Study on the Liberalisation of the Capital and Financial Account of Malawi

Prepared for FinMark Trust

July 2014

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EXECUTIVE SUMMARY

Over the past several years Malawi has gradually begun to reform its economy. The most significant of these reforms has been the liberalisation of the currency regime from a managed peg to a free float. In early 2014, in the latest in a series of financial reforms, the Basel II capital adequacy requirements were enacted by the Reserve Bank of Malawi. Given a recent trend toward a more liberal economic regime, this paper seeks to determine whether Malawi is now ready to further liberalise its capital and financial account.

Additional motivations for the report come from the questions that have been raised during previous foreign reserve crises over the actual effectiveness of capital controls as a tool for managing demand for foreign exchange. In addition, as one of the most donor-dependent countries in the world, the paper has been spurred by the need to diversify official funding services and reduce the macroeconomic effect of donor actions.

As a signatory of the SADC Finance and Investment Protocol (FIP), Malawi has committed to liberalising its capital and financial account. From an international relations perspective, the question of capital account liberalisation is thus a non sequitur, and the important question relates to the local economic case for liberalisation. This paper takes an agnostic view to the political implications of Malawi’s SADC commitment, focusing instead on the domestic case for capital account liberalisation, and making recommendations as to the desirability, extent and timing of liberalisation initiatives for Malawi’s economy in isolation of FIP commitments. This economic perspective forms an input into the ultimate political decision.

The report uses a synthesis of several different methodologies to argue the case for liberalisation. A wide range of academic and policy literature is drawn on to inform the report, and themes from the literature recur throughout the remaining sections. An overview of the international position of Malawi’s economy is conducted, as well as an historical view relating to the previous use of capital control measures to manage the economy. Key risks of liberalisation are identified from in-country interviews with Reserve Bank of Malawi officials and bankers and industry. Finally, an extensive country comparison with Zambia, Tanzania, Botswana, Rwanda, Uganda and Chile is carried out, before the costs and benefits of liberalisation are laid out. A variety of data sources, including various measures of capital account openness, inform the different methodological approaches.

Summary of findings

1. An extensive review of the state of the current literature on capital account liberalisation reveals a large divergence to analogous issues on the current account. Overall, there are clear benefits to liberalisation under certain conditions, the case for which is made most strongly in the neoclassical growth theory. At the same time there are many, and serious, key risks which require consideration before any start is made on liberalisation. The evidence on the growth effects of liberalisation is conflicting with most surveys on literature concluding that there remains no statistically significant cross-sectional proof of consistent benefits from liberalisation. A major finding in the literature was the existence of an “institutional threshold”, below which an underdeveloped country will not experience the major benefits theorized in academia. On a different interpretation, underdeveloped countries are seen as requiring the “discipline effect” generated by the obligations to foreign creditors that accrues under a globally integrated financial account. Studies supporting careful “sequencing” of reforms have been replaced by an approach, pioneered by the IMF, which sees liberalisation as part of a wider series of developmental economic reforms, but with no set order. Traditional sequencing placed capital account liberalisation at the back end of a reform programme. This integrated approach is compatible with pursual of the discipline effect.

2. Analysis of Malawi’s domestic economy raised several concerns. Malawi is a small, undiversified economy, and is highly fragile to external and natural shocks. Recently, the CashGate scandal, which led to a withdrawal of official donor support and consequent government austerity programme, has hampered institutional development in the economy. A number of reforms to the financial sector and international accounts have been implemented, most
importantly the liberalisation of the current account and float of the Kwacha in 2012. This has led to a more positive foreign reserve position, but has led to challenges in administration of monetary policy, as policy instruments have lost traction against imported inflation. Nonetheless, Malawi is in a stronger position to consider liberalisation policy than before on the basis of its recent reforms, and can take a medium term view on the issue assuming a stabilisation in the macroeconomy.

3. **Legal restrictions, as enacted in Reserve Bank of Malawi subordinate regulation, are classified as highly controlled.** Controls in the form of limits, licensing and approval by the RBM apply to all international direct, portfolio and bank activities, and apply equally for inward and outward transactions regardless of the term of the underlying asset. The laws place an onerous and costly burden on banks, the RBM and commercial entities. The assessment of the level of control in Malawi’s legal control of the capital account is supported both by the Chinn-Ito index of capital account openness (based on the IMF’s AREAER database), as well as by the small level of de-facto capital flows observed relative to Malawi’s GDP. The current “blanket controls” leave significant room for a number of different liberalisation paths, allowing regulators to gradually open different elements of the capital account as Malawi stabilizes.

4. **The analysis of key risks is split between those arising from inflows and outflows of capital.** Most global policy institutions and academic economists have focused on the risks from inflows in recent years, an outcome of the 1998 Asian crisis. The primary risk is that inflows – into portfolios, property and bank lending – can lead to domestic bubbles. When these bubbles burst, capital flies to safety and the deflation turns into an economy-side crisis. This has happened in Asia and elsewhere, and is a strong justification of maintaining policy space for temporary controls in the event of a crisis. However, such controls are also a risk in themselves. It is difficult to time their introduction and suspension correctly, and controls are vulnerable to political capture. On the outflow side, the largest risk is of capital flight when residents are allowed to move capital out of the country – a risk which would make liberalisation policy perverse. Such flight tends to be pro-cyclical. To manage it, liberalisation of outflows by residents should be left to the end of the sequence, and should be enacted during a period of economic stability. However, given that parallel markets already allow for a fair amount of capital flight during downturns, this risk may be exaggerated in Malawi’s case. Finally, both inward and outward surges may destabilize the Kwacha away from its fundamental value. There are a number of policy options open to the central bank to manage such an event before capital controls are re-imposed, primarily interest rate control and open market interventions.

A wide-ranging comparison of the experience of different liberalised economies, all with fundamental similarities or other relevance to Malawi, formed a large portion of the analysis. The countries selected for comparison are listed in Table i below, and were compared on the basis of their approach to liberalisation and the macroeconomic effects of opening their capital and financial account.

<table>
<thead>
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<th>Country</th>
<th>Region</th>
<th>Reason for inclusion</th>
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<tbody>
<tr>
<td>Zambia</td>
<td>SADC</td>
<td>Zambia is a neighbour of Malawi and a country that has successfully liberalized the capital account. Recently, Zambia has undergone a reform reversion episode that is informative to Malawi.</td>
</tr>
<tr>
<td>Botswana</td>
<td>SADC</td>
<td>Botswana is the second of two landlocked SADC countries that have introduced a fully liberal capital account, and is therefore relevant to Malawi.</td>
</tr>
<tr>
<td>Tanzania</td>
<td>SADC</td>
<td>Tanzania has a closed capital account, but industry players report that it is de facto more open than that of Malawi. Tanzania is an important case for Malawi, given its proximity, position as a trading partner, and similar economic conditions.</td>
</tr>
<tr>
<td>Rwanda</td>
<td>EAC</td>
<td>Rwanda is a small, landlocked, agrarian economy that has been growing and developing at a rapid pace. Recently, Rwanda’s capital account has been completely liberalised.</td>
</tr>
<tr>
<td>Uganda</td>
<td>EAC</td>
<td>Uganda is similar to Rwanda, but is at a further stage of development and liberalisation, and has a population density more similar to that of Malawi.</td>
</tr>
</tbody>
</table>
5. *The most important finding from the country comparison was the lack of any significant measurable harm from liberalising.* The effects were found in all cases to be positive, or, at worst, benign. Significantly, in a period of severe global financial unrest, not one of the open economies experienced a currency, debt or financial crisis. This undermines some of the arguments coming from the risks of liberalisation. It is hypothesised that the reason for this extraordinary level of stability is a combination of effective sequencing and underdeveloped capital markets – the countries do not have markets with sufficient sophistication or depth to be vulnerable to hot money or sudden flight. This essentially allows regulators in economies such as Malawi’s to essentially delay the concern – within reasonable boundaries – of inflow led crisis when considering liberalisation. Openness leads to better and cheaper access to credit in the economy, and higher levels of FDI.

6. *Interestingly, the country comparison raised conflicting evidence on the space for temporary capital controls that can be activated in a crisis.* Chile has used such policies effectively. However, Zambia, a more relevant case for Malawi, tried to introduce temporary controls to deal with the devaluation of the Zambian Kwacha, and was severely punished in international markets. The government faced intense domestic pressure to maintain a liberalised regime. In Malawi’s case, attempts to introduce controls without exhausting all alternative policy options would likely lead to the same scenario.

7. *The final section of the analysis considers the issue of capital account liberalisation from a cost/benefit point of view.*

<table>
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<tr>
<th>Benefits</th>
<th>Costs</th>
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<tr>
<td>Use in foreign exchange administration: Controlling capital movements to maintain currency independence was the initial existential justification for such controls. Under a floating Kwacha, this is no longer applicable.</td>
<td>Expense of administration: There is a direct financial cost to running an exchange control regime, which crowds out other spending. Additionally, human resources must be trained and deployed to uphold controls. Firms that must adhere to capital controls experience a large administrative expense. Overall, the inefficiency introduced by the system is widespread and high.</td>
</tr>
<tr>
<td>Use as a crisis management tool: Controls have been tightened at points of severe foreign exchange shortage to reduce demand for forex.</td>
<td>Competition for foreign investment: By increasing the difficulty of doing business in Malawi, the capital controls affect the country’s ability to attract FDI, and disadvantages local exporters.</td>
</tr>
<tr>
<td>Insulates domestic economy from contagion: by preventing build-up of cross-border asset exposures.</td>
<td>Lack of imperative for financial sector development: Malawi’s financial and capital markets are underdeveloped, with a severe lack of long-term instruments. Financial integration introduces investment and encourages competition and regulation conducive to development.</td>
</tr>
<tr>
<td>Protection from financial sector-driven bubbles: through limitation of access to capital, leading to a relatively benign domestic financial sector.</td>
<td>Continuing donor dependence: A closed capital account means that the market for government debt remains illiquid, small and subject to high interest rates. A more developed market might allow the government to begin to escape donor dependence.</td>
</tr>
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</table>

When taking a cost/benefit view in macroeconomics, final effects are uncertain and weighting is a serious challenge. Given that Malawi has not been able to practically realise the value of controls in periods of crisis (due to parallel markets), and given that the liberalised Kwacha no longer required capital controls to ensure RBM policy...
independence, there seems little positive reason to maintain controls, especially when weighted against the large, and very tangible, direct and opportunity costs required to retain controls.

Indeed, this finding is confirmed by an extensive quantitative model developed under the study. Using panel data from low and low-middle income, the model finds that the removal of capital controls has the potential to add between 0.7 and 2 percentage points to annual GDP growth. However, this finding is strongly moderated by the finding that capital controls are a negative constraint, and de jure openness does not necessarily lead actual inflows, as these respond primarily to the underlying investment opportunities in the economy. This implies that opening the capital account must be pursued in an integrated fashion with other reforms to improve fiscal performance.

Toward an integrated financial sector in Malawi

Upon weighing the positive and negative angles, it is concluded that the evidence supports an integrated series of policy reforms targeted at fully liberalising the capital account over the medium term. The evidence is balanced on the finding that the potential risks of liberalisation are manageable, and that with this finding in place, there are no strong reasons not to liberalise.

With the broad recommendation to liberalise in place, a set six of guiding principles are established to direct the liberalisation process as it moves through the institutions that will eventually bring it into realisation.

1. **The recommendation is complete:** Although certain reforms may happen in stages, the capital account should be fully liberalised, within certain *macroprudential* limits imposed on domestic financial institutions, with respect to foreign exchange exposures.

2. **Reforms should be permanent:** The reform processes should be fully committed to once it has begun, and no space should be left for regulators to re-impose capital controls arbitrarily. This principle is put in place to convince both internal stakeholders and external investors of the commitment of authorities to the programme and avoid the consequences of reversals seen in Zambia.

3. **Substitute control for monitoring:** As regulators relinquish control over the timing, size and approval of financial flows, increased monitoring over the financial sector is critical. Regulators must ensure that reporting standards are met, and become strict and intrusive in their monitoring to ensure that financial freedom does not translate into increased systemic risk.

4. **Long-term before short-term:** The liberalisation of long-term flows, particularly FDI, should be prioritised over short-term portfolio and banking flows.

5. **Inflows before resident outflows:** The developmental impact of inflows is higher than that of outflows, and particularly with regard to long-term flows, presents less risk. This does not apply to non-resident outflows, which need to be unconstrained in order to encourage further investment.

The exact programme for reform and the necessary reforms required to bring it to realisation are outlined in detail in the list of recommendations. It is worth noting that since Malawi is starting from a position in which some of the economic reforms to support liberalisation have already occurred, this programme should be achievable within three to five years, depending on the pace of institutional development accompanying the reforms. While certainly not a big-bang approach, this is on par with the pace of liberalisation that has been witnessed in East Africa, which took roughly seven years from the initial currency and current account reforms to complete capital account liberalisation.

In order to realise the vision of a liberalised capital account, several immediate action points can be set in motion in the short term on the basis of the recommendations of this report. These are stated in further detail below, but include:
• Broadening the scope of inputs to begin to fully formulate a plan of action for capital account liberalisation that includes the input of the important and influential stakeholders in the reform process.

• Legislative and regulatory overhauls can be implemented as part of the first phase in the sequencing of the liberalisation initiative. Major reforms will be required in the regulation of the financial sector and banks.

• The task of regulators will begin to shift from implementation exchange controls to the regulation of the banking sector, whose risk appetite will guide the effective level of control over exchange transactions. The regulator can begin to enhance systems and human capital required for efficient and effective regulation of the newly liberalised account.
1. Introduction

As a signatory of the SADC Finance and Investment Protocol (FIP), Malawi has committed itself under FIP Annex 4 to the liberalisation of the capital and financial accounts of its balance of payments, and to the revision of exchange controls with the aim of converging with other SADC states at a macroeconomic level to achieve currency convertibility.

At present, Malawi’s exchange control regime gives the Reserve Bank of Malawi (RBM) extensive powers to set rules and operationally control both inward and outward financial flows. Although there has been a gradual movement over the past several years toward more liberalised guidance and regulations governing capital movements through commercial banks (measures which have come in conjunction with other liberalisations, such as the adoption of a floating exchange rate regime in May 2012), the account remains both *de jure* (legally) and *de facto* (operationally) controlled. Capital controls have historically been used by the RBM as a tool for the management of foreign exchange reserves and (indirectly), broad money supply, which the bank targets. The use of controls in times of macroeconomic stress, such as the 2011 currency crisis, has been questioned on the grounds of its effectiveness in practice.

From a macroeconomic perspective, Malawi finds itself in a uniquely challenging position. Its economy is small and undiversified, making it highly vulnerable to external and natural shocks, which have caused regular crises over the past several decades. Production is primarily agricultural, and the main cash crop, tobacco, has a significant effect on the foreign exchange position of the country and influences macroeconomic cycles. Financial markets in Malawi are small, both in absolute terms and relative to GDP. The majority of bank lending is short-term and confined primarily to trade finance and consumer loans. Similarly, the term deposit market is minor. Capital markets are almost exclusively limited to the low-liquidity trade in government bonds. The stock exchange is illiquid and has not seen any listing action in the past four years. FDI flows are low (in fact, recently there have been some major disinvestments), and most of the formal economy outside of agriculture is dominated by foreign-owned firms. Malawi has one of the highest rates of donor dependence in Africa and the world.

Over the past three years, Malawi has made a number of reforms to its monetary sector. Most significant of these was the official floatation of the Malawi Kwacha in 2012. This action led to a rapid devaluation to a more fundamental value, and, after a period of adjustment, has allowed for an improvement in the foreign reserve position of the Reserve Bank and a large reduction in the scale of parallel foreign exchange markets. Prior to this, the final leg of trade liberalisation was enacted when the administration of controls on the current account was devolved to the banking system. In January 2013, Basel II officially came into effect for the banking system as the culmination of a number of reforms to the sector, which have included anti-money laundering (AML) legislation, revisions to the licensing regime for foreign exchange dealers and updates to legislation governing non-bank financial institutions.

Given the progress that Malawi has made in reforming areas of the monetary system and international economic regime, and acknowledging the commitments that Malawi has made to SADC under the FIP, the purpose of the paper is to evaluate (1) whether Malawi is ready to liberalise its capital and financial account to broaden its reform programme, (2) indicate the extent of reforms and set a roadmap for the continuing removal of controls, and (3) situate the recommended liberalisations within a broader programme of economic reform.

Rather than arguing from an explicitly theoretical or empirical standpoint, the report seeks to address the question from a wide range of angles, and using several different analytical approaches. Qualitative regulatory and historical analysis based on desktop research and primary interviews, as well as analysis of important quantities, are all employed. The synthesis of findings from these multiple lines of enquiry will lead to a robust set of findings and considered recommendations, which will move the RBM forward on the issue of capital controls.

This study follows the publication of an Inception Note to the RBM and FinMark trust, detailing initial findings and clarifying the scope and methodologies to be employed in the final study. As part of this process, currency convertibility issues were deprioritised on the basis of interviews conducted at the bank prior to the publication of the inception report, and the report focuses primarily on the capital account, with the acknowledgement that a more open capital account enhances currency convertibility.
The remainder of this introductory section will discuss the motivations for the report and analyse the progress made by the region on the obligations made to SADC regarding liberalisation of international accounts. Section 2 contains an academic analysis of the issue, which introduces theoretical positions on capital flows and development, discusses relevant empirical evidence on the issues, and sets out methodological considerations and assumptions underlying the remainder of the report. Section 3 contains a “deep dive” into Malawi’s economy, and consists of a macroeconomic overview; analysis of restrictions on capital flows both in law and in practice; and discussion of previous use of capital controls as a macroeconomic policy tool. Section 4 outlines the key risks that will be faced by Malawi in the event of liberalisations, leading into an extensive comparative analysis with liberalised economies in section 5. Section 6 presents a macroeconomic cost / benefit analysis of capital controls, split into a qualitative section focusing on Malawi’s historical experiences with controls and quantitative model of the effects of an open capital account. Recommendations are presented in section 7.

1.1. MOTIVATIONS FOR THE REPORT

As has been alluded to in the introduction, the motivations underlying the report are four-fold. These motivations will set the context for the analysis, and will be used to guide issue-weighting in the recommendations list.

- The primary reason for the commissioning of the study is Malawi’s ratification of the SADC Finance and Investment Protocol (FIP), which explicitly requires financial integration between member states. The FIP sets a framework of agreement for the convergence of the monetary and financial systems of countries in the region. Most signatories, barring Zambia and Botswana, are lagging the envisaged timeframe for the requirement to liberalise capital and financial transactions across borders. In this context, Malawi’s review may provide leadership to other signatories.

- Most of the literature situates capital account liberalisation as one of the final steps in the wider reform process. Typically, capital account liberalisation is preceded by liberalisation of the current account, reforming monetary policy, prudential oversight of the banking sector, and even the development of domestic capital markets. Given that Malawi has recently undergone a number of reforms to its international accounts and banking sector, the report seeks to determine whether Malawi is ready to liberalise capital controls, and if so, how.

- A number of previous crises, most recently the 2011 currency crisis, have raised significant questions over both the effectiveness of capital controls as a macroeconomic management tool, and the practical ability of the authorities to implement controls that curtail the existence of parallel markets. The report will consider whether a liberalised capital account will allow for the operation of a more effective currency regime, as well as identify the risks that will be faced in a crisis if capital controls are no longer a policy option.

- A final, subsidiary reason for the commissioning of the study comes in the context of Malawi’s high level of donor dependence. Malawi’s reliance on both official and unofficial support for administration and development leaves the economy fragile to the withdrawal of aid (as has occurred recently) or to international interests. The liberalisation of the capital account may provide a route to eventual funding independence via market mechanisms.

1.2. SADC AND CAPITAL ACCOUNT INTEGRATION

Before an analysis of the status of capital controls in Malawi is conducted, a brief overview of Malawi’s SADC commitments under the FIP will clarify the regional context of the FIP.
1.2.1. Malawi and SADC

Malawi signed the original Southern African Development Community (SADC) Treaty and Declaration in 1992 and, in so doing, has committed to SADC’s regional economic integration agenda. It was one of the member states to ratify the Protocol on Finance and Investment (FIP), contributing to the two thirds majority required to bring it into effect for all member states. Malawi is also a member of the Common Market for Eastern and Southern Africa (COMESA), which holds currency convertibility as a strategic objective. Government officials that were consulted during the FIP Baseline Study (2011) raised concerns that this may lead to conflicting commitments as further regional integration occurs moving forward.

1.2.2. Regional integration and the FIP

Regional financial integration (RFI) is an economic and political process whereby national capital and financial markets in a region become increasingly interconnected. A region can be said to be fully financially integrated when domestic financial systems function as a single regional system. In theory, RFI should facilitate convergence of the cost of capital across member states, since it enables easier and faster movement of capital in various forms from country to country.

To facilitate RFI, certain regulatory and supervisory frameworks and functions must be harmonised and converge to regionally accepted standards. In the SADC region, the FIP facilitates this harmonisation process. The FIP is one of the protocols entered into by SADC member states to give legal and practical effect to their commitment to achieve RFI under the SADC Treaty. The FIP was signed in August 2006 by all SADC member states and was ratified by the required two-thirds majority of member states during 2010. The FIP came into force on 16 April 2010.

Although the FIP stops well short of referring to full financial integration it should be read alongside other SADC documents, notably the SADC Regional Indicative Strategic Development Plan (RISDP) which sets out the broader goals that underpin the FIP. Ultimately, these goals are full regional financial integration, formation of a monetary union and adoption of a single currency.

Malawi has committed to the process of capital account liberalisation and is an active member of the subcommittee on exchange control liberalisation, within the FIP structures. However, this commitment must be balanced with a considered and logical approach in order to achieve liberalisation – the focus of this study.

1.2.3. Commitments under the regional framework

The SADC Treaty was legally adopted by the heads of state in the region in 1992 and came into force in 1993. The Treaty establishes the broad objectives for regional integration, and instructs that protocols be defined to achieve these objectives. In relation to regional financial integration, the SADC Treaty states that:

“In order to achieve the objectives set out in Paragraph 1 of this article, SADC shall: ”

...encourage the peoples of the region and their institutions to take initiatives to develop economic, social and cultural ties across the region, and to participate fully in the implementation of the programmes and projects of SADC…

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1 As discussed at: http://about.comesa.int/index.php?option=com_content&view=article&id=78&Itemid=118
2 This was a concern echoed by some of the representatives from Malawi interviewed for this report.
3 The SADC Treaty is the anchor that provides the legal basis for SADC as a regional community.
...develop policies aimed at the progressive elimination of obstacles to the free movement of capital and labour, goods and services, and of the peoples of the region generally among member states."

The FIP sets out member states’ commitments to achieve these objectives. Specifically, in terms of capital market liberalisation, Article IV of the FIP states that:

*State Parties shall cooperate and coordinate exchange control policies in order to:*

a) *Liberalize current account transactions amongst State Parties;*

b) *Liberalize capital and financial account transactions between State Parties;*

c) *Achieve convergence and full currency convertibility between State Parties; and*

d) *Improve the availability of information regarding cross-border foreign exchange flows between State Parties.*

Interestingly, Annex IV is more strongly worded than most of the other annexes in the FIP. While other annexes call for states to “endeavor to cooperate…” or “strive to coordinate…”, Annex IV begins with “State Parties shall…”. This is a clear indication that capital market liberalisation is a priority within the FIP. The complete Annex IV is available in Appendix 1.

The Regional Indicative Strategic Development Plan (RISDP) is a roadmap that establishes the timelines and sequencing of activities within the various SADC protocols, including those for capital market liberalisation. Many of these deadlines have lapsed, and the RISDP is in the process of being revised.

**Box 1: Timelines in the RISDP**

<table>
<thead>
<tr>
<th>Year</th>
<th>Timeline</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>All member states to liberalise all controls on all current account transactions</td>
</tr>
<tr>
<td>2008</td>
<td>Achieve currency convertibility</td>
</tr>
<tr>
<td>2010</td>
<td>All member states to liberalise all controls on all capital account transactions</td>
</tr>
<tr>
<td>2016</td>
<td>Establish a SADC Monetary Union</td>
</tr>
<tr>
<td>2018</td>
<td>Launch a regional currency for the SADC Monetary Union</td>
</tr>
</tbody>
</table>

In 2011, FinMark Trust and GIZ commissioned Genesis Analytics to devise frameworks for monitoring progress towards FIP commitments. The FIP Matrix of Commitments was developed for this purpose and was adopted as an official monitoring tool by the Committee of Ministers of Finance and Investment in SADC at their meeting in 2011. The section of the Matrix of Commitments applicable to Annex IV is included below.

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Table 1: Matrix of Commitments - Annex IV on Exchange Control Liberalisation

<table>
<thead>
<tr>
<th>Annex</th>
<th>Article</th>
<th>Indicator</th>
<th>Source/Institution</th>
<th>Reason for Inclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2a</td>
<td>Liberalized Current Account</td>
<td>Country-level commitment: central bank</td>
<td>Achievement promotes capital flows within the region</td>
</tr>
<tr>
<td></td>
<td>2a</td>
<td>Liberalized Capital (Financial) Account</td>
<td>Country-level commitment: central bank</td>
<td>Achievement promotes capital flows within the region</td>
</tr>
<tr>
<td></td>
<td>2c.3.1.c</td>
<td>Full Currency Convertibility</td>
<td>Country-level commitment: central bank</td>
<td>Achievement promotes capital flows within the region</td>
</tr>
<tr>
<td></td>
<td>2d, 3d</td>
<td>Collect and publicise data on foreign exchange transactions (e.g. automated cross border reporting system)</td>
<td>Country-level commitment: central bank</td>
<td>Improves the availability of information between member states</td>
</tr>
<tr>
<td></td>
<td>2a</td>
<td>Roadmap for exchange control liberalisation in current and capital (and financial) account transactions is drafted and approved</td>
<td>Regional level commitment: Exchange Control subcommittee</td>
<td>Consensus on this roadmap will create a focal point for member states’ exchange control liberalisation programmes and improve coordination of policy reform</td>
</tr>
</tbody>
</table>

The FIP, however, only speaks to the regulatory and legal measures that are a necessary foundation for RFI. The FIP does not allow for the measurement of progress towards *de facto* RFI. Therefore, Genesis developed a second framework, called the RFI Dashboard, which measures the achievement of *de jure* RFI (the necessary steps toward capital market liberalisation) and *de facto* RFI (the outcomes of capital market liberalisation).
### Table 2: RFI Dashboard

<table>
<thead>
<tr>
<th>Thematic area</th>
<th>#</th>
<th>Indicator of RFI</th>
<th>Why is this important to RFI?</th>
<th>Data required to create indicator and track progress</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>De jure indicators – preparatory steps by government</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1</td>
<td>Exchange controls are removed</td>
<td>Exchange controls hinder the free cross-border movement of capital</td>
<td>Number of SADC member states with liberalized capital controls</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>Member states have a real-time gross settlement payment system and this is linked to a regional payments system</td>
<td>Payments system provides the physical link for transfer of funds across borders</td>
<td>Number of SADC countries with an RTGS-linked to a regional payment system</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>Regulatory and supervisory frameworks are harmonised</td>
<td>Regulatory and supervisory harmonisation ensure that the ‘rules’ for doing financial business across SADC start to look the same</td>
<td>Number of SADC countries compliant with all 25 Core Basel Principles</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>One banking license serves all member states</td>
<td>This would mean identical bank licensing requirements, lowering barriers and costs to regional banking</td>
<td>Number of bank licenses required per number of countries in SADC</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>SADC converges on globally competitive investment climate ratings</td>
<td>A healthy investment climate is a concurrent factor in improving capital flows and doing business in other member states. Also, investment climate is included in the FIP.</td>
<td>Overall Competitiveness Score, Financial Market Development Score and Investor Protection Score from WEF Global Competitiveness Survey</td>
</tr>
<tr>
<td><strong>De facto RFI: capital and investment flow indicators</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>Investment flows into and within SADC increase in volume</td>
<td>Improved investment climate and lower capital barriers should attract more investment</td>
<td>International and intraregional flows of inward FDI</td>
</tr>
<tr>
<td></td>
<td>8A</td>
<td>Capital flows increase within SADC</td>
<td>As barriers are removed, and investment climate improves, capital should flow more freely between the member states and from external sources</td>
<td>Value of the intra-SADC capital flows (sub-indicators are: 1) volumes of portfolio investment, 2) FDI, 3) trade credits, 4) reserve assets, and 5) remittances)</td>
</tr>
<tr>
<td></td>
<td>8B</td>
<td>Capital flows increase into SADC</td>
<td>As barriers are removed, and investment climate improves, capital should flow more freely between the member states and from external sources</td>
<td>Value of the international capital flows (sub-indicators are: 1) volumes of portfolio investment, 2) FDI, 3) trade credits, 4) reserve assets, and 5) remittances)</td>
</tr>
</tbody>
</table>

### 1.3. MALAWI’S CONTRIBUTION TO REGIONAL FIP INDICATORS

Malawi’s progress in implementing its FIP commitments is largely aligned with regional progress; however, regional progress has been stronger on current account liberalisation and lagging on capital account liberalisation.

