Captial Account Liberation:

The Malawi Experience

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THE MALAWI PERSPECTIVE

BACKGROUND

Controls on capital account transactions have for a long time been advocated as a way to deal with financial and currency crises. Some countries facing severe balance of payments problems have resorted to various controls on capital outflows including taxing funds remitted abroad, operating dual exchange rates, and outright prohibition of fund transfers. In some cases, controls have also been applied to capital inflows because of their deleterious effects on money and inflation.

Large capital inflows can also cause real exchange rate appreciation, aggravate risks to the financial sector and precipitate unsustainable deficits in the current account. In a world with imperfect information, free capital mobility was likely to simplify existing distortions, create situations of moral hazard, encourage

excessive risk taking and generate major and costly crises (Bhagwati, 1998). In addition, financial markets of most developing countries are generally underdeveloped and hence are not integrated in the global financial system. It is against this background that most developing countries have adopted capital controls as a way of dealing with the harmful effects of unrestricted capital mobility.

CURRENT AND CAPITAL ACCOUNT LIBERALISATION

Since Malawi embarked on the liberalization process in the 1980s, removing capital controls has not been an issue. Rather, sequencing and the speed of reforms has been the main consideration. Liberalizing the balance of payments has, for Malawi, meant liberalizing the current account first before progressing on to the capital account.

Malawi's current and capital accounts were fully controlled before 1988. This meant that prior approval of the central bank was a requirement to import and effect payment for goods and services. Exports of merchandise were closely monitored by the central

bank and 100 per cent of the proceeds were surrendered to the central bank which converted them into local currencies at an exchange rate determined by the authorities. Foreign exchange rationing was also common as demand often outpaced supply.

In 1988 Malawi initiated reforms to liberalise the current account. These reforms were fully supported by the World Bank's Industrial and Trade Policy Adjustment Credit (ITPAC) and a series of balance of payments support facilities of the IMF. During the 1990s almost all current account transactions were liberalised. Payment of services including travel is however still being restricted, but commercial banks have now been mandated to grant approvals/rejections depending on their assessment of the application. The Reserve Bank of Malawi only provides guidelines.

Of necessity, the liberalisation of the current account has meant a simultaneous liberalisation of the foreign exchange market and the exchange rate. Also, the financial sector has been liberalized. Financial institutions are however required to observe prudential regulations and acceptable banking standards. Interest rates have

therefore been liberalised. The central bank only regulates the market.

Exporters are now allowed to operate foreign currency denominated accounts (FCDAs) within the country. The operation of offshore accounts is still prohibited by law. Currently, exporters can retain up to 40 per cent of export earnings in FCDAs while the rest is converted into local currency. Authorities are now considering increasing retention levels on traditional exports to 70 per cent and allowing 100 per cent retention on non-traditional exports. However the recent weakening of the Kwacha suggests that this may not happen in the very short term.

Reforms of the 1990s have not however been extended to the capital account which remains heavily controlled. Whereas both inflows and outflows are subject to the Reserve Bank's control, in recent years restrictions on capital inflows have been eased. In an attempt to attract investment, Government has streamlined procedures and requirements for foreign investment. Foreign investors are however required to register their investments with the Central Bank for purposes of remittance of profits, dividends

e.t.c. Just as income from these investments is freely remittable, foreign investors are permitted to transfer their capital out of Malawi at anytime without any restrictions. Foreign investment is also allowed on Malawi's embryonic stock exchange and the money market which is dominated by the Government's short-term paper, the Treasury Bill.

Law does not allow residents to invest outside the country unless prior approval has been given by central bank. Hence Malawians cannot participate in cross-boarder investments. Since local banks cannot meet seasonal foreign exchange requirements of tobacco buying firms, the central bank has authorised these firms to borrow short-term capital (or pre-finance) offshore. Companies wishing to source offshore finance (short or long term) need to get central bank's approval.

