because of its footloose nature. Sixth, governments have become increasingly convinced of the benefits of a more efficient and robust domestic financial system for growth and stability of the economy and for the diversification of the public and private sectors' investor base.

2. Borrowers and Investors

Borrowers and investors, including households and firms, have also become main agents of financial globalisation. By borrowing abroad, firms and individuals can relax their financial constraints to smooth consumption and investment. Firms can expand their financing alternatives by raising funds directly through bonds and equity issues in international markets and thereby reducing the cost of capital, expanding their investor base, and increasing liquidity. As rationalised by Aremu (2005), borrowing countries benefit not only from new capital but also, in the case of FDI, from new technology know-how, management, and employee training. More financing alternatives help foreign investors overcome direct and indirect investment barriers. International investors, as argued by Obstfeld (2001) have

taken advantage of financial globalisation to achieve cross-country risk diversification of their portfolios. Consequently, institutions and individuals in developed countries can easily invest in emerging/developing countries markets through buying shares of international mutual funds (including global, regional, and country funds) as shown in Kaminsky and Reinhart (1999). Investors can also purchase depository receipts, cross-listed shares of international companies, and international corporate and sovereign bonds in international capital markets.

3. Financial Institutions

Financial institutions, through the internationalisation of financial services, are also a major driving force of global capital flow. According to the IMF (2000), changes at the global level as well as changes in both developed and developing countries explain the role of financial institutions as a force of globalisation. At a global level, the gains in information technology have diminished the importance of geography, allowing international corporations to service several markets from one location. The improvement in information technology has had three main effects on the financial services delivery across countries as they:

- ❖ promoted a more intensive use of international financial institutions,
- ❖ led to a major consolidation and restructuring of the world financial services industry, and
- ❖ gave rise to global banks and international conglomerates that provide a mix of financial products and services in a broad range of markets and countries, blurring the distinctions between financial institutions and the activities and markets in which they engage.

In developing countries alike, the liberalisation of the regulatory systems has opened the door for international firms to participate in local markets. The privatisation of public financial institutions has equally provided foreign banks increasing opportunities to enter local financial markets. Macroeconomic stabilisation, a better business environment, and stronger fundamentals in emerging/developing markets have ensured a more attractive climate for foreign investment.

II.2 Structure of Global Private Capital Flows

Flows of capital do occur from one nation to another in exchange for significant ownership stakes, for higher returns on capital invested in host companies or for other reasons. There are varieties of such flows:

1. Foreign Direct Investment

FDI occurs when new companies are set up or existing companies are taken over by foreign enterprises in developing countries. FDI has proved to be resilient during financial crises. For instance, in the East Asian countries, such investment was remarkably stable during the global financial crisis in 1997-98. In sharp contrast, other forms of private capital flows—portfolio equity and debt flows, and particularly short-term flows—were subject to large reversals during the same period (Dadush, Dasgupta, and Ratha, 2000). The gains to host countries from FDI can take several other forms: FDI allows the transfer of technology—particularly in the form of new varieties of capital inputs—that cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market. Recipient of FDI often gain employee training in the course of operating the new business. Profits generated by FDI contribute to corporate tax revenues in the host country.

2. Portfolio Investment (Debt)

Portfolio debt investment occurs when a foreign entity purchases debt securities such as bonds issued by another country or an institution in another country. Developing countries generally welcome the inflows of foreign portfolio debt investment, which they often see as a vote of confidence in their economic management. Portfolio debt investment has contributed to lower government borrowing costs by exerting downward pressure on domestic interest rates. But there are risks attached to this kind of investment. Volatile private debt capital inflows can complicate the management of exchange rate and monetary policy. As the experience of other developing countries show, portfolio capital inflows can reverse sharply, leading to large swings in exchange and interest rates, as it occurred in the South East Asian economies in the late 1990's.

3. Portfolio Investment (Equity)

Portfolio equity investment occurs when foreign entities invest in a local stock market by buying shares in local companies. However, the number of developing countries with stock markets is very few. Moreover, most of them are very small or underdeveloped to absorb relative large portfolio equity investment. Except for South Africa and Nigeria, the markets are small. To broaden the capital market, Economic Community of West African States (ECOWAS) is collaborating with regional stakeholders in the establishment of regional capital market. Already, the West African Capital Market Integration Council (WACMIC) was inaugurated by the President of ECOWAS Commission early in 2013. This kind of reforms could support development of the region to become attractive to portfolio equity investments.

4. International Bank Lending (Loan)

Another noteworthy trend in the 1990s was the substantial rise in the share of private borrowing in total borrowing. Short-term international debt is defined as cross-border debt with a maturity of one year or less. One potential advantage of global financial integration may be the enlarged access it gives countries to smooth consumption by using short-term loan in the face of adverse economic shocks. But the advantage of contracting short-term debt for counter-cyclical purposes can be wiped out if lenders' decision, changes in risk perceptions, and other factors make access to such short-term capital flows pro-cyclical. Moreover, shocks may attract large capital inflows and encourage consumption and investment at levels that are unsustainable in the longer term, and countries may be forced to over-adjust to adverse shocks when capital reverses.

Short-term capital flows appear to be pro-cyclical in developing countries, increasing when economic growth is accelerating and declining during economic slowdown. In addition, short-term lending is driven by external (or "push") factors. For instance, when short-term interest rates drop in industrial countries it causes an expansion in global liquidity. Some of this encourage short-term lending to developing countries. Two reasons may explain the pro-cyclical behavior of short-term capital flows. First, economic shocks tend to be large and more frequent in developing countries, due to weak economic bases and greater dependence on primary commodity exports. Adverse shocks cause a country's creditworthiness to be downgraded. Changes in risk perception and rating downgrades can lead to rationing of credit to marginally creditworthy borrowers, and such changes can worsen rather than smooth their adjustment. Second, these negative effects are exacerbated by information asymmetry between borrowers and lenders, which may trigger herd behaviour as panicked investors rush to withdraw their capital in response to an adverse shock.

Of the different types of private capital flows discussed so far, short-term loans are the most likely to be withdrawn during difficult times. This is because the cost of pulling out is minimal for lenders of short-term debt, whereas liquidating FDI may involve selling plant and machinery, and selling stocks or bonds during a crisis usually involves a loss for the sellers. In sum, international debt flows, especially of the short-term variety is risky. It is driven by speculative considerations based on interest rate differentials and exchange rate expectations, not on long-term considerations. Its movement is often the result of moral hazard distortions such as implicit exchange rate guarantees or the willingness of governments to bailout the banking system. It is the first to run for the exits in times of trouble and is responsible for boom-busrt cycles of the late 1990's in the South East Asian economies.