The findings of the FIP Baseline Study suggest that Malawi supports the RFI agenda and initiatives to improve the pace of implementation. However, this perspective is only really matched by strong, positive reforms where Malawi’s national interests are aligned with regional interests. Therefore, there has been slower progress on implementing the less politically (and, some may argue, economically) feasible areas of the FIP – for example, capital account liberalisation.
This was a clear theme of the FIP Baseline Study – countries were more likely to embrace reforms necessary for RFI if:

- These were aligned to national interests (for example, the establishment of a real-time gross settlements system); or,
- There was political will to accomplish tasks that were not aligned with national interests.

In box 2, a more detailed discussion of the reasons that other SADC members have not liberalised their capital account regimes is undertaken. A case in point is that the Annex IV FIP regional subcommittee has managed to design a roadmap for current account liberalisation, but cannot agree on sequencing and timelines for capital account liberalisation. The FIP Baseline Study concluded that Malawi’s progress on Annex IV is dependent on:
1. Building a good understanding of the implications and results of the capital account liberalisation process;

2. Understanding how COMESA and SADC capital account liberalisation processes align; and

3. Establishing buy-in to the process of capital account liberalisation amongst key decision-makers within the RBM and the Ministry of Finance.

The study will address point (1) and will contribute toward point (3). Because it has been unilaterally commissioned as an independent analysis, the study takes an agnostic view to the political objectives of SADC and considers Malawi’s interest in implementing the FIP. The study acknowledges that the commitment has been made by Malawi, and from this point restricts analysis strictly to Malawi’s economic case for liberalisation.

Box 2: Why have SADC countries not met their mandate to achieve currency convertibility?

There are a number of potential explanations for the majority of SADC members not having implemented CAL and having been slow movements toward currency convertibility. All of these relate to the theme of countries working in accordance to priorities formed in their own interest.

- Priority of the current account: In theory and practice, current account liberalisation is a more pressing and more important concern than capital account liberalisation. For this reason, SADC countries have sought to achieve this first, and have put CAL on the back-burner.

- Loss of faith in the SADC programme: In the wake of the global financial crisis and the subsequent experience of smaller members in the Euro debt crisis, SADC members may have lost a degree of faith in the body’s end-goal of moving toward currency union. Currency convertibility is a first and critical step toward such a union.

- The prisoner’s dilemma: In this classic game-theoretic though experiment, a lack of coordination leads to individual optimisation that is not in the interest of the group. A similar coordination problem may be playing out in SADC, where individual members are unwilling to “feel the pain” of implementation of the commitments under the FIP.

In order to formally establish the reasons, a fuller study involving interviews with officials across SADC would be required. However, it is clear that improved coordination should be a SADC priority for the RISP.
2. THEORETICAL OVERVIEW

2.1. METHODOLOGY, DEFINITIONS AND MEASUREMENT

2.1.1. Definitions

There is no uniformly accepted international definition for capital account liberalisation (CAL) or control. Restrictions on financial flows are diverse, arise from very detailed subordinate regulations and tend to be country-specific. As noted in the literature review, this is one of the reasons underlying the difficulty of forming a comparative measure of CAL.

The IMF\(^5\) provides a working definition of CAL, in which the concept is defined negatively, as “(t)he removal of CFMs [Capital Flow Management Measures]”. CFMs are in turn defined rather loosely as any measures that are designed to limit capital flows. This definition captures only measures specifically intended to limit capital flows, and does not take into account other institutional arrangements that have the effect of unintentionally limiting capital flows.

Malawi’s capital and financial account is controlled through the country’s exchange control regime under the Exchange Controls Act (1989). Under its exchange control regulations, the Reserve Bank of Malawi\(^6\) defines the capital account as any “receipts or payments of capital transfers and acquisition or disposal of non-produced and non-financial assets”, and the financial account as any “transactions associated with changes of ownership of foreign financial assets and liabilities, including creation and liquidation of claims on, or by, the rest of the world”.

Merging these different definitions, this study defines capital controls as any attempt to restrict or control the free flow of funds on the capital and financial account as defined by the RBM. The corollary definition of capital and financial account liberalisation is the removal of any such controls. Currency convertibility (sometimes referred to as capital account convertibility) is defined as a state in which the capital account is fully liberalised, allowing a given currency or assets dominated in that currency to be freely converted to and from the local currency. This concept must be distinct from the idea of monetary union, in which several countries adopt a single currency with a uniform valuation.

2.1.2. Typology of cross-border capital flows and restrictions

Table 3 below breaks down the types of capital flows that can occur into different categories along two dimensions. These are the direction of flows and the term of the underlying capital obligations. Inward flows imply the movement of assets or positive financial claims from foreign jurisdiction to local ones, and outflows the reverse. Generally this means transfer of ownership between residents and non-residents, but can also refer to remittance flows and cross border transactions with one owner converting capital between currencies. Long-term inward flows include FDI and certain types of financing and bank lending, whereas shorter term flows are generally used to refer to portfolio investment, both inward and outward.

---


Table 3: Types of Capital Account Transactions

<table>
<thead>
<tr>
<th>Inward (Local liability)</th>
<th>Short-term Flows</th>
<th>Long-term flows</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Portfolio inflows</td>
<td>Foreign Direct Investment (FDI) and purchase of local property, plant and equipment</td>
</tr>
<tr>
<td></td>
<td>• Debt</td>
<td>Long-term bond issuance by resident firms in international markets</td>
</tr>
<tr>
<td></td>
<td>• Equity</td>
<td>Foreign bank lending</td>
</tr>
<tr>
<td></td>
<td>• Other financial securities</td>
<td>• To residents</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• To fund resident banks</td>
</tr>
</tbody>
</table>

| Outward (Local Asset)   | Portfolio outflows, such as global pension fund allocations | Outward direct investment and property purchase |
|                        | Outward lending by local banks | Long-term bond issuance by non-resident firms in local markets |

Source: Jeffries, 2011

2.1.3. Measurement of capital account controls

In order to assess the extent of a country’s financial openness, two separate approaches can be taken. Regulators and policymakers are typically concerned with assessing legal, or de jure restrictions or absence of restrictions. De jure measures indicate how open policymakers allow the economy to become, or intend it to be. However, for policy analysis, one should also take note of the actual level of openness of a given economy. This can be assessed in terms of de facto financial flows - measurements of actual cross-border flows and stock accumulations.

Both de facto and de jure measures have limitations as measures of openness, which are discussed below. The report will, in all cases, balance both measures to form a complete picture of the actual openness of economies under analysis.

2.1.3.1. De jure measurement

Capital controls are highly particular to the jurisdiction in which they are implemented. Controls can occur in the form of quantitative restrictions, timing requirements, permission and license requirements, and reporting requirements. Different combinations make CFMs in different jurisdiction difficult to measure and compare. For this reason, it is best to gain an understanding of the exact applicable regulations in a given country, and to make comparisons on the basis of general categories of control.

Nonetheless, indices can be useful if their limitations are understood. One of the most extensively used measures of de jure financial openness is the Chinn-Ito\(^7\) index. This index, based on binary variable classifications from the IMF Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)\(^8\), assigns an index score (KAOPEN) to each country using a principle components method. A KAOPEN score of 2.44 represents complete openness, while a score of -1.86 represents the strictest level of controls observed globally. The limitations of the index are outlined below.

- The index scores the entire Balance of Payments (BoP) (including the current account) for openness, and does not allow for a narrower observation of capital account openness.
- The index only ranges to 2011, a policy turning point for Malawi’s macroeconomic management.

Scores on the Chinn-Ito index are step-like due to the limitations of the methodology. Thus, countries on the same score may differ significantly in the form and extent of openness, but not sufficiently to move a step up the scale. Despite these weaknesses, alternatives to the Chinn-Ito index, which try to address some of these problems, are closely correlated with the Chinn-Ito index (usually with a correlation coefficient above 0.8\(^9\)), and many are subject to the same or similar issues. No other index has a longer sample period than Chinn-Ito, nor are they updated as frequently.

Given these characteristics of *de jure* measures, the report will make use of the Chinn-Ito index for comparative assessment and to form a “snapshot” of openness. However, where data allows, a full examination on capital account limitations, restrictions and rules are included using both local regulations and the IMF AREAER database.

2.1.3.2. *De facto* measurement

Measuring *de facto* openness is fundamentally a quantitative issue. The RFI dashboard identified broad quantitative indicators for openness under FIP, referring to the size of bilateral flows within SADC and flows into SADC. In practice, economists find measuring and comparing the extent of *de facto* openness both conceptually and practically difficult because of the complexity of the different determinants of inflows and outflows, only some of which are related to a country’s capital and financial control regime. There are three common approaches to measurement of *de facto* openness, all of which come with different challenges. These measurement approaches are summarised by Eichengreen *et al.*\(^{10}\) and Klein *et al.*\(^{11}\):

1. **Price-based measures:** Price-based measures are a group of estimation techniques that consider the effectiveness of controls through measuring discrepancies in asset prices between free and controlled markets. These methods take on differing levels of sophistication, but all assume that where capital can move freely, the law of one price for a given asset should hold. If there are distortions in price (usually defined as arbitrage opportunities), capital controls are deemed to be in effect. Some studies simply analyse cross-border differences in securities prices or look at saving and investment differentials. Other studies, such as Hutchinson *et al.*\(^{12}\) take more sophisticated approaches. In this case, the difference between the theoretical covered interest parity condition and observed forward rates in the Indian bond market was seen as evidence that capital controls has a distortionary effect on flows, and were to some extent effective. A more generalized approach would be to measure the so-called “parallel market premium” between quoted bank exchange rates and black market rates.

   a. **Benefits:** This methodology can fairly conclusively and convincingly show that controls are distortionary or, alternatively, ineffective.

   b. **Drawbacks:** For LDCs, conducting a proper pricing analysis is difficult because of the lack of development in capital markets. Malawi, for instance, does not have a forward rate for financial securities, or even a stable spot interbank rate to base parity conditions off of. Additionally, price-based measures to not determine the quantum of distortion, only the implied effect on price. Finally, the methodology is not broad, and must be repeated in all types of capital markets and instruments. Black market premiums are difficult to measure due to the lack of availability of public price data on black market exchanges.

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\(^{9}\) Ellyne, M., and Chater, R., *Exchange Control and SADC Regional Integration*, MPRA Paper No. 46648


\(^{12}\) Hutchinson, M., *et al.*, (2012), *Some Market Measures of Capital Account Liberalization in India, China and Asia in the Global Economy*
2. **Flow measures**: Many studies on capital account restrictions use flow-based measures. Generally gross capital inflows and gross capital outflows are stated relative to an economic indicator (usually nominal GDP) to give an idea of the scale of capital movements

   a. **Benefits**: The measure is easy to understand and relatively simple to calculate.

   b. **Drawbacks**: There are three drawbacks to flow methodologies. First, the measure relies on relative assessments to be meaningful. Second, it is difficult to link flow measures directly to controls and not to other constraints such as adverse financial market conditions. Addressing this problem requires an event study at the point where controls are changed. Controlling for financial variables becomes relatively complex. Finally, only capital movements are assessed with flows, thereby missing the capital stock already invested into or out of the country, which is a determinant of future flows. Flows also tend to be quite volatile and subject to measurement error.

3. **Stock measures**: These measures usually included alongside flows in order to address drawbacks. Stock measures are usually simply the counterparts of flows already identified. Examples are inward and outward FDI, and inward and outward portfolio investment.

   a. **Benefits**: Stock measures address the weaknesses seen in flow measures, while also being simple to calculate and understand.

   b. **Drawbacks**: Similar to flow measures, stock measures rely on relative rather than absolute interpretation and suffer from a difficulty of linking directly to controls rather than other conditions.

For the purposes of this study, building an effective set of specifications to assess *de facto* openness based on no-arbitrage price conditions would be too difficult and time consuming given the lack of sophistication of Malawi’s financial sector and tight time-frames of the study. For this reason, Malawi’s *de facto* openness will be assessed using stock and flow measures.

Table 4 below specifies the precise measures that will be used to assess *de facto* capital account openness

<table>
<thead>
<tr>
<th>Table 4: <em>De Facto</em> measures of financial openness</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Category</strong></td>
</tr>
<tr>
<td>Flow measures</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
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<td></td>
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<tr>
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<tr>
<td>Flow measures</td>
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<td>Stock Measures</td>
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<td>Stock Measures</td>
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</tbody>
</table>

These measures are applied both to Malawi, with the most recent available data, and to the various countries included in the cross-country analysis in section five.
2.2. THEORY OF LIBERALISATION

Before the wider literature on CAL is reviewed, some of the theory on the motivation and effects of CAL is briefly presented. This literature establishes analytical rationale for exchange control, with which the substantial empirical and policy literature on the subject, attempts to confirm or utilise.

2.2.1. The impossible trinity

Given its goal of eventual monetary union, the presumed basis for SADC’s requirement that members abolish capital controls is determined by a result of the Mundel-Flemming open economy macro model called the “impossible trinity hypothesis”. The hypothesis states that it is impossible for a country to achieve all three of (a) exchange-rate stability, (b) free capital movement and (c) independent monetary policy in relation to interest-rates. Any combination of the two can be achieved. This is a classical logical trilemma. Since Malawi has recently relinquished control over the exchange-rate, which was previously a fixed policy goal, there is no longer a trade-off between independent domestic monetary policy and the ability of capital to flow freely between Malawi and the global economy, as the exchange rate will adjust to mediate changes in global capital flows in response to domestic monetary policy decisions. In essence, the floating of the Kwacha in 2012 has opened up the policy space to liberalise the capital account without sacrificing independence. Although this was not the primary intention of the floatation of the Kwacha (the exchange rate target was becoming increasingly artificial relative to fundamentals, and reserve accumulation was not sufficient to maintain the target), the bank is nonetheless now in a stronger position in relation to the goal of currency convertibility.

Figure 3: The impossible trinity trilemma

As figure 3 indicates, a monetary union or currency board as envisaged by SADC, would require member states to become financially integrated and allow for free movement of capital between economies. In order to achieve this in the medium-term (pre-integration), economies in the intended union must integrate capital flows. If monetary independence is still a concern during this stage, then exchange regimes must be floated. When integration occurs, however, and relative exchange valuations must remain fixed between countries and independent monetary policy sacrificed in each member state, financial integration must remain in place. The places a currency board system in the intersection of capital account openness and currency stability.

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Of course, even under a floating regime, the exchange rate can be influenced by the central bank. The difference is that interventions tend to take place through interest-rate channels (combined with sanitisation operations) rather than through direct maintenance of an exchange rate target. Even so, a central bank may intervene directly in the exchange rate if it chooses, but, in doing so, trades off a degree of independence in interest-rate policy. A managed float regime makes use of this trade-off.

One clarification, relating to the scope of the study, must be made at this point. When referring to CAL, this study refers to capital account liberalisation vis-à-vis all international partners, not only those within SADC. This limitation is made due to the practical impossibility of selectively opening the economy to flows from only certain economies, and the distortions that would occur if “open” economies were used by “closed” economies as a means to channel capital flows into Malawi.

### 2.2.2. Capital account liberalisation and growth

The primary theoretical underpinnings for capital account liberalisation are found in the standard form of the neoclassical growth model. A formal exposition of the theory can be found in the literature\(^\text{14}\). Only the results are presented in this section.

The growth benefits of CAL, according to neoclassical theory, result from the effects of capital account liberalisation on the cost of capital, where the domestic rate under a closed economy is replaced by the global equilibrium interest rate (plus a risk premium). Since the domestic rate is typically high due to a lack of savings relative to investment demand in developing or underdeveloped economies, this results in a lower cost of capital, as shown in figure 4. The domestic economy now has access to the global savings pool.

**Figure 4: Interest rates under CAL**

![Interest Rate Graph](image)

*Source: Henry, P., 2007*

The lower cost of capital results in an increase in investment in the domestic economy, shown in figure 5 as a step-change in the rate of growth of the domestic capital stock. Assuming a Cobb-Douglas production function for the economy, this results in a permanent effect on the level of per-capita GDP, also illustrated in figure 5.

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Note that this neoclassical view has some limitations. First, it does not consider the different roles of different types of portfolio, direct and other investment types on the economy. Nor does it attempt to analyse the risks associated with an open account. Both of these limitations are addressed in this study. Additionally, the central place afforded to exchange rate stability that underpinned the Bretton-Woods system, and the general opposition of both the traditional and the “new” institutional economics to outright liberalisation (based on historical associations between open accounts and financial crisis), is not directly addressed by the neoclassical school.

Nonetheless, the neoclassical view provides a good positive basis for liberalisation against which risks, complicating limitations, and potential distortions should be measured in order to assess the case for liberalisation in Malawi.

Of course, theory is only as good as the empirical studies that validate it. Given the large effects of CAL on an economy, empirical support of the propositions presented above is crucial. The empirical literature, and policy positions generated from it, is presented below.

It is worth noting that even neoclassical positions, such as those of McKinnon\textsuperscript{15}, have acknowledged that there are risks involved in CAL based on the actual experiences of the countries who led the post-Bretton-Woods CAL wave. These qualifications, while not undermining the neoclassical position on CAL, did lead to the extensive literature on optimal sequencing of reforms. This literature is incorporated into the review below.

\textsuperscript{15} McKinnon, R. 1982, \textit{The Order of Economic Liberalisation: Lessons from Chile and Argentina}, CRCSPP, 17
2.3. REVIEW OF EMPIRICAL LITERATURE

Proponents of CAL have traditionally drawn on a number of arguments to support their position. Aside from the economic argument outlined above, these include the facilitation of inter-temporal trade (allocation of capital over time), and positive growth and specialisation effects of investment on industrial development of capital-attracting countries. The ability of local companies and financial institutions to diversify risk and the dampening effect of financial flows on business cycles are also cited as benefits. Underlying these arguments is the idea that the allocation and efficiency gains of capital flows are analogous to trade in physical items or services rendered, and therefore subject to the same analytical conclusions that apply to the current account. On the theoretical front, certain risks – such as increased volatility, the potential for crisis and the potential of overheating economies – have been acknowledged, but, until fairly recently, were analytically side-lined and assumed to be largely manageable. Beginning after the Asian crisis and the acknowledgement that the large foreign debts of East Asian firms played a major role in causing and extending the crisis, a research programme attempting to more rigorously analyse the macroeconomic effects of liberalisation was initiated.

Several surveys have collated the results of numerous academic studies in order to examine the relationship between capital account openness and various fundamental economic indicators. In 2001, two widely-cited studies began to shift the consensus, which, until then, was strongly in support of capital controls. A 2001 study by Eichengreen focused on results from various cross-sectional country comparisons. The study introduced an important difficulty: that of measuring comparative financial openness. Different papers have addressed the problem using differing indexing methodologies. This is a problem that has been encountered and handled in the methodological section introduced above. At this point it is worth identifying the major challenges as: being how to form an idea of the severity of controls (rather than a binary classification of a country as ‘liberalised’ or ‘controlled’) and accounting for changes in CAL levels over time. Next, Eichengreen’s study discussed the relationship between liberalisation and growth. It was found that there is consensus in the literature that liberalisation is positively and significantly correlated to per-capita income, but that the direction of causation is not established. Two landmark findings from papers basing their analysis off different liberalisation indices were then contrasted. These two papers reach opposing conclusions on the link between CAL and economic growth. A discussion of this discrepancy concluded that there are minimum levels of institutional sophistication below which liberalisation has negative effects. This results from the idea that CFMs might protect under-developed economies from capital flight and “crowd-in” domestic investment by forcing local outlays at a point where foreign inflows would not have been attracted under a liberalised account.

Also in 2001, Cobham conducted a review of literature focusing on the link between CAL and poverty. This review emphasizes the inconclusive nature of evidence on the connection between CAL and growth effects, but identifies a number of costs in relation to poverty that might accrue from rapid liberalisation. Most significant of these is that the distortion of fundamentals in financial markets may limit domestic access to credit (particularly for SMEs), and the expense of currency sterilisation (holding reserves against the foreign exposure of the banking sector).

In 2005, Klein’s breakthrough analysis used both analytical and empirical methods to refine the academic consensus on CAL. A U-shaped relationship between the benefits of CAL and institutional development was proposed. For countries with weak institutions, it was hypothesized that CAL might in fact reduce growth; while for countries with stronger institutions free capital flow would boost growth via channels of access to capital and portfolio investment. This model was confirmed by three separate empirical verifications using a sample of 78 countries. The estimations confirmed (contrary to earlier studies) a static link between CAL and growth, but found that this result was non-monotonic (‘U-shaped’) in relation to the

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16 Eichengreen, B. (2001), Capital account liberalisation: What do the cross-country studies tell us? World Bank Economic Review
introduction of institutional quality as a variable. This implies that a certain level of institutional development is a pre-requisite for CAL, a view now referred to as the “threshold theory”.

Also of relevance is a paper by Subramanain, focused mainly on the Indian capital account, which considers portfolio flows only (excluding FDI and short-term flows). It concludes that there is significant evidence of an important relationship between the ability of a developing nation to maintain a currency that does not overvalue relative to fundamentals on a sustained basis, and the country’s ability to achieve economic growth. CAL therefore can potentially damage a country’s ability to maintain a growth-oriented and competitive exchange rate through its effects on demand for local specie, particularly if the country does not have the reserves or the policy space to maintain a managed float.

Lastly, a 2008 paper by respected economists Prasad and Rajan (now India’s central bank governor) introduces the concept of externalities as a primary benefit of liberalisation. Essentially, the argument goes, by forcing regulators and institutions to manage the financial sector and macroeconomy in the face of uncontrolled inflows and outflows, these institutions are forced to learn and will develop in ways that bring positive benefits on an integrated level. This argument might be termed the market “discipline effect”, in which an implicit threat from international institutions is used to ensure sound macroeconomic management via an open capital account. It is possible, however, that Prasad and Rajan are observing the threshold effect from a different perspective, and have simply reversed the direction of causality usually stated in the theory. Irrespective, the paper goes on to recommend a complex securitisation structure for foreign reserves as a practical approach to liberalisation. Although the pragmatic approach to liberalisation is beyond the ability of African financial markets, the discipline effect is particularly relevant to many African nations, in which a combination of controlled capital accounts and poor fiscal discipline have led to episodes of macroeconomic volatility.

2.3.1. Policy approaches to the capital account

Unlike the current account side of the balance of payments, which has a formalised international process of opinion-making and policy-setting under both the IMF article VIII (at a country level) and the WTO (at a multilateral level), there is no global body with an explicit mandate that includes capital transactions. In the 1990s, the IMF attempted to include formal authority over capital flows into its articles of incorporation, but failed to garner sufficient support to pass the motion. The upshot of this is that CAL, or the imposition of controls, has been extremely varied on a country-by-country basis. Nonetheless, over the past decade, several international organisations, led by the IMF, have attempted to communicate more transparent institutional views on the control over the capital account and appropriateness of liberalisation.

In 2005, following sustained criticism of its management of the 1998 Asian debt crisis, the IMF published an internal evaluation report on the outcome of engagements with its member institutions in relation to the capital account. The purpose of the review was to document IMF practice in capital account advice and programming, as well as to suggest areas for improvement. The study found a consistent pattern of pro-liberalisation advice before the mid-1990s, and thereafter a less cohesive approach, which acknowledged risks to a much larger extent. This more discriminatory approach was precipitated in part by emerging evidence of the successful use of capital account restrictions in Chile. During the 1998 crisis and Russian defaults, however, capital account controls were not recommended, and IMF staff preferred structural adjustments. Overall, the review judges the IMF as generally supportive of CAL, but sympathetic to individual nations using controls to manage specific economic challenges. The IMF was advised to clarify the institutional mandate and position on CAL and pay more attention to supply-side (‘push’) determinants of capital flows when managing challenging inflows.

Since 2005, and particularly over the course of the past three years, the IMF has formalised its approach to the liberalisation and management of capital flows for member countries. The analytical results of several targeted studies were collated into a 2012 document outlining the IMF’s official position on the subject\textsuperscript{23}. The paper notes a broad, gradual global trend toward increased liberalisation based on the beneficial outcomes of greater openness. These include access to the global savings stock and increased financial sector sophistication that enhances risk diversification. It also acknowledges that CFMs can be very costly to maintain and can potentially reduce financial market discipline. The IMF adopts the already established consensus of the threshold condition; that the majority of gains from liberalisation occur only above a certain level of institutional development and that below this CAL may have neutral or detrimental effects. The institution also points to the established risks of liberalisation, including increased volatility, the potential to influence interest rates and currencies adversely, and finally the repeated empirical finding that financial crises tend to follow rapid liberalisations.

Based on this analysis, the IMF adopts the view that there should be no assumption that capital account liberalisations are always appropriate for a country under review. Instead, an integrated approach is adopted, in which a country – if it deems CAL a desirable policy goal – is encouraged to cautiously phase in liberalisation measures along with a series of supporting institutional reforms. The core of the integrated approach is that long-term inflows (FDI) should precede portfolio flows and that inflows should take priority over outflows when portfolio flows are later freed up. In times of stress, separate recommendations are made for inflow challenges and outflow crises. The IMF prioritises use of exchange rate revaluations, sterilisation and interest-rate policy when managing inflows, but does reserve a small place for controls as a last resort. In the case of a large or sustained surge in outflows, the IMF sees temporary controls as one part of a broader policy management toolkit, but argues that CFMs should never replace sound macroeconomic policy. A drawback of using CFMs to manage flows is that it is difficult to identify just when a crisis is ‘incipient’, as well as to time the withdrawal of temporary controls effectively. In 2013, the IMF followed up the publication of its institutional view with a practical guide for IMF staff in member countries\textsuperscript{24}.

