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To: Members of the Executive Board

From: The Secretary

Subject: Policies to Promote Private Capital Inflows in Fund-Supported Adjustment Programs

Attached for consideration by the Executive Directors is a paper on policies to promote private capital inflows in Fund-supported adjustment programs. This paper will be brought to the agenda for discussion in the context of the review of conditionality (EBS/89/17, 2/13/89 and Supplement 1, 2/23/89 and Supplement 2, 2/24/89), which has now been scheduled for Monday, June 19, 1989.

Mr. Stuart (ext. 4579) or Ms. Puckahtikom (ext. 8780) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

Policies to Promote Private Capital Inflows in Fund-Supported Adjustment Programs

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by Thomas Leddy

June 7, 1989

1. Introduction

Traditionally, Fund-supported adjustment programs have attached importance to the need to stem capital flight and strengthen private capital inflows, both in the design of policies and in the assessment of financing resources. More recently, with the large scale of flight capital from many developing countries, and in the absence of offsetting inflows, these issues have required closer attention in adjustment programs. In the staff paper "Fund Involvement in the Debt Strategy--Further Considerations" (EBS/89/96, 5/12/89), it was suggested that in cases where Fund support of debt and debt service reduction is considered an essential element of the country's approach to its debt problem, particular importance should be attached in program design to policies aimed at reversing capital flight and attracting private capital inflows, especially foreign direct investment.

This paper provides further information on the approach (Section 2) and the experience in Fund-supported adjustment programs in addressing the questions of capital flight and private capital flows (Section 3). 1/ The latter section gives particular attention to the lessons that can be drawn from recent experience, including those relating to

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1/ In this paper, private capital flows refer to transfers of workers' and emigrants' remittances (which could be in the services, transfers, and capital accounts of the balance of payments), capital transactions of the private nonbank sector, and other transactions of these kinds that may be unrecorded and/or subsumed in various lines in the balance of payments, including under the heading of errors and omissions. Data coverage and statistical practices in this area can vary significantly across countries, for example, as regards those related to interest earnings on foreign assets of nationals. In some cases, such earnings are imputed from international sources and recorded as an inflow on the services account, with a counterpart outflow in the capital account for the unrepatriated portion. Private capital flows, for the purposes of this paper, do not cover flows related to syndicated bank loans and bonds.

specific mechanisms designed to attract such flows. The paper also addresses issues related to the monitoring of private capital flows, including in the context of Fund arrangements (Section 4). A summary of conclusions is provided in Section 5.

2. The approach to private capital flows in Fund-supported programs

In general, Fund-supported programs approach the question of private capital flows--both of resident and nonresident nationals and of foreigners--from the premise that such flows respond primarily to the differential in the risk-adjusted yields of assets held domestically and held abroad. 1/ With increasing integration of world financial markets, a growing volume of capital flows should be seen as normal and desirable and may not be a reflection of deficiencies in the savings and investment environment at home. Also, such outflows need not weaken the growth prospects of the domestic economy provided that adequate savings remain or capital on a sufficient scale could, at the same time, be attracted through international financial intermediation. However, outflows of a capital flight nature are often the result of weak domestic policies, usually including an overvaluation of the currency and unduly large official borrowing, and require domestic policy adjustment.

More recently, closer attention has been given to private capital outflows, as a considerable proportion of outflows from developing countries is believed to have been of a flight nature, reflecting a lack of confidence in the domestic economy. 2/ At the same time, with tight external financing constraints, such capital flight entails a real resource loss in that a part of savings is diverted away from domestic real investment in favor of foreign investment.

When the domestic economic environment is characterized by accelerating inflation leading to negative real interest rates and an increasing overvaluation of the currency, the expected return on domestic assets is likely to be perceived as inferior to that of foreign assets, resulting in an outflow of private capital. A reversal of such

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1/ For empirical tests on the extent to which capital flight can be explained by differences in risk perceived by residents and nonresidents in selected countries, see "Capital Flight--A Response to Differences in Financial Risks" by Michael P. Dooley, in IMF Staff Papers, Vol. 35, No. 3, September 1988.