5. Remittances

Remittances are closely associated with outward migration, but policies matter, too. Usually, a lower transaction costs and the absence of exchange restrictions, black market exchange rate premiums, and unstable macroeconomic environments have been associated with higher remittances. In addition, remittances are less volatile than other private capital flows and that they tend to move counter-cyclically with recipient country income (Chami et al., 2005). Furthermore, remittances tend to be a stable source of foreign exchange earnings. Migrants usually send more money when the family back home experiences hardships, for whatever reason, and therefore remittances act as insurance against economic adversity. Also, remittances have been remarkably resilient during global economic crises. In sum, remittances reduce poverty, increase welfare, and provide foreign currency that enables countries to pay for essential imports and service external debt. That in turn improves access to international capital markets.

At a macroeconomic level, however, large sustained remittance flows may lead to currency appreciation, with adverse consequences for exports. Moreover, some analysts say remittances dampen growth because recipients may become dependent on them and work less. Finally, an even more insidious effect of remittances on economic development and well-being is their impact on institutions and governance. A remittance-receiving household no longer has to care as much about the quality of the government and its ability to provide infrastructure and institutions that facilitate growth. If conditions are bad at home, families send more members abroad and use remittance income to compensate for the lack of government services. They lose interest in pressuring the government to deliver better services. The government, for its part, does not feel compelled to provide these services because it realises that these households can fend for themselves, and the quality of government declines even further. Hence, remittances are not the highway to a better future.

II.3 Innovative Sources of Private Capital for Development

Innovative financing approaches are required, especially for private sector borrowers in developing countries, who face ever harsher credit rationing than public sector borrowers. Some innovative market-based financing mechanisms that developing countries could use include:

a) Diaspora Bonds

The rationale behind diaspora bonds is twofold. For the countries, diaspora bonds represent a stable and cheap source of external finance, especially in times of financial stress. For investors, diaspora bonds offer the opportunity to display

patriotism by helping their country of origin. Furthermore, the worst case scenario for diaspora bond is that debt service payments by the issuer are in local rather than hard currency. But because diaspora bond investors often have liabilities in their country of origin, they are likely to view the risk of receiving payments in local currency with much less trepidation than would non-diaspora investors.

b) Performance-Indexed Bonds

Coupons on this kind of bonds are set to vary according to the growth performance of a country's GDP, a proxy for its ability to pay. This feature lets a developing country to follow counter-cyclical fiscal policy, paying less during an economic slowdown and more during an expansion. It is plausible that developing countries would be willing to pay a higher rate on indexed bonds than they would pay on fixed-coupon bonds to be able to avoid potential debt defaults. Similar to the growth-indexed bonds issued by sovereigns, sub-sovereign borrowers could issue performance-indexed bonds. A performance-indexed bond would be linked to a well-defined indicator of the performance of the borrowing entity.

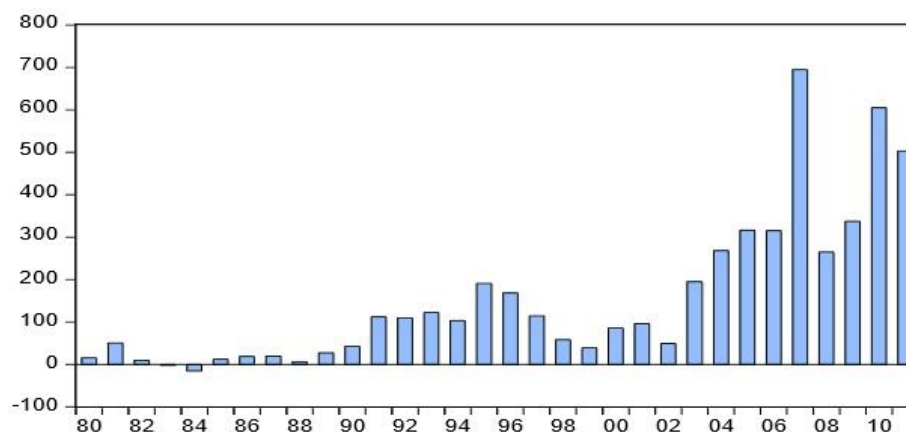
c) Future-Flow Securitisation

Securitisation is provided to allow for decline in the value of the underlying collateral, debt securitised by future hard-currency receivables will be a viable option for developing countries seeking to raise funds in the prevailing environment of low global risk appetite. By pledging future hard-currency receivables, securitised transactions subordinate the interests of current and future creditors. The transactions backed by future revenue streams are structured so that the payments do not enter the issuer's home country until obligations to bond investors are met.

II.4 Trends in Global Capital Flows

It has been discovered that financial globalisation has proceeded at a more rapid pace than trade over the past few years as developing countries experienced surge in capital inflows after mid-2009 followed by reversal in the course of 2011 as the European debt crisis worsened (see fig, 1). Renewed disruptive exchange rate swings vis-à-vis the United States dollar broadly mirrored the tidal flows of private capital. Global finance remains in upheaval (IIF,2012)

Figure 1. Private Capital Flows to Emerging and Developing Economies, 1980-2011 (US\$ billion)



Source: International Financial Institute, 2012

The rise in international capital flows involving developing countries has led to a corresponding rise in cross-border financial holdings and an expansion in their international investment positions, recording foreign assets and liabilities. The relative rise in developing countries gross foreign assets and liabilities provides further evidence of progressing financial globalisation. As financial globalisation proved hazardous in the experience of many developing countries, maintenance of a competitive exchange rate became a policy focus. If foreign exchange market interventions are used to contain pressures for currency appreciation, a build-up of international reserves arises as a by-product. Perhaps the rule of finance over trade in the modern age of accelerated globalisation is best illustrated by trading in foreign exchange markets.

Risks and Net Effects of Global Capital Flows

Although financial globalisation has several potential benefits, it can also carry some risks. The recent stream of financial crises and contagion after countries liberalised their financial systems and became integrated with world financial markets might lead some to suggest that globalisation generates financial volatility and crises (Gallagher (2011)). Though domestic factors tend to be key determinants of crises, there are different channels through which financial globalisation can be related to crises.

First, when a country liberalises its financial system, it becomes subject to international market discipline exercised by both foreign and domestic investors. When an economy is closed, only domestic investors monitor the economy and

react to unsound fundamentals. In open economies, the joint force of domestic and foreign investors could encourage countries to achieve sound fundamentals although this process might take a long time.