In short, the IMF’s view can be summarised as broadly in favour of liberalisation (providing a certain threshold level of institutional development has been reached), that liberalisation occurs in concord with other reforms, and that space be left for temporary re-introduction of controls in response to certain types of crisis.

While the IMF is the most important and influential institution when it comes to CAL, it is worth identifying and contrasting the position of other organisations in relation to the IMF’s view. The UN, through its Conference on Trade and Development (UNCTCAD), is firmly in favour of the global regulation of capital flows\textsuperscript{25}. In support of this view, the UN points to the disruptions and crises linked to large flows into developing countries and the resultant reintroduction of controls by several developing nations since 2008. It concedes that the success of these policies has been mixed, primarily due to the ad hoc nature of their implementation. The UN calls for CFMs that are flexible and can be adjusted in a way that essentially turns them into a countercyclical policy tool. This places the UNTCAD broadly in opposition to the IMFs qualified support for liberalisation.

The World Bank, for its part, does not have a need to express an explicit policy view such as that of the IMF in relation to CAL. The World Bank does forward opinions on CAL in relation to very specific circumstances in individual economies, and is concerned specifically with the developmental link between openness and growth (as opposed to the IMF’s mandate for stability and sound policy management). The World Bank has come out in support of liberalisations in some cases, and has remained silent on, or supported, controls in other cases. Theirs is an evidence-based approach.

\textsuperscript{24} IMF, (2013), Guidance Note for the Liberalisation and Management of Capital Flows, Washington DC: IMF
2.3.2. Sequencing

The reconsideration of the position of the IMF has followed from a large body of literature that begins from the position that there are strong benefits to CAL, but with acknowledgment of the considerable risks faced by a small open economy. The focus of this line of investigation is how, from a policy and developmental perspective, to sequence a series of macroeconomic and financial sector reforms to maximise the benefits of CAL while containing the risks.

This issue is unsolved in the general sense: there is no roadmap that readily translates between different countries looking to liberalise, and local context is, again, important. It has not been established that the human and financial resources required to implement a liberalisation programme are either smaller or larger than those required to administer controls. Moreover, there is no “hard and fast” rule governing the correct speed and timing of reforms. Nonetheless the progression of the literature has revealed important lessons for policymakers considering sequence.

The initial studies on sequencing, such as McKinnon26 were based on the experience of South American economies, particularly Chile and Argentina. These studies emphasised a focus on macroeconomic stabilisation, financial liberalisation and trade liberalisation preceding capital account liberalisation.

This view was replaced in the 1990s by arguments in favour of the “big bang” approach to capital account liberalisation, which held that the time required to build a comprehensive reform package was insufficient, and that momentum toward CAL may be lost if the policy were not rapidly implemented27. In smaller economies such as Uganda, it was argued that market discipline on the domestic banking sector was needed sooner rather than later28 to bring the economy onto a sound and stable footing.

After the 1998 Asian crisis, the tide in the literature reversed against the “big bang” approach. The sequencing approach that emerged looks very much like the IMF’s integrated approach, and emphasised that CAL not necessarily follow, but at least form one part of, a series of wider economic reforms29. Concurrent policies to gradual CAL include revision of legal financial sector frameworks, improvements in measurement and reporting, strengthening prudential management and restructuring capital markets30. At the same time, a phased approach to CAL, such as focusing on long-term outflows first, was recommended. This view has faced some opposition, who claim it is too broad, not a practical guideline, and requiring domestic policymakers to do the bulk of the legwork for determining when CAL should be introduced31.

2.3.3. Relevance of literature to the study

Four important themes can be drawn together from the theoretical, empirical and analytical literature, which can usefully be applied to the study. These insights will be added to the direct findings of the study to inform recommendations in later sections.

1. There are clear benefits to the liberalisation of capital flows under the correct conditions. These relate to growth effects via investment channels, increased financial sector sophistication, economic diversification and a reduced exposure to domestic shocks. On the other hand, there are also very clear risks. These are founded in observations that show asset bubbles, overheating and financial crisis to follow fairly consistently after periods of rapid liberalisation. There is also the issue of contagion, in which open economies become exposed to global shocks.

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26 McKinnon, R, 1982, The Order of Economic Liberalisation: Lessons from Chile and Argentina, CRCSPP, 17
27 Funke, N., 1993, Timing and sequencing of reforms: Competing vies and the role of credibility, Kyklos, 46
29 Eichengreen, B., and Leblang, D., 2002, Capital Account liberalisation and growth: was Mr. Mahathir right? NBER working paper 9427
31 Asian Policy Forum, 2002, Policy proposal for sequencing the PRC’s domestic and external financial liberalisation, Tokyo: ADBI
2. There is a distinct lack of consensus on the relationship between liberalisation of the capital account and economic growth and development in practice. The most sophisticated study into this issue suggests a three-way dependency between liberalisation, growth and wider economic development.

3. Most academics and policymakers subscribe to the idea of a threshold effect, which holds that the benefits of liberalisation are realised subject to a certain level of economic development, with the corollary that below this level CAL may have negligible or adverse effects. However, studies into this threshold effect use broad proxy indicators for institutional development, and policy papers do not explicitly detail institutional requirements. For this reason, the utility of the theory is limited, as policymakers must at this stage essentially make a guess as to the level of development that constitutes the threshold. An alternative view is the discipline effect put forward by Rajan, in which the liberalisation of capital flows acts as an incentive for sound macroeconomic management via an implicit threat of withdrawal. This view places liberalisation at the front of the integrated approach to development, rather than at the rear, as in the case of the threshold theory. In either case, the literature ultimately implies that CAL requires a leap of faith on the part of policymakers – that the current state of institutional development in Malawi is sufficient to realise the benefits of CAL, or, that CAL can bring institutional discipline such that the resulting new equilibrium does not leave the country worse off.

4. The integrated approach to sequencing reforms has recently gained ascendancy. While this approach may be somewhat generalised, a gradual reform process which correctly calibrates gradual CAL to a wider set of developmental reforms is a strong outcome of three decades of discourse on the issue, and represents a synthesis of competing arguments on the issue. Further to the point above, and noting the importance of the discipline effect, this implies that CAL need not be placed at the tail end of a reform programme, but can be a leading or intermediate step if well-supported.

Before concluding the literature review, a gap in the literature must be addressed. In general, studies tend to treat CAL as a negation – defined as an absence of controls. This has limitations when CAL relates to a regional integration agenda, as in the case of Malawi and the SADC FIP. If the achievement of regional integration with the eventual goal of currency convertibility – or even currency union - is taken as the starting point to the analysis, then the conclusion tends very naturally to the need to liberalise the capital account. This is a purely mechanical conclusion – such a currency regime cannot be implemented on a technical level if capital flows are constrained within the union. Further, to maintain controls while belonging to a union is self-defeating of the political and economic purpose of such a union. However, the extent, sequencing and pace of the reforms are still subject to sovereign policy goals, and thus relevant to the literature studied above.

Balancing these two seemingly conflicting goals, it is reasserted this study will take an agnostic approach to the goals of SADC and the FIP. The study will assess the case for liberalising in relation to the region and to the world at large, thereby allowing the RBM and Malawian policymakers to decide on the correct trade-offs implicit in the findings, and implement recommendations according to Malawi’s own broader regional policy goals.
3. CAPITAL CONTROLS AND MALAWI’S ECONOMY

3.1. MACROECONOMIC OVERVIEW

Malawi has been ranked by the UN DESA as one of the least developed countries in the world since 1971. Despite the onset of regular crises, primarily caused by external and natural shocks to the dominant agricultural sector, the country has been growing at an average rate of nearly 6% per year for the past 10 years. This growth however, comes off of a very low base. Figure 6 below shows that Malawi’s per-capita income, when last measured by the World Bank, was USD 268 per annum, perilously close to the ~USD 1 per day that generally signals the line of extreme poverty. Moreover, a decline in real GDP growth between 2009, when Malawi was exposed both to the fallout from the financial crisis and a severe internal crisis in 2011, led to a reversal of per-capita GDP in 2012 to 2007 levels. Malawi’s developmental challenge, summarised in its share of wealth per individual, must underlie any policy analysis.

At present, Malawi’s economy is effectively stalled by a large corruption scandal. In early October 2013, the Malawian authorities released details of what came to be known colloquially as the “CashGate” scandal. Official estimates are that MWK 9bn (USD25m), which equates to 0.7% of GDP, was misappropriated in mid-2013 by government employees\(^{32}\). In response, donor organisations withdrew USD180m in funding (nearly 5% of GDP), equivalent to 55% of total budgetary support and dedicated grants for the year. It is expected that this aid, mostly in the form of budgetary support, will remain frozen until late 2014. The government is implementing an action plan to address the fraud. This plan takes a five-tiered approach including: prosecutions, audits to unveil whether the fraud has been long-standing, and security revisions and upgrades to the government’s accounts. Despite the strong proclamations of the Presidency in response to the crisis, the public remains sceptical of the leadership, and the investment climate in Malawi has deteriorated significantly. CashGate will remain the dominant narrative of Malawi’s economy for at least the next year, and the effect of the crisis on the fiscus has been severe. This is unfortunate, as it undermines the gradual progress that had been made in the economy since the 2011 crisis.

Figure 6: GDP per capital and real GDP growth, 2003 - 2013

![Figure 6: GDP per capital and real GDP growth, 2003 - 2013](image)


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\(^{32}\) IMF, 2014, Malawi, Third and Fourth Reviews Under the Extended Credit Facility Arrangement, Washington: IMF
Figure 7 shows a breakdown of Malawi’s national income by sector. The agricultural sector dominates the economy, making up a combined 52% of GDP. Half of this production is in primary agriculture, roughly half in post-harvest agricultural beneficiation, and a small amount from forestry and fishing. The next-largest sector of the economy is wholesale and retail distribution. Manufacturing makes up only 6% of national income (and there is reason to believe that this share may have dropped since 2010), showing the seriousness of the lack of diversification. The financial sector is small relative to GDP compared to many regional and international peers.

**Figure 7: GDP contributions by industry, per cent, 2010**

Moving to another set of macro fundamentals, Figure 8 below shows a historical view of selected interest rates against the inflation rate. Until early 2012, there was a clear trend of declining prime and central bank interest rates, matched by a reasonable spread between the two rates. Inflation remained relatively contained, ranging between 5% and 15% over the period. In early 2012, there is a clear break in the data when interest rates spiked, along with growth in the prime margin. Between January 2012 and January 2013, inflation more than tripled, before settling to its current rate of around 25%. The event that triggered the break in the time series was the decision to abandon a currency peg and move to a floating exchange rate in May 2012. Although this decision caused some turmoil in financial markets, this may also represent volatility and a regression to fundamentally valued pricing of capital, which the exchange rate peg had kept artificially low. The inflation spike was caused via the import channel, as a sustained depreciation in the value of the Kwacha led to a surge in the price of imported goods (import demand is highly inelastic in Malawi due to a lack of locally-produces substitutes) and a widening of the current account deficit.

*Source: Reserve Bank of Malawi, 2010*
In Figure 9, the IMF’s programmed projections for government finance are shown as a proportion of GDP. The projections imply a programme of austerity in response to the withdrawal of donor funds in response to the “CashGate” scandal, in order to avoid a build-up of debt as government income falls, and thereafter loosening to a moderate expansion. This forecast suggests that due to the scandal, the country is on a trajectory toward a period of comparative austerity, increasing the fragility of the economy to shocks. This must be borne in mind when considering the timing of capital account liberalisation.

Source: Reserve Bank of Malawi, 2014

Figure 8: Inflation and interest rates, 2003 - 2013

Source: Reserve Bank of Malawi, 2014

Figure 9: Fiscal balance as a proportion of GDP, Forecast

Source: IMF, 2014
Figure 10 shows the shift between exchange rate regimes. The graph shows the value of the Kwacha relative to the US Dollar over a ten year period. There is evidence of three distinct exchange rate regimes, which are highlighted in separate background colours. First, between 2003 and the end of 2005 there was a gradual, controlled depreciation in the Kwacha. This was followed by a period of managed peg and currency defence, with a stable, if slowly depreciating, value. The decision to float the currency, based on extended pressure on the RBM’s ability to maintain the peg using limited reserves, which resulted in an extended economic crisis, is evident in early 2012. Subject to pure market forces, the Kwacha more than halved in value between January 2012 and January 2014 to the current level of ~MWK 425/ USD 1. The devaluation of the Kwacha, indecently, is supported by the IMF in the interest of achieving macro stability and strengthening Malawi’s export competitiveness.\(^{33}\)

![Figure 10: MWK/USD, 2003 – 2013](image)

Source: Reserve Bank of Malawi, 2014

The primary focus of this study is on Malawi’s economic relationship with the rest of the world. Foreign transactions are captured in the most recently updated RBM data for the balance of payments in Table 5 below.

### Table 5: Malawi’s Balance of Payments, Millions of Kwacha

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Current Account</td>
<td>(78 127)</td>
<td>(136 215)</td>
<td>(105 639)</td>
<td>(190 032)</td>
<td>(361 751)</td>
</tr>
<tr>
<td>Goods: exports f.o.b.</td>
<td>179 052</td>
<td>171 441</td>
<td>240 931</td>
<td>296 828</td>
<td>539 433</td>
</tr>
<tr>
<td>Goods: imports f.o.b.</td>
<td>(283 513)</td>
<td>(344 286)</td>
<td>(404 745)</td>
<td>(536 806)</td>
<td>(981 004)</td>
</tr>
<tr>
<td>Balance on Goods</td>
<td>(104 461)</td>
<td>(172 845)</td>
<td>(163 814)</td>
<td>(239 977)</td>
<td>(441 571)</td>
</tr>
<tr>
<td>Services: credit</td>
<td>11 165</td>
<td>12 255</td>
<td>15 406</td>
<td>18 009</td>
<td>39 553</td>
</tr>
<tr>
<td>Services debit</td>
<td></td>
<td></td>
<td>(36 848)</td>
<td>(44 679)</td>
<td>(85 951)</td>
</tr>
<tr>
<td>Balance on Goods and Services</td>
<td>(127 030)</td>
<td>(192 567)</td>
<td>(185 256)</td>
<td>(266 647)</td>
<td>(487 969)</td>
</tr>
<tr>
<td>Income: credit</td>
<td>51</td>
<td>190</td>
<td>1 427</td>
<td>1 766</td>
<td>876</td>
</tr>
<tr>
<td>Income: debit</td>
<td>(17 297)</td>
<td>(28 800)</td>
<td>(17 564)</td>
<td>(20 379)</td>
<td>(36 249)</td>
</tr>
<tr>
<td>Balance on Goods, services and Income</td>
<td>(144 277)</td>
<td>(221 178)</td>
<td>(201 394)</td>
<td>(285 260)</td>
<td>(523 342)</td>
</tr>
<tr>
<td>Current transfers: credit</td>
<td>67 309</td>
<td>86 556</td>
<td>97 951</td>
<td>98 336</td>
<td>166 343</td>
</tr>
<tr>
<td>Current transfers: debit</td>
<td>(1 159)</td>
<td>(1 594)</td>
<td>(2 198)</td>
<td>(3 108)</td>
<td>(4 752)</td>
</tr>
</tbody>
</table>

\(^{33}\) IMF Malawi Country report, February 2014
Table 5 shows Malawi to maintain a persistent current account deficit, which in 2012 stood at 13% of nominal GDP. Broadly put, Malawi’s retail expenditures are primarily on imported goods, and exports in cash crops are not sufficient to balance the current account. Additionally, services and income categories of the current account are net outflows.

The current account deficit is financed through the capital and financial account. The capital account recorded a net inflow, which in 2012 was 47% of the current deficit, or roughly 6% of GDP. The remainder of the deficit was made up by the financial account and a decline in reserves. The most important net financial inflows were through the general government.
monetary authorities and via FDI. Banks recorded a net financial outflow. Securities markets and capital markets are shown to be under-developed. The data for 2013 are worryingly unreliable, with the net errors and omissions category of nearly twice the financial account. We question whether this figure may relate to remittance flows into Malawi.

The analysis will turn to capital and financial flows in later sections, in the context of assessments of the actual openness of Malawi’s economy to capital flows. At this point, it is worth noting the pressures created by the current account deficit, lack of export diversification and very small FDI and portfolio flows on the balance of payments (BoP). Most external financing comes via official inflows and government financing.

Figure 11 below shows the RBM’s gross reserve position and the number of months of import cover that reserves afford the country. Two observations are made. First, the cyclical nature of reserve accumulation, related to the tobacco season, is evident. Second, there has been a large improvement in reserve accumulation since the currency was floated and the RBM is no longer required to intervene in the market to manage the value of the Kwacha. The RBM targeted reserve accumulation in 2013 successfully, using the mild recovery in the exchange rate in the same period to buy dollars on the international market. This strategy has continued into the 2014 tobacco selling season.

**Figure 11: Foreign Reserves and Import Cover**

![Diagram showing foreign reserves and import cover]

*Source: Reserve Bank Malawi, 2014*

Figure 12 shows the growth of the domestic financial sector. Total net domestic credit has grown at a rate that far outstrips inflation and economic growth, implying fairly rapid growth of the sector as a whole. It remains a concern, however, that the majority of this credit is in instruments with a maturity below three months, primarily in trade finance and consumer lending.

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34 The Ministry of Finance puts this figure, anecdotally, at 90%
A final observation to make as part of the macroeconomic overview is that Malawi currently lies at number 171 on the World Bank’s ease of doing business index, down 10 places from 2013 and lagging Sub-Saharan African averages significantly. The index concatenates indicators of a variety of obstacles to business operations, which ultimately place constraints on foreign direct and portfolio investments.

Overall then, it must be emphasised that Malawi’s policymakers face significant challenges. The economy is small, underdeveloped, frictional, undiversified, import-reliant, and has under-developed financial markets. Capital account liberalisation, to the extent that it might occur, must clearly do so in conjunction with reforms aimed at tackling Malawi’s broader development problem, without exposing the economy to additional risks from external shocks and volatility.

3.1.1. Recent reforms to support capital account liberalisation

Despite the challenges faced by Malawi’s economy that have been identified above, several reforms have taken place over the past several years which can be seen as broadly supportive of the integration of capital account liberalisation into the economic agenda. These reforms relate positively to the literature on sequencing and currency regimes presented above:

1. **The liberalisation of the Kwacha**: With reference to the theory on the “impossible triangle”, allowing the Kwacha to float sets the scene for a currency regime that allows financial integration with foreign jurisdictions while also maintaining monetary independence. Prior to 2012, the policy of a fixed exchange rate was a major obstacle to capital account liberalisation.

2. **Current account liberalisation**: The theoretical case for trade liberalisation is far stronger than that of CAL. No country will liberalise the capital account before the current account. Therefore, the liberalisation of the current account in Malawi was a signal that the intended policy direction was toward a more open economy, and sets a more receptive environment to foreign capital inflows.

3. **Financial sector reforms**: Over the past decade, the overhaul of the Banking Act and other financial sector regulations, have set far stronger regulatory environment for the banking sector, which is a critical factor in the
successful management of the risks of CAL. In particular, the adoption of the Basel II framework, implemented in early 2014 in advance of other SADC members (barring South Africa), which shows a relative level of financial sector regulatory sophistication. Malawi’s domestic banking sector is liberalised.

4. **AML and monitoring frameworks**: Included in the package of financial sector reforms are Anti-Money Laundering (AML) and financial monitoring and reporting regulations. These are crucial requirements for any open economy, and their introduction lays further groundwork for CAL. However, interview participants have indicated that both of these regulations can be improved in terms of operating procedures and actual submissions by banks. These improvements are necessary before CAL can take place.

### 3.2. EVALUATION OF CAPITAL CONTROLS IN MALAWI

Before assessing the merits of the case for liberalising Malawi’s capital account, and considering how this might be achieved, the form and extent of the country’s existing controls must be understood in detail. The following section assesses Malawi’s capital controls from a *de jure* and *de facto* perspective.

#### 3.2.1. *De jure* control

Malawi’s capital control regime is governed under the Exchange Control Act as amended in 1989 (the Act). The Act nominates the Ministry of Finance as the government arm responsible for the exercise of exchange controls. In turn, the RBM\(^{36}\) is delegated operational responsibility for the implementation of controls via the financial institutions through which capital flows will be enacted.

The RBM regulates the day-to-day implementation of the Act via its ability to issue subordinate legislation and regulations under the Act. These regulations recognise the licensing of two types of organisations that are permitted to deal in cross-border transactions and foreign exchange. The first is an Authorised Dealer Bank (ADB), which authorises a financial institution licensed under the Banking Act to conduct foreign exchange denominated transactions and deal in foreign exchange, and the second is an Authorised Foreign Exchange Dealer (AFED), which is a non-bank financial institution licensed to deal in foreign exchange.

The most recent set of regulations governing exchange controls was issued by the RBM in June 2013. From time to time, the RBM also issues circulars, manuals and notes detailing, clarifying or updating control over certain areas of the capital or current account. Updates to subordinate regulations are made fairly regularly in accordance with the Finance Ministry’s and the RBM’s changing policy stances. In certain cases, regulation has been revised to the point of becoming inconsistent with the Act itself.

In interviews in Lilongwe, it was explained that the legislative process is too slow to accommodate necessary policy changes, requiring sub-ordinate legislation to contradict the Act for the sake of economic expediency. A case in point is the 2012 adoption of a fully floating exchange rate, while actual Ministry of Finance regulations issued directly under the Act (updated 1994) still provide for a regular pegging exercise\(^{37}\). While this approach does work in general, it creates some coordination problems between governmental bodies with jurisdiction over different elements of exchange control implementation, for instance between the RBM and Home Affairs departments relating the control of transfers during immigration. This study may provide a window to begin to reorganise the legislative framework for exchange controls in line with current policy.

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\(^{36}\) The Reserve Bank of Malawi is owned by the Finance Ministry and does not have governance independence. However, it is considered to be increasingly operationally independent.

3.2.1.1. Reserve bank regulations

The RBM’s most recent rules for the capital account are outlined in the June 2013 exchange control operational manual for authorised foreign exchange dealers and authorised dealer banks.

Table 6 outlines the controls that are place on the capital account. Although a prevalent issue in Malawi, any assessment of controls on the current account is outside the scope of the study and is not considered.

Table 6: Malawi Capital and Financial Account Controls

<table>
<thead>
<tr>
<th>CAPITAL: May the following be effected without prior approval from the RBM and, if so, any limits:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Migrant worker earnings.</td>
</tr>
<tr>
<td>b) Emigrant settling-in allowances.</td>
</tr>
<tr>
<td>c) Residents temporarily abroad allowances.</td>
</tr>
<tr>
<td>d) Income tax refunds.</td>
</tr>
</tbody>
</table>

Are the remaining assets of emigrants controlled? | NR | NR |

May residents without prior approval from the Central Bank issue guarantees to non-residents. | NR | NR |

May residents accept guarantees from non-residents? | NR | NR |

May foreign nationals (expatriates) retransfer funds previously introduced? | NR | NR |

May immigrants retransfer funds previously introduced? | NR | NR |

FINANCIAL INWARD: May non-residents without prior approval from the Central Bank:

- Invest in fixed property. | NR | No, RBM approval is required |
- Invest in equity.        | NR | No, RBM approval is required |
- Invest in portfolios.    | NR | No, RBM approval is required |
- Invest in bonds.         | NR | No, RBM approval is required |
- Maintain local currency bank accounts. | NR | Yes |
- Maintain foreign currency accounts locally. | NR | Yes |

May residents enter into foreign loan agreements without prior approval from the Central Bank? | NR | No, RBM approval is required |

Is it a requirement to declare the accrual of foreign currency? | NR | No, but ADBs are required to present records of all controlled transactions on request to the RBM |

May residents retain foreign currency accrued / obtained? | NR | Yes |

Is the purchase/sale of foreign currency between residents restricted? | NR | Yes, only authorised ADBs and AFEDs may purchase or sell foreign currency as counterparties to residents subject to exchange control rules |

FINANCIAL OUTWARD

Is it a requirement to declare the accrual of a foreign asset? | Yes | Yes, any outward investment is subject to RBM approval |

May foreign assets so declared be retained abroad? | No | Yes, subject to RBM approval |

May income on foreign assets be retained abroad? | No | No |

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38 Over the course of in-country interviews, several divergent opinions were expressed about the legal and actual level of control over the current account. For the purpose of this review we acknowledge the RBM’s assertion that the current account has been liberalized, and that ADBs hold the authority to approve current-account related financial transfers and remittances, but also concede that there may be other bureaucratic barriers to free flows on the account.
### Study on the Liberalisation of the Capital and Financial Account of Malawi

<table>
<thead>
<tr>
<th>Description</th>
<th>Allowed</th>
<th>Limits</th>
</tr>
</thead>
<tbody>
<tr>
<td>May private individuals maintain foreign bank accounts and, if so, any limit.</td>
<td>Not allowed</td>
<td>Not allowed</td>
</tr>
<tr>
<td>May resident private individuals maintain onshore accounts denominated in foreign currency, if so, indicate any limits.</td>
<td>Yes, as long as they earn foreign exchange regularly</td>
<td>Yes</td>
</tr>
<tr>
<td>May resident private individuals maintain foreign accounts denominated in domestic currency.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>May resident private individuals be allowed to convert their domestic/local currency accounts into foreign currency?</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>May private individuals invest into fixed property, equity, portfolios, bonds abroad, and, if so, any limits</td>
<td>No</td>
<td>Yes, subject to RBM approval</td>
</tr>
<tr>
<td>May residents, excluding commercial banks, enter into loan agreements with non-residents without prior approval from the Central Bank, if so, any limits.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>May companies, etc. maintain foreign bank accounts and, if so, any limit.</td>
<td>Not allowed</td>
<td>Not allowed</td>
</tr>
<tr>
<td>May resident companies maintain onshore accounts denominated in foreign currency? If yes, indicate limit.</td>
<td>Yes, as long as they earn foreign exchange</td>
<td>Yes, not subject to limits</td>
</tr>
<tr>
<td>May resident companies maintain foreign accounts denominated in local/domestic currency?</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>May resident companies be allowed to convert their domestic/local currency accounts into foreign currency?</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>May non-residents denominated in local currency be allowed to be converted into foreign currency?</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>May companies, etc. invest into fixed property, equity, portfolios abroad and, if so, any limits</td>
<td>Require prior approval</td>
<td>Yes, subject to RBM approval</td>
</tr>
</tbody>
</table>

**May the following transfers be effected without prior approval from the Central Bank and, if so, any limits:**

- **Inheritances, legacies and distributions from estates.**
  - Yes, no limit
  - Yes, no limit

- **Monetary gifts to non-residents or residents temporarily abroad.**
  - Yes, up to USD 100 (K15 080.00) per annum
  - Yes, up to USD 1,000 (MWK40,000) per annum

- **Maintenance.**
  - Yes
  - Yes

- **Alimony.**
  - Yes, against court order
  - Yes, against court order

- **Loans to non-residents.**
  - No
  - No

- **Casino, gambling and lottery winnings.**
  - No
  - No

**FINANCIAL OTHER: May residents, without prior approval from the Central Bank:**

- **grant local financial assistance to non-residents and, if so, indicate limits.**
  - Yes, no prescribed limits
  - Yes, no prescribed limits

- **enter into forward exchange contracts.**
  - Yes
  - Yes

- **be allowed to issue abroad bonds, debt securities, shares or other securities of a participative nature.**
  - No
  - No

- **be allowed to purchase or issue abroad derivative**
  - No
  - No
Overall, the legal restrictions on capital and financial transactions are assessed as strict. Certain elements of the capital account are moderately open according to RBM regulations. However, the RBM maintains discretionary control over key categories in the financial and capital account.