2/ The term "capital flight" is not well defined but is used in this paper to refer broadly to capital flows motivated by a resident's concern for risks of possible financial losses if wealth were held domestically. For a detailed analysis of the conceptual issues involved in measuring capital flight, see "Capital Flight: Concepts, Measurement, and Issues" in Staff Studies for the World Economic Outlook (August 1987).

outflows would require that the expected returns on domestic assets be enhanced relative to returns on assets abroad. The best prospect and, indeed, a necessary condition for such an enhancement is offered by sustained implementation of sound macroeconomic policies--in particular, realistic interest and exchange rate policies--and a general improvement in economic performance.

The inflow of capital can be on account of residents (including the return of flight capital), nonresident nationals, and foreign investors. In practice, the distinction on the basis of residency or nationality may be difficult to draw. Furthermore, this distinction may not be of particular significance as regards the implications for external financing in the short term; however, over the longer term, reflow of capital of residents and nonresident nationals could have different implications, to the extent that profits of investments funded by such capital is more likely to be reinvested domestically, whereas investments by foreigners would result in a repatriation of profits and dividends abroad.

Fiscal, monetary, exchange rate, and structural policies play key roles in enhancing the expected returns on domestic assets. Expectations of future exchange rate movements are particularly important in the return and risk calculations. An exchange rate policy that is perceived to be unsustainable often prompts large outflows as residents seek to avoid losses, or to secure gains in local currency terms, connected with the eventual correction of the rate. Capital outflows can also be prompted by domestic interest rates that are negative in real terms and that also give rise to a significant differential in favor of foreign assets, after adjusting for expected exchange rate changes.

Large and growing fiscal deficits tend to weaken confidence, as increasing financial imbalances create expectations of future taxes, including through inflation. Thus, a policy that aims at a realistic exchange rate, combined with a flexible and realistic interest rate policy, appropriate credit policies, and supported by a reduction in the financing needs of the public sector, can be expected to have significant positive effects on private capital flows. When combined with such policies, successful debt and debt service reduction operations should also have a favorable impact on such flows, insofar as they enhance the fiscal prospects and lower expectations of future taxes.

In the past, program emphasis has been on decisive and early actions in these areas because of the need for strong policies to change expectations and the time needed for confidence of the private sector to be restored and capital to reflow. When policy corrections such as interest rate and exchange rate adjustments are too gradual, they may not be credible and could instead lead to discrediting of these instruments.

In addition to sound financial policies, removal of cost/price and other structural distortions in the economy should help to mobilize and retain savings for investment at home. For example, a strengthening of the financial system and reform of the domestic equity markets should lower the risk and expand the scope for use of savings. Improving the efficiency of and access to home financial markets should also enhance the attractiveness of domestic investment. By fostering a hospitable climate for direct investment, trade liberalization, reforms of the foreign investment code, liberalization of the exchange system that facilitates repatriation of profits and dividends, reduction of labor market rigidities, and price decontrol can all help to attract capital held abroad by residents and nonresidents.

Simplification of institutional and administrative procedures for foreign investment could also be helpful in this context and countries might consider subscribing to the convention of the Multilateral Investment Guarantee Agency (MIGA). In addition, tax reforms might also better ensure after-tax international competitiveness of domestic financial assets. Restructuring of the tax code that makes possible a lower tax rate on investment income may be an efficient and transparent way of providing adequate incentives for investment, both of nationals and foreigners. 1/ The Fund's policy advice on removing institutional constraints on the mobilization and utilization of capital inflows, especially as regards foreign direct investment, has been provided in close consultation with the World Bank.

In this context, it might be noted that adjustments in certain policies of countries receiving flight capital could also help. This applies in particular to the current tax practices in the industrial countries that ease the tax burden on certain financial investments of nonresidents. Also, tax treaties involving information sharing among industrial and developing countries could be helpful. 2/ In practical terms, however, the role of such adjustments may be rather limited, and they may not help stem capital flight unless policy adjustments are also made in the country from which capital is fleeing. Also, such efforts may turn out to be ineffective in reversing capital flows insofar as they could merely result in a diversion of flows to other financial centers or other kinds of assets.

1/ On the other hand, special tax treatments accorded to income on foreign investment result in resource misallocation as well as considerable budget revenue foregone.

2/ Such improved information, together with the debtor country's effort to modify the tax system to permit taxation of residents' income originated abroad (i.e., residence-based taxation), could serve to expand the tax base and generate some reflow of capital, but such taxes may be difficult to administer.