Secondly, financial globalisation can also lead to crises if there are imperfections in international financial markets, which can generate bubbles, irrational behaviour, herding behaviour, speculative attacks, and crashes, among other things. Imperfections in international capital markets can lead to crises even in countries with sound fundamentals. For example, if investors believe that the exchange rate is unsustainable they may speculate against the currency, which can lead to a self-fulfilling prophecy on balance-of-payments crisis regardless of market fundamentals.

Thirdly, financial globalisation can lead to crises as a result of the importance of external factors on an economy, even in countries with sound fundamentals and even in the absence of imperfections in international capital markets. If a country becomes dependent on foreign capital, sudden shifts in foreign capital flows can create financing difficulties and economic downturns. These shifts do not necessarily depend on country fundamentals. Calvo et al., (1996) argue that external factors are important determinants of capital flows to developing countries. In particular, they find that world interest rates were a significant determinant of capital inflows into Asia and Latin America during the 1990s. Economic cyclical movements in developed countries, a global drive towards diversification of investments in major financial centers, and regional effects tend to be other important global factors. Frankel and Rose (1996) highlight the role that foreign interest rates play in determining the likelihood of financial crises in developing countries.

Fourth, financial globalisation can also lead to financial crises through contagion, namely by shocks that are transmitted across countries. Three broad channels of such contagion can be identified as: real links, financial links, and herding behaviour, or "unexplained high correlations." Real links is associated with trade links. When two countries trade among themselves or if they compete in the same external markets, a devaluation of the exchange rate in one country deteriorates the other country's competitive advantage. As a consequence, both countries will likely end up devaluing their currencies to rebalance their external sectors. Financial links exist when two economies are connected through the international financial system. When the value of their collateral falls as a result of a negative shock in one country, leveraged companies need to increase their reserves. Therefore, they sell part of their valuable holdings in the countries that are still unaffected by the initial shock. This mechanism propagates the shock

to other economies. Thirdly, financial markets might transmit shocks across countries as a result of herding behaviour or panics. At the root of this herding behaviour is asymmetric information. Information is costly, so investors remain uninformed. Therefore, investors try to infer future price changes on the basis of how other markets are reacting. In this context, a change in Thailand's asset prices might be useful information about future changes in Nigeria or Ghana's asset prices. Additionally, in the context of asymmetric information, what the other market participants are doing might convey information that each uninformed investor does not have. This type of reaction leads to herding behaviour, panics, and irrational exuberance.

II.5 Policy Options in Managing Global Capital Flows

There are different views on how governments can maximise the benefits of financial globalisation while simultaneously minimising its risks (maxi-mini). One of the most important benefits of financial globalisation is the development of the financial sector. But, on the other hand, it can also be associated with some costs, particularly higher sensitivity to crises and contagion. This sensitivity to financial contagion makes many economists to believe that some degree of government intervention on financial globalisation is advisable. In spite of this, there are yet disagreements what governments should do regarding financial integration.

A first view argues that government intervention is at the root of recent crises. This view believes that international capital markets are efficient and developed (or at least international financial markets are more efficient than financial markets in developing countries). Therefore, countries with underdeveloped financial markets would benefit from full financial liberalisation, with minimal government intervention. Certain types of government intervention create distortions that can lead to moral hazard and crises. In support of this opinion, Akerlof and Romer (1993) show that government guarantees can induce firms to go broke at society's expense (looting). They claim that once looting becomes established in one sector, it can distort production in other sectors.

A second view claims that cross-country capital flows should be restricted. According to this view, anomalies such as asymmetric information, moral hazard, asset bubbles, speculative attacks, herding behaviour, and contagion are present in international financial markets. These anomalies make economies open to capital flows to suffer the consequences of these imperfections. The recent crises showed that international financial markets punished similarly countries with different fundamentals and policies. Given this evidence, Krugman (1998), Stiglitz (2000), and Tobin (1978) argue that government intervention to

restrict cross-country capital movements can be socially beneficial. In this regard, Stiglitz (2000) clamours for developing countries to put some limits on capital inflows to moderate excessive boom-bust patterns in financial markets. Governments can mitigate the cost of volatile capital flows, reducing excessive risk taking and making markets less vulnerable to external shocks, and still pursue integration with international financial markets.

A third view concentrates on risk management. This view focuses on strengthening the domestic financial sector and sequencing financial liberalisation. Obiechina (2010) supports this view by recommending, among others that capital account liberalisation should be sequenced. This is because opening a weak domestic financial sector to large capital movements is potentially risky. If the domestic financial sector does not manage risk properly, is adequately capitalised, or lacks the right incentives, large capital flows swings can create severe problems in the domestic financial sector. Since financial crises can be very costly, this view proposes an adequate regulation and supervision of the domestic financial system without distinguishing between foreign capital and domestic capital. Additional proposals include the use of counter-cyclical fiscal policy, the stability of prices, the active management of reserve requirements, and the implementation of contingent liquidity arrangements. Improved prudential regulation and increased market discipline, through more transparency and information, are also recommended as a way to avoid excessive risk taking.

From the above reactions, it is clear that capital control measures have important roles to play, particularly in developing countries. They are measures to smooth the pro-cyclicality of short-term debt inflows and outflows in and out of countries' financial markets. Capital flows tend to be pro-cyclical in the financial markets of developing countries, meaning that they often get too much during good times which cause asset bubbles and appreciation in the exchange rate or at least exchange rate volatility. If there is lots of currency mismatches, or maturity mismatches, capital account regulations/controls can be used to throw a wedge into them. Perhaps, the most important reason why nations consider capital account regulations is to have a more independent monetary policy.

III. History of Global Governance of Capital Controls

A. Pre-World War I

In the first age of globalisation which is generally dated from 1870–1914, capital controls remained largely absent as there was generally little need for capital controls due to low levels of international trade and financial integration. The

"core" countries of the pre-1914 era largely adhered to the classical gold standard that by 1880 had evolved from the historic specie regime based on bimetallism. The gold standard was a system of backing a country's currency with its gold reserves. Such currencies are freely convertible into gold at a fixed price, and the country settles all its international trade transactions in gold. Between 1900 and 1914 world's major economic powers were on gold standard, but could not maintain it during World War I (1914-18). The essence of the classical gold standard for the core countries was a credible commitment to maintain gold convertibility and this was embedded in their long history of financial development. The prevalent view was that adopting a specie standard meant adherence to sound money with stable prices. Floating regime was considered to be a radical departure from monetary and fiscal probity to be tolerated only in the event of temporary emergencies such as wars or financial crises

B. World War I to World War II: 1914 - 1945

Highly restrictive capital controls were introduced with the outbreak of World War I. The first widespread capital controls were adopted in World War I as a method to finance the war effort. At the start of the war, all the major powers suspended their participation in the gold standard for the duration of the conflict but maintained fixed-exchange rates. The gold standard with free capital mobility, however, had to be jettisoned during the inter-war years, except for a brief period of gold exchange standard, because of the compelling need of the monetary authorities to pursue their domestic goals.