The RBM approves all foreign borrowing by residents, and sets an onerous and complex application process for consideration of such an approval, which requires extensive documentation and two separate applications to an ADB and the RBM.

Direct outward investment by residents is similarly controlled by the RBM. ADBs must submit applications on behalf of clients for such investments, which include the submission of annual audited accounts. This requirement excludes individual and small business from realistically being considered for approval of outward investments. The RBM allows, again by approval, for residents to purchase listed foreign securities through registered stockbrokers. Again, the application for such a purchase is fairly onerous. The RBM discourages the purchase of bearer bonds and unquoted external securities by residents. Additionally, the net proceeds of disposal of these securities must be immediately repatriated.

Inward investment is provided for in the regulations, but flows are not liberalised. The RBM allows capital inflows in the form of cash (subject to AML provisions), capitalisation of imported or locally purchased plant and machinery, through the capitalisation of cost of technology or technology services, or though debt-equity swaps. All of these inflow types must be applied for and approved by the RBM, subject to provision of company information and documentation in the case of capitalisation of costs already incurred and proof of a board-level decision to capitalise the asset. Foreign investment into Government securities (a portfolio flow) must be registered (but not approved by) the RBM.

Repatriation on disinvestment is allowed, but only provided that the initial capital investments were registered with the RBM, and subject to the submission of several other forms of documentation. Outward remittances arising from the disposal of financial assets must be reported to the RBM. The RBM reserves the right to inspect ADBs’ records of all financial asset purchases and disposals.

### Table

<table>
<thead>
<tr>
<th>May the commercial banks, without prior approval from the Central Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>- borrow abroad</td>
</tr>
<tr>
<td>- maintain accounts abroad</td>
</tr>
<tr>
<td>- lend locally in foreign currency</td>
</tr>
<tr>
<td>- grant local financial assistance to non-residents and, if so, indicate limits</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>For institutional investors:</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Is there any limit on securities issued locally by a non-resident?</td>
</tr>
<tr>
<td>- Is there any limits on foreign portfolio investments to be held by the institutional investors? If any, indicate limits.</td>
</tr>
</tbody>
</table>

Source: Jefferies, 2011 and Reserve Bank of Malawi, 2013

Note: Red cells represent controlled portions of the capital account, orange cells represent partial controls, and green cells represent liberalized portions of the capital account.

Note: “NR” refers to a lack of published information on a particular type of transaction
The RBM requires ADBs to apply due diligence to any applications by residents or non-residents to open foreign-currency denominated accounts (FCSAs). In this instance, ‘non-resident’ refers to Malawians living abroad. Non-residents are exempt from any foreign exchange conversion or retention ratio and from exchange controls on ordinary remittance flows. ADBs are only required to credit non-resident FCDA accounts with Kwacha for proceeds of a sale of property in Malawi, or from the local sale of personal effects imported duty-free by a non-resident. Resident FCDA accounts are required to comply with a conversion/retention ratio published from time to time by the RBM. In 2013 this ratio was relaxed from 80/20 to 60/40. Remittances are subject to the applicable current-account exchange controls. Encashment of hard currencies are allowed for the purposes of travel only. In all cases, FCDAs must have a zero balance before a citizen may apply for foreign exchange. Transfer between FCDAs is subject to exchange controls, and a FCDA (resident) transfer to a FCDA (non-resident) is not permitted (i.e. only inward flows are permitted).

The literature review and theoretical overview discussed the difficulty of measuring and comparing capital account openness globally. The primary reasons for this difficulty are the varied approaches to capital account restriction, the differing enforcement success, and the problem of indexing degrees of control compared to a (simplistic) binary liberalised/controlled assessment. The alternative, considered in the following section, is to bypass regulatory controls completely and analyse actual flows.

Figure 13 below tracks the Chinn-Ito score for Malawi over the 20 year period from 1991 to 2011. The global trend, according to Chinn and Ito, is broadly toward a more open capital account. Malawi is ranked at the minimum value of the index (showing a high level on control), and appears to have been steadily becoming less liberal since 1995. Although this index has limitations, it does confirm negative perceptions on the openness of Malawi’s balance of payments, and is in agreement with the above analysis of capital control regulations. Malawi can be seen to be moving against the global average trend.

**Figure 13: Chinn-Ito KAOPEN score for Malawi**

Source: Chinn-Ito dataset, 2013, available: http://web.pdx.edu/~ito/Chinn-Ito_website.htm
3.2.1.2. Other regulations affecting capital account transactions

In addition to regulations that directly impact on the capital account, there is a class of flows, technically belonging to the current account, which affect the decision of foreign firms to invest in long-term inflows. This is the ability of non-resident firms to remit profit and dividend flows out of Malawi. Clause 32 of the RBM’s Operational Manual for Cross-Border Foreign Exchange Transactions allows for the transfer of dividends to shareholders outside of Malawi. ADBs may authorise such transactions, but only subject to the receipt of audited financial statements proving that the dividends were paid out of distributable profits and not out of capital disposals or revaluation allowances. Therefore, outward remittance of returns on inward capital investment is allowed, but is subject to fairly tight practical requirements. Similar requirements such as board approval are placed on the otherwise liberalised transfer of director’s fees and pensions to non-residents.

During in-country meetings, the issue of trade credit was raised. This is seen as a financial flow by the bank (not a capital flow); as the provision of credit is seen as separate from the underlying asset transaction. The RBM imposes limits of USD 25,000 before RBM approval is required for import of goods into Malawi. Some observers see this limit as an imposition of control over the current account, as it effectively places limits on free trade. This practice is unusual by international standards. The reason for the control is to prevent a build-up of foreign liabilities arising in times of capital outflow crisis. In either case, the imposition of such a limit represents a control, whether it is considered a capital or current transaction.

3.2.1.3. Summary of capital control regulations

It is clear that the Malawian capital account is subject to a high degree of control, and that, unlike the current account, the RBM can approve or disallow financial and capital transactions at its discretion. Several important conclusions can be drawn from the analysis of legal controls over the capital and financial account:

1. Malawi’s capital account should be considered to be controlled. The extent of this control in law, although difficult to assess relative to international standards, should be regarded as “high”.

2. There is little difference in controls between different categories of the account. Foreign inflows of capital are controlled in the same way regardless of term, source or purpose, and controls are roughly equivalent to those on outflows. This “blanket” approach leaves significant space for consideration of different types and sequencing of reforms.

3. Even where sections of the capital account are liberalised in the sense that the RBM does not need to authorise transactions, such as in relation to residents temporary abroad allowances, there is a large burden placed on the business or individual wishing to make transfers to submit documentation to the ADB. This effectively limits small business and individuals from these provisions, particularly when audited financial statements are required in the application process.

The administrative complexity pointed out in item 3 does not technically constitute a *de jure* control, but will affect *de facto* openness, which is analysed in the following section.

3.2.2. *De facto* control

The difference between *de jure* (legal and regulatory) and *de facto* (actual or observed) openness has been defined earlier in this study. There are several reasons to include an indication of *de facto* openness in conjunction with analysis of the legal and regulatory framework. By analysing actual flows, the effectiveness of *de jure* openness can be assessed. If actual flows deviate significantly from what would be expected under legal restrictions, it is possible to make a case for improved implementation of legal restrictions. Alternatively, if capital is flowing despite restrictions, a revision of the goals of regulations might be in order. Conversely, if capital is not flowing on comparatively unregulated sections of the capital
account, this points to non-regulatory barriers to capital flows, and may inform the recommendations of the study in relation to sequencing and concurrent developments.

As outlined in the methodological note above, both flow and stock variables are considered.

3.2.2.1. Malawi’s De facto openness

There is no theoretically established upper limit for capital flows or capital stock accumulation. For this reason, a de facto assessment of openness is necessarily comparative in nature. A fuller assessment of Malawi’s de facto openness is therefore established in the following section. At this stage it is worth making some comments on the development of capital stocks and flows in Malawi over time.

First, as demonstrated in figure 14, at its peak at the turn of the century, the sum total of foreign assets in the form of debt and foreign exchange reserves stood below 30% of GDP. By any standards, this represents an economy that tightly controls capital outflows. The fact that outward portfolio and direct investment were each less than a percent of GDP only serves to reinforce this finding.

Capital stock liabilities, which refer broadly to ownership of Malawian assets by foreign nationals, hit a peak of nearly 200% of GDP early in the century. At first glance this would point to a highly financially integrated economy. However, if official debt is removed (which represents portfolio instruments as well as private and public borrowing), we find that FDI stocks do not at any point top 35% of GDP, while portfolio equity is negligible. This again suggests an economy with tight limitations on capital flows, but with a high level of external dependence on foreign debt financing, which is substantial relative to GDP.
Capital flow indicators reinforce the findings from the analysis of capital stocks. Figure 15 below shows portfolio debt movements as a percentage of GDP. Unlike the stock measurement, this IMF data has stripped out other forms of debt, and looks only at the exchange of debt instruments for investing purposes. On both the asset and liability side, flows were negligible in relation to GDP. The 2006 spike in inflows was equal to less than half a percent of a percent of GDP.

It is informative that the equivalent IMF survey to establish equity portfolio flows does not contain data for Malawi. This suggests either that there are no such flows, or that they are too small to warrant collection. In either case, the implication is that Malawi is not an economy with sufficiently open equity markets to warrant participation in the survey.

Figure 16, based on a separate UNCTAD database, shows annual FDI flows into and out of Malawi. According to these data, outward direct investment is very low, at less than a percent of GDP. Inward investment appears to be relatively liberalised, although a peak investment inflow level of 5% of Malawi’s small GDP is far below the country’s developmental requirements. It is not possible to establish whether the relatively level of these flows reflects the difficulty of moving capital into the country or is related to economic fundamentals. Interviews in Malawi suggested that both are at work.
Even without a comparative analysis, it is evident from *de facto* stock and flow analysis that Malawi’s capital account is tightly controlled. This is the case particularly for portfolio flows (which may also be related to issues of market depth and development) than for FDI. Nonetheless, even these more open sector measures appear restricted relative to Malawi’s already below-potential GDP.
4. KEY RISKS OF LIBERALISATION PROGRAMMES

While the theoretical benefits of capital account liberalisation have been presented in the theoretical overview, the analysis of key risks warrants its own section. This reflects the treatment of key risks in economic policy literature, which initially were seen as negligible or at least subordinate to the strong theoretical priors supporting capital account liberalisation in neoclassical economics. It was in attempts to implement liberalised capital accounts, particularly in rapidly developing countries such as South East Asia and parts of Latin America, that the extent and importance of the risks of liberalisation came to be more widely acknowledged and received proper academic attention. In the aftermath of the Asian financial crisis, multilateral institutions such as the IMF moderated their views on rapid capital account liberalisation.

This section breaks down the identification of key risks into those originating from capital inflows, those originating from capital outflows and other risks that have been identified by policymakers and scholars. In general, risks relate to short-term capital flows rather than longer term flows. The effect of liberalised capital accounts in relation to global or regional crises is a particular focus of most sources. For each risk that is identified, a brief discussion on mitigation or counteracting arguments is included. General comments on the response of other countries to these risks, as well as the implications of the identified risks to Malawi, are discussed in the final subsection.

4.1. INFLOWS

Risks relating to the effects of capital inflows – particularly large portfolio inflows – on macroeconomic stability and policy management, dominate the discourse on open account risks. While interviews in Malawi have revealed the more immediate concern is in fact in relation to outflow risks, the shallowness and underdevelopment of Malawi’s bond and equity markets mean that the country will be sensitive to relatively small inflow fluctuations. Additionally, inflows that are channelled through the banking sector also carry significant risks, and were not generally pointed out by stakeholders. Any recommendations must therefore be informed by an understanding of inflow risks as well as outflow risks.

**Exchange rate appreciation**

Sustained demand for a country’s financial assets can lead to appreciation of the domestic exchange rate. The predominant disadvantage of such an appreciation is to skew the exchange rate away from the fundamental value required for equilibrium in the current account. Indeed, in developing countries, a competitively weak currency is often seen as a tool to support export-led growth. The effect of sustained financial inflows may, in this sense, be contrary to growth policy and possibly a hindrance to development. In addition to appreciation of the average value of the currency, an open capital account and corresponding inflows will lead to a higher level of currency volatility. This carries negative consequences, as it introduces volatility risk into financial and current account transactions, and frustrates economic planning. Both of these risks are widely acknowledged as having materialised in South Africa, and are commonly discussed monetary policy issues. Moreover, in a country with a cyclical export cycle as Malawi, volatility in the exchange rate carries even more serious risks, as external or global factors may lead to adverse swings at critical periods in the cycle. Naturally, a country that allows the currency to float at a market-determined equilibrium is more susceptible to such currency risks.

One way to mitigate extreme currency fluctuations is for the Reserve Bank and government to intervene in the market to stabilise the value of the currency. Many jurisdictions are able to do this successfully in response to highly irregular short term disturbances in the pattern of global financial flows. Chile, for instance, has made use of month-long auctions of foreign exchange twice in the past decade in order to protect the Peso from run-ups. However, this policy is widely acknowledged to be unsustainable in the long term, and is therefore not an acceptable response to persistent inflows. By

selling domestic currency in order to dampen appreciations, the central bank will expand the domestic money supply, placing upward pressure on inflation. Sterilizing this policy by selling government bonds to “mop up” the additional money supply can be effective, but is limited by the appetite of the government to expand its balance sheet, and does not address the underlying cause of portfolio inflows (usually interest-rate differentials). Thus, the most commonly recommended and implemented mitigant (assuming a floating currency⁴⁰) is to utilise monetary policy in response to the inflow – in the case of a sustained appreciation by lowering domestic interest rates. While this can be effective, it will also be a stimulating influence on the domestic economy, which is not necessarily an aligned policy goal – the economy may overheat and internal inflationary pressures will remain a concern. Another, more sustainable response, is to deepen the ability of domestic financial markets to absorb inflows. This will require the development of sound financial products, such as hedging tools, which allow local actors to manage the risks associated with an open account.

Asset price bubbles

A major risk of CAL relates to the tendency of inflows that are large relative to the domestic economy to spark off asset price booms. These occur most commonly in domestic equities (short term flows), and in domestic real-estate. Any long bubble inflation and rapid bust leads to macroeconomic instability, but in the case of a foreign inflow-fuelled bubble, the bust is amplified by a rapid and even more destabilising withdrawal of capital. In the worst-case scenario, this can precipitate a financial crisis. Real estate bubbles were implicated in the 1998 financial crisis, while a number of emerging markets have experienced large inflations and reversals in equity markets that are tied to global trends in capital allocation. While the real damage of an asset price bubble driven by inflows occurs when capital is suddenly withdrawn or reversed, an additional effect of asset price booms, particularly in property, is to disadvantage residents by excluding them from the market for domestic assets. Inflated housing and rental prices resulting from a property boom, aside from carrying financial risk, has negative welfare effects on residents. Such exclusion has been observed in Nairobi and Cape Town.

Asset price bubbles driven by international demand do not have a simple policy solution. While domestically driven bubbles can be contained or deflated by tight monetary policy that has the effect of dampening domestic demand, tight monetary policy will also widen interest differentials, and therefore attract inflows. For this reason, and particularly in property markets, limited capital controls are accepted as a policy management tool by the IMF and others, and have been successfully deployed in countries such as Chile to manage such appreciations. This approach can form part of a well-sequenced liberalisation programme. Many otherwise liberated economies place limitations on foreign ownership of property specifically to prevent property bubbles. A first, and preferred option, however, is to have in place the macro-prudential management tools that limit the possibility for such asset price run-ups through the financial sector. As a general observation, asset price bubbles remain one of the definitive economic problems of the century in both developed and developing economies, and the topic is still only understood to a limited extent. Until the advent of further breakthroughs, containing bubbles in closed and open developing and developed countries will prove channelling.

Credit booms

Credit booms are one of the most heavily analysed inflow risks that can be experienced by an open economy. While there are obvious developmental benefits from increased access to credit and improved cost of credit, there is also a risk that CAL may lead to a decrease in risk management standards and consequent credit boom and bust cycles. The first channel through which a credit boom poses a risk is through domestic (non-financial) firms becoming over-leveraged, and therefore fragile to a downturn or slowing pace of economic growth. The second is within the financial sector, where a sudden surge in funding from international savings leads domestic financial institutions to expose themselves to excessively risky lending – sometimes, as in the case of East Asia, based on collateral driven by a separate asset bubble – which then leads to defaults and financial system stress or collapse. Post-crash deleveraging has been shown to have lasting effects on incomes and

⁴⁰See discussion on the “impossible trinity” on page 13
saving. The first channel can be funded directly by international banks lending to domestic firms, or via cheaper funding to local banks. The second channel operates via the domestic banking sector. In both cases, the bubble is driven by a miscalculated risk premium in the cost of lending into the domestic economy.

The primary tool that can be used to mitigate a credit boom driven by inflows is to ensure that domestic banks follow a sound prudential policy framework. By holding both domestic and foreign banks to strong risk management standards, in which the resulting risk premium is correctly priced, such booms can be avoided. This solution leads to two considerations for the implementation of CAL. First, it implies that from a sequencing perspective, a strong prudential framework (such as adherence to Basel Committee standards) should precede liberalisation of lending and financing inflows. Such a framework should cover both macro-and-micro prudential issues. Second, the possibility of credit booms emerging implies that after liberalisation, significant regulatory resources must be applied to monitoring bank compliance to prudential standards.

4.2. OUTFLOWS

Outflow risks relate to flows of domestic capital – often scarce to begin with in developing countries – toward investments in other economies. As with inflows these may take the form of direct investment into foreign property or enterprise, portfolio flows into foreign financial instruments, private flows into foreign banking sectors, or lending by domestic banks to foreign banks or foreign enterprises. The extent and timing of such outflows pose risks for liberalising economies.

Capital flight

The most commonly identified outflow risk of liberalisation, particularly in less developed economies, is capital flight. The concern is that by liberalising capital outflows, domestic savings, which previously were contained in the country by decree, will flee to international jurisdictions in order to avoid risks perceived as inherent in the local economy. The effect of such a flight, particularly if it is not balanced by inflows of similar size and maturity, will be to destabilise the exchange rate and, in the medium to long term, starve the local economy of a savings base that can be intermediated by the financial sector into productive, developmental investment. In Malawi, stakeholders have indicated that capital flight, particularly in the period immediately post-liberalisation is one of the primary concerns of liberalisation. Indeed, given the macroeconomic instability to which Malawi has been prone in the past, there is an appetite for holding “safe” assets outside of the domestic economy. Foreign-denominated domestic bank accounts are already popular. The fear is that liberalised outflows will result in a run on foreign currency reserves as residents scramble to move savings abroad.

Cobham identifies two important arguments which to some extent mitigate the fear of a damaging capital flight in Malawi post-liberalisation. First is the observation that, according to Cobham and FitzGerald, the extent of illegal capital flight in developing countries that impose capital controls is already high. Although there is no readily available study analysing the issue for Malawi, sources in the RBM and Ministry of Finance indicate that this is especially true in Malawi. This fact alone significantly weakens the case against CAL, as it undermines the intended effectiveness of CFMs in retaining domestic capital in the first place. If capital can flee under a managed account, what is lost from liberalising? In fact liberalising under a scenario of pre-existing illicit flight will at least formalise flows and make the extent of the flight measurable. Cobham takes this argument further, and notes that CAL may in fact act to reverse capital flight. That is, the liberalisation of the capital account signals an improvement in domestic conditions, and allows for the natural “home bias” of domestically owned capital to act to return capital that was removed from the country through parallel markets to return to the domestic economy. As will be shown in the following section, capital flight did not occur in Uganda, Rwanda, Zambia or Botswana.

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41 Stiglitz, J., 2012, Restoring growth and stability in a world of crisis and contagion, Barcelona: Barcelona Graduate School of Economics
42 Cobham, A., 2001, Capital Account Liberalisation and Poverty, Queen Elizabeth House, Oxford: Finance and Trade Policy and Research Centre
43 Fitzgerald, V., and Cobham, A., Capital Flight: Causes, Effects, Magnitude and Implications for Development, UK: DFID
after CAL. Indeed, in the case of Uganda, has been argued that parallel markets were formalised and capital returned “home”\(^4\).

Although these arguments may mitigate the risk of capital flow to some extent, the fact remains that the primary determinant of the level of capital flight – whether legitimate or illegal – is the level of macroeconomic stability in the domestic economy, and the growth outlook of the same. Once again, this has important implications for sequencing, suggesting that outflow liberalisation should follow the achievement of macroeconomic stability. Liberalising in an environment of volatile exchange rate movements, high inflation or high uncertainty may indeed lead to capital flights. For this reason, the IMF and others typically place outflow liberalisations at the back of an integrated liberalisation programme, behind reforms to the financial sector and the achievement of a reasonable level of macro stability. Indeed, it was the final step of liberalisation efforts in both Rwanda and Uganda.

**Pro-cyclical outflows**

In most cases, capital account liberalisation implies liberalising, or at least increasing, the ability of local financial institutions – particularly pension funds, insurers and mutual funds – to allocate domestic savings into foreign portfolio instruments. While this has positive implications in relation to risk and return diversification and access to more appropriate financial instruments, significant changes in these allocations carry the risk of destabilisation. A particular risk is the tendency of these flows to be pro-cyclical. When the domestic economy is weak or capital-starved, or when there is run on the domestic currency, these funds will tend to allocate savings away from the domestic economy, thereby magnifying the underlying economic weakness. The reverse is true in an over-heating or “bubbly” domestic economy, which such domestically-owned capital will tend to return, seeking high yield and supporting the bubble (and also eventually sharing in the fall-out). Chile experienced both of these challenges prior to and during the 1998 Asian crisis.

Obviously, allocating capital into international markets carries its own risks. For this reason, foreign capital allocations are often limited on a macro-prudential control basis (rather than an exchange control basis). These types of limits will also protect the domestic economy from pro-cyclical risks, and should be set with this ancillary goal in mind.

**Exchange-rate devaluations**

As in the case of sustained inflows, large and sustained outflows will lead to depreciation of the local currency. This will have inflationary consequences in countries with high and inelastic import demand, and will thus undermine macroeconomic stability. The risks and mitigants that were introduced in the case of inflows apply in reverse to the case of outflows. Again, monetary policy operating through the interest rate and the creation of favourable differentials (if aligned with domestic considerations) are the most commonly recommended macroeconomic solution to this risk.

### 4.3. OTHER RISKS

Risks caused by unfavourable, large or sustained inflow and outflow patterns are the most important to the overall question of how (and if) CAL should be implemented. However, CAL affects the economy in many varied and sometimes unexpected ways, introducing additional risks which require careful thought to manage. Two of these, relating to market discipline and taxation are briefly discussed.

**Adverse market discipline effects**

Open economies with governments and institutions that are funded on international capital markets are subject to market discipline. International investors can use premia to signal approval or disapproval of the management of the domestic
economy. This is commonly cited as a benefit of liberalisation, and does indeed introduce an influential line of accountability onto governments that under closed (or donor supported) conditions might otherwise not have strong incentives to manage the economy efficiently and effectively. However, authors such as Cobham have noted that the phenomenon of market discipline is often relatively narrow, restricted as it is to the interests of financiers rather than economists or local citizens. The credit rating agencies, whose ratings summarise market sentiment and play a large role in directing capital allocation between sovereign states, are often accused of myopia and excessive interest in short-term indebtedness ratios. The ability of governments to implement feasible developmental programs with strong social security components or to introduce government-led counter-cyclical policy has been limited by fears of significant outflows from the domestic economy. In the context of Malawi’s choice between international market discipline and the particular narrow and ideological views implicitly underlying developmental aid (which is also volatile), the adverse effects of market discipline must be of secondary priority, behind achieving donor independence.

**Shifting taxation burdens**

The final risk identified in this study is the possibility that under certain conditions, an open economy might shift tax burdens in a way that is retrogressive. This relates to the competition between developing economies for international FDI flows. In order to compete, some countries offer special tax incentives on foreign capital. If large enough, this can shift more of the tax burden onto domestic incomes, broadly seen as a movement of the tax burden from capital to labour. This is an anti-progressive effect.

Because such incentives have been shown to be a very weak determinant of FDI, one legitimate response might be to forgo such incentives entirely, and focus instead on other ways to attract capital, for instance infrastructure development or wage differentials.

4.4. **THE IMPLICATIONS OF CAL RISKS**

It is the nature of risks that they can be reduced or managed in a way that allows for a favourable trade-off against the associated benefits. This holds for the risks of capital account liberalisation. By isolating the most important risks to Malawi and focusing on mitigating these risks, the potential benefits of liberalisation can be maximised.

Of the risks identified in this section, the most significant for Malawi in the short term is the risk of a capital flight. This is followed by the risks relating to the ability of the domestic financial sector to manage risks appropriately to avoid asset and credit bubbles. This leads to the conclusion in relation to this section that the risks of liberalisation are not so large as to outweigh the benefits of CAL, but that important sequencing methods should be considered. These are:

- Delay portfolio inflow liberalisation until the administration of recently introduced Basel II has stabilised and been proven. Add complimentary risk management regulations that deal specifically with international capital flows to the existing regulations covering Basel II and AML in the closed environment. In particular, manage the open foreign currency position that banks may adopt, in order to limit the possibility of credit bubbles channelled through domestic banks with exposure to global savings pools.

- Delay portfolio and personal outflow liberalisation to be one of the last measures implemented, and make use of macro-prudential controls to avoid some of the negative effects of portfolio outflows. Note that this applies only to residents. Non-residents should be allowed to freely remit and divest, as exit possibilities form a major part of the decision to invest.

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47 This is the core of the conflict between so-called “austerians” and “Keynesians” in the European peripheral response to the debt crisis.

• Only implement portfolio and personal outflow liberalisation once the current inflationary situation has been contained, and in a period of exchange stability.

• Finally, there may be room to provide for the temporary introduction of controls in the event of an inflow crisis or sudden capital flight. As has been noted in the literature review, this is associated with its own risks, including difficulty in timing and withdrawal. Additionally, such a policy is vulnerable to political capture, and would require rigorously defined rules for implementation and withdrawal.
5. CROSS-COUNTRY COMPARATIVE ANALYSIS

The literature review has highlighted the somewhat inconclusive results of several large-scale cross-country analyses of capital account liberalisation. The intention of this section is to focus on a narrower set of economies that are comparable to Malawi, or of specific interest in relation to Malawi’s potential capital account liberalisation. The countries included in the comparative analysis have been selected from both inside and outside of SADC, and include both fully and partially liberalised economies. Table 7 below discusses the countries selected and the reason for their selection. Appendix 2 contains a macroeconomic summary page for each economy.