3. Experience with policies to promote private capital inflows 1/

The weakness of data on private capital flows makes it difficult to draw clear conclusions about the efficacy of policies to promote such flows, particularly when policy adjustments were not sustained over a reasonable period of time. Nonetheless, some tentative observations are possible. Countries undertaking adjustment have had a mixed record in addressing the question of capital flows in general and capital flight in particular. The overall experience suggests that adjustment programs with early and strong policy actions have been quite successful in promoting workers' and emigrants' remittances through official channels and in helping to halt private capital outflows. In this regard, significant improvements can follow policy adjustment within a relatively short time.

However, progress in promoting a reflow of flight capital on a substantial scale appears to have been more limited and the experience seems to suggest that a longer period of sustained adjustment is required to restore the necessary degree of private confidence. Where progress in these areas was considerable, the common factors have included a strengthening of the macroeconomic environment, and clear and lasting shifts in exchange rate, interest rate and fiscal incentives in favor of domestically held assets.

To the extent that a part of flight capital had been for illegal transactions (for example, outflows that took place through false trade invoicing and avoiding capital controls or outflows related to illegal activities), the scope for a full return of such capital may be quite limited. Similarly, flight capital that had been directed toward real investment abroad may be illiquid, and not amenable to an early reflow.

a. Macroeconomic policies

The experience in a number of countries emphasizes the prime importance of macroeconomic policy adjustment. For example, Indonesia responded to the steep declines in crude oil prices in the 1980s by adopting timely and appropriate macroeconomic policies, including two large devaluations in 1983 and 1986. With strong policy adjustment and structural measures, especially the progressive deregulation of trade and industry, the problem of capital flight has been avoided and inflow of foreign direct investment has been sustained. Also, Mauritius successfully promoted substantial foreign direct investment for its export sector in the 1980s, through maintenance of firm financial policies and flexible exchange rate management, under a liberal trade and payments system.

1/ While this section focuses mainly on the experience of countries with Fund-supported programs, it also covers the experience with policies outside the context of Fund arrangements.

In the case of Mexico, implementation of an adjustment program beginning in the latter part of 1982 led within a relatively short time to a major turnaround in economic conditions; this in turn had a considerable impact on capital outflows. 1/ Principal elements of the program were a strengthening of the fiscal and monetary policy stance and a sharp real depreciation of the currency. Also, in the latter part of 1986 and the first nine months of 1987, Mexico experienced a large net inflow of private capital, following the large depreciation of the currency and a major tightening of monetary policy in the second half of 1986; 2/ these factors were reflected in a considerable interest rate differential (adjusted for exchange rate changes) in favor of assets held in Mexico relative to those held abroad.

For Argentina, the adoption in June 1985 of a comprehensive adjustment program led to a major strengthening in the balance of payments in ensuing months, as reflected in the marked reduction of the spread between official and parallel market exchange rates. In Israel, the introduction of a comprehensive stabilization program in 1985 which included strong exchange rate action combined with a tightening of financial policies helped halt large private capital outflows. Similarly, the large-scale capital flight from Nigeria prior to 1987 was effectively contained by a substantial tightening of monetary and fiscal policies, as well as the transitional floating of the exchange rate through an auction/interbank market. 3/

The record of countries that are heavily dependent on workers' and emigrants' remittances indicates significant responsiveness of such flows to exchange rate and interest rate policies. For example, the recovery in inflows of remittances was marked in the cases of Turkey 1980-82, Bangladesh 1985/86-1986/87, Morocco 1985-86, and Yugoslavia 1988, following sustantial adjustments in exchange rate and interest

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1/ This was reflected in the data on private capital flows which showed a decline of net outflows from a peak of US$8 billion in 1982 to US$4.6 billion in 1983 and further to US$3.4 billion in 1984.

2/ This refers to inflows of private sector capital exclusive of interest earnings retained abroad (whose imputed values are shown in the balance of payments). For 1987 as a whole, there was a net outflow of private capital; this reflected sizable payments in the fourth quarter of the year in connection with the prepayment amounting to US$2.7 billion of private sector debt, after completion of an agreement with commercial banks on the restructuring of private debt covered by the Foreign Exchange Risk Coverage Trust Fund (FICORCA) scheme.