Malawi continues to control capital account transactions for several reasons. First, over 80 percent of the country's export earnings are controlled by a handful of firms in the tobacco, tea and sugar industries. Allowing these firms the liberty to hold and/or invest their proceeds offshore would deny the country of the much-

needed foreign exchange. Investment opportunities are not that plentiful in Malawi. Second, foreign owned insurance companies are sitting on huge amounts of funds in the country that would readily flow out to more lucrative and safer investments abroad. It is unlikely that the country would benefit from income on these investments. Third, Malawi's commerce and industry is dominated and controlled by non-indigenous Malawians and foreigners. Political and economic instability, which are common in our part of the world, have created conditions for capital flight. Liberalising the capital account would formalise these outflows. Fourth, Malawi's financial market is underdeveloped, and has a limited range of financial instruments that can be traded. Because of this, the market is ill equipped to handle particularly large volumes of short-term capital inflows. In addition, monetary and financial stability of the economy would be undermined as instruments for monetary control would be overwhelmed. The instability in the exchange and interest rates would have deleterious long-term effects on the economy. Fifth, Malawi's macro-economic situation in the 1980s and throughout the 1990s has been weak. Large fiscal imbalances have led to excessive monetary expansion and high inflation. The external position has generally been weak and

growth subdued. This is hardly the right environment within which to liberalise the capital account. Despite these problems Malawi is now seriously considering liberalising the capital account as well. We believe that the liberalisation process so far has been beneficial.

Macro-economic instability remains the main problem for Malawi. Efforts now focus on achieving fiscal discipline as a priority, bringing down inflation and interest rates, opening up at the economy further and building capacity in public institutions to regulate the economy. Government is also working on creating an environment that would support the development of sound banking/financial systems and at the same time developing appropriate prudential requirements that are internationally practiced.

Authorities acknowledge that controls have largely been ineffective and may also have contributed to capital flight. The private sector will always find ways of evading controls, moving large amounts of funds when faced with the prospect of a major crisis.

The crucial issue for Malawi has been the orderly transition from controlled capital account transactions to total liberalisation. In this regard we have sought advice not only from our main development partners, the IMF and the World Bank, but also from neighbouring countries, in particular Zambia, Mozambique and Tanzania. Of the three only Zambia has liberalised both the current and capital accounts.

The Regional Perspective

i. Zambia

Although Zambia has not yet repealed her Exchange Control Act, all exchange controls were abolished in 1993. This means that all current and capital account transactions are no longer being controlled by the central bank. The burden of facilitating international transactions has now been left to local banks and other foreign currency authorised dealers. Residents are free to operate foreign currency accounts alongside Zambian Kwacha accounts. They are also allowed to carry out cross border

investments without violating the law. No controls apply to the sale of assets between non-residents and residents.

The exchange rate is determined in the interbank market for foreign exchange. Only a few banks (five banks) dominate in this market. The Bank of Zambia is also a major player. Interest rates have also been liberalised and the Treasury Bill market provides direction for short-term interest rates.

The transition of Zambia from a controlled economy to a market based economy was the only viable option out of the economic malaise suffered prior to 1993. The economy had suffered serious macro-economic imbalances, foreign exchange had dried up in the system, the publicly owned copper mines could hardly operate due to shortage of spare parts and other essential inputs and life for the ordinary Zambian was not easy. Authorities had virtually nothing to control.

In order to reign in the liberalisation of the economy, the Government privatised most of the parastatals including the copper mines. Massive capital inflows were experienced as a result of this move. Very little flowed out, probably because all that could have flowed out did so before the crunch. So far in Zambia the liberalisation of the capital account is believed to have brought net gains to the country.

The major challenge for the Zambian authorities now is to ensure that the economy is properly and effectively regulated. Issues of capacity, particularly in the central bank, are pertinent. In the Foreign exchange market, the Bank of Zambia cannot maintain a totally hand off policy particularly if it is to ensure exchange rate stability. Also ensuring that there is price stability in the economy by containing monetary expansion through open market operations has been a costly exercise. Fortunately Zambia has not experienced problems associated with short-term international capital flows, particularly because her

markets are not developed and the range of financial instruments is still narrow.