Table 7: Selection of countries for comparative analysis

<table>
<thead>
<tr>
<th>Country</th>
<th>Region</th>
<th>Reason for inclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zambia</td>
<td>SADC</td>
<td>Zambia is a neighbour of Malawi and a country that has successfully liberalised the capital account. Recently, Zambia has undergone a reform reversion episode that is informative to Malawi.</td>
</tr>
<tr>
<td>Botswana</td>
<td>SADC</td>
<td>Botswana is the second of two landlocked SADC countries that have introduced a fully liberal capital account, and is therefore relevant to Malawi.</td>
</tr>
<tr>
<td>Tanzania</td>
<td>SADC</td>
<td>Tanzania has a closed capital account, but industry players report that it is de facto more open than that of Malawi. Tanzania is an important case for Malawi, given its proximity, position as a trading partner, and similar economic conditions.</td>
</tr>
<tr>
<td>Rwanda</td>
<td>EAC</td>
<td>Rwanda is a small, landlocked, agrarian economy that has been growing and developing at a rapid pace. Recently, Rwanda’s capital account has been completely liberalised.</td>
</tr>
<tr>
<td>Uganda</td>
<td>EAC</td>
<td>Uganda is similar to Rwanda, but is at a further stage of development and liberalisation, and has a population density more similar to that of Malawi.</td>
</tr>
<tr>
<td>Chile</td>
<td>South America</td>
<td>Chile is the international “poster child” for slow, moderated capital account liberalisation as part of a broader integrated approach with built-in flexibility to re-introduce controls as needed.</td>
</tr>
</tbody>
</table>

As discussed above, most of the SADC region retains capital controls, and therefore would not be informative if included in a comparison of this kind. South Africa, with its partial liberalisation and more advanced monetary system is not directly comparable to Malawi. Neither are liberalised Mauritius and the Seychelles, due to their tourism and services focus, small populations and isolated island locations. The selection of countries for the study involved a trade-off between a wide breadth of countries and depth of analysis per country. Considering that the literature contains several large-scale comparative studies, a smaller selection of countries, with high relevance to Malawi, was preferred. This allows for the disaggregation of trends in large studies to a context similar to that of Malawi in a way that complements the aggregated analysis presented in the literature review.

The section proceeds by analysing the level of legal and observed openness in each economy in comparison to Malawi. This is followed by an analysis of the links between openness and development in the economies that have liberalised, before specific episodes of interest are discussed, drawing on linkages and themes between the different economies. The lessons drawn from the comparative analysis are then applied to Malawi in a concluding section. The methodology for this section of the study is explicitly outside-in. The format of the study does not permit for in-country discussions, and information was therefore collected from secondary and tertiary sources. For this reason, analysis is largely quantitative, although some effort is made to discuss qualitative policy issues where informational access allows.

5.1. APPROACHES TO CAPITAL ACCOUNT CONTROL

Before an analysis of the effects and experiences of liberalisation in different jurisdictions is analysed, it is necessary to understand the differing levels of control over the capital account in different jurisdictions. As discussed in the methodological section above, this is split between analysis of de jure control and de facto control.
5.1.1. *De jure* control and liberalisation

Figure 17 below presents a time-series view of the Chinn-Ito index scores for the period 1970 – 2011. This gives an indication of the extent and timing of exchange control liberalisation in the various jurisdictions. During the 1990s and early 2000s, Uganda, Zambia, Botswana and Chile all liberalised fully. Chile later reversed some of its liberalisations of the capital account during and after the 2008 financial crisis. Rwanda, although relatively closed, liberalised some aspects of its balance of payments in 2010 and 2011, and has continued on this trajectory into 2013. Tanzania remains the comparative foil to the liberalised countries in the comparison with its relatively low score (driven by capital controls). Malawi was at the global index minimum for liberalisation in 2011 when the index was last updated, although its score may have improved recently due to the currency liberalisation and continuing trade liberalisation reforms.

**Figure 17: Historical Chinn-Ito index scores**

![Figure 17](http://web.pdx.edu/~ito/Chinn-Ito_website.htm)

Although the Chinn-Ito index gives a useful snapshot of the relative level of liberalisation of the sample, it must be seen as a very blunt way of understanding capital account liberalisation. The index does not separate exchange restrictions between the current and capital accounts. In addition, it does not locate the different types of capital and financial account controls in each jurisdiction, nor tie these restrictions to their policy justifications. Table 8 below, and the discussion that follows it, rectifies these issues by analysing actual restrictions in detail.

Table 8 contains a summary the most recent IMF Annual Report on Exchange Arrangements and Exchange Restrictions database. Each item in the summary breaks down into several more detailed measures, the most relevant of which are discussed per country below. The table confirms that Malawi and Tanzania are the most restricted countries in the set; that Chile and Botswana’s capital accounts are partially managed; and that Zambia and Uganda are fully liberalised. Importantly, Rwanda’s financial flows are shown to be liberalised (the country’s low Chinn-Ito score derives from controls in the current account and elsewhere, not from the capital account).
Table 8: Table of Exchange Arrangements and Exchange Restrictions (2012)

<table>
<thead>
<tr>
<th></th>
<th>Botswana</th>
<th>Chile</th>
<th>Malawi</th>
<th>Rwanda</th>
<th>Tanzania</th>
<th>Uganda</th>
<th>Zambia</th>
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<td>Crawl-like arrangement</td>
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<td>Pegged exchange rate within horizontal bands</td>
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<td>Dual exchange rates</td>
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<td><strong>Arrangements for Payments and Receipts</strong></td>
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<td>Bilateral payments arrangements</td>
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<td>Payments arrears</td>
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<tr>
<td><strong>Controls on payments for invisible transactions and current transfers</strong></td>
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<td>Surrender requirements</td>
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<td><strong>Capital Transactions - Controls on:</strong></td>
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<td>Guarantees, sureties, and financial backup facilities</td>
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<td><strong>Provisions specific to:</strong></td>
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</table>

Source: IMF online AREAR Database (imfareaer.org)

5.1.1.1. Botswana

Botswana runs a crawling peg currency regime, with a forward-looking rate of crawl set as the difference between inflation in a basket of benchmark currencies and the Bank of Botswana’s (BOB) inflation objective. While the current account is fully liberalised, there remain ‘light’ controls over portions of the capital account. These include controls over transactions
in shares and money-market instruments, a maximum of 70% international fund allocation for pension funds and life insurers. Note that these would generally be considered prudential rather than exchange controls. No such limitations apply to individuals or other fund types. There are limitations on the ability of non-residents to purchase financial instruments used as domestic policy levers, such as the BOB’s liquidity absorption instruments, and there is a 20% cap on foreign holding on government bonds. In addition to prudential limits on foreign derivative instruments, bank exposures to non-residents are limited to 25% of unimpaired capital. Similarly, there are prudential limits on the net open currency positions allowed to banks (30% of unimpaired capital).

Botswana’s capital account position has been largely liberalised since 2009. However, some limits to foreign exposure of pension funds are in place, and the effective foreign exposure of banks is limited by prudential requirements. There are no limits on direct investment, although short-term portfolio inflows into the money market and equity market are subject to controls. Additionally, there are no limits on transfers on invisible transactions that substantively affect foreign investors. This last point is linked to the crawling peg currency regime, which requires some level of stability.

Overall, Botswana is liberalised, but protects its banking and institutional sector with prudential requirements and limits its exposure to volatile inflows.

5.1.1.2. Chile

The Chilean Peso floats freely, and its value is determined on both spot and forward markets. The Central Bank of Chile (CBC) conduct occasional, formally defined (period and size) interventions to reduce volatile shifts away from equilibrium via auctions of Treasury-held currency, although the primary policy approach of the bank is an inflation target. There are no limitations on invisible payments and transfers or their proceeds for residents for either inflows or outflows.

Since 2008, Chile has reintroduced some controls on international financial capital transactions. These limit transactions in Chile’s money market to extraterritorial mechanisms of the securities exchange, and limit money market, CIS, bond and equity listings by non-residents to the Peso, Euro or Dollar. Additionally, resident pension funds may not hold foreign exposures totalling more than 10% of funds under management. Derivative instruments are controlled in a similar way.

Unlike several jurisdictions, there are no exchange controls on lending and credit arrangements.

Somewhat idiosyncratically, inward direct investment is controlled in several ways. Firstly, incorporation in Chile is required for operators of shipping companies, non-bank financial companies and financial institution auditors. Only Chilean residents may register aircraft, fishing and cartage vessels. Road freight is reserved for Chilean registered companies, or companies owned by direct neighbours. Foreign holdings in broadcasting licenses are limited to 10%. There are also limitations on purchase of property in border-zones by non-residents. Finally, authorisation is required for investments into mining and other mineral processing venture.

No outward direct investment limitations apply to Chilean residents.

There are no specific limitations on foreign exposures in the banking sector, but banks are required to limit their risk exposure in accordance with the recommendations of the Basel committee on Banking Supervision’s guidelines. Additionally, prudential regulations limit the outward investment activities of pension funds, and total foreign exposures by funds are limited to 50%.

Overall, Chile’s approach to the capital account represents a baseline philosophy of openness, with controls place on the otherwise liberalised account to favour policies of local ownership, infant and strategic industry protection and financial-sector stability and risk management.
5.1.1.3. Rwanda

Although the official status of the Rwandan Franc is floating, the National Bank of Rwanda (NBR) has intervened frequently to ensure a gradual depreciation to the dollar continues, leading the IMF to classify of the RWS as a crawl-like arrangement.

Licensed banks may approve certain invisible transactions, but there are controls via bone-fide proof requirements for investment-related payments (interest and reimbursement of capital). Similar requirements apply for travel and personal transfers. There are no listed controls on proceeds from capital transactions for residents.

Since 2012 (and updating the Chinn-Ito score for 2011), portfolio transactions have been liberalised. These include equities, bonds, money market instruments and derivatives. In addition to the FDI liberalisations previously entrenched, capital transactions are now fully liberalised.

Banks’ funding and financing activities abroad are still somewhat controlled. The level of holdings in foreign currency accounts is limited, banks require authorisation to extend loans to exporters and reserve and liquid asset requirements are in place for foreign exposures. Long and short foreign exchange positions are limited to 10% of capital and reserves. These are prudential rather than capital controls.

At present, there are laws completely limiting foreign exposures by pension funds. These are expected to be revised soon.

Rwanda has recently joined the ranks of countries with almost fully liberalised capital accounts. However, there are limitations on invisible transactions and capital proceeds and repatriations that effectively limit certain times of financial and capital account transactions, most notably direct investment.

5.1.1.4. Tanzania

The Tanzanian shilling is free floating. Foreign exchange is provided by the Bank of Tanzania (BOT), in a market that, similar to that of Malawi, it relatively shallow.

Like Malawi, Tanzania places extensive controls on invisible transaction’s, including bona-fide tests on trade and investment-related payments, quantitative limits for travel allowances, and requirements of documentation for personal transactions. The controls do not extend to transfers on the proceeds of invisible transactions for residents.

Controls on capital transactions are extensive. Outward flows, including portfolio and direct investments, as well as holding foreign-denominated accounts, requires BOT approval. Holding of foreign securities is allowed, provided the securities were acquired with externally-generated funds. For foreign investors, there are limitations and conditions on equity transaction in the Dar es Salaam Stock Exchange. Cross-listings are allowed only vis-à-vis the EAC. Non-residents are not permitted to hold government securities. Non-residents may not sell or issue debt locally. Credit, both inward and outward, is pervasively controlled. Foreign loan agreements must be submitted through the BOT. Banks are subject to reserve requirements for foreign exposures, and face limitations on certain transaction types, such as foreign denominated lending. No specific rules relating to pension funds are indicated in AREAER.

Outward direct investment requires BOT approval. Inward direct investment must be registered with the Tanzania Investment Centre, and may be subject to incentives upon registration. Repatriation of investments is administered by commercial banks, but requires heavy documentation. Nonresident purchases of property are subject to the approval of the Commissioner for Lands.

Overall, Tanzania retains strict and extensive controls over its capital account.
5.1.1.5. Uganda

The Ugandan Shilling is free floating, and the central bank intervenes only when volatility threatens the orderly operation of the currency regime.

Uganda’s balance of payments was liberalised along with its currency regime in the 1990s. There are no restrictions on investment related invisible transactions for residents or non-residents.

What controls there are on the capital account relate not to exchange control, but to prudential requirements over banks, and anti-money-laundering regulations. Banks are allowed open currency positions of +/- 25% and must hold reserves and liquidity against foreign exposures. One small control over inward property investment is a maximum 99-year lease system for foreign nationals regardless of residency status. There are no limitations indicated for pensions and insurance funds.

Uganda, along with Zambia, has the most liberalised exchange regime under the IMF’s AREAER classifications.

5.1.1.6. Zambia

The Zambian Kwacha is free floating in practice and in law, and the Bank of Zambia does not intervene extensively in the market. In January 2012 the Kwacha was rebased against the dollar by a factor of 10^{-3}.

All payments and transfers, both inward and outward, on invisible transactions on investment activities can be actuated via banks. Similarly there are very few restrictions in place on the capital account of the BoP. The only exceptions are certain provisions relating to commercial banks. These relate to lending by residents to non-residents, which are confined to long-term lending in Kwacha. Additionally, banks are subject to open foreign exchange position limits of 30% of capital.

In 2013, certain controls were reintroduced relating to dollar denominated transactions and export proceeds repatriation. These were reversed in 2014.

5.1.2. *De facto* control and liberalisation

As has been discussed in the methodological notes above, it is important to establish level of openness of a given economy in practice. This is done for the sample set below, using both stock measures and flow measures. Aside from contextualising the level of openness of the various economies, this approach also presents the opportunity later to explore the relationship between *de jure* and *de facto* liberalisation.

Figures 18 to 22 disaggregate the capital stocks of each country into their constituent components. Each measure is shown as an asset view (resident ownership of foreign assets), liability view (ownership of local assets by nonresidents), and netted out. Figures 23 to 26 then analyse capital flows on the same measures. In all diagrams, stocks and flows are adjusted to proportions of GDP in order to correct for the effects of differing levels of economic activity in the sample countries on the natural level of international investment positions. Stock data are taken from the Lane and Milesi-Ferretti database, which in turn is constructed mostly from IMF sources. Flow data are directly from the IMF and UNCTAD.

Figure 18 below shows the evolution of the capital stock in portfolio equity for the sample set. Botswana and Chile – both resource-driven growth economies – experience considerably higher levels of equity flow than other economies. While there is very little outward investment by the African economies, Zambia, Rwanda, Malawi and Tanzania all experienced inflows in the emerging market boom post-2008. This level has since declined slightly in all markets. The relatively small equity stocks in the African countries of the set, apart from Botswana, are attributable to low levels of stock market development. *De facto* openness does not appear to significantly different in equity markets between the African economies. Indeed, the two partially controlled economies, Chile and Botswana, are most open.
Figure 18: Capital stock measures of openness – portfolio equity (% of GDP)

Source: Updated and extended version of dataset constructed by Lane and Milesi-Ferretti (2007)

Debt flows are analysed in Figure 19, where a very different picture emerges. These aggregated debt flows include portfolio debt, public debt and banking obligations. Here again, there is not a significant difference between de jure closed and de jure open economies. However, this may be driven by large levels of public debt. Indeed, the large drop in liabilities in the African economies from around the beginning of the century and reversion to near net balance is correlated to periods of debt forgiveness and rationalisation. Flow analysis focusing only on portfolio debt flows will present a more controlled picture below.

Figure 19: Capital stock measures of openness – debt (% of GDP)

Source: Updated and extended version of dataset constructed by Lane and Milesi-Ferretti (2007)

Figure 20 analyses possibly the most important stocks from a developmental perspective - foreign direct investment (FDI). As in equity markets, local assets are significant only for Chile and Botswana. In fact, the closed economies all have foreign ownership positions of 0% of GDP. The open African economies are not outwardly open in practice. However, there is a different pattern for inflows. Zambia, Uganda, Chile and Tanzania have attracted significant inflows. Malawi’s FDI capital stock has been declining gradually since 2004, along with that of Botswana. Uganda has fluctuated around 16% of GDP. Clearly, Tanzania’s incentive schemes and encouragement of FDI is working despite capital controls. The same appears to be true for Rwanda’s capital account liberalisation programme. Similarly, Zambia and Chile’s copper boom has not been held back by controls on foreign inflows – indeed, Chile’s FDI level is soaring despite controls in some protected sectors.
Analysing stocks of foreign reserves, Figure 21 can be interpreted as showing that capital controls may be harming Malawi’s ability to accumulate foreign reserves. While the open economies, as well as Tanzania, manage positions above 15% of GDP, Malawi has not been in such a position since 2000. In terms of foreign reserve accumulation, Malawi appears closed in relation to its peers.

Figure 22 aggregates the various components of the capital stocks presented above. Overall, Malawi, with its closed account, ranks as least open, followed fairly closely by Tanzania. Zambia, Chile, and Botswana are most open, while Rwanda and Uganda appear fairly closed compared to their level of de jure openness.
While capital stocks represent the ownership of assets between different jurisdictions, capital flows represent actual cross-border movements of monetary assets for physical items. This measure usefully augments the *de facto* openness view formed from stocks. Figure 23 shows that in terms of portfolio equity outflows, Chile is the only economy that shifts significant resources abroad on a regular basis. In terms of inflows, as markets have developed, the more liberalised economies have attracted more investment than the less open ones. In particular, Zambia, Botswana and Tanzania have seen more inflows than Tanzania and Malawi. Rwanda is an outlier, with very small flows.

In contrast to the view provided by debt stocks, actual flows relating to portfolio debt are nearly inconsequential in economies apart from Chile. Rwanda and Zambia have seen the highest flows, and are also more liberalised economies. Overall, with highly unsophisticated capital markets, flows are small in the African economies. Even the more liberalised economies have rules limiting active foreign trade in government bonds, and the corporate bond markets are underdeveloped.
Figure 24: Capital flow measures of openness – portfolio debt (% of GDP)

Source: IMF (2014)

Figure 25 shows the IMF’s calculation of direct investment flows, which shows a relatively wide dispersion of changes between economies. This dataset was only established in 2009, and in addition, appears to underestimate actual private investment flows. Figure 26, using data from UNCTAD, places FDI flows in the more credible region of between 0 and 12% of GDP per annum. While outflows are most common in Chile and Zambia, inflows appear to roughly correlate with openness, although with a relatively high level of cyclicality. Significantly, Malawi’s account, despite being highly controlled, allows for direct outward investment flows of over 1% of GDP. Malawi, Rwanda and Botswana have seen much lower investment inflows than the other economies over the past half-decade.

Figure 25: Capital flow measures of openness – net change in direct investment positions (% of GDP)

Source: IMF (2014)
Two main observations are made based on the comparison of de facto openness. The first is that Malawi appears to be significantly more closed than the other economies, on aggregate, over the different measures. Chile, on the other hand is most open, followed by Zambia and Botswana. Rwanda and Uganda, despite open accounts, are not very open in practice relative to the size of their economy. It is not clear whether this is due to underlying fundamentals or whether it is a function of administration of controls by banks. Malawi is significantly less open than Tanzania in practice, despite similar levels of de jure control. Second, there is a high level of variation in de facto openness between different items in the capital account. This implies that a policy can be tailored to target openness in some sectors while retaining low flows in other sections of the account, if this is desirable. In the following subsection, de jure and de facto openness are compared in relation to developmental agenda.

5.2. THE MACROECONOMIC EFFECTS OF LIBERALISATION

When analysing capital controls on a global scale, it is difficult to prove definitive macroeconomic effects of liberalisation econometrically. This more targeted country comparison set provides the opportunity to analyse a narrower set of examples in more detail to draw direct lessons for Malawi. Previous sections have discussed the theoretical case for liberalisation – that under neoclassical models liberalisation should have positive effects on growth via improved access to capital and through lower cost of capital. These hypotheses are tested below for the countries in the sample set.

First, however, the interaction between de jure and de facto liberalisation is analysed in order to establish whether legislative and regulatory reform in the various countries has in practice led to increased cross-border investment transactions. Here, international evidence is conclusive: on aggregate, legal liberalisation leads to increasing cross-border flows. This is tested in the sample set in figures 27 and 28 for FDI flows and the sum of total asset and liability capital stocks respectively.

What emerges is a fairly unclear picture. What is certain is that international capital exchange has not decreased with liberalisation. It is difficult assert the opposite, and there does not appear to be a stable correlation. In the case of FDI flows, Uganda, and to some extent Botswana, Zambia and Chile appear to have benefitted from liberalisation. Rwanda and Tanzania experience low levels of FDI inflows, although both were able to increase FDI without any reforms and with already controlled accounts.
The picture relating to capital stocks is not significantly different. In its more liberalised years, Chile appears to have seen increased accumulation of stocks. The same is not true for Botswana, Zambia or Uganda, all of which observe a range of high and low capital stocks over various levels of de jure liberalisation.
Despite the fact that there is no strongly observable pattern of liberalisation and growth in capital flows in the sample set, there is still reason to investigate the effects of liberalisation on the wider economy. This is because the act of liberalisation itself has a range of potential channels for macroeconomic impact. These include, but are not limited to, signalling effects which indicate a wider liberalisation programme is present (thereby kick-starting investment cycles), the effects of liberalisation on previously neglected industries, the introduction of international market discipline on economic policy management, and the potentially large effects on the domestic financial sector of access to international funding (in term of both the cost of credit and the supply of credit in the domestic economy, channelled through domestic banks).

In figures 29 to 31 below the x-axis represents a time scale, where t=0 represents the point at which de jure liberalisation programmes were initiated. To fully liberalise took the economies in question on average three to five years. Macroeconomic and financial indicators are presented on the y-axis. Rwanda is excluded due to the recency of its capital liberalisations, and Tanzania and Malawi are excluded because these countries remain closed.

First, the broadest possible relationship is presented in figure 13 – that between liberalisation and growth. The most striking pattern, common to all countries, was a decrease in the volatility of growth after reforms were put in place. While the average growth rate did not move significantly over the sample period, growth stabilised, particularly in Zambia and Chile. Zambia did not observe a contraction in the ten years after liberalisation. Similarly, while Botswana’s growth was volatile during the period of liberalisation, it staged a significant recovery in year 6 to 10. Uganda experienced high and accelerating growth in years 1 to 5, followed by normalisation in years 6 to 10.

Figure 29 is significant to Malawi, as it shows that, contrary to common perceptions, liberalisation led to stabilisation, rather than increasing volatility, in growth levels in the sample countries. This suggests that liberalisation may in fact be one tool that Malawi can employ to calm the macroeconomic turbulence it has experienced recently. Indeed, the improvement of the...
reserve position after the Kwacha was floated is indicative that a return to market fundamentals can have superior effects to attempts at controlling capital flows.

**Figure 29: Openness and growth (x = Chinn-Ito de jure openness; y = Real GDP growth)**

![Graph showing openness and growth for Botswana, Chile, Uganda, and Zambia](source)


Figure 30 below analyses the effects of liberalisation on the domestic lending rate. Consistent with theory, Chile, Uganda and Zambia all observed significant moderations in the lending rate after liberalising the capital account and opening banks to foreign funding markets. The exception is Botswana, where the rate remained relatively flat over the period. Figure 30 gives credence to the theory on interest rates presented in the theoretical review section of the paper. This is significant in the context of Malawi’s recent interest rate spike, where the interbank market has moved away from fundamentals and the prime margin has spiked.

**Figure 30: Openness and interest rates (x = Chinn-Ito de jure openness; y = Lending rate)**

![Graph showing openness and interest rates for Botswana, Chile, Uganda, and Zambia](source)


Figure 31 reinforces evidence on the magnitude of effects of policy on the domestic financial sector. All countries in the set experienced a strong trend of increased domestic credit extension during and after liberalisation programmes. In Zambia, this trend was observed around strong cycles, while in the other sample countries, the trend is level and sustained. Domestic
credit extension is strongly linked to small business and private firm growth. Despite these lending increases, the IMF does not record any financial, currency or debt crises in this period for the sample countries.

Figure 31: Openness and credit extension (x = Chinn-Ito de jure openness; y = Domestic credit to private sector, % of GDP)


5.3. INSIGHTS FROM THE SAMPLE SET

Each country in the sample set has had idiosyncratic successes and challenges during their liberalisation process. The episodes that are of relevance to Malawi are outlined below, and will be incorporated into the findings and recommendations of the report.

Zambia’s re-introduction of exchange controls

Like Malawi, Zambia’s exports are skewed toward a single resource, in which the local exporters are price takers. In Malawi, this is tobacco, while in Zambia the resource is copper. Zambia was one of the first SADC countries to liberalise its accounts in the mid-1990s. From that point until 2013 Zambia’s current and capital account remained liberalised. However, in early 2013, two new laws were introduced relating to exchange arrangements. While the government insisted that these measures did not constitute a re-introduction of exchange controls, businesses and international investors saw them as measures to de-liberalise, and raised concerns both via political channels and through exits of Zambia’s currency and asset markets.

The first regulation in question banned businesses from conducting dollar-denominated transactions within Zambia’s borders, moving away from currency convertibility with the greenback. The second regulation, introduced on the current account, required repatriation of foreign currency earned on exports back to Zambia. Both of these measures were introduced in response to fears over currency weakness following falls in the copper price in 2012, and exasperated by a widening fiscal deficit. Figure 32 shows that over the course of 2013, these new controls were ineffective in dealing with downside pressures on the exchange rate, which devalued sharply.

http://www.lusakatimes.com/2013/09/26/zambia-has-not-introduced-foreign-exchange-controls-yaluma/
In April 2014 Zambia dropped both of the controversial regulations in response to the negative fallout. The Kwacha’s fall promptly stabilised on this announcement. Zambia’s deputy president, Ian Scott, stated that “We have learnt to back off from our mistakes and listen to people”.  

Figure 32: ZMW/USD, 2013 - 2014

Source: Oanda, 2014

The Zambian experience highlights the strong role of international markets in disciplining the local authorities when accounts are open. Importantly for the case of Malawi, it suggests that for small economies in the region, liberalisation might be a once-off exercise. Regressions on liberalisation are badly punished in the markets. This means that the ability of local authorities to temporary introduce controls is extremely limited, although the market may be more forgiving in a true financial crisis. The IMF supports the reintroduction of controls. It also supports a very carefully sequenced set of reforms. A ‘big bang’ liberalisation will not be reversible without serious exchange rate and other economic consequences.

Chile’s reform sequencing

As shown in figure 17, Chile’s reform process was gradual and subject to occasional reversals. Capital controls have been seen in Chile as a component of the country’s economic development programme. From the early 1990s, Chile implemented an export-driven development programme, which required a competitive exchange rate as a central component. Controls were used as one way to set a favourable exchange environment. While the trade account was entirely liberalised, the approach to the capital account was more diverse. In response to large inflows placing unwanted upward pressure on the exchange rate, a central component of capital controls was the use of the *encaje*. This was an unremunerated reserve requirement on capital inflows. Under this policy, 20% (a rate which changed frequently and was used as a policy tool) was required to be held at the central bank, with a minimum term of a year – punishing short-term speculative flows. This lowered yield on inflows and limited the ability of non-residents to rapidly withdraw. This effective tax on foreign investment was used to manage the currency. At the same time, de facto liberalisation of inward equity and debt flows was enacted.