3/ Using partner country trade data, the staff has estimated that capital flight in the form of overinvoicing of imports may have fallen to around US$0.2 billion in 1987 from an average of about US$1 billion annually in 1985-86.

rate policies. 1/ Similarly, in Tunisia, the adoption of a comprehensive adjustment program in 1986, including a major devaluation of the currency, led to a recovery of remittances which had fallen sharply in earlier years.

The experience also indicates that any improvement in the external position that is achieved solely through exchange rate and positive real interest rate policies may be fragile, unless there is also a fundamental strengthening of the domestic financial situation. For instance, in Yugoslavia a policy of maintaining the real exchange rate together with positive real interest rates in 1988 contributed to a major improvement in the external position but domestic inflation rose sharply.

In the case of Chile, the resumption of private capital inflows was gradual. Private capital inflows, which had stopped during the severe economic crisis of 1982/83, did not begin to recover appreciably until 1985, two years after the authorities embarked on a series of adjustment programs supported by the Fund. Confidence was restored gradually with the progressive shift in economic policies toward a comprehensive medium-term strategy and as economic conditions strengthened; improving terms of trade, particularly after 1987, also enhanced confidence in the country's economic prospects. Policies that were particulary important in encouraging private capital inflows in this case comprised sound financial policies, including restraint on public spending which permitted the phased reduction of corporate and personal income taxes 2/, a major real depreciation of the currency, market determination of interest rates, and a comprehensive financial system reform.

Finally, the record points to the sensitivity of private capital flows to the political environment. In the case of the Philippines in 1986-87, the capital account periodically came under pressure because of political uncertainty. In Chile, the substantial widening of the spread between the official and the parallel exchange rates in 1988--an indication of a weakening private capital account--was attributed in large measure to increased political uncertainty. In the case of South

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1/ More specifically, for Turkey, foreign exchange repatriated by Turkish workers abroad amounted to US$2.5 billion on average during 1981-82, compared with US$1.7 billion in 1979; for Bangladesh, workers' remittances rose from US$0.4 billion in 1984/85 to reach US$0.7 billion in 1986/87; for Morocco, workers' remittances increased from SDR 0.8 billion in 1984 to SDR 1.2 billion in 1986; and for Yugoslavia, workers' remittances recovered in 1988 to US$1.5 billion from a low of US$1 billion in 1987.

2/ In the event, the phased reduction of personal income taxes announced in 1984 was delayed; however, with growing confidence in the government's program, the prospect of tax reductions in the future may have favorably affected saving and investment behavior.

Africa, very large capital outflows in 1985 were associated in part with a sharp deterioration of the sociopolitical climate at that time.

b. Specific mechanisms

This section reviews the experience with a number of specific mechanisms and their impact on private capital flows. The experience suggests that specific mechanisms can play a role in attracting capital in an environment of strong macroeconomic policies and confidence, although it is often difficult to distinguish the impact of these mechanisms from that of the general economic situation. Also, while specific mechanisms can be effective supplementary measures, their potential distortive effects need to be kept in clear view and, as a general rule, mechanisms should aim at removing existing rigidities without introducing fresh distortions.

Recent experience also shows that where macroeconomic policies remain inadequate and economic prospects weak, specific mechanisms may produce only temporary results. Without a strong improvement in the macroeconomic environment, special mechanisms may not be fundamentally credible, and they often fail to produce a sustained inflow of capital. When special mechanisms are being relied on as transitional measures, there is also the risk that such mechanisms may serve to delay and complicate the needed adjustment in policy fundamentals. The record shows that when the mechanisms are maintained for more than a relatively short period, their distortive effects could far outweigh any short-term financial gains. Moreover, specific mechanisms that seek to promote capital inflows without correction of distortions affecting investment may not contribute to sustained economic growth.

(i) Debt conversion mechanisms

Debt conversion mechanisms typically involve the refinancing of external debt (public or private) by domestic debt at a ratio negotiated between debtor and creditor. In the case of debt-equity conversions, the creditor exchanges his claim for equity; the incentive for such investment is usually provided by a debt exchange ratio that represents a sharing of the discount on the country's debt in the secondary market.