These restrictions raised revenues in two ways. First, by keeping capital in the domestic economy, it facilitated the taxation of wealth and interest income. Second, it permitted a higher inflation rate, which generated more revenue. In the 1920s, they were generally relaxed, only to be strengthened again in the wake of the 1929 Great Depression. This was more an *ad hoc* response to potentially damaging flows rather than based on a change in normative economic theory. The use of capital controls peaked during World War II. An example of capital control in the inter war period was the *flight tax* introduced in 1931 by Chancellor Brüning of Germany. The tax was needed to limit the removal of capital from the country by wealthy residents. At that time Germany was suffering economic hardship due to the Great Depression and the harsh war reparations imposed on its economy after World War I.

C. The Bretton Woods Era: 1945–1971

A widespread system of capital controls were decided at the international 1944 Bretton Woods conference . At the end of World War II, international capital was "caged" by the imposition of strong and wide ranging capital controls as part of

the newly created Bretton Woods system it was perceived that this would help protect the interests of ordinary people and the wider economy. Keynes, one of the principal architects of the Bretton Woods system, envisaged capital controls as a permanent feature of the international monetary system, though he agreed that current account convertibility should be adopted once international conditions had stabilised sufficiently. This essentially meant that currencies were to be freely convertible for the purposes of international trade in goods and services, but not for capital account transactions. Following the Keynesian Revolution, the first two decades after World War II saw little argument against capital controls from economists, with an exception was Milton Friedman. However, from the late 1960's the effectiveness of capital controls began to break down.

D. Transition Period and Washington Consensus: 1971 - 2009

The demise of the Bretton Woods system in the early 1970s was largely precipitated by the pursuit of financial policies inconsistent with maintaining the pegged rate system by some of the key countries, and this has been followed by an era of a more flexible regime. By the late 1970s, as part of the displacement of Keynesianism in favor of free market orientated policies and theories, countries began abolishing their capital controls, starting between 1973 - 1974 with the U.S., Canada, Germany and Switzerland and followed by Great Britain in 1979. Most other advanced and emerging economies followed, chiefly in the 1980s and early 1990s. During the period spanning from approximately 1980 - 2009, known as the Washington Consensus era, the normative opinion was that capital controls were to be avoided except perhaps in a crisis. It was widely held that the absence of controls allowed capital to freely flow to where it is needed most, helping not only investors to enjoy good returns, but also helping ordinary people to benefit from economic growth. During the 1980s many emerging/developing economies were coerced into following the advanced economies by abandoning their capital controls as a result of the structural adjustment programs (SAP) that became inevitable to resolve their debt crisis.

However, the orthodox view that capital controls are a bad thing was challenged following the 1997 South Asian Financial Crisis. Asian nations that retained their capital controls escaped the crisis relatively unscathed. Malaysia's prime minister, Mahathir bin Mohamad imposed capital controls as an emergency measure in September 1998. Both strict exchange controls and limits on outflows from portfolio investments, put in place by Malaysian government were found to be effective in containing the damage from the crisis on the economy.

E. Post Washington Consensus: 2009 and Later

By 2009, the global financial crisis had caused a resurgence towards Keynesian thought. During the 2008–2012 Icelandic financial crisis, the IMF proposed that capital controls on outflows should be permitted by Iceland, calling them an essential feature of the monetary policy framework, given the scale of potential capital outflows. In the latter half of 2009, as the global economy started to recover from the global financial crisis, capital inflows to emerging market economies—especially, in Asia and Latin America—surged, raising macroeconomic and financial-stability risks similar to the Iceland crisis. Several emerging market economies responded to these concerns by adopting capital controls measures; for example, Brazil imposed a tax on the purchase of financial assets by foreigners and Taiwan restricted overseas investors from buying time deposits.

The return towards capital controls witnessed pro-capital control statements by various prominent economists, together with an influential staff position note prepared by IMF economists in February 2010 (Ostry et al., 2010). A follow-up note prepared in April 2011, have been hailed as an end of an era that eventually led to a change in the IMF's long held position that capital controls should be used only in extremis, as a last resort, and on a temporary basis. In February 2011, citing evidence from new IMF research (Ostry et al., 2010) that restricting short-term capital inflows could lower financial-stability risks, over 250 economists headed by Joseph Stiglitz wrote a letter to the Obama administration asking them to remove clauses from various bilateral trade agreements that allow the use of capital controls to be penalised.

IV. Policy Challenges Associated with Capital Flows and Types of Controls

A. Purposes of Capital Controls

At least six core reasons why nations may want to deploy capital control measures in their various economies. Fear of appreciation: capital inflows cause upward pressure on the value of the domestic currency, making domestic producers less competitive in the international market, hurting exports and therefore the economy. Fear of “hot money”: the large injection of money into a small economy may cause distortions, and eventually a sudden reversion if foreign investors try to leave simultaneously. Fear of large inflows: large volumes of capital inflows, even if not all hot money, can cause dislocations in the financial system. Fear of loss of monetary autonomy: a trinity is always at work: it is not possible to have a fixed (or highly managed) exchange rate, monetary policy autonomy, and open capital markets. Specifically, when central banks

intervene in the exchange market buying foreign currency in order to curb the appreciation of the exchange rate, they effectively increase the domestic monetary base. Trying to raise interest rates to offset that effect causes more capital inflows, as foreign investors rush in to take advantage of higher yields. Fear of asset bubbles. This is a particularly important issue in the 2008 financial crisis, since the bursting of the real state bubble was the root cause of the banking crisis around the globe. Fear of capital "flight" whereby capital may rapidly leave a nation in the event of a crisis or because of contagion (Gabel, 2003; Epstein, 2005).

These fears have led to five main possibilities for capital control, and further arranged in Table 1 as well so as : to restrict capital outflows in the event of a balance of payments crisis; to curb capital inflows, before it leads to crisis; to check and restructure the composition of capital inflows, in particular to discourage short-term banking inflows, and favour FDI, relative to other inflows; impose a tax on foreign exchange transactions, with the aim of reducing volatility; separate domestic interest rates from foreign, with the aim of restoring some monetary independence.