This policy was tested during the 1998 Asian-Russian-LTCM crisis. Chile experienced a particularly difficult time as an emerging market during the crisis. The country experienced heavy interest rate surges and a rapid currency devaluation, which tested the country’s purchasing power. It was acknowledged in the IMF’s 1998 Article IV consultation that the *encaje* played a useful role in reducing the volatility of capital flows and in lengthening the maturity of obligations. At the

51 http://www.ft.com/intl/cms/s/0/17b5e90e-b0fa-11e3-bbd4-00144feab7de.html?siteedition=intl#axzz2z1sb1ekx
same time, the encouragement of outward investment by pension funds resulted in a pro-cyclical outflow of domestic funds. This meant the cause of Chile’s volatility during the crisis was in fact internally generated rather than a result of international withdrawals. When pension funds and other domestic institutions began to return to Chile’s attractive yield late in the crisis, Chile bounced back robustly and sustained its recovery.

Shortly after the crisis, however, Chile removed the *encaje* as part of a movement toward a more liberalised financial account. This was required as part of a wider reform process, which substituted an inflation-targeting framework for the managed currency band that was in place up to that point. Price stability required a trade-off between monetary independence and currency stability, (as outlined in section above), and a wide range of capital account reforms were enacted. Access to foreign debt, equity and direct investment was opened up, with limitations over foreign participation in certain targeted sectors. This framework was tested during the financial crisis, and Chile was able to favourably recover from the crisis faster and more robustly than most other emerging economies, and in a less painful manner than that experienced by Chile during the Asian crisis. The capital control / stable exchange rate regime in 1998 proved less robust than the inflation targeting / flexible rate regime in place when the great recession hit.

There are three lessons in Chile’s experiences. The first is that liberalisation of the capital account is an effective complement to a shift in policy focus toward price stability as the primary macroeconomic objective, and requires flexibility in the exchange regime. This regime appears to be more effective during international financial shock episodes. Second is the effective limitation of short-term flows via an effective tax on these inflows. This allowed Chile to skew inflows to longer-term, productive spending. However, this was not compatible with an inflation targeting framework. Finally, the dangers of asymmetric policy on inflows and outflows are highlighted. The *encaje* allowed for an arbitrage of artificially high domestic returns by local funds, who for this reason did not take the opportunity before 1998 to invest abroad. When the currency weakened during the 1998 crisis, the relative attractiveness of local assets declined, and local funds rapidly allocated international to their foreign investment cap. This outflow was pro-cyclical and damaging. Thus, asymmetrical inflow and outflow policies interacted via domestic yield, and created a structural allocation imbalance that reversed during the crisis. This finding in Chile weakens the asymmetrical liberalisation argument in the context of portfolio flows.

**Sequencing in central Africa**

The two central African countries in the sample set, and in particular Uganda, provide interesting examples of liberalisation programmes with explicit and considered sequencing of reforms. Uganda and Rwanda are at different stages in this process, and both have had to incorporate an approach to reducing reliance on foreign aid into their reform planning. This will be familiar to Malawi, as all three countries have at times had difficult relationships with donors and budgetary support institutions.

Louis Kasekende\(^\text{53}\) outlines and interrogates Uganda’s economic reform process (ERP) in detail. Prior to 1991, the need to reform Uganda’s economy was acknowledged, but there was limited consensus on what these reforms should be. The primary motivation for liberalisation was the known existence of extensive duel markets for currency and major exports, and the need to formalise these flows. A period on instability in 1992 led to political agreement over a ‘big bang’ approach, in which the full liberalisation of the macroeconomy was envisaged. Despite the name, this reform process was carefully sequenced. The motivation for capital account liberalisation strung from what can be termed the “Mishkin argument”\(^\text{54}\), that low local savings rates constrain domestic investment, and that with open capital accounts, the global savings pool can be accessed to finance development. This would reduce the reliance on official development aid.

In concord with the academic literature, capital account liberalisation was seen as one of the later aspects of economic reform. The last capital control removals were finalized in 1997, following a reform process which favoured domestic

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\(^{53}\) Kasekende, L, 2000, *Capital Account Liberalisation: The Ugandan Experience*, AfDB

stability to global integration in the sequence. The first round of reforms focused on floating the exchange rate, achieving a degree of price stability (an implicit inflation targeting framework) and the imposition of greater fiscal discipline. Next, the domestic banking sector was liberalised. State ownership was removed from the major commercial banks and foreign banks were allowed to establish local subsidiaries. This led to rapid expansion of the financial sector after 1994. Uganda also imposed a strong focus on prudential regulations in the banking sector, particularly in relation to foreign risk exposures. A number of regulatory reforms followed. In parallel to these reforms, Uganda was a leading African country in re-structuring debt, and was the first candidate for highly indebted poor country (HIPC) relief. This reduction in the fiscal burden allowed the country to focus on more sustainable funding in the era of an open BoP. Institutional development in the private sector, political arena and international policy dialogue forums were also instituted.

In the same vein as Uganda, but with a delay of several years, Rwanda has been implementing an integrated developmental agenda, with priority given to trade liberalisation, debt restructuring, domestic banking sector development and stability-oriented reforms. In 2010, Rwanda’s capital account became completely open, although some limitations remain on payments relating to invisible transactions.

Figure 33 below shows the increases in FDI in Rwanda and Uganda, which is the major component of capital flow into both countries. While cyclical patterns are similar, both are growing at roughly the same rate, and Rwanda lags Uganda by around 7 years. Neither economy has experienced destabilising short-term flows, although some instability in foreign exchange markets, relating mostly to current and fiscal developments, has been experienced. These events have had implications for price stability, but have largely been managed. This will be discussed in more detail below.

Figure 33: Rwanda and Uganda - FDI Inflows, % of GDP

Exchange rate volatility and macro stability

While the effects of exchange rate liberalisation have been mostly benign or positive in the country sample set, one challenge is common to all of the liberalised African countries in the set (as well as Malawi). All have been subject to episodes of macroeconomic instability resulting from large exchange rate swings in floating currencies. Figure 34 below outlines major currency events in the Zambia, Uganda, Rwanda and Botswana, followed in figure 35 by the effects on interest rates, under liberal or liberalising regimes.
Figure 34: Currency volatility episodes (LCU/USD)

Source: World Bank WDI, 2014

Figure 35: Interest rate events

Source: World Bank WDI, 2014
These diagrams show that open economies can be subject to instability generated from adverse changes in both internal and international conditions. The knock-on effects of shocks of this type are reductions in credit outlay and eventual real economy slowdown. This highlights the importance of effective monetary management, most notably via sound sterilisation procedures and recourse to interest rate policy. Note that effective monetary policy tools must be implemented that price stability is an important target. Given the turmoil in Malawi interbank and lending markets at the time of publication, this is an important lesson if a reform programme is to be initiated.

**General crisis avoidance**

The final issue, raised to some extent to mitigate the point made above in relation to exchange and monetary volatility, is that in all of the countries that have removed exchange controls in the sample set, not a single one has experienced a serious financial, currency or debt crisis, as defined by the IMF. The most recent events in the comparison set is Rwanda’s 1992 currency crisis, related to the political instability experienced in the country at the time, and a currency crisis in Zambia, which occurred in 1996, just prior to the implementation of liberalisation. This includes a low level of contagion in all countries from the 1998, 2001 and 2008 crises.

The reason that both inflow and outflow crises are largely absent in the sample set relates partially to the lack of sophistication in financial markets, particularly for portfolio investments (the exception is Chile). This can be seen as an infrastructural constraint to ‘hot money’ flows. However, effective sequencing and regulation of the banking sector has also been a determinant of the observed stability.

The implication of this finding is that, for a country like Malawi, the lack of sophistication in portfolio markets reduces the risk of damaging flows, and allows policymakers to essentially postpone this concern. As capital markets develop, measures can be put in place to manage these types of risks. This is only limited to portfolio instruments however, and other risk mitigations, particularly those on prudential regulation in the banking system, should not be ignored.

### 5.3.1. Liberalisation and reform programmes

While the analysis of economic data has allowed some conclusions to be drawn from country experiences, the nature of this evidence is weak in one key way. In all cases, capital account liberalisation has been one component of a wider set of reforms. Capital account liberalisation followed or was accompanied by exchange regime reform, trade liberalisation, privatisation programmes and in some cases central bank policy mechanism reforms. The various liberalisation mechanisms are strongly re-enforcing, and separating the effects of general reforms and direct effects from capital account liberalisation entirely is not possible. This concluding sub-section reverses perspective to situate removals of capital controls in the context of wider reform programmes.

1. Seeing capital account liberalisation as part of a reform programme necessarily requires a negative rather than positive logical standpoint. This leads to a first, and fairly strong, finding: according to the quantitative portion of the analysis, in the countries included in the comparative set, **there do not appear to be any major macroeconomic harms** originating from the removal of capital controls. The effects on the local financial sector appear to be positive or and at worst benign. This finding is the most significant of the comparison, as it mitigates some of the stronger arguments against liberalisation by showing that economies in early stages of development have successfully mitigated the risks of liberalising capital flows.

2. The **threshold theory** is validated by the evidence. Botswana and Chile have both gained in de facto and macroeconomic terms following the introduction of capital liberalisations. Smaller economies, such as Uganda and Zambia, have only more recently seen large de facto flows associated with liberalisation as their economies have overcome developmental thresholds below which capital account liberalisation did not encourage improved capital allocation. This finding is weaker in the case of FDI than other flows, where, for instance, Tanzania has attracted
significant flows despite heavy controls over the capital account. The implication of this funding for Malawi is that the actual effects of liberalisation of the capital account will depend heavily on concurrent measures targeted at developing capital markets and encouraging inflows from non-residents. For the major benefits of capital account openness to accrue, a lot will depend on integrated measures. However, according to the country comparison, liberalising will not bring immediate harms, but will at worst have a neutral effect.

3. Evidence on the space for reversals or temporary capital controls is conflicting, but leans toward an “all or nothing” approach. The two conflicting cases are Zambia, which was severely punished in international markets for the reversal of exchange controls, and Chile, which has changed or reviewed capital control regulation regularly. Given the much greater economic similarities between Zambia and Malawi, it is likely that a similar response to that of Zambia would be the result of with a liberalisation reversal in Malawi. However, depending on the justification for reversals (for instance, a major banking crisis) and support of international institutions, the controls may be more leniently accepted. Issues over political risk and moral hazard, however, remain.

4. The absence of serious financial, currency or debt crises in any of the open economies in the set is encouraging for the prospect of capital account liberalisation in Malawi. However, this is to some degree due to the lack of a market for short term flows, a challenge that will need to be addressed as these economies develop. Additionally, in all cases prudential legislation preceded capital account liberalisation, limiting the level of currency risk that banks were able to absorb. This finding is particularly startling, coming as it does in period of significant financial market turmoil.

Overall, findings from cross-country comparisons do not weaken the case for liberalisation of the capital account in Malawi, although the experience of other countries does support careful sequencing of the reforms that are put in place. Chile and Rwanda offer evidence that reforms can be put in place at a fairly gradual pace.
6. MACROECONOMIC COST/BENEFIT ANALYSIS

Having analysed the issue theoretically, comparatively and through a risk framework, this section provides one final lens through which to view the question of CAL for Malawi. This is done by translating the microeconomic concept of a cost/benefit analysis to fit the macroeconomic context of this analysis. The analysis is split into a qualitative section, looking at historical experiences, and a quantitative section, which projects the potential effects of capital account liberalisation to 2020.

The qualitative section diverges from the traditional cost/benefit methodology in that it does not attempt to calculate the actual measurable cost of liberalising or not liberalising the capital account. Rather, the conceptual approach of analysing costs and potential benefits is replicated, but without quantifying the impact of each cost and benefit. This more qualitative approach provides a useful input to the final recommendations, but does not constitute a decision-rule, as would be the case in a microeconomic cost/benefit.

The reasons for this approach are many. Most importantly, however, is the fact that macroeconomic effects of a single action along the balance of payments is immensely difficult to accurately quantify. This is because the benefits will be realised in the future, requiring a macroeconomic model to estimate. However, macroeconometric forecasting is notoriously unreliable. It is difficult to know what assumptions and variable interactions would change under a liberalised economy compared to a closed one. The results from other countries cannot simply be imported to a model of Malawi’s economy. Additionally, model specification (even with consistent data) will to a large extent determine the observed outcome, and there is no wide agreement on the optimal forecasting model to employ. Finally, data limitations in this study have meant that there is insufficient data to build such a model reliably, even assuming that the model is optimally specified and the assumptions reliable.

Despite these misgivings, an attempt is made, using cross-country panel data and leveraging off a number of previous studies, to model the potential effects of CAL. It is stated upfront, however, that this model is only as good as its data and assumptions, and should not be taken as the only, or even primary, decision tool for CAL. Instead, it should be seen as giving a sense of the possible quanta involved with liberalisation, and constitute one input out of many that will lead to an eventual liberalisation decision. This chapter is split into two subsections. The first identifies the particular benefits of a closed capital account to Malawi’s historical economic administrations. The next section identifies a list of costs that have been associated to capital controls as they have been administered in Malawi. In the following section, which concludes the study and makes recommendations, the outputs from this section are combined with those developed in the rest of the study.

6.1. BACKWARD-LOOKING QUALITATIVE ANALYSIS

6.1.1. Benefits

It is useful to understand the imposition of CFMs in Malawi less as a policy decision made for the benefits it accrues to the local economy, and more as a necessity arising from the choice of monetary policy regime that has historically been run by Malawi’s authorities. Controls have also brought some external benefits relating primarily to the partial insulation of the economy to global or regional crisis. The benefits of capital account controls that have been identified are identified below.

1. **Use in foreign exchange administration:** Theory presented above on the “impossible trinity” suggests that if monetary independence is to be maintained, then financial integration and CAL are not possible under a fixed exchange regime. Therefore, Malawi’s policy of maintaining a fixed (artificially strong) exchange rate until 2012 required management of capital inflows and outflows. In theory, the role of capital controls in achieving exchange rate
stability operates through the mechanism that controls provide to manage demand for local currency and foreign exchange. Additionally, during periods of destablising outflows or inflows, CFMs can be used to simply end or delay the financial flows and transfers. CFMs were a necessary part of Malawi’s monetary system, and supported the fixing of the exchange rate and the ability of RBM to retain a level of independent interest-rate and monetary policy.

2. **Use in crisis management**: As alluded to above, capital controls can be seen as one of the tools available to manage very serious inflow or outflow crises. The IMF\(^{55}\) has acknowledged the role of temporary controls even in otherwise liberalised economies. Malawi’s capital control regime created the space for officials to prevent or delay transactions that would place additional pressure on reserves during previous crises. For instance, during the 2011 political-economic crisis, the RBM made use of its ability to contain outflows while managing the severe foreign reserve crisis precipitated a donor withdrawal and aggravated by poor agricultural yields in that year’s tobacco cycle. The ability of administers to simply halt outflows during a severe crisis is one of the few remaining widely acknowledged benefits of CAL, and Malawi has certainly made use of this tool in the past.

3. **Insulation from contagion**: An almost unintended benefit of the existence of CFMs is the insulation of the domestic economy from global financial crisis and financial contagion. By limiting the ability of domestic banks and funds to take significant positions in international assets, and by limiting the dependence of the local banking sector on foreign banks exposed to global downturns, CFMs effectively prevent the destabilising outflows or collapses that are commonly associated with financial downturns.

Although capital controls may prevent financial contagion, they do not prevent, and in fact may exacerbate, the spread of real economy effects of global recession. These are transmitted primarily via a slump in consumption and investment demand, resulting in low trade volumes and decreased domestic and foreign direct investment spending.

4. **Protection from bubbles and macroeconomic instability caused by the financial sector**: Finally, capital controls have been credited with creating a relatively stable and benign financial sector. By restricting foreign investors from accessing Malawi’s capital markets, Malawi has avoided the property bubbles and credit boom and bust cycles sometimes experienced by developing countries during periods of economic growth. The prevention of build-ups in short term “hot money” capital stock liabilities, which can be rapidly withdrawn from the economy.

Overall, the benefits of CFMs relate to their central role in the previous currency regime, and to their ability to manage real economic crisis and prevent financial contagion. These benefits must now be weighed against the observed costs of controlling the capital account.

6.1.2. **Costs**

The costs of capital controls are various. Some costs have always been acknowledged as a trade-off against the goal of currency stability. With the liberalisation of the currency regime, the continuing justification of these costs is less compelling. Additionally, there are unintended costs to CFMs, or costs that materialise to a greater extent than expected. The costs of capital account liberalisation as experienced in Malawi are listed below:

1. **Expense of administration**: One of the costs of capital account restrictions most commonly-cited in interviews with local stakeholders and institutions is the expense of the bureaucracy required to uphold the administration of exchange controls. This cost manifests in several ways. First is the direct financial cost of running government departments to draft and administer exchange control regulations. In a fiscally constrained environment, these outlays carry a high opportunity cost. Additionally, the human resources in legal, financial and economic expertise that are diverted to the administration of controls are significant. The requirements imposed on firms that are subject to capital and exchange control.

controls create inefficiencies in the smooth operation of transactions that are routine or commonly permitted. Adhering to capital control implies costs for firms in legal, administrative and managerial departments, as well as arguably increasing their costs of financing. Second, there is a duplication of effort between the banks, which are required to perform some of the capital control requirements, and the Reserve Bank of Malawi, which reserves approval of some transactions to it. Finally, even in the liberalised current account, the Reserve Bank sets strict requirements for application to transfer funds in banks, and sometimes sets low limits for transactions that do not require approval. This form of liberalisation retains many of the costs of bureaucracy, and does not realise the benefits of full devolution of international financial account risk management to banks.

2. **Competition for foreign investment**: Related to the concerns over the costs to firms of complying with capital controls, there was a wide acknowledgement in the interview process that these costs and time constraints resulted in a poor perception of Malawi as an investment destination. An additional deterrent is uncertainty over the ability of companies remit dividends or divest capital. Companies noted that Tanzania, which also controls the capital account but is friendlier to foreign direct investors, is a preferred investment destination. Thus there is an opportunity cost to direct investment arising from capital controls. Removal could signal to investors that Malawi is ready to accept development-oriented investments, thereby improving inflows.

3. **Lack of imperative for financial sector development**: It has often been observed that financial integration creates strong competition in banking sector and is a positive influence on financial sector development and deepening. An open capital account may lead to the development of more innovative financial products for the poor, or for use in hedging agricultural commodities. In addition, nascent bond and equity markets might be deepened by access to foreign investors. CFM may therefore have constrained financial sector development.

4. **Absence of market discipline**: The effect of open capital accounts on instilling a sense of market discipline has been raised in previous section. While market discipline may have contributed to improved fiscal management in the past, the narrow views of “the market” in relation to public finance allocations must also be considered.

5. **Continuing donor dependence**: The administration of capital controls has undoubtedly limited access to funding for government and local firms via both domestic and international markets, and has increased the cost of this capital. This has narrowed the menu of possible funding mechanisms in Malawi, and has subsequently sustained Malawi’s reliance on Bretton-Woods institutions and donor support.

6. **Practical administrative effectiveness**: The use of capital controls to manage crises was outlined as a benefit of CFM in the previous section. However, the effectiveness of controls in practice has been consistently questioned. During the crisis of 2011, foreign exchange reserves were depleted, precipitating a fuel shortages and macroeconomic instability. Given the valid questions over the actual effectiveness of controls in limiting demand for foreign exchange in a crisis, the balance of their existence is skewed toward cost.

The only directly observable costs of capital controls are those associated with their administration. These are severe, and constitute grounds to question the appropriateness of capital controls for Malawi. However, there are at least five other cost types which have taken the form of opportunity limitations – access to finance, donor dependence and competition for foreign investment. Seen in this light, the costs of the closed account appear to be fairly severe, and in light of the floating Kwacha, very difficult to justify retaining in their current form.
6.2. FORWARD-LOOKING QUANTITATIVE ANALYSIS

6.2.1. Purpose and approach

The purpose of this section is to develop a quantitative model that can be used to form an idea of the potential effects (future costs and benefits) of liberalisation of the Malawian capital account. As further discussion will make clear, limitations in data quality and fundamental assumptions mean that this model should be interpreted as giving an idea of orders of magnitude of changes in capital flows and output, not as a prediction of the actual effects of liberalisation. Nonetheless, it is useful have a picture of the potential effects of liberalisation as one input to evaluation of the policy decision around CAL.

At the level of conceptual economic rigour, it must be noted that the methodology employed in this projection is necessarily different from that of the more commonly applied microeconomic cost/benefit study. At its core, a microeconomic cost/benefit analysis is an attempt to deterministically reach a policy decision by quantifying and comparing the outcome of two or more different choices. This is most frequently done by the measuring net financial benefit of each option and selecting the most financially viable alternative on this basis, considering only direct and measurable inputs. For instance, a firm might conduct a cost/benefit to select between several competing investment options, or a regional government might conduct a cost/benefit analysis to determine whether or not to allocate a portion of its budget to a given social project.

In contrast, a macroeconomic analysis of a cost-and-benefit trade-off necessarily requires the establishment of a counterfactual (what would happen in the future if this policy is not implemented?), and for this reason cannot be estimated precisely in the manner of a microeconomic cost/benefit analysis. Correctly projecting potential future effects, while controlling for other macroeconomic and political effects, is not possible without use of a range of assumptions, which can drastically affect the outcome of the model. Further, endogeneity (bi-directional dependence) of key variables (here, for instance, growth and FDI levels) make predictions non-linear and co-dependent. This reduces the statistical reliability of the model.

The methodology employed in the paper uses assumptions ratified by the Reserve Bank of Malawi to formulate its counterfactual baseline, and deals with endogeneity by using multiple projections over a base-line level of for response variables (further explained in the methodological discussion below). However, the limitations of the model should again be acknowledged, and projections should be seen in the context of other sections of the report, not as a defining basis for the liberalisation decision.

The quantitative analysis proceeds by discussing the methodology employed to select and specify the model, before presenting the finding of the estimation and diagnostic tests conducted on the model. Finally, the results are interpreted in light of their application to the report.

6.2.2. Methodology

A full technical discussion on econometric methodology employed in the study is detailed in Appendix 3. A brief non-tech summary of the contents of Appendix 3 follows below.

6.2.2.1. Approach to modeling

The purpose of the model it to provide an estimate of the effects of liberalisation on the following variables over a five-year forward-looking time-frame:

1. Financial account flows

1.1. Inward FDI
1.2. Outward FDI

1.3. Inward portfolio flows (debt and equity)

1.4. Outward portfolio flows (debt and equity)

2. Effect of changes in capital flows on GDP

Appendix 3 lists reasons for the exclusion of other capital flows, notably banking flows and official flows.

The econometric methodology follows three phases. First, a panel of 76 low and low-middle income countries is used to test the scale and significance of responsiveness of capital flows to a series of explanatory variables, with includes capital account openness and a number of underlying macroeconomic drivers of capital flows (set out in table 12 in appendix 3). In the second phase of the estimation, the significant variables in the set are used to model Malawi’s capital flows under an open economy (where Malawi’s flows revert to the fundamentals implied by the model), compared to the closed economy baseline. In phase three, the effect of these flows is mapped to GDP via coefficients established in the academic literature.

6.2.2.2. Inputs

Table 12 in Appendix 3 details the list of independent variables used to estimate the model. These include the Chinn-Ito index as a proxy of de-jure capital account openness, as well as a list of macroeconomic indicators that have been selected from the literature to control for the underlying determinants of capital flows. The estimation and significance of the coefficients of these variables are used to calculate the fundamental position of Malawi’s capital account without capital flows.

The variable series form a panel of 76 countries (listed in table 11), over the time period 1993 to 2011.

6.2.2.3. Key assumptions

In order to use the estimated coefficients of the model to make projections relating to Malawi’s international flows and their effect on GDP, a number of forward-looking assumptions must be made relating to Malawi’s macroeconomic fundamentals. These are outlined in table 13 for both a neural scenario and an optimistic scenario.

To formulate a baseline counterfactual for financial flows and GDP against which to compare projections, the IMF’s WEO database is used where possible, and four-year moving averages are used elsewhere (see Table 14 in the Appendix).

6.2.3. Model Estimation, diagnostics and projections

The results of the estimation are listed in Table 15 in Appendix 3. The table shows that neither capital flows nor portfolio flows respond significantly to the level of capital account openness observed in a given country, but rather to macroeconomic fundamentals - primarily per-capita GDP the savings rate (to which inflows respond in a negative relationship), and the level of world GDP growth.

Two diagnostics were conducted to confirm the validity of the model estimation. First, the Breusch-Pagan Lagrange multiplier test for selection between fixed-effects and random effects models confirmed at the 1% level that the pooled random effects estimation (results of which are presented in the table) is superior to a fixed effects model. Second, the

Breusch-Godfrey/Woolridge test confirmed the null hypothesis that serial correlation of the error term (which would lead to under-estimated explanatory coefficients) is not present at the 1% level.

Using the results shown in table 15 and the assumptions discussed above, figures 36 to 40 below present the projected scenarios under baseline (closed) against the neutral (open) and optimistic (open) scenarios for GDP growth. Full detail on capital flow and GDP projections is captured in table 16 in Appendix 3.

Figure 36: Projected FDI Inflows (% of GDP)

![Projected FDI Inflows (% of GDP)](image)

Figure 37: Projected FDI Outflows (% of GDP)

![Projected FDI Outflows (% of GDP)](image)
Figure 38: Portfolio Inflows (% of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual</th>
<th>Estimated</th>
<th>Projected</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2011</td>
<td>-0.5</td>
<td>-0.5</td>
<td>-0.5</td>
</tr>
<tr>
<td>2012</td>
<td>-1.0</td>
<td>-1.0</td>
<td>-1.0</td>
</tr>
<tr>
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<td>-1.5</td>
<td>-1.5</td>
<td>-1.5</td>
</tr>
<tr>
<td>2014</td>
<td>-2.0</td>
<td>-2.0</td>
<td>-2.0</td>
</tr>
<tr>
<td>2015</td>
<td>-2.5</td>
<td>-2.5</td>
<td>-2.5</td>
</tr>
<tr>
<td>2016</td>
<td>-3.0</td>
<td>-3.0</td>
<td>-3.0</td>
</tr>
<tr>
<td>2017</td>
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<td>-3.5</td>
<td>-3.5</td>
</tr>
<tr>
<td>2018</td>
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<td>-4.0</td>
<td>-4.0</td>
</tr>
<tr>
<td>2019</td>
<td>-4.5</td>
<td>-4.5</td>
<td>-4.5</td>
</tr>
<tr>
<td>2020</td>
<td>-5.0</td>
<td>-5.0</td>
<td>-5.0</td>
</tr>
</tbody>
</table>

Baseline: Conservative, Neutral, Optimistic

Figure 39: Projected Portfolio Outflows (% of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual</th>
<th>Estimated</th>
<th>Projected</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
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<tr>
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<td>-0.5</td>
<td>-0.5</td>
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<tr>
<td>2014</td>
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<td>-1.0</td>
<td>-1.0</td>
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<tr>
<td>2015</td>
<td>-1.5</td>
<td>-1.5</td>
<td>-1.5</td>
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<tr>
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<td>-2.0</td>
<td>-2.0</td>
</tr>
<tr>
<td>2017</td>
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<td>-2.5</td>
<td>-2.5</td>
</tr>
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<td>-3.0</td>
<td>-3.0</td>
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<tr>
<td>2019</td>
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<td>-3.5</td>
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</tr>
<tr>
<td>2020</td>
<td>-4.0</td>
<td>-4.0</td>
<td>-4.0</td>
</tr>
</tbody>
</table>

Baseline: Conservative, Neutral, Optimistic
6.2.4. Discussion of results

The model estimations and projections reveal four important findings with bearing on the question of capital account openness and relation to the findings of other sections of the study:

1. The lack of statistical significance of the openness indicator emphasises a point made several times in the report, and which is critical to the policy programme that will be developed in Malawi moving forward. As in a range of academic studies, the strongest conclusion is that underlying macroeconomic conditions are the primary driver of capital flows, and should be the core focus of developmental policy. Simply liberalising the capital account does not guarantee that de-facto flows will emerge – although the positive sign on the coefficient suggests that de-jure liberalisation will not decrease flows. In mitigation of this finding, it must be noted that the construction of the index may have an effect on the finding. A binary definition or weighting of capital account categories may indeed yield significant finding. Here, more research on differently constructed indices is suggested.