In Chile, various debt conversion schemes introduced beginning in 1985 have been a major channel for private capital flows, and the case illustrates that such schemes can be effective in the context of a strong macroeconomic environment. 1/ One of these mechanisms, which aimed at encouraging the repatriation of flight capital, permitted domestic residents to convert external loan claims (purchased with their

1/ Private capital inflows that were associated with various debt conversion operations rose steadily from about US$0.3 billion in 1985 to US$1.7 billion in 1988.

own foreign exchange) into local currency bonds that were tradable in the secondary market; conversion rights were auctioned by the Central Bank. This mechanism proved effective as the direct monetary impact of debt conversions was sterilized and the demand for foreign exchange and the effects on the parallel exchange rate were limited by the auction system. The authorities attempted to ensure the most efficient use of these resources through screening of investment projects by the Central Bank, application of cash requirements where appropriate, and monitoring of project execution.

In Brazil, foreign investment associated with the debt-equity conversion scheme introduced in February 1988 (from which Brazilian residents were excluded) amounted to US$1.5 billion in 1988 and, at an average discount of 25 percent, reduced Brazil's external debt by US$2 billion. In this case, conversion rights were auctioned and the authorities attempted to secure additionality of foreign investment through a provision that directed such investment to priority areas. In the case of the Philippines, the Central Bank's debt-equity conversion scheme (which was accessible to both domestic and foreigninvestors) has generated considerable interest. 1/ The Central Bank examined applications in an attempt to ensure that they represented additional inflows rather than a diversion of flows and that funds were used to finance physical investment. While impossible to quantify exactly, the rapid expansion in conversions is suggestive of true additionality in foreign investment. 2/

Where domestic financial conditions were fragile, special debt conversion schemes to promote capital inflows tended to complicate economic management and their scope was more limited. For example, in the case of Mexico, the debt-equity scheme introduced in May 1986 was suspended in late 1987, in part because of the difficulties the authorities faced in their attempt to sterilize the monetary impact of such operations. The Brazilian debt-equity swap program was stopped in January 1989 at the time of the introduction of a rapid disinflation program, reflecting concerns over the effects of such operations on monetary management.

1/ From its introduction in August 1986 through the end of 1988, applications for debt equity conversions amounted to US$1.8 billion, of which US$1.2 billion were approved. In this period, total debt conversions rose steadily, to a cumulative total of US$0.6 billion. In 1988 alone, such conversions almost tripled to US$0.4 billion, despite the restrictions imposed on the scheme in February 1988. Part of the discount received on external debt is taxed through a fee of 5-10 percent of the face value of the external debt instrument.

2/ There were also considerable inflows from other conversions which largely involved the informal prepayment of private sector external debt in pesos for use in investment or other purposes. About one half of total conversions appear to have been undertaken by Filipino nationals, indicative of a reflow of flight capital.

(ii) Liberalization of investment regimes

The experience suggests that given a stable macroeconomic environment, the liberalization of foreign investment regulations can contribute to a rise in net capital inflows. In the case of Spain, the sharp rise in inflows since 1985 reflected the impact of the liberalization of the foreign investment regime, as well as the benefits expected to be derived from EEC membership and the effect of prudent economic management on the confidence of foreign investors. Similarly, an easing of foreign investment regulations in Korea in recent years, along with strong economic management and favorable economic conditions, has been accompanied by a substantial increase in inflows of direct investment. In contrast, in the case of Venezuela, a substantial liberalization of the foreign investment regime in 1986 may have had only a modest impact on foreign investment, in part because supporting financial policies were not fully adequate and the economy remained subject to controls and structural distortions.

(iii) Foreign currency deposits

Foreign currency deposit schemes have been introduced or maintained in a number of instances to forestall the outflow of capital, to provide incentives for private inflows particularly in the form of workers' and emigrants' remittances, or to discourage financial disintermediation. These accounts are effectively protected from exchange rate risk, and when interest rates on such accounts are similar to or higher than comparable rates offered abroad, they can be quite effective in attracting capital (e.g., Egypt, India, Poland, Turkey, Yugoslavia, Uruguay). 1/ In some of these cases, more formal arrangements between foreign banks and domestic financial institutions further facilitated the mobilization of resources (e.g., the Dresdner scheme in Turkey). 2/

The experience shows, however, that unless domestic financial imbalances are also being effectively addressed, the policy of retaining savings in foreign currency deposits may not be credible and may not

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1/ In India, deposits in nonresident foreign currency accounts rose from less than US$1 billion in 1983 to almost US$4 billion in 1988. In the case of Turkey, foreign exchange deposits (by residents and nonresidents) grew rapidly from their introduction in 1983 to about US$11 billion in 1988.