1. Restrict Capital Outflows

Conditional on a speculative attack occurring, controls on capital outflow can help slow down or minimise the loss of reserves or the required increase in interest rates. Needless to say, controls on outflows can also weaken the discipline that international financial markets place on the quality of macroeconomic policy of a country. For a country experiencing potentially excessive capital inflows, liberalisation of controls on outflow may offer a way of reducing net national indebtedness (Epstein, 2012). On the other hand, international investors sometimes respond to such liberalisation by accelerating the capital inflows, particularly when such liberalisation is perceived to boost investors' confidence -- particularly their confidence that they will be able to take their money back out of the country in the future if they wish. This logic could be inverted to suggest that if a country wants to discourage volatile capital inflows, it could do so by retaining controls on outflows, thereby deliberately depressing investor confidence.

2. Curb Capital Inflows

The usual basis for capital controls on inflows, as earlier pointed is to prevent overvaluation and over indebtedness. It is understood that, high levels of capital inflow and cumulative indebtedness, often in conjunction with a currency overvalued in real terms, have been considered key indicators of the risk of financial crises. Such surges in capital flows usually comes before financial crisis.

For example, Mexico and Thailand had large net capital inflows in 1994 and 1996 (Frankel and Rose, 1996), respectively, in advance of their financial crises. It is probably easier to keep capital out than to keep it in. As earlier said, discouraging inflow (particularly temporary inflows), is meant to limit real appreciation and aggregate debt, and subsequently to have withstood contagion from other crises. Such controls have a role to play as a temporary measure when a country faces a large upsurge of inflows. They might help a government play for time until it can determine whether the funds are going to useful investments, which will generate the foreign exchange earnings needed in the future to service the debt, or whether they are instead going towards mere consumption. The efficacy of controls on inflows is likely to be greater than controls on outflows, in part because it is easier to "scare capital off" than to "keep it in against its will." Enforceability remains a serious limitation however, the more so as time goes by.

3. Check the Components of Capital Inflows

The knowledge the capital inflow is a leading indicator to the probability of currency crashes occurring at a future date. The higher the reliance on FDI, the lower the probability of crisis (Aremu, 2005). The higher the reliance on foreign-currency borrowing that is short-term or intermediated through banks, the higher the probability of crisis. In addition, bank flows in particular are more vulnerable to moral hazard problems than are other sorts of modes of finance, and that a mismatch of short-term bank liabilities with longer-term bank assets (e.g., real estate) leaves a country more vulnerable. Flows of longer-term securities have the advantage that the price of a stock or bond adjusts automatically in the event of adverse developments ("risk-sharing"), with fewer sticky negotiations with bankers over terms of rollovers or restructuring.

4. Introduce Tax on all Foreign Exchange Transactions

Introducing a small uniform tax on all buying and selling of foreign exchange (ie Tobin tax), with no attempt to ascertain the purpose of the transactions is equally a convenient way of discouraging unwanted capital flows. It is believed that a small Tobin tax would automatically dampen short-term capital movements (such as the majority of transactions that take place in well-developed foreign exchange markets, which are typically unwound within hours), more than it would discourage long-term movements or trade in goods and services.

Table 1 Purposes of Capital Controls

S/N	Purpose of Control	Methods	Direction of Control
1	Generate Revenue/ Finance War Effort	Controls on capital outflows permit a country to run higher inflation with a given fixed-exchange rate and also hold down domestic interest rates.	Outflows
2	Financial Repression/ Credit Allocation	Governments can use the financial system to reward favored industries or to raise revenue, may use capital controls to prevent capital from going abroad to seek higher returns.	Outflows
3	Correct a Balance of Payments Deficit	Controls on outflows reduce demand for foreign assets without contractionary monetary policy or devaluation. This allows a higher rate of inflation than otherwise would be possible.	Outflows
4	Correct a Balance of Payments Surplus	Controls on inflows reduce foreign demand for domestic assets without expansionary monetary policy or revaluation. This allows a lower rate of inflation than would otherwise be possible.	Inflows
5	Prevent Potentially Volatile Inflows	Restricting inflows enhances macroeconomic stability by reducing the pool of capital that can leave a country during a crisis.	Inflows
6	Prevent Financial Destabilisation	Capital controls can restrict or change the composition of international capital flows that can exacerbate perverse incentives in the domestic financial system.	Inflows
7	Prevent Real Appreciation	Restricting inflows prevents the necessity of monetary expansion and greater domestic inflation that would cause a real appreciation of the currency.	Inflows
8	Restrict Foreign Ownership of Domestic Assets	Foreign ownership of certain domestic assets—especially natural resources—can generate resentment.	Inflows
9	Preserve Savings for Domestic Use	The benefits of investing in the domestic economy may not fully accrue to savers so the economy, as a whole, can be made better off by restricting the outflow of capital.	Outflows
10	Protect Domestic Financial Firms	Controls that temporarily segregate domestic financial sectors from the rest of the world may permit domestic firms to attain economies of scale to compete in world markets.	Inflows and Outflows

5. Differentiate Interest Rates

Differentiating domestic interest rates from foreign interest rates in order to retain some independence for monetary policy is another way of controlling capital flows. The goal of policy independence is not directly relevant to the goal of minimising financial crises. Like it happened in Southeast Asia, in the face of large capital inflows they were able to sterilise the increase in reserves, so as to avoid real appreciations of their currencies. A reasonable interpretation is that they in fact were able to attain (only) a modest amount of policy independence through modestly incomplete liberalisation of capital markets.

B. Capital Controls and Exchange Rate Issues

Movement of capital flows could cause excessive exchange rate pressures, as it happened in early 1980's in Nigeria and the country was forced to adopt the second-tier foreign exchange market (SFEM). In fact, the magnitude and gyrations of capital flows have become the primary determinant of exchange rate movements on a day-to-day basis for most developing countries, rather than trade deficits and economic growth as in the past. Adverse expectations, especially fuelled by the uni-directional movement of currencies have often turned out to be self-fulfilling prophesies. For the majority of these economies, such exchange rate movements have had significant impact on both financial and real sector of the economy seriously affecting domestic growth trajectories.

It is in this context that, the choice of an appropriate exchange rate regime and the conduct of monetary policy has become more challenging tasks for monetary authorities. While fixed exchange rate is seen to have the advantage of a nominal anchor for "importing" credibility, providing transparency, reducing unpredictable volatility and transactions costs, floating exchange rate has the benefits of monetary independence, insulation from real shocks and a less disruptive adjustment mechanism in the face of nominal rigidities. Accordingly, the choice of exchange regime is not straightforward and is in fact contingent on a host of factors, such as the size of the economy, degree of openness, product diversification/export structure, divergence of domestic inflation from trading partners, labor mobility, vulnerability to real/nominal shocks, fiscal policy flexibility, capital mobility, credibility of policymakers and degree of economic/financial development.