Apart from investments in copper mines, there is very little foreign investment that has gone into other sectors. South African investors seem to be the only major foreign investors that have come into Zambia. Their investments are largely in retail and distribution, in a way providing an outlet for South African products. Local manufacturing that existed before the reforms, seems to have collapsed, primarily because of competition from lowly priced imported goods. Macro-economic stability seems to be elusive, with inflation continuing to be a major problem and the Zambian Kwacha exchange rate remaining under pressure.

ii. Mozambique

Mozambique abolished all controls on current account transactions in December 1998. Consequently all current account transactions are handled by commercial banks. The capital account however remains controlled.

Payment of imports of goods and services are handled by commercial banks, and reference is made to the central bank. Residents and non-residents are allowed to operate foreign currency accounts in local banks provided the foreign exchange comes from external sorces. In addition individuals and corporates are allowed to operate offshore accounts provided prior approval has been granted by the central bank.

As mentioned above, the capital account remains controlled. In principle the Banco de Mozambique does not restrict capital inflows, in practice they do, particularly short term capital that is perceived to cause instability in the financial system. The central bank also uses controls to channel foreign investment (long-term) into priority areas such as tourism and agriculture. Remittance of earning on foreign capital is subject to approval by the central bank.

Mozambique is developing a stock market for long-term capital and a money market to cater for short term needs of banks and Government. Foreigners are not allowed to invest in these markets. In particular short-term capital cannot be invested.

Authorities in Mozambique believe their economy is not ready to liberalise the capital account. Their main fear is that the little capital available in the country would flow out to South African markets i.e. stock exchange or money markets. There are more lucrative investments opportunities in South Africa than Mozambique. Until such time that their economy can effectively compete with neighbouring countries, and until they develop their financial system, opening the capital account is out of the question

iii. Tanzania

Tanzania liberalized the payments and exchange in 1986. In 1991 it formally transferred the administration of current transactions to commercial banks, although

Tanzania Revenue Authority, Tourism Board and Transporters Association also had a role to play. Following these changes, banks and financial institutions may provide foreign exchange to residents in respect of all current account payments and transfers free of any ceilings except for travel allowances currently allowable up to US$10,000 per transaction. For all transaction, banks and financial institutions are expected to observe normal prudency in banking practices as well as comply with certain general requirements.

The capital account has not been liberalized. This notwithstanding, banks may process some capital account related transactions without reference to the central bank. Foreign loans, overdrafts, financial facilities, deferred payments or guarantees by resident individuals or companies with a tenure exceeding 365 days should be supported by copies of executed agreements disbursements and debt-servicing schedules and submitted by the approving commercial bank to the approving commercial to the Bank of Tanzania within 14

days of grant of approval. BOT issues a Debt Record Number which is required for disbursements and debt service. In processing these applications banks are required to ensure that repayment periods are tied to the ability of the project to generate enough funds to service the loans in a progressive manner.

With respect to outward capital account transactions, banks may consider for remittances of capital and income to foreign shareholders in respect of direct investment (including proceeds in the event of liquidation) provided applications for the same are supported by audited reports and authenticated clearances from TRA confirming payment of all relevant taxes.

In general Tanzania does not allow foreign investments in their stock exchange or money market. Foreign direct investment is however encouraged. Tanzania views short-term capital from abroad as being potentially destabilizing, particularly if the domestic financial system is not developed. Until such a time that their markets are

well developed, Tanzania does not intend to open the capital account. There is pressure from the East African Community to open up the capital account. This might actually cause Tanzania to decide to liberalise sooner than later.

CONCLUSION

The issue of capital account liberalization has received mixed reaction from the region. Malawi is preparing ground to remove controls on capital account transactions. What may delay the process however is the instability in the macro-economic situation of the country. Interest rates are currently too high, the exchange rate is unstable, fiscal budget deficits are large and current account deficits are unsustainable. In addition there is need to build up adequate capacity in public institutions to regulate the market.

In contrast Zambia has gone ahead with the liberalization of the capital account despite macroeconomic problems in

the economy and lack of capacity to manage the reforms. In all, Zambia's situation has improved greatly from what it was before these reforms. Mozambique and Tanzania seem to be politically undecided to implement capital liberalization at this stage even though their economies are much stronger than those of Malawi and Zambia. In conclusion, the region does not have sufficient experience with capital account liberalization from which we can draw some lessons.

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