2/ The Dresdner scheme involves an arrangement under which the Dresdner Bank collects deposits from Turkish workers in Germany for transfer to the Central Bank of Turkey. The deposits and interest paid on them are in foreign currency, 90 percent of which are in deutsche marks. Remittances under the scheme have risen rapidly in recent years, and total amounts outstanding under the scheme reached US$5.9 billion at end-1988, or equivalent to about 18 percent of Turkey's total public sector external debt.

offer sufficient incentive to attract and maintain foreign exchange receipts. For example, in the case of Egypt the growth of the foreign currency value of such deposits has slowed markedly since 1980, and in Yugoslavia inflows of workers' remittances dropped by almost half in 1987 reflecting uncertainties over the liquidity of foreign currency deposits and general economic prospects.

More generally, reliance on foreign currency deposits to support the balance of payments can give rise to complications. For example, if significant interest rate differentials were allowed to develop in favor of foreign currency deposits over domestic financial assets, such an approach would encourage currency substitution (e.g., Israel 1981-84, Uruguay 1981-83). With these schemes, the authorities give up seigniorage on the foreign currency held by the public, and a growing share of foreign currency components in the money supply has complicated the conduct of monetary policy, especially when the currency is depreciating (e.g., Peru 1982-86, Poland since 1987, and Yugoslavia 1986-88).

Also, the existence of large foreign currency deposits, especially if they are mainly short maturities, increases the vulnerability of reserves to changes in the public's perception of economic prospects, which would complicate the task of reserve management. To the extent that the authorities hold reserves against such deposits, the net additionality of foreign exchange from such deposits will be less than their original gross inflow. Also, where such deposits are held by public sector banks, they could be tapped by the public sector which could hamper the banks' ability to provide adequate cover for these deposits.

Finally, the administrative and financial costs of such financing of the balance of payments--particularly of schemes involving implicit subsidies--have to be weighed carefully against the costs of other sources of external financing. For example, in the case of the Dresdner scheme, the staff of the World Bank has recently estimated that the costs of funds to the Central Bank included considerable administrative charges in addition to an average interest rate of 10 percent on deposits (or about 4 percentage points above deposit rates in Germany--the main source of funds).

(iv) Exchange rate or interest rate premia

In some instances, the authorities have sought to maintain and encourage inflows by applying special exchange rate or interest rate premia for such flows. Typically, such schemes have been regarded by the Fund as second-best solutions and useful only as transitional measures toward a unification of exchange rates at an appropriate level. When underlying domestic economic conditions are weak, such premium arrangements may prove inadequate for stemming outflows, and more fundamental policy adjustments are eventually needed. Also, they have often been helpful only in channeling foreign exchange transactions from parallel markets into official channels.

Attempts to attract capital inflows have at times included a separate exchange rate that offered a premium over the official exchange rate (e.g., Bangladesh, Egypt 1983-86, Venezuela 1983-88). Incentives have also been provided indirectly through domestic financial instruments, e.g., in the form of foreign exchange certificates that can be traded at a premium (e.g., Pakistan since 1985), and through financial premia specifically paid on such inflows by domestic banks (e.g., Morocco 1983-87, Yugoslavia 1986-88).

These measures involve in varying degrees some form of multiple currency practice and, where the differential between rates is large and/or maintained over an extended period of time, can lead to serious economic distortions, again pointing to the need for reform of the exchange system. For example, in the case of Chile in 1983-84, subsidized swap arrangements and foreign currency deposits--while providing short-term balance of payments financing--resulted in a large quasi-fiscal deficit in the Central Bank. In the case of Venezuela, the operation of a multiple exchange rate system (1983-early 1989) led to large exchange losses by the Central Bank and serious economic distortions, without providing adequate protection for the balance of payments in a sustained way.