No doubt, extensive work has been done in the area of exchange rate regime, across countries, yet it still continues to attract a fair share of attention on regular basis. Although the results of empirical studies on the experiences of different exchange regimes across countries differ, by and large, a majority of the studies infer that for relatively poor countries with little access to international capital

markets, pegged exchange rate regimes had worked well, delivering both relatively low inflation and relatively high exchange rate regime durability (Hussain et al., 2004). As countries developed economically and institutionally, some of them seem to have found considerable benefits in adopting a more flexible exchange rate system. In fact, the key distinction for exchange rate regime choice between advanced and emerging economies is found in the degree of financial maturity.

Because the determination of exchange rate has long been a sensitive topic in international finance, opinions differ as to which types of capital flows are important for exchange rate determination because some flows appear to matter far more than others do. The following questions always emerge: First, do net cross border capital flows explain exchange rate movements and if yes, is it net bond flows or net equities flows that matters? Second, is it the net accumulation of foreign assets that matter? Thirdly, through which channels do equity return differentials and interest rate differentials affect the nominal exchange rate? In foreign exchange markets, exchange rates are explained, to a large extent by the level of capital flows because the flows convey investors' private information. However, it has been difficult to identify which capital flow components convey the most private information, partly because private information by its very nature cannot be observed directly. In an IMF recent working paper, Gyntelberg et al., (2012) provided robust empirical evidence, using capital flows into Thailand as a sample, that not all capital flows influence exchange rate equally: capital flows induced by foreign investors' stock market transactions have both an economically significant and permanent impact on exchange rate, whereas capital flows induced by foreign investors' transactions in the government bond market do not.

The question is whether the private information contained in foreign exchange order flow is based primarily on information generated initially in stock or bond markets and is then subsequently transmitted to the foreign exchange market where it may generate follow-up adjustments in the currency's exchange value. There are several types of private information that stock market investors may have about the fundamental determinants of a firm's value. These include knowledge of the quality of the firm's products, the prospects for successful product innovation, management quality, and the strength and likely strategies of the firm's competitors. Private information may further include passively collected information about macro variables and other exchange rate fundamentals which may be dispersed among customers. This type of private information is relevant for both equity and bond market participants.

Private but dispersed information characterises many macro variables at the center of exchange rate modelling, such as output, money demand, and consumer preferences. These variables are first realised at the micro or household/firm level and only later aggregated by markets and/or governments. For some macro variables, government- provided aggregations exist, but their publication lags the underlying realizations by weeks and months, leaving room for market-based aggregation well in advance of their eventual publication. For other measures, such as risk preferences and money demand functions, the task of aggregation is left fully to markets.

These authors proposed that when it comes to external capital flows; it is foreign investors' private information that related to the stock market and not the bond market which drives the exchange rate. They tested this proposition using daily-frequency data from financial markets in Thailand, and found strong evidence in favour of this proposition. Specifically, they found that only the relatively small portion of foreign exchange flows that is driven by foreign investors' transactions in the stock market has a lasting effect on the exchange rate. Given that these flows in the stock and foreign exchange markets are consistent with information asymmetry between domestic and foreign investors, they infer that the reason these flows have a lasting effect on the exchange rate is that they convey investors' private information to the market. In contrast, the much larger portion of foreign exchange flows that is not explained by stock market variables plays at most a transitory role in determining the exchange rate.

Taken together, these findings strongly suggest that (at least for the case of Thailand) foreign exchange order flow is relevant for the exchange rate if it has to reflect investors' private information about the prospects of individual firms. Their findings also suggest that data collection efforts on external capital flows might be made more informative if they were categorized according to their private information content; and that analysts should focus their attention on those flows that convey private information.

Expected Stance on Nigeria's Exchange Rate Policy

Overtime, Nigeria's exchange rate policy essentially focuses on managing volatility with no fixed rate target, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way. The Central Bank of Nigeria (CBN) continues to follow the approach of watchfulness, caution and flexibility in regard to foreign exchange market as well as co-ordinates its market operations carefully, particularly in regard to the foreign exchange market with appropriate monetary, regulatory and other intervention measures as considered necessary from time to time in the

foreign exchange market. From this my observation, the conduct of exchange rate policy in Nigeria today appears to be guided by three major reasons viz: (i) to maintain orderly conditions in the foreign exchange market by providing foreign exchange as considered necessary from time to time, and to prevent the emergence of destabilising and speculative activities of participants in the foreign exchange market; (ii) to help maintain an adequate level of foreign exchange reserves; and (iii) to help eliminate market constraints with a view to facilitating the development of a healthy foreign exchange market.

If this agrees with the monetary authority's position, it is my suggestion that the various tiers of the governments in the country should be carried along for fiscal prudence. This is because the overall approach to foreign exchange rate and reserve management should be judiciously built upon a host of identifiable factors and other contingencies, which include: the size of the current account deficit of the country; the magnitude of short-term liabilities (including current repayment obligations on long-term loans); the possible variability in portfolio investments and other types of capital flows; the unanticipated pressures on the balance of payments arising out of external shocks; and movements in the repatriable foreign currency deposits of non-resident Nigerians.

Among the issues that could affect the exchange rates and reserves of the country of which the CBN must collaborate with the various tiers of governments: First, the need for clear hierarchy in the nature of capital flows with equity flows getting more preference to short-term debt flows. Within equity investments, governments should ensure that FDI should be given precedence over portfolio investment.

Secondly, the Nigeria external liabilities have to be kept under constant watch and any eventuality of reverse movement should be factored in. For this purpose:

- ❖ external debt should be calculated not only in terms of its original maturity but also residual maturity,
- ❖ there should be a clear understanding of the quality and magnitude of contingent liabilities and derivatives,
- ❖ maturity profile of external borrowings should be carefully modulated so as to prevent payments that are difficult to implement,
- ❖ short term debt/trade credits need to be constantly monitored, and
- ❖ there should be flexibility of retirement/prepayment of costly debt at times of benign international interest rate regime.

