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Keynote address at the CBN Executive Seminar on "Capital account liberalization: issues, problems, and prospect"

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Keynote Address

*Obadiah Mailafia (Ph.D)**

Director of Research and Statistics
The Branch Controller, Calabar Branch
Executives of the Research and Statistics Department
All Executives present
Distinguished participants
Ladies and Gentlemen,

It gives me great pleasure to be here on this occasion of the 2006 Executive Seminar organized by the Research and Statistics Department in collaboration with the Human Resources Department. The theme of this year's seminar, "Capital Account Liberalization: Issues, Problems and Prospects" is very apt, in view of the developments in the global economy, and our policy reforms embedded in the National Economic Empowerment and Development Strategy (NEEDS), and the Millennium Development Goals (MDGs), which seek to further open-up the Nigerian economy.

Thus, this seminar presents an opportunity for participants to deliberate on questions such as: are restrictions or non-restrictions on the capital account beneficial for a developing economy undergoing economic reforms such as Nigeria? Should there be a big bang or gradualist approach to capital account liberalization? Should it be a complete liberalization? What are the available options?

These questions have assumed greater importance with the emergence of the World Trade Organization (WTO), the International Monetary Fund (IMF), the International Financial Architecture and the Basle Capital Accord as forces for trade and financial transactions in the World economy. Permit me to add

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that the answers to these questions that would emanate from your deliberations would provide the leeway for proactive policies by the Bank.

Perhaps, it is pertinent to recall at this stage that the Bank also refocused its research efforts with a view to preserving the external sector viability through the close monitoring of balance of payments developments. The capital account forms a central part of a country's balance of payment's account. This account, as you know, x-rays transactions between a domestic economy and the rest of the world. Thus, capital flows in the form of short and long term investments, which are usually recorded in the capital and financial account could be susceptible to external shocks. These shocks could be in the form of sudden reversals and/ or foreign ownership/control-related concerns. The apparent question becomes why a country would want to liberalize its capital account given this fact.

From a theoretical point of view, economists would generally point to the following benefits with regard to capital account liberalization; technology transfer, higher risk adjusted rates of returns, reduction in the savings investment gap, improved efficiency of capital allocation, risk and portfolio diversification, amongst others.

You will recall that the 1990s witnessed a series of financial crises which disrupted exchange rate and financial arrangements in a significant number of countries, particularly in Asia and Latin America. Most of these crises occurred in the wake of capital account liberalization. In the light of these experiences, most economies have become more careful to determine when and under what conditions liberalization of the capital account becomes desirable. In the context of the unrelenting forces of globalization and integration, it would not be wise to assume that capital mobility and investment flows as an economic development tool would not remain as a critical and integral part of economic policy for many years to come.

Net capital flows to developing economies are estimated to have tripled from $50 billion annually in 1987-1989 to more than $150 billion in 1995-1997 before most countries witnessed sharp reversals following the Asian crisis.

Nevertheless, a large number of IMF-member countries have removed restrictions on capital account transactions in the wake of globalization to take advantage of the potential and *ex-ante* benefits that arise from liberalizing the capital account. Over the years, the growth of international financial transactions *cum* capital flows has been attributed mainly to globalization, financial integration, technological developments, deregulation of domestic institutions in industrialized and developing economies, trade multilateralization as well as growth of financial derivative instruments.

For a developing economy such as Nigeria with the current policy efforts geared towards encouraging capital flows into the economy, achieving our key macroeconomic objectives requires addressing not only the questions posed above but also devising ways to minimize the shocks that may from time to time affect the domestic economy. This factor becomes even more prominent when it is realized that, although capital account liberalization shifts the risk burden to the private sector, the risks to macroeconomic management can become complicated.

Distinguished ladies and gentlemen, the most important considerations, in my view, relate to the imperative of designing a framework of macroeconomic stabilization and policy reforms that would put the economy on the path of sustainable growth and development with equity. Embarking and achieving most of the policy reforms and its objectives, as outlined in the NEEDS framework clearly requires a sizeable quantum of financial resources. The dilemma between attracting financial resources and undertaking reforms, without exposing the domestic economy to harmful external shocks becomes very apparent.

At this juncture, it is pertinent to clearly state the objective of any capital account liberalization, bearing in mind that liberalization can apply to inflow and/or outflow, and the type of capital to be liberalized. Is it debt or equity market liberalization? Internal financial practices by market participants also need to be enhanced. These market participants range from banks, and companies to supervising authorities. Banks and non-bank financial intermediaries must engage in sound and prudent risk management. The supervising authorities need to engage in rigorous prudential regulations.

Countries such as Chile and Colombia have tried to discourage domestic corporations and banks from excessive foreign exposures by taxing all short term capital inflows; others have adopted more stringent measures. The need to develop in-house models that would manage risk cannot be overemphasized at this stage. Suffice to note that, the world over, negative conditions in the domestic financial system such as market indiscipline in the form of inadequate accounting, auditing, disclosure practices, implicit government guarantees that encourage excessive and unsustainable capital flows as well as inadequate prudential supervision/regulation of local financial institutions have to be addressed and reduced to the barest minimum before any credible program of capital accounts liberalization could be put in place.

Distinguished participants, capital account liberalization is indeed inevitable for economies wanting to tap into the benefits that accrue from participating in the global economy. Do we go with the flow? Like anything in existence and as recent experiences have shown, liberalizing the capital account also has its risks. But the opportunities are stupendous. I urge participants in this very important seminar to explore the opportunities that would help put our economy at the next level even as we identify the risks and explore mechanisms for hedging against them. Ladies and gentlemen, there is no doubt that the research agenda described herein not only provides a deep intellectual challenge, but can also yield good returns in our common quest for sustainable capital flows.

I thank you for your kind attention and wish you fruitful deliberations.