(v) Other measures

Some form of indexation of financial assets has been introduced by a number of countries to enhance the attractiveness of assets denominated in local currency (e.g., Argentina, Brazil, Chile, Iceland, Yugoslavia). Such schemes tend to introduce rigidities in domestic financial markets and complicate monetary management, particularly when policy fundamentals are weak and inflation is high and rising.

In a number of cases, financial system reform has proven to be a prerequisite for the restoration of confidence in the domestic banking system, and thus for attracting capital inflows. For example, in the case of Chile the strengthening of the financial system after the crisis of 1983 is considered to have been an important factor in the country's success in attracting capital flows. In particular, improved banking supervision and the introduction of a deposit insurance scheme may have contributed to investors' confidence. In Uruguay, the de facto insurance of bank deposits, together with appropriate financial incentives and generally favorable economic developments, may have strengthened the external capital account.

In some countries, specific measures were designed to encourage the repatriation of export proceeds. For example, since early 1988 exporters in Turkey receive high rates of export subsidy if export receipts are surrendered during the first month after the date of export. While such schemes may contribute to a one-time acceleration of repatriation of export proceeds, they would probably not affect the total amount surrendered on a sustained basis. Also, general export surrender requirements have been supported in some cases by attempts to improve auditing of trade invoices. When the basic macroeconomic environment is weak, however, such efforts might trigger additional attempts at evasion or a drop in export activity.

A specific measure to attract the reflow of flight capital was introduced in France in 1986. Residents who repatriated funds within a certain period of time were granted amnesty with regard to taxes and previous exchange control violations. The amnesty proved relatively successful in promoting a repatriation of about US$2 billion, partly also because it was implemented in a favorable macroeconomic environment and during the process of financial reform which included a gradual lifting of exchange controls. Such amnesties might be an expedient one-time measure to facilitate the return of flight capital, but attention needs to be paid also to the implications for the future enforceability of tax and exchange regulations.

4. Monitoring private capital flows

When private capital flows are especially important, for example when the country relies heavily on workers' remittances as a source of foreign exchange, adjustment programs place particular emphasis on early and decisive policy actions to maintain and encourage such inflows. A similarly strong approach is adopted in cases where capital flight is believed to have been substantial or to pose a particular risk. Thus, major corrections in exchange rate and interest rate policies are often critical initial elements of a Fund-supported program, and are among the prior actions to be taken. Since sustained implementation of such policies is essential, during the course of the program these policy elements are also usually monitored closely through performance criteria or program reviews.

More generally, prospective developments in private capital flows are taken into account in formulating the quantitative financial program and are examined in the staff's ongoing analysis of the member's balance of payments. Major unforeseen developments in such flows clearly have an impact on the member's ability to achieve the net international reserve targets that may be specified under the Fund arrangement, and therefore must be carefully analyzed.

Closer monitoring of private capital flows could be useful in focusing policy attention on the need to promote a reflow of capital. In the context of Fund-supported programs, more precise monitoring of private capital flows would need to address two issues: first, how to improve the predictability of such flows in response to policy actions; and second, how to improve the quality and timeliness of data on private capital flows in general and capital flight in particular.

With regard to the first issue, as noted above, the experience of countries has been diverse with respect to the size and pace of capital inflows. In many cases, it has taken longer than anticipated to attract a return of flight capital, and unpredictable factors such as political developments have also played a role. To the extent that illegal transactions were involved in the original outflows, or resources have been invested in fixed assets abroad, the scope for full return of capital will be reduced or slowed. With these uncertainties, program expectations regarding these kinds of inflows have been on the conservative side, and in the short run the program assumptions have been mainly for a stemming of outflows. Better-than-expected capital inflows have at times been reflected in overperformance in the international reserves target of the program.

As regards workers' remittances, it has generally proven more practical to incorporate a recovery in these flows into programs, and progress in this area has been an important program element (e.g., Tunisia 1986). In cases where steady progress in capital inflows has been made over a number of years, program assumptions in succeeding programs have evolved in light of the experience to allow for an increasing inflow over time (e.g., Chile 1986-89). Overall, however, uncertainties in the size and timing of capital reflows would suggest the need for prudence in projecting capital inflows so as to avoid complicating the authorities' implementation of the program.