Thirdly, that management of capital account involves a distinction not only between residents and non-residents or between inflows and outflows but also

between individuals, governments' functionaries, corporate institutions and financial intermediaries. The financial intermediaries are usually a greater source of volatility amongst these. Therefore, a necessary condition for capital account liberalisation of Nigerian economy is the presence of a well-regulated and mature financial sector with strong supervisory framework from the various organs of the government. Only after Nigerian financial sector has attained some degree of credibility and resilience could it gain from capital flows emanating from better accounting procedures, transparency norms, corporate governance etc.

Lastly, our foreign exchange reserves should at least be sufficient to cover likely variations in capital flows or the "liquidity-at-risk" and not to be continuously depleted monthly. Furthermore, adequate reserves, keeping in view the national balance sheet considerations, which include public and private sectors, also provide comfort and confidence to market participants. In addition, constant improvements in information base needs to be made to all stakeholders in the economy to ensure the appropriateness, timeliness and quality of data dissemination. It is important to communicate to the public, in a transparent way as possible, the type of policy that is being followed.

III. Capital Flow, Capital Control and ECOWAS Financial Integration Program

The lessons learnt from the Asian Financial Crisis and even the recent global financial crisis reinforce the need to monitor the capital flows in the region and channel appropriately the region's savings towards productive investments within the region. Unfortunately, ECOWAS financial markets are still individually and the range of products and openness within ECOWAS remains low. Unless ECOWAS financial markets work together to achieve parity with developed markets in terms of cost, liquidity, product range and technology investments, investors and issuers in the region will rely on the larger and more liquid markets outside the community, thus making the economic integration of the region less relevant. This threat of marginalisation has acted as a catalyst for greater capital market integration among ECOWAS Member States.

V.1 Objectives of ECOWAS Financial Market Integration

Under ECOWAS Common Investment Market (ECIM), greater cross-border access to investors can help broaden the investor base and range of products, and can provide the liquidity, scale and capacity to compete globally. Furthermore, financial integration can, by facilitating access to a larger pool of issuers, investors and financial services providers, build awareness of ECOWAS as an asset class

and enhance the attractiveness of the region for global capital flows. Holistic benefits of financial market integration include the following:

- ❖ There will be overall benefit to Member States in terms of promoting and facilitating economic growth, enhancing the breadth and depth of the financial market and diversifying sources of financing, investment channels and investor base.
- ❖ For investors, financial market integration will lead to enhanced product and service innovation, and lower prices for financial services as competition lowers transactions costs and allows larger regional firms to exploit economies of scale and scope. Investors can also now diversify their investments to a greater extent than before.
- ❖ The integration of financial markets will allow the financial intermediaries to benefit from economies of scale, leading to improved and more innovative services at lower prices, as well as from the opportunity to tap the larger pool of investors' resources in the region.
- ❖ For companies/issuers, harmonisation of standards can considerably reduce the administrative burden and costs by replacing many different sets of diverging rules with a single set. Under such harmonisation of standards, issuers seeking to issue equity or debt securities in more than one ECOWAS Member States will be required to prepare only one set of disclosure documents, with additional limited wrap-around for multi-jurisdiction offers.
- ❖ For governments and regulators, financial market integration will lead to a more efficient allocation of financial resources, arising from the fact that savings can flow more easily and at lower cost to investment and because barriers will have been dismantled. Through sequenced liberalisation and integration process, regulation of cross-border trades and investment will be strengthened as regulators are able to offer greater protection for investors. In addition, through harmonization and mutual recognition agreements, ECOWAS financial markets will be able to improve their regulatory standards by benchmarking with international standards and adopting best practices.
- ❖ Integration of financial system across Member States will also hasten the development of the less developed financial markets in the region as they would be able to benefit from the experiences of the more developed ECOWAS financial markets than from other Member States and thus accelerate their adoption of regional/ international standards.

Because of these reasons, and in spite of this paper's position on the need for capital control, there is a strong case for ECOWAS to step up its financial

integration initiatives to enhance capital flow among its Member States under its ECIM initiative. The Commission is taking necessary steps to ensure that the liberalisation of the financial sector among Member States is not an obstacle to the efforts of each individual market to develop themselves. To this end, the initiative is being worked out in a systematic and complimentary fashion so as to ensure that domestic and regional efforts progress efficiently and in tandem with Vision 2020. Policy harmonisation and coordination efforts are being enhanced and clear goal setting put in place for the short, medium and long-term. The Commission believes that having a clear roadmap on the liberalisation of the sector is critical with established milestones and regional stakeholders providing a systematic approach to ensure efficient financial integration.

V.2 ECOWAS Capital Market Integration

Given that ECOWAS capital markets are at different stages of development, rendering large differences in market practices, institutional development and regulatory standards, laws and process, an opt-in approach is proposed. This means that Member States which are ready will proceed with the support of ECOWAS Commission, while the other jurisdictions will undertake a more gradual approach and pursue integration initiatives as and when they are ready. The Commission is doing this through two approaches: First, strengthening ECOWAS capital markets through development and integration of the community. This is achieved through greater harmonisation in offering standards, facilitating mutual recognition, allowing greater flexibility in language and laws in securities issuance, enhancing tax structures and facilitating market linkages. Secondly, allowing greater capital mobility via its on-going regional payment and settlement system. This is expected to be achieved through liberalisation of capital movements across Member States, subject to having in place necessary safeguard mechanisms.

The Commission expects its various Committees to work out the modalities towards achieving the following:

1. Regulatory Alignment and Harmonization

Areas requiring attention of the Committees include regulation of special purpose vehicles, allowing the use of omnibus accounts for custody of exchange linked trades, prevention of cross-border market misconduct, and disclosure of material information in a timely manner to investors of exchanges, and non-discriminatory investor protection schemes and standards. The Committees are to set out a mid-term targets to achieve the ECOWAS interlinked market as soon as possible through:

- ❖ Alignment of environments – regulatory and legal (trading, clearing, settlement and custody, market conduct, enforcement and disclosure), and market practices (settlement deadlines and periods, operational hours, corporate action processing rules)
- ❖ Address impediments and barriers such as capital controls
- ❖ Address cooperation and partnership issues such as technical assistance, technology and infrastructure

2. Market Infrastructure to Facilitate Connectivity

The Committees are looking into the following trading models:-

- ❖ Dual / cross listing of securities Issue: Regulatory cost of listing due to disclosure and listing requirements of both exchanges
- ❖ Depository receipt instrument Issue: When a company depository receipt is traded on a foreign exchange, the listed company needs to satisfy the disclosure and listing requirements of both exchanges – again, this could add to the regulatory cost
- ❖ Offshore trading Issues: Issuers not subject to listing requirements of the foreign exchange and not therefore required to disclose information. Only need to comply with domestic requirements. Arrangements needed to allow dissemination, ease of access to information from corporate disclosures of the foreign issuers