2. The high significance of certain fundamental variables underlines the finding in the point above. Different capital flows on the term/origin typology responded differently economic variables (detail in Table 15 in Appendix 3). What is important about this finding is the confirmation of capital account controls as a negative concept – they can restrict (measured) capital flows if present, but flows themselves are driven by economic fundamentals such as the savings rate, trade and productivity, not by the de jure status of capital flow regulation. This negative interpretation extends the usefulness of macroeconomic indicators to that used in projections, by allowing the researcher to interrogate the fundamental value that should be obtained in the absence of restrictions (the method used to project capital flows under liberalised regime).

3. The findings in tables 36 to 39 reveal a number of interesting possibilities relating to changes in capital flows under an open capital account and given the assumptions made about the underlying macroeconomy:

3.1. FDI flows: Most importantly from a developmental perspective, opening the capital account and allowing Malawi’s capital flows to revert to a fundamental, frictionless value has the potential to add FDI inflows of up to
4% of GDP to the expected baseline total. Depending on the public policy objectives pursued in Malawi and the success of parallel reform programmes, even higher values could be achieved. From an outflow perspective, the concern about capital flight is confirmed, but the model suggests that outflows should settle at half a percent of GDP (provided there are no underlying crises pushing capital outside of the country). This is less than the potential gains from FDI inflows, suggesting an overall net gain in direct investment.

3.2. **Portfolio flows:** The most striking finding on the portfolio front is the very small quanta predicted to occur, even under fundamental “frictionless” capital flow conditions. This confirms the concept that liberalisation relates mainly to the attraction of FDI and banking sector financing, given the small and illiquid bond markets present in the country. A worrying property of the projections on portfolio flows is the tendency for outflow given Malawi’s underlying conditions – a more direct form of capital flight that that observed via FDI. This suggests that these flows should be liberalised gradually under fairly stringent macro-prudential conditions than direct investment.

4. The potential FDI inflows projected in the second phase of the model suggest a potential increase in GDP of just over 1% accruing through direct and multiplier effects. Even at the lower standard division, the effect is positive and economically significant. This confirms the positive growth case of liberalisation in relation to these types of flows. However, the dependence of FDI flows themselves on a range of macroeconomic indicators must not be forgotten.

With a strong confirmation of one benefit (higher growth from long-term inflows) and one key risk (capital flight) in the quantitative portion of the analysis, the discussion turns now to final findings and policy recommendations.
7. RECOMMENDATIONS

Drawing together the information and analysis presented throughout the study, as well as from workshops and direct stakeholder meetings conducted in-country, this section of the report summarises the findings of the study and makes final recommendations. First, the recommendation as to whether or not to liberalise is made. This is followed by a series of practical considerations and actions designed to achieve the recommended policy.

7.1. SHOULD MALAWI LIBERALISE ITS CAPITAL ACCOUNT?

The study had approached the question of whether or not Malawi should liberalise from a number of different, and somewhat fragmented angles. Drawing these together, it is concluded that the evidence supports an integrated series of policy reforms targeted at fully liberalising the capital account over the medium term. The evidence is balanced on the finding that the potential risks of liberalisation are manageable, and that with this finding in place, there are no strong reasons not to liberalise.

7.1.1. Summary of arguments

To reiterate a point made several times in the study, if political obligation made to the SADC in signing the FIP document is taken as a starting point, the issue of whether or not to liberalise, and in what time frame, is determined. Malawi’s FIP commitment does not constitute an argument so much as an obligation. For this reason, the study took an agnostic view of this political issue, and focused on the economic question underlying it: Should Malawi liberalise?

The foundational theoretical basis of global moves toward integration is found in the neoclassical growth theory, which posits that access to the international savings pool via an open capital and financial account will increase real income per capita through a decrease in the cost of capital and increase in investment in the domestic economy. The underlying assumption of this model, exposed in empirical results, is that the domestic economy offers the opportunity for investment returns in the first place. The empirical literature finds that growth effects of CAL are inconclusive, but importantly, not negative, and suggests that a “threshold” effect is in place, in which a certain level of institutional support is required to realise the benefits of CAL. This theory is complementary to the integrated reform approach supported by most academics and the IMF, which sees CAL as an important part of a broader development and stability programme.

The existence of a “threshold effect” begs the question of whether Malawi is above or below this threshold. The analysis of Malawi’s economy and institutional context did not definitively answer this question. It was found that as an economy, Malawi remains undiversified and extremely vulnerable to external and natural shocks. In addition, the political economy environment is dominated by the continuing fall-out over the CashGate scandal – more certainty will be established after the elections. At the same time however, Malawi has been engaged in a reform programme, which has included sound risk management in the financial sector, the floating of the Kwacha and liberalisation of the current account. These reforms can be seen as paving the way for capital account reform. On balance, Malawi is probably very close to the speculated threshold that academics predict. The policy recommendations in this section are designed to push Malawi just over the threshold.

What is more, even if Malawi is below the theoretical threshold at present, the more recent convergence on an “integrated” approach to CAL suggests that liberalisation can be placed in the middle or end of a reform process. Additionally, the discipline effect, in which international capital markets are able to hold domestic officials to a higher level of accountability, is particularly strong in the case of Malawi, and a reason to foreground CAL as a major reform.

The largest risk that was identified for an open Malawian economy was that of capital flight. This alone is not sufficient to rebut the case for liberalisation and finds its solution in correct sequencing. Outflows should be liberalised during a time of macroeconomic stability, when the pressure on capital to flee is low. Even if some flight does occur, liberalisation will have
the effect of formalising outflows, which have found their way out of the country in any case, and may even signal some of that capital to return. Inflow risks, relating to credit and asset bubble inflation and reversals, should also be acknowledged, and risks management procedures built into reforms. But Malawi can take comfort in the fact that its shallow and underdeveloped markets will probably protect it from the vagaries of global investors. The major risks, then, are manageable.

Some of the most convincing findings came out of the comparative analysis of similar economies to Malawi that have liberalised their capital account. In the countries analysed, particularly in Africa, there has been no financial crisis after liberalisation. FDI was attracted by the open economies, and compared to Malawi and Tanzania, growth rates of liberalised countries were both high and more stable. With both higher growth rates and lower cost of capital, the liberalised economies replicated the predictions of theory. Uganda and Rwanda set the example of well-sequenced capital liberalisation programmes, and neither of these two countries experienced severe outflows after liberalising. Indeed, Malawi has begun to take many of the same steps that preceded Uganda’s liberalisation, including floating the currency and overhauling banking regulations. The largest negative funding coming out of the country comparison was the evidence from Zambia that any reversal on the principle of openness will be severely punished by investors and local business classes alike.

The costs that have been identified as being associated with the controlled regime provide a strong case for reform. The expense of bureaucracy, the foregone opportunities to more productively utilise scarce human capital, continuing donor dependence, lack of competitiveness in attracting FDI and the absence of market discipline are all good reasons to liberalise. In addition, the benefits of liberalisation in terms of managing currency crisis are questionable. Moreover, the necessity of exchange controls to maintaining a fixed currency and monetary policy independence no longer applies under a floating currency regime. In contrast, econometric modeling has suggested that the growth benefits of an open capital account would add around one extra percentage point to GDP, provided that macroeconomic conditions remain stable. Overall, provided capital flight is effectively managed, there is more upside to liberalisation than down-side.

On balance, the findings of the study support liberalisation, but with the qualification that the reform process be carefully sequenced in order to avoid some of the larger risks associated with CAL, and that certain reform principles, outlined below, are adhered to.

7.1.2. Statement of principles

Before detailed recommendations are outlined, a set of six of guiding principles are established to direct the liberalisation process as it moves through the institutions that will eventually bring it to realisation.

1. **The recommendation is for eventual full liberalisation:** Although certain reforms should happen in carefully-sequenced stages, the capital account should be fully liberalised, within certain macro-prudential limits designed to maintain the stability of the domestic financial system.

2. **Reforms should be permanent:** The reform processes should be fully committed to once it has begun, with no space should be left for regulators to re-impose capital controls arbitrarily. This principle is put in place to convince both internal stakeholders and external investors of the commitment of authorities to the programme and avoid the consequences of reversals.

3. **Substitute control for monitoring:** As regulators relinquish control over the timing, size and approval of financial flows, increased monitoring over the financial sector is critical. Regulators must ensure that reporting standards are met, and become strict and intrusive in their monitoring to ensure that financial freedom does not translate into increased systemic risk.
4. **Long-term before short-term**: The administrative and legislative liberalisation of long-term flows, particularly FDI, should be prioritised over short-term portfolio and banking flows.

5. **Inflows before resident outflows**: The developmental impact of inflows is higher than that of outflows, and particularly with regard to long-term flows, presents less risk. This does not apply to investment-related non-resident outflows, which must to be unconstrained in order to encourage further investment.

### 7.2. HOW SHOULD THE RECOMMENDATIONS BE IMPLEMENTED?

#### 7.2.1. Reform sequencing

Table 9, based on Table 6 in Section 3, details recommendations on the timing of different actions and concurrent reform actions suggested from the findings of the report. Together, the different sections of Table 9 form a recommendation on the sequencing of reforms. The time periods for implementation in Table 9 are split into “short-term” recommendations, “medium-term” recommendations and “long term” recommendations. The precise length of these periods should be left to policy-makers’ discretion in response to economic and institutional conditions. However, as a guide, “short term” may refer to a period less than two years, “medium term” to a period between two and five years, and “long term” to a period longer than 5 years. It is intended that inflow liberalisation precede outflow liberalisation, unless authorities deem conditions appropriate to introduce inflow and outflow liberalisation in tandem.

It is worth noting that since Malawi is starting from a position in which some of the economic reforms to support liberalisation have already occurred, this programme should be achievable within five years, but may require more time depending on the pace of institutional development and accompanying the reforms. While certainly not a “big-bang” approach, this is on par with the pace of liberalisation than has been witnessed in East Africa, which took roughly seven years from the initial currency and current account reforms to complete capital account liberalisation, striking a balance between gaining momentum and pacing to avoid risks.

Table 9: Capital control regime and suggested reform schedule

<table>
<thead>
<tr>
<th>Current status</th>
<th>Short-term reforms</th>
<th>Medium-term reforms</th>
<th>Long-term reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>FINANCIAL INWARD: May non-residents without prior approval from the Central Bank:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Invest in fixed property.</td>
<td>No, RBM approval is required</td>
<td>Allow inward fixed-property FDI without RBM approval for capital movement</td>
<td></td>
</tr>
<tr>
<td>- Invest in equity.</td>
<td>No, RBM approval is required</td>
<td>Liberalise investment in publically traded equity.</td>
<td></td>
</tr>
<tr>
<td>- Invest in bonds.</td>
<td>No, RBM approval is required</td>
<td>Allow free investment in publically traded bonds. Shift application procedure for bond trading accounts to commercial banks, with RBM oversight</td>
<td></td>
</tr>
<tr>
<td>- Maintain local currency bank accounts.</td>
<td>Yes</td>
<td>Retain record keeping regulations, updated to revised controls, and improve regular</td>
<td></td>
</tr>
<tr>
<td>- Maintain foreign currency accounts locally.</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is it a requirement to declare the accrual of foreign currency</td>
<td>No, but ADBs are required to present records of all controlled transactions on request</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current status</td>
<td>Short-term reforms</td>
<td>Medium-term reforms</td>
<td>Long-term reforms</td>
</tr>
<tr>
<td>----------------</td>
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</tr>
<tr>
<td>to the RBM</td>
<td>reporting to financial stability team at the RBM.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**May residents retain foreign currency accrued / obtained?**
- Yes

**Is the purchase/sale of foreign currency between residents restricted?**
- Yes, only authorised ADBs and AFEDs may purchase or sell foreign currency as counterparties to residents subject to exchange control rules
- Retain AFED and ADB system to protect the legitimacy of the currency

**FINANCIAL OUTWARD**

<table>
<thead>
<tr>
<th>Is it a requirement to declare the accrual of a foreign asset?</th>
<th>Yes, any outward investment is subject to RBM approval</th>
<th>Retain discretionary controls on outward flows in short term</th>
<th>In line with gradual liberalisation of outward investment, require bank to keep records of transactions.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May income on foreign assets be retained abroad?</td>
<td>No</td>
<td>Retain inward remittance requirement for earnings on current account transactions to prevent currency arbitrage</td>
<td>Allow for retention of income on foreign assets for re-investment into long-term assets, but retain inward remittance on current account (trade) earnings.</td>
</tr>
<tr>
<td>May private individuals maintain foreign bank accounts?</td>
<td>Not allowed</td>
<td>Allow private individuals to hold foreign bank accounts, but retain monitored application procedures. Require disclosure of accounts.</td>
<td>Allow earnings to be retained abroad within macroeconomic limitations.</td>
</tr>
<tr>
<td>May resident private individuals maintain onshore accounts denominated in foreign currency, if so, indicate any limits?</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>May resident private individuals maintain foreign accounts denominated in domestic currency.</td>
<td>No</td>
<td>N/A – there is no such market</td>
<td></td>
</tr>
<tr>
<td>May resident private individuals be allowed to convert their domestic/local currency accounts into foreign currency?</td>
<td>No</td>
<td>Allow, but set to a limit (barrier limit, not proportional).</td>
<td></td>
</tr>
</tbody>
</table>
## Study on the Liberalisation of the Capital and Financial Account of Malawi

### Current status

**May private individuals invest into fixed property, equity, portfolios, bonds abroad, and, if so, any limits:**
- Yes, subject to RBM approval

**May residents, excluding commercial banks, enter into loan agreements with non-residents without prior approval from the Central Bank, if so, any limits:**
- No

### Short-term reforms

**May companies maintain foreign bank accounts and, if so, any limit:**
- Switch prohibition to discretionary control, and require banks to administer rules.

**May resident companies maintain foreign accounts denominated in local/domestic currency? If yes, indicate limit:**
- Yes, not subject to limits

**May resident companies maintain offshore accounts denominated in foreign currency? If yes, indicate limit:**
- Gradually increase limit below which RBM approval is not required.

**May onshore accounts of non-residents denominated in local currency be allowed to be converted into foreign currency?**
- No

### Medium-term reforms

**Shift approval of foreign investment to banks below a certain limit set by the RBM. Any limit extension should happen in a period of macro stability**

**Set limit on size of loan above which RBM approval is required Gradually raise limit in annual review.**

**Set final limit below which RBM approval is not required.**

### Long-term reforms

**Set final limit below which RBM approval is not required.**

**Set final limit within macro prudential limits on individual foreign exposure.**

---

### May the following transfers be effected without prior approval from the Central Bank and, if so, any limits:

- **Inheritances, legacies and distributions from estates.**
  - Yes, no limit

- **Monetary gifts to non-residents or residents temporarily abroad**
  - Yes, up to USD 1,000 (MWK40,000) per annum

- **Maintenance.**
  - Yes

- **Alimony.**
  - Yes, against court order

- **Loans to non-residents.**
  - No

- **Casino, gambling and**
  - No

---

**Yes, subject to RBM approval**

**Increase to USD10, 000 and hold limits to individual scale (within inflation) to prevent capital outflow.**

**Increase limits**

**Treat as private wealth**

---

**Remove limits**

**Remove limits, or set final limits**
<table>
<thead>
<tr>
<th>Current status</th>
<th>Short-term reforms</th>
<th>Medium-term reforms</th>
<th>Long-term reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>lottery winnings.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FINANCIAL OTHER: May residents, without prior approval from the Central Bank:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- grant local financial assistance to non-residents and, if so, indicate limits.</td>
<td>Yes, no prescribed limits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- enter into forward exchange contracts.</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- be allowed to issue abroad bonds, debt securities, shares or other securities of a participative nature.</td>
<td>No</td>
<td>Allow for foreign issuance of securities by domestic firms to raise capital, within prudential currency matching requirements. Shift approval to banks.</td>
<td>Conduct technical study on advantages and risks of foreign purchase and issue of derivative instruments</td>
</tr>
<tr>
<td>- be allowed to purchase or issue abroad derivative instruments, options and futures.</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>May the commercial banks, without prior approval from the Central Bank</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- borrow abroad</td>
<td>No</td>
<td>Allow banks to borrow abroad without approval, subject to macro prudential limitations below a (relatively low) limit.</td>
<td>Gradually increase approval limit, but maintain strong reporting and monitoring of foreign exposures.</td>
</tr>
<tr>
<td>- maintain accounts abroad</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- lend locally in foreign currency</td>
<td>No</td>
<td>Protect currency by preventing local direct lending in foreign currency.</td>
<td></td>
</tr>
<tr>
<td>- grant local financial assistance to non-residents and, if so, indicate limits</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>For institutional investors:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Is there any limit on securities issued locally by a non-resident?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Is there any limits on foreign portfolio investments to be held by the institutional investors? If any, indicate limits.</td>
<td>No</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Overall, Table 9 reflects a sequencing approach to liberalisation based on the following principles. Deviations from the recommendations in Table 9 can nonetheless still be guided by these principles:

- The removal in the short-term of administrative controls that in practice are not exercised by the RBM, along with the liberalisation of inflows.
- Over the medium and long term, phased introduction of, and increase in, approval limits for portfolio flows and outflows until fully liberalised or set to a prudential cap.
- Over the medium term, shifting the administration of remaining controls to commercial banks, lightening the administrative burden and shifting risk assessment away from the Reserve Bank.
• The formalisation of existing de-facto arrangements, such as the legalisation and formal monitoring of foreign bank accounts.

### 7.2.2. Parallel policy considerations

One major finding of the study, which has been emphasised throughout the paper and confirmed in quantitative modeling, is the dependence of de facto capital account flows on the position and stability of the macroeconomic. For this reason, liberalisation of the capital account should occur in tandem with a set of integrated progressions in other sectors in order to support the opening of the economy. This would require the involvement and coordination of a wide range of stakeholders in the public and private sector, meaning that the effectiveness of the capital account reform programme will not be dependent solely on its implementation partners. Below, several of the most important concurrent reforms and macroeconomic preconditions for liberalisations are discussed. Fully detailed recommendations to institutions outside of the RBM lies outside of the scope of this report, but a broader consensus to the recommendation should be developed if implementation is to be effective.

#### 7.2.2.1. Concurrent reforms and institutional coordination

1. **Budgetary stability:** As the macroeconomic model has shown, both direct and portfolio investment is affected by the primary balance on the government budget. For this reason, the achievement of a stable primary balance is a highly complementary goal to the of capital account liberalisation. A second consideration is the tendency of fiscal policy to be pro-cyclical. An inflow surge may have the effect of increasing fiscal outlays (particularly if greater global integration leads to increased access to funding), and lead to unsustainable spending. The pressure of holders of local assets on government to achieve this goal will be a positive influence. Additionally, there is downside risk in a combination of open economy and fiscal profligacy. Thus, the capital account liberalisation recommendation is complementary to calls from other sectors for responsible fiscal management.

2. **Improving the investment environment:** Because access to international FDI flows is competitive between regions and sectors, the liberalisation of inflows must be achieved in parallel with concerted efforts to improve the business environment, over and above the stable political and macroeconomic conditions that businesses look for when making investments. There are two ways to do this in Malawi; by focusing on ease-of-doing-business indicators, and through the on-going development of the Malawi Investment and Trade Centre.

3. **Improvement of “doing business” rankings:** The World Bank’s ease of doing business ranking criteria provides a framework that can focus efforts to improve the country’s attractiveness to external investors. Rwanda’s focused targeting of improvement in these rankings is informative to other small countries, showing that strong and direct interventions are needed to make the necessary changes, is instructive to policymakers elsewhere. In order to competitively attract FDI against countries in the region, especially without a substantial minerals base, improvements in the different doing business rankings will be instrumental for Malawi.

4. **Continuing development of the Malawi Investment and Trade Centre:** In order to facilitate direct investment, the Malawi Investment and Trade Centre has been established to coordinate different government departments to ease the administrative burden of investing in Malawi. The continuing efficiency gains of the organisation, embodied in improvements in targeted amount of time taken to facilitate business entry, will be able to directly improve the foreign investment condition of the economy. Effective inter-ministerial coordination is important in this body, and in this sense it may be a vehicle for wider coordination of exchange control liberalisation.

5. **Reporting and monitoring:** Within the Reserve Bank and the Ministry of Finance, the move from exchange control regime to integrated economy will shift the role of regulators to one of monitoring rather than control. In the short and
medium term, this will require these institutions to initiate a capacity improvement and human capital development plan to ensure that they are correctly skilled for the role of monitoring systemic risk in the banking sector and in relation to macroeconomic indicators. Within the commercial banking sector, interviews and workshops highlighted a need for improvement in reporting regularity and quality. This process is being worked out as part of the Basel II implementation currently underway. Opening the capital account will require this process to be refined in order to ensure that financial risk originating from international positions can be flagged and managed.

6. **Regional reporting financial information integration**: In addition to improved domestic reporting and monitoring, improvements in financial flow information sharing in the region (provided for in the FIP) must be actively pursued. The establishment of SIRESS, and its expansion beyond the initial four implementing states, will create the technical possibility for greatly improved cross-border flow data. Significant political effort, as well as technical integration, will be required to improve such reporting, implying that it is a medium-term reform under the time framework presented above.

7. **Security market development**: In order to facilitate the increased interest in portfolio flows that is likely to materialise after the implementation of eased controls on these flows, security market infrastructure must develop in order facilitate higher volume. Additionally, the liberalisation programme would benefit from continuing efforts of security markets to increase market liquidity and attract domestic listings and regional duel-listings.

8. **Economic development path**: The placement of capital account liberalisation, along with the other factors addressed above, into broader, multi-stakeholder development path would both improve the likelihood of success of the initiative, and increase its complementary effects on other reforms being initiated as part of a more integrated growth path. Both politically and economically, the country is at a ripe position for the development and implementation of such a plan.

7.2.2.2. **Macroeconomic stability and sequencing**

The study recommends that gradual liberalisation of outward resident flows in the medium term. In order to avoid the risk of capital flight, this should be carried out during a period of macroeconomic stability. This will reduce pressure on companies and individuals to move capital from the country, and will allow for the introduction of such measures with relatively little pain. This is contrasted to liberalising during an inflationary episode of currency crisis, when exits would be significant and pro-cyclical, exacerbating negative conditions. The difficulty is to establish a definition of what counts as a macro-economically stable environment, and for how long this should have existed, before liberalisation measures take effect. These issues are considered in box 3 below. Overall, because of the risk of an unrealistic or overly rigid definition of stability holding back positive reforms, it is recommended that policymakers employ discretion at the time to determine whether the economy is sufficiently stable to enact measures.
Box 3: What constitutes macro stability?

In order to form a definition of “macroeconomic stability”, a number of different indicators should be considered:

- Inflation, and its anchoring level against expectations
- Interest rates, and interest rate premiums
- Budget deficits and debt levels
- Current account balance
- Consumer or producer confident levels

In addition to the indicators of economic stability, the definition of “stable” can be defined to include two separate concepts: levels and volatility. An economy might have acceptable levels in measured indicators despite a relatively high level of volatility which is nonetheless unconducive from a policy perspective. On the other hand, unacceptably high, but stable levels of inflation may persist with low volatility levels, also unconducive to policy action. Both levels and volatility must be taken into account for stability measures.

These indicators and definitions can be used to set a deterministic quantitative condition for a policy can be formed. However, this carries significant risk, as policies may never be implemented, despite adequate conditions for their implementation, thereby holding programs back artificially. The alternative is the use of discussion to evaluate indicators at a given time to ascertain the ability of the economy to absorb a policy change.

7.3. WHAT ARE THE IMMEDIATE ACTION POINTS

In order to realise the vision of a liberalised capital account, several action points can be set in motion in the short term on the basis of the recommendations of this report. These include:

- Broadening the scope of inputs to begin to fully formulate a plan of action for capital account liberalisation that includes and coordinates the input and efforts of the important and influential stakeholders in the reform process.
  - Ministry of finance
  - Revenue services and home affairs departments
  - Legislators
  - Banking and financial institutions
  - Business forums
  - International institutions and donor community
  - Malawi investment and trade centre
- Legislative and regulatory overhauls can be implemented as part of the first phase in the sequencing of the liberalisation initiative. Major reforms will be required in the regulation of the financial sector and banks.
  - Updates to the major banking legislation to:
    - (a) give effect to liberalisation, and;
    - (b) instil the necessary macro-prudential controls required to manage major risks.
  - Revision of supervisory legislation to become more intrusive and protect banking institutions from excessive risks
  - Updating AML and counter-terrorism legislation to standards required with liberalisation
- The task of regulators will begin to shift from implementation exchange controls to the regulation of the banking sector, whose risk appetite will guide the effective level of control over exchange transactions. The regulator can begin to enhance systems and human capital required for efficient and effective regulation of the newly liberalised accounts.
  - Enhancing staff and systems in monitoring and supervision departments.
  - Require banks to invest in improved systems and invest in development of compliance departments.

In addition to carrying out pre-policy work relating to the recommendations of the report, additional coordination and research relating the following points can be carried out by the bank to ensure effective implementation:

- The role of domestic and international derivatives in promoting risk management in the agricultural sector, and the implications for capital account policy.
- Technical requirements for liberalisation in payment systems, equity and bond markets.
- Coordination priorities and mechanisms and work toward an integrated economic plan that includes the capital account programme.
APPENDIX 1: ANNEX IV OF THE FIP

ANNEX 4

CO-OPERATION AND COORDINATION OF EXCHANGE CONTROL POLICIES

PREAMBLE

The High Contracting Parties:

RECALLING the provisions of Chapter Five of the Protocol, which require State Parties to co-operate and coordinate their exchange control policies;

RECOGNISING the fact that SADC economies are characterised by significant exchange control divergences in terms of currency convertibility and exchange control liberalisation;

DETERMINED to achieve co-operation and coordination of exchange control policies,

HEREBY AGREE as follows:

ARTICLE 1

DEFINITIONS

1. In this Annex, terms and expressions defined in Article 1 of the Protocol shall bear the same meaning unless the context otherwise requires.