With regard to the question of data availability, private capital flows, and especially capital flight, cannot be fully and accurately measured under any one single heading in the balance of payments. Improved performance in private capital flows may be reflected not only in the private capital account but also in other items in the balance of payments, e.g., through a reduction in the degree of false invoicing of trade transactions, in the tourism accounts, private transfers, and in the errors and omissions item. Detailed analysis of these items cannot give more than broad indications of capital flows.

Moreover, within the available data on private capital flows, systematic and routine compilation of data on capital flight has not been practical, given the difficulties of distinguishing capital flows that are normal and those flows that are motivated by residents' expectations of relative rates of return on domestically held assets. Also, the errors and omissions item in the balance of payments could give an unreliable indication of unrecorded flows since this heading includes statistical discrepancies including those arising from normal leads and lags in external transactions.

In addition to national balance of payments statistics, the Fund's international banking statistics also provide measures of nonbank financial transactions, which may reflect in part capital flight and repatriation. However, within these data the elements of capital flight cannot be discerned from other reasons for nonbanks to change their holdings of foreign deposits, such as for working balances of public and private entities. Also, these data only concern bank transactions which would provide a partial coverage of capital flight.

For all these reasons, it has been preferable to avoid the targeting of specific balance of payments items. Analysis of developments in the area of private capital flows has involved not only a tracking of the various components of the balance of payments where possible, but also great care in the interpretation of such data.

It would therefore seem appropriate that private capital flows along with other key items in the balance of payments be monitored on the broad basis of the targets for net international reserves. Where a strengthening of private capital flows is considered a particularly important program objective, staff reports could indicate the program assumptions regarding private capital flows that are incorporated within the international reserves targets (as in the recent cases of Mexico, the Philippines, and Venezuela), and program reviews could also cover developments in this area. Specific policy measures essential to a promotion of private capital flows would continue to be monitored as appropriate by way of prior actions, performance clauses, and program reviews.

5. Concluding remarks

The main lessons to be drawn from the experience of countries undertaking adjustment in promoting private capital flows appear to be as follows.

-- A focus on the fundamentals of macroeconomic adjustment is critical for restoring confidence and establishing an environment conducive to a reflow of capital. Particular attention should be given to securing, at an early stage of adjustment, credible and lasting shifts toward a realistic exchange rate, appropriate domestic interest rates, and prudent fiscal and credit policies. These policies should give confidence that capital flight would be stemmed and workers' and emigrants' remittances strengthened relatively quickly. A reflow of flight capital on a substantial scale, however, appears to require sustained policy adjustment and improved economic performance over a longer period of time.

-- In addition to the emphasis on appropriate macroeconomic policies, adjustment programs should also attach particular importance to those structural reforms that improve the savings climate and enhance prospective returns on domestic investment. These reforms are clearly important in fostering private capital inflows, but the results might take time to materialize. Greater attention might be given to strengthening analytical work in these areas, particularly in those cases where the potential reflow is significant. The Fund's policy advice on removing institutional constraints on the mobilization and utilization of capital, particularly on foreign direct investment, should continue to be provided in close consultation with the World Bank.

-- Specific mechanisms to promote private capital inflows can play a role, provided that they are used in support of, and not in place of, needed changes in macroeconomic policies, and especially if they are structured in a way that removes or avoids fresh distortions. They could be helpful in a relatively short transitional phase while rapid progress is being made to correct the fundamentals and to improve the macroeconomic environment. When they are being relied on as transitional measures, careful attention needs to be given to the potential implications of such schemes, e.g., in terms of structural distortions, complications in the conduct of monetary policy, and fiscal costs.

-- Where the promotion of private capital inflows is considered particularly important, closer monitoring in the context of Fund arrangements could help to focus policy attention on these issues. This could be achieved through incorporation of the assumptions regarding such flows into overall balance of payments targets specified as performance criteria, and supplemented by a careful review of policies and quantitative and qualitative analysis of such flows. Uncertainties in the size and timing of capital reflows would suggest the need for a substantial degree of judgment and prudence in projecting capital inflows so as to avoid complicating the authorities' implementation of the program. A more precise and separate monitoring of developments in private capital flows would generally not seem to be practical, given large forecasting uncertainties, the inherent weakness of the data and the sensitivity of such flows to political factors.