IV. Conclusion

VI.1 Framework for Resiliency of Nigerian Capital Flow Management

The basic neoclassical model suggests that, with rising financial globalisation, capital should flow from rich to poor countries, making people in both sets of countries better off by enabling a more efficient international allocation of capital from countries where capital is less productive to those where it ought to be more productive. In addition, financial flows should allow for more efficient sharing of risk across countries, thereby facilitating the smoothing of national consumption against country-specific shocks to national output. These benefits are likely to be greater for developing countries, like Nigeria, as they have less capital and more volatile growth, implying that both the growth and risk sharing benefits would be larger for them. Have international capital flows delivered these benefits? Unfortunately, evidences that financial integration have accounted for systematically higher growth rates in developing economies is not robust. On the contrary, some observers have argued that financial globalisation is the proximate determinant of the financial crises experienced by many developing economies over the last two decades. And yet, financial globalisation has continued apace, with rising cross-border financial flows. In

practice, large capital flows can create substantial challenges for policymakers. These challenges have recently come to the forefront again for emerging market economies.

Capital controls, which prevent money from moving in and out of an economy irrespective of the economic health of the nation (causing financial instability), can insulate domestic monetary policy to some extent. This presentation has argued that such preventive method is acceptable particularly in emerging countries like Nigeria. Two types of such controls have been considered: controls on capital outflows, and controls on capital inflows. However, controls on outflows – and, in particular, quantitative controls on outflows, are largely ineffective because they are easily circumvented, encourage corruption and, may not help the adjustment process. A major drawback of controls on outflows is that, in most cases, they are not used as a temporary device to face a crisis situation but most often they become a permanent feature of the country's incentive structure. For capital controls on inflows however, it was argued that it: make monetary policy more independent; alter the composition of capital flows; reduce real exchange rate pressures. For both controls, it would be interesting, for policy purposes, for the CBN to examine differences between short run and long run impacts of the measures, so as to ascertain how quickly control measures lose their effectiveness.

From this presentation, two critical questions emerge under the current financial globalisation. First, is global financial integration avoidable? Secondly, if so, should it be avoided by Nigerian policy makers? If the answer to either of these questions is no, then Nigeria is going to have to live in a world characterised by occasional large shocks emanating from the capital account of the balance of payments. If this is so, it is likely that surges and reversals will continue to be facts of life for the economy like all other countries. It is the responsibility of the CBN to work out how the country can take advantage of external capital, while achieving resiliency to inflows/outflows in a financially-integrated world. How can such resiliency be achieved?

First, the composition of the country's external financing seems to be of paramount importance. Not only does the volatility of capital flows differ along a spectrum from FDI at one extreme to short-term foreign currency- denominated borrowing from banks at the other, but the growth benefits of different types of inflows seem to line up fairly closely with their stability. There is a strong professional presumption that FDI is beneficial for growth, and there's a significant amount of evidence supporting positive growth effects of portfolio equity flows, while there is little evidence that the more volatile debt-related flows have

significant growth benefits (see Jeanne et al., 2012). This suggests that Nigerian economy can reap growth benefits from international financial integration while enhancing their resiliency to the ebbs and flows of international capital flows if her external financing takes the form of equity rather than debt. But achieving this outcome has a strong institutional component: reducing corruption across the three tiers of governance, ensuring well-defined property rights, maintaining appropriate accounting and disclosure standards, and high standards for corporate governance.

A second important component of resiliency is a well-functioning domestic financial sector, meaning a financial sector that is well capitalised and regulated to minimise credit risk and to avoid currency mismatches in financial institutions and their customers, as well as one that is protected against panic by a well-functioning central bank (lender of last resort) and well-designed deposit insurance system. Resiliency is achieved under such a system by avoiding the misallocation of resources arising from capital inflows, by reducing the chances that inflows may trigger credit booms and asset-price bubbles, and by reducing the vulnerability of the system to sudden capital outflows.

Third, resiliency is also likely to be enhanced by an exchange rate regime that allows substantial short-run exchange rate variability, supported by a large stock of liquid foreign exchange reserves (a managed float with active intervention as the CBN regularly do in the foreign exchange market). Short-run exchange rate variability not only avoids the perception of exchange rate guarantees that may favour short-term foreign exchange-denominated capital inflows, but more importantly, provides an automatic stabiliser against the effects on macroeconomic stability of surges in capital inflows or sudden outflows. The overheating associated with large inflow surges can be at least partially offset by real exchange rate appreciation, and the contractionary effects of sudden outflows can be ameliorated by real exchange rate depreciation. The accumulation of reserves, by CBN, during inflow episodes and their use during sudden stops, on the other hand, can ensure that real exchange rate variability is not excessive, thereby preventing capital flows from too severely aggravating the signal extraction problem faced by agents deciding how to allocate capital between traded and non-traded activities in the domestic economy.

Fourth, because monetary policy is often the first line of defence against macroeconomic shocks, including those emanating from capital inflows and outflows, a resilient domestic environment will feature a central bank that can flexibly implement effective monetary policy without being constrained by reputational concerns, by fiscal dominance, or by concerns over its own

solvency. This implies a central bank that is independent, has a good understanding of the domestic monetary transmission mechanism, has cultivated an anti-inflationary reputation, and operates a well-understood policy rule.

Finally, the single most important component of resiliency is probably a fiscal one, including a safe margin of fiscal solvency, a set of fiscal institutions that allow the implementation of fiscal restraint during boom times, a preponderance of long-term, domestic currency denominated debt rather than short-term foreign currency debt among the government's liabilities, and strong automatic fiscal stabilisers. A safe margin of fiscal solvency is critical to prevent concerns about the government's ability to service its debt itself becoming a driver of capital outflows. However, it is also important to allow the government to run deficits when required to stabilise the economy in response to capital outflows triggered by other factors. It is also important that a country's fiscal institutions allow it to resist pressures to spend or cut taxes during good times (i.e., when output is above potential). Policy responses to capital-inflow episodes that favor a tight fiscal-loose monetary policy mix is likely to have a variety of beneficial effects, so institutions that encourage the exercise of fiscal restraint in booms are an important component of resiliency. Similarly, avoiding reliance on short-term foreign currency debt makes the government less vulnerable to Mexican-style liquidity crises. Designing strong automatic fiscal stabilisers (such as counter-cyclical transfer payments) would help minimise reliance on discretionary fiscal policy responses to both inflows and outflows, which may take time to implement.

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