2. In this Annex, unless the context otherwise requires:

“capital and financial account transactions” means, all transactions that involve the receipt or payment of capital transfers and the acquisition or disposal of non-produced, non-financial assets, as well as all transactions associated with changes of ownership in the foreign financial assets and liabilities of the economy of that State Party and such changes include the creation and liquidation of claims on, or by, the rest of the world in relation to that State Party;

“currency convertibility” means, the ability of residents of that State Party and non-residents to exchange the currency of that State Party for foreign currency and to utilise the foreign currency in transactions. A measure of currency convertibility of a State Party is the absence of restrictions on:

(a) the making or receipt of payments for international transactions; and

(b) the exchange of the currency of that State Party for foreign currency for such purposes;

“current account means, all transactions (other than those in “transactions” financial items) that involve economic values and occur between residents of a State Party and non-residents, and includes offsets to current economic values provided or acquired without a quid pro quo;

“SADC Exchange Control means the SADC Exchange Control
“Committee” Committee contemplated in Article 4(1).

ARTICLE 2

OBJECTIVES

State Parties shall:

(a) establish a framework for co-operation and co-ordination with regard to the promotion of exchange control in respect of:

(i) current account transactions; and

(ii) capital and financial account transactions;

(b) review exchange control policies to ensure exchange control convergence as State Parties move towards full exchange control liberalisation;

(c) implement exchange control policies aimed at achieving full currency convertibility amongst State Parties;

(d) improve the availability of information regarding cross-border foreign exchange flows amongst State Parties, with the aim of facilitating performance monitoring and assessment, as well as of maintaining transparency and accountability.

ARTICLE 3

CO-OPERATION AND COORDINATION

1. State Parties shall co-operate and co-ordinate exchange control policies in order to:

(a) Liberalise current account transactions amongst State Parties;

(b) Liberalise capital and financial account transactions between State Parties;

(c) Achieve convergence and full currency convertibility between State Parties; and

(d) Improve the availability of information regarding cross-border foreign exchange flows between State Parties.

2. State Parties shall conclude multilateral agreements between themselves to provide for the conversion and repatriation of State Parties’ banknotes through the forum of their respective Central Banks.

ARTICLE 4

INSTITUTIONAL ARRANGEMENTS

1. To achieve the objectives stated in Article 2 of this Annex, the State Parties shall establish a SADC Exchange Control Committee.

2. Each State Party shall be represented on the SADC Exchange Control Committee by one representative from the Ministry of that State Party responsible for finance and investment and one representative from the Central Bank of that State Party.

3. Decisions of the SADC Exchange Control Committee shall be by consensus.
4. Each State Party shall respond promptly to any recommendation made to that State Party by the SADC Exchange Control Committee and if that State Party, after consultation (where consultation is required) with its Ministry responsible for finance and investment, decides to implement such recommendation, that State Party shall do so promptly.

5. The SADC Exchange Control Committee shall report to the Committee of Senior Treasury Officials and to the CCBG.

ARTICLE 5

FUNCTIONS OF THE SADC EXCHANGE CONTROL COMMITTEE

1. In order to facilitate and ensure continued compliance with this Annex, State Parties shall hold regular consultations among themselves with a view to reconciling their respective interests in the formulation, modification and implementation of exchange control policies for the Region and in regard to any other matter arising from, or relating to exchange control.

2. The SADC Exchange Control Committee shall:

   (a) for the fulfilment of its functions, convene in regular session at least twice in every year and, if so requested by any State Party, at such other time being as soon as possible after receipt of such request by that State Party;

   (b) expedite as far as possible any business referred to it;

   (c) use its best endeavours to find a solution satisfactory to all State Parties in regard to any matter referred to it, and make recommendations to State Parties accordingly;

   (d) determine its own procedures, including the establishment of such subcommittees as, in its opinion, are necessary.

ARTICLE 6

CONSULTATIONS

1. State Parties shall consult with one another and, where required, with their respective Ministries responsible for finance and investment, in order to improve the operation and implementation of exchange control and to resolve any matters that may arise in this regard. Each State Party shall, in order to enable the other State Parties to take such action as may be necessary to fulfil their respective obligations and to protect their respective interests under this Annex 4, in circumstances where the urgency of the relevant matter precludes prior consultation with such other State Parties through the SADC Exchange Control Committee, notify such other State Parties and the SADC Exchange Control Committee of any change in that State Party’s exchange control policies or in the administration thereof, including any amendments to the exchange control provisions of that State Party which may affect the interests of such other SADC State Parties. Such notification shall be made by that State Party, where practicable, before such change or, if such notification in advance is impossible or impracticable, such notification shall be made immediately after such change.

2. If any State Party wishes to consult with any other State Party on any exchange control issue which does not directly affect all of the State Parties, that State Party may consult with such other State Party but shall notify the remaining State Parties, in advance, of its intention to do so, and shall, as soon as possible after the conclusion of such consultation furnish the remaining State Parties with a report on the results of such consultations.
3. The State Party furnishing its report under paragraph 3 shall lay the report before the SADC Exchange Control Committee at its following meeting.
APPENDIX 2: COUNTRY PROFILES

In the following pages, a brief country summary is provided for each of the economies analysed in section 3. Each one-page summary presents a macroeconomic overview, a discussion of key issues in the economy and evidence of the level of liberalisation of the capital and financial account for each country. The country profiles are intended to be read for quick reference and familiarisation with the casket of economies selected for comparative purposes.
Botswana

Botswana is a small, landlocked SADC member. It was one of the first economies in the region to liberalise its current account. Botswana is a resource-rich economy, but is also reliant on livestock industries. The government has implemented strong social and infrastructural development programmes. The Pula is set on a depreciating crawling peg to a basket of currencies. Recently, growth has slowed and the economy is facing risk from high credit extension to households.

Doing business ranking (2013): 56

**Economic Indicators**

**Measures of liberalisation**

From 1996 to the present, Botswana liberalised its current and capital accounts completely.

**Chinn-Ito index and exchange rate**

**De facto measures of openness**
Chile

Chile is the only country outside of Africa in this set, chosen for its cautious, “integrated” liberalisation of controls. Over the past decades Chile has experienced a huge commodities boom (copper) not dissimilar to that of several African countries. Chile has converted growth to significant developmental gains. Chile weathered the financial crisis well, partially through the re-introduction of some controls on capital flows.

Doing business ranking (2013): 34

Economic Indicators

Measures of liberalisation

Chile maintains the use of capital controls as a part of wider economic programs, and is often held up as a model for capital account liberalisation. The Peso is free floating.

Chinn-Ito index and exchange rate

De facto measures of openness

Capital stocks as a proportion of GDP

Capital flows as a proportion of GDP
Rwanda

Rwanda is generally considered to be in international developmental success story. Over the past 15 years it has aggressively grown and diversified through a government-led growth programme. Macroeconomic policy is stable, but Rwanda remains (formally) a relatively closed economy. Similar to Malawi, Rwanda is landlocked, runs large trade deficits, is primarily agricultural and faces uncertainly over donor assistance flows and wider international support.

Economic Indicators

Measures of liberalisation

Rwanda remains relatively closed on the capital and financial side of the balance of payments, although inflows are more liberalised than outflows. The Franc is on a crawling peg.

Chinn-Ito index and exchange rate

De facto measures of openness

Capital stocks as a proportion of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Portfolio equity</th>
<th>Portfolio debt</th>
<th>FDI</th>
<th>Derivatives</th>
<th>FX Reserves</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>29.0</td>
<td>13.0</td>
<td>16.0</td>
<td>42.0</td>
<td>14.0</td>
<td>50.0</td>
</tr>
</tbody>
</table>

Capital flows as a proportion of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Portfolio equity</th>
<th>Portfolio debt</th>
<th>FDI</th>
<th>Derivatives</th>
<th>FX Reserves</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>0.009</td>
<td>0.005</td>
<td>0.012</td>
<td>-0.001</td>
<td></td>
<td>0.012</td>
</tr>
</tbody>
</table>
Tanzania

Tanzania has experienced buoyant growth over the past decade and has reached a point of relative macroeconomic stability. Like Malawi, Tanzania is highly import reliant and has a widening current account deficit. As the data below show, Tanzania is an interesting case in that it has a relatively closed capital account in the legal sense, yet attracts significant financial inflows and has a large capital liability stock. The Tanzanian Shilling is free-floating.

Doing business ranking (2013): 145

Economic Indicators

Measures of liberalisation

Although Tanzania’s capital account remains closed on de jure measures, in practice inward investments are liberalised almost to levels of liberalised regional peers. The Tanzanian Shilling is free-floating.

Chinn-Ito index and exchange rate

De facto measures of openness
Uganda

Uganda’s economy is among the most liberalised in Africa. Recently, price levels and high interest rates have been a concern, although in late 2013 the economy moderated somewhat and in inflationary episode is believed to be contained. Characteristically for an open economy, high interest rates led to inflows, which were absorbed through effective policy management using currency appreciation and reserve accumulation as a policy buffer. In 2018 Uganda is expected to begin oil production on Lake Albert.

Doing business ranking (2013): 132

Economic Indicators

Measures of liberalisation

Uganda made strident efforts to liberalise its international accounts in the 1990s, although in practice outflows remain very small. The Ugandan Shilling is free-floating.

Chinn-Ito index and exchange rate

De facto measures of openness
Zambia

Zambia has achieved high economic growth for the past decade, fuelled primarily by strong copper prices. Foreign Direct Investment in mining and infrastructure projects has been extremely high by regional standards, and the current account deficit is near balanced. This international position is allowed through an open balance of payments. Recently, Zambia has experienced an episode of fiscal loosening coupled with temporary exchange controls. This position has been reversed.

Doing business ranking (2013): 83

Economic Indicators

Measures of liberalisation

Following decades of centralised economic control, Zambia liberalised its economy and capital account rapidly in the mid-1990s. The Zambia Kwacha is free-floating.

Chinn-Ito index and exchange rate

De facto measures of openness
APPENDIX 3: TECHNICAL APPENDIX

SCOPE OF THE MODEL

The model is designed to support the estimation of the following variables:

1. Financial account flows
   1.1. Inward FDI
   1.2. Outward FDI
   1.3. Inward portfolio flows (debt and equity)
   1.4. Outward portfolio flows (debt and equity)

2. Effect of changes in capital flows on GDP

Note that three substantial categories of capital flows have been excluded. These are listed below, along with reasons for their exclusion:

3. Official flows: Excluded due to unpredictability of government and monetary authority policy decisions, which are not systematically related to fundamental economic variables.

4. Donor flows: Similar to official flows, donor flows are excluded due to their lack of systemic relationship to economic fundamentals and the unpredictability of donor allocations to a given country.

5. Banking flows: Authors such as He et al. note that banking flows are typically of a short term, relatively unpredictable nature. Long term flows have been shown not to respond reliably to economic indicators. Additionally, aggregated data on banking flows of the quality required for this project is difficult to source publically.

CONCEPTUAL METHODOLOGY

In order to arrive a projection of the end effect of an open capital account on GDP, a three-phase methodology is followed. These phases are explained in table 1 below.

Table 10: Process for estimation

<table>
<thead>
<tr>
<th>Phase</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Capital flow</td>
<td>Use panel data from developing economies including Malawi (T=20, N=32) to determine significant determinants of the four types of capital flows identified in section 2.1. These parameters yield coefficients for projection. Include the best-practice diagnostics in the estimation.</td>
</tr>
<tr>
<td>parameterisation</td>
<td></td>
</tr>
<tr>
<td>2 Capital flow</td>
<td>Use the coefficients identified in phase 1 to project future capital flows for Malawi to construct a stylised projected balance of payments for Malawi (including reserves). The projection will take a 5 year horizon from 2015 to 2019 (incl.)</td>
</tr>
<tr>
<td>projection</td>
<td></td>
</tr>
<tr>
<td>3 Growth</td>
<td>Use coefficients identified in the literature for the interaction between FDI and portfolio flows on growth to estimate the effects of the flows in phase 2 on GDP growth rates in Malawi.</td>
</tr>
</tbody>
</table>

The flow of the models is presented in the logical schema below, where g represents the growth rate, X a list of predictors, y the aggregation of capital flows, and i and t refer to country and year respectively (j=1,3,…,5):

\[ X_{i,t} \rightarrow y_{i,t} \ g \subset X \]
\[ y_{i,t} \rightarrow y_{i,t+j} \]
\[ y_{i,t+j} \rightarrow g_j \]

### MODEL PARAMETERISATION

#### Governing equations

The determinants of capital flows are estimated using Equation 1 below. Because flows rather than stock positions are modeled, a static model is preferred to a dynamic or auto-regressive model. In order to select between fixed and random effects in the static model, a Hausman test is conducted in the diagnostic section of this note.

\[ y_{i,t} = \alpha + \beta X_{i,t} + \mu_i + \nu_{i,t} \quad \text{(Equation 1)} \]

The subscripts \( i \) and \( t \) denote country and year respectively. \( \alpha \) is an intercept term, and \( X \) represents a vector of independent variables (see table 3) with corresponding estimated parameters \( \beta \). \( \mu_i \) is the country-specific error, while \( \nu_{i,t} \) is the standard white-noise error term. The dependent variable \( y \) represents the type of capital flow being estimated (of the four listed above). In the second phase of the estimation, a deterministic projection is made by dropping the two error terms.

In the third phase of the project, the literature is used to estimate the effect of projected capital flows on GDP growth. The equation is shown below, where the estimation of IMF staff Dabla-Norris et al. of \( \varphi = 0.72 \) for non-oil exporting low-income countries is used. This is the only significant predictor for GDP found by the authors, including a number of controls.

\[ g = \varphi FDI \quad \text{(Equation 2)} \]

In the equation 2, \( g \) is the growth of GDP in the economy. Note that Dabla-Norris et al. take account of a number of control variables in their estimation, meaning that their coefficient can be taken directly without adjustments for other fundamentals. Nonetheless, an upper and lower bound based on the standard error (0.30) will also be provided in projections.

To be clear, this estimated contribution is *additional* to the assumed base-case growth used to project capital flows. This is one consequence of the endogeneity between growth and portfolio flows.

#### Projections

In order to estimate the effect of openness on capital flows, it is assumed that capital account openness will allow Malawi to revert to the fundamental values implied by the significant explanatory variables in the model. These fundamental projections for capital flows are compared to a baseline generated auto-regressively using an average of previous years’ capital flows.

---

MODEL INPUTS

County set

The countries listed in table 36 below form the sample set for the estimation of the equation in phase 1 are drawn from the set of low income and low-middle income countries as defined by the World Bank. Higher middle-income and developed countries were excluded from the estimation in the interest of retaining a higher level of comparability with Malawi. LICs defined by severe political instability (predominantly warfare), or for which sufficient data did not exist, were excluded from the list in table 36.

Table 11: Countries used for panel regression

<table>
<thead>
<tr>
<th>Country</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola</td>
<td>Middle Income</td>
</tr>
<tr>
<td>Armenia</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>Low Income</td>
</tr>
<tr>
<td>Benin</td>
<td>Low Income</td>
</tr>
<tr>
<td>Bhutan</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Bolivia (Plurinational State of)</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Botswana</td>
<td>Middle Income</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>Low Income</td>
</tr>
<tr>
<td>Burundi</td>
<td>Low Income</td>
</tr>
<tr>
<td>Cape Verde</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Cambodia</td>
<td>Low Income</td>
</tr>
<tr>
<td>Cameroon</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Chad</td>
<td>Low Income</td>
</tr>
<tr>
<td>Comoros</td>
<td>Low Income</td>
</tr>
<tr>
<td>Congo</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Côte d'Ivoire</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Dem. Rep. of the Congo</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Djibouti</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Egypt</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>El Salvador</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>Low Income</td>
</tr>
<tr>
<td>Gabon</td>
<td>Middle Income</td>
</tr>
<tr>
<td>Gambia</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Georgia</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Ghana</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Guatemala</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Guinea</td>
<td>Low Income</td>
</tr>
<tr>
<td>Guinea-Bissau</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Guyana</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Haiti</td>
<td>Low Income</td>
</tr>
<tr>
<td>Honduras</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>India</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Kenya</td>
<td>Low Income</td>
</tr>
<tr>
<td>Kiribati</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Lao People's Dem. Rep.</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Lesotho</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Madagascar</td>
<td>Low Income</td>
</tr>
<tr>
<td>Malawi</td>
<td>Low Income</td>
</tr>
<tr>
<td>Mali</td>
<td>Low Income</td>
</tr>
<tr>
<td>Mauritania</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Republic of Moldova</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Mongolia</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Morocco</td>
<td>Low-Middle Income</td>
</tr>
<tr>
<td>Mozambique</td>
<td>Low Income</td>
</tr>
<tr>
<td>Namibia</td>
<td>Middle Income</td>
</tr>
</tbody>
</table>
Time period

Nineteen time observations per country per variable were included in the model, covering the time period 1993 to 1997. This time period is relatively homogenous in relation to economic regimes worldwide. The panel data is unbalanced, as every country has a full data series for each variable for the entire time period.

Projection assumptions and baseline inputs

Table 12 below presents the list of dependent and explanatory variables used for the study, along with details of the units of each series, the transformations performed upon them, and their source.

<table>
<thead>
<tr>
<th>Variable type</th>
<th>Variable</th>
<th>Unit</th>
<th>Transformations</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent</td>
<td>Inward FDI</td>
<td>% of GDP</td>
<td></td>
<td>UNCTAD</td>
</tr>
<tr>
<td>Dependent</td>
<td>Outward FDI</td>
<td>% of GDP</td>
<td></td>
<td>UNCTAD</td>
</tr>
<tr>
<td>Dependent</td>
<td>Inward portfolio flows</td>
<td>% of GDP</td>
<td></td>
<td>IMF BMP5</td>
</tr>
<tr>
<td>Dependent</td>
<td>Outward portfolio flows</td>
<td>% of GDP</td>
<td></td>
<td>IMF BMP5</td>
</tr>
<tr>
<td>Explanatory</td>
<td>Index of capital account liberalisation</td>
<td>Linearly shifted so that range is non-negative</td>
<td>IMF AREAER (Chinn-Ito)</td>
<td></td>
</tr>
<tr>
<td>Explanatory</td>
<td>Stock market capitalisation as a proportion of GDP</td>
<td>% of GDP</td>
<td>World Bank WDI</td>
<td></td>
</tr>
<tr>
<td>Explanatory</td>
<td>World growth in GDP</td>
<td></td>
<td>World Bank WDI</td>
<td></td>
</tr>
<tr>
<td>Explanatory</td>
<td>Narrow money and quasi-money (M2) as a proportion of GDP</td>
<td>% of GDP</td>
<td>World Bank WDI</td>
<td></td>
</tr>
</tbody>
</table>

*60 In Malawi’s case, internal Reserve Bank data was used where possible*
For the forward-looking projections made in the second phase of the model, the basis of neutral and optimistic macroeconomic scenarios are presented in table 13, and the baseline FDI and growth calculation methodologies used for comparative purposes are defined in table 14.

Table 13: Macroeconomic projection scenarios

<table>
<thead>
<tr>
<th>Variable</th>
<th>Neutral scenario</th>
<th>Optimistic scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Index of capital account liberalisation</td>
<td>Malawi implements full capital account liberalisation in early 2015 and full liberalisation in 2016</td>
<td>Malawi implements full capital account liberalisation in early 2015 and full liberalisation in 2016</td>
</tr>
<tr>
<td>Stock market capitalisation as a proportion of GDP</td>
<td>Stock market capitalisation retains its historical 5-year average of 27% of GDP</td>
<td>Stock market capitalisation increases to 40% of GDP based on open capital account</td>
</tr>
<tr>
<td>World growth in GDP</td>
<td>IMF WEO projection for world GDP growth</td>
<td>IMF WEO projection for world GDP growth</td>
</tr>
<tr>
<td>Narrow money and quasi-money (M2) as a proportion of GDP</td>
<td>Stabilises at 30% of GDP</td>
<td>Stabilises at 30% of GDP</td>
</tr>
<tr>
<td>National savings rate as a proportion of GDP</td>
<td>Gradual increase of 5% of previous year’s proportion per year as financial intermediation improves</td>
<td>Gradual increase of 10% of previous year’s proportion per year as financial intermediation improves</td>
</tr>
<tr>
<td>Trade-to-GDP (De-Facto CA openness)</td>
<td>Gradual increase of 2% per year as de facto current account openness improves, assumes no tobacco shocks</td>
<td>Gradual increase of 2% per year as de facto current account openness improves, assumes no tobacco shocks</td>
</tr>
<tr>
<td>Real interest rate differential to USA</td>
<td>Remains at 10%</td>
<td>Moderates to 6% by 2020</td>
</tr>
<tr>
<td>Real GDP per capita (Natural logarithm)</td>
<td>IMF WEO trend in real GDP growth for Malawi (assumes capital controls)</td>
<td>IMF WEO trend in real GDP growth for Malawi (assumes capital controls)</td>
</tr>
<tr>
<td>Public sector cash surplus / deficit as a proportion of GDP</td>
<td>Public sector deficit will remain at an average of 4%</td>
<td>Public sector deficit will remain at an average of 3%</td>
</tr>
</tbody>
</table>

Table 14: Baseline projections for estimated variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Source or Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inward FDI</td>
<td>4-year moving average</td>
</tr>
<tr>
<td>Outward FDI</td>
<td>4-year moving average</td>
</tr>
<tr>
<td>Inward Portfolio Flows</td>
<td>4-year moving average</td>
</tr>
<tr>
<td>Outward Portfolio Flows</td>
<td>4-year moving average</td>
</tr>
<tr>
<td>Malawi GDP Growth</td>
<td>IMF WEO projections (assume closed capital account)</td>
</tr>
</tbody>
</table>
## RESULTS TABLES

Table 15: Regression Results and Diagnostic Tests

<table>
<thead>
<tr>
<th>Pooled random effects estimation</th>
<th>Inward FDI</th>
<th></th>
<th></th>
<th>Outward DI</th>
<th></th>
<th></th>
<th>Inward portfolio flow</th>
<th>Outward portfolio</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CAL Index</td>
<td>0.015</td>
<td>0.119</td>
<td>0.898</td>
<td>0.063</td>
<td>0.026</td>
<td>0.174</td>
<td>1.243</td>
<td>0.899</td>
<td>0.168</td>
<td>0.476</td>
</tr>
<tr>
<td>Stock market capitalisation / GDP</td>
<td>0.006</td>
<td>0.005</td>
<td>0.236</td>
<td>0.004</td>
<td>0.001</td>
<td>0.001</td>
<td>0.066</td>
<td>0.037</td>
<td>0.073</td>
<td>0.009</td>
</tr>
<tr>
<td>World GDP growth</td>
<td>0.554</td>
<td>0.114</td>
<td>0.000</td>
<td>0.037</td>
<td>0.025</td>
<td>0.143</td>
<td>1.600</td>
<td>0.862</td>
<td>0.064</td>
<td>0.891</td>
</tr>
<tr>
<td>M2 / GDP</td>
<td>0.020</td>
<td>0.010</td>
<td>0.047</td>
<td>0.004</td>
<td>0.002</td>
<td>0.092</td>
<td>-0.183</td>
<td>0.076</td>
<td>0.017</td>
<td>0.015</td>
</tr>
<tr>
<td>Savings / GDP</td>
<td>0.012</td>
<td>0.019</td>
<td>0.533</td>
<td>0.019</td>
<td>0.004</td>
<td>0.000</td>
<td>0.065</td>
<td>0.145</td>
<td>0.656</td>
<td>-0.200</td>
</tr>
<tr>
<td>Trade / GDP</td>
<td>0.033</td>
<td>0.007</td>
<td>0.000</td>
<td>0.001</td>
<td>0.002</td>
<td>0.691</td>
<td>0.051</td>
<td>0.053</td>
<td>0.340</td>
<td>0.005</td>
</tr>
<tr>
<td>Interest rate differential</td>
<td>-0.050</td>
<td>0.017</td>
<td>0.004</td>
<td>-0.003</td>
<td>0.004</td>
<td>0.365</td>
<td>-0.117</td>
<td>0.129</td>
<td>0.363</td>
<td>-0.036</td>
</tr>
<tr>
<td>Real GDP per capita (Natural logarithm)</td>
<td>0.000</td>
<td>0.000</td>
<td>0.004</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.003</td>
<td>0.001</td>
<td>0.017</td>
<td>-0.001</td>
</tr>
<tr>
<td>Budget Balance / GDP</td>
<td>-0.034</td>
<td>0.046</td>
<td>0.451</td>
<td>-0.015</td>
<td>0.010</td>
<td>0.142</td>
<td>0.169</td>
<td>0.343</td>
<td>0.622</td>
<td>0.308</td>
</tr>
</tbody>
</table>

### Diagnostics

<table>
<thead>
<tr>
<th></th>
<th>Inward FDI</th>
<th></th>
<th></th>
<th>Outward DI</th>
<th></th>
<th></th>
<th>Inward portfolio flow</th>
<th>Outward portfolio</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Random effects test (p-value)</td>
<td>2.2E-16</td>
<td></td>
<td></td>
<td>2.2E-16</td>
<td></td>
<td></td>
<td>2.2E-16</td>
<td>2.2E-16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BWR Test for collinearity (p-value)</td>
<td>0.597836681</td>
<td>0.257254985</td>
<td>0.665536364</td>
<td>0.600000801</td>
<td>0.487</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Green cells represent estimators that are significant on the 5% level.
Table 16: Projections based on findings of estimation

<table>
<thead>
<tr>
<th></th>
<th>Observed</th>
<th>Estimated</th>
<th>Projected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inward FDI</td>
<td>2.27</td>
<td>3.01</td>
<td>3.32</td>
</tr>
<tr>
<td>Outward FDI</td>
<td>(0.99)</td>
<td>(1.16)</td>
<td>(1.35)</td>
</tr>
<tr>
<td>Net FDI</td>
<td>3.26</td>
<td>4.16</td>
<td>4.67</td>
</tr>
<tr>
<td>Inward Portfolio Flows</td>
<td>0.02</td>
<td>0.02</td>
<td>0.03</td>
</tr>
<tr>
<td>Outward Portfolio Flows</td>
<td>(0.00)</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Net Portfolio Flows</td>
<td>0.03</td>
<td>0.02</td>
<td>0.02</td>
</tr>
<tr>
<td>Net Change in Reserves</td>
<td>3.29</td>
<td>4.19</td>
<td>4.69</td>
</tr>
<tr>
<td>GDP Growth</td>
<td>0.07</td>
<td>0.04</td>
<td>0.02</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Neutral Scenario</th>
<th>Optimistic Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inward FDI</td>
<td>5.88</td>
<td>5.88</td>
</tr>
<tr>
<td>Outward FDI</td>
<td>0.33</td>
<td>0.38</td>
</tr>
<tr>
<td>Net FDI</td>
<td>5.55</td>
<td>6.27</td>
</tr>
<tr>
<td>Inward Portfolio Flows</td>
<td>(2.26)</td>
<td>(2.37)</td>
</tr>
<tr>
<td>Outward Portfolio Flows</td>
<td>1.35</td>
<td>0.98</td>
</tr>
<tr>
<td>Net Portfolio Flows</td>
<td>(3.61)</td>
<td>(3.57)</td>
</tr>
<tr>
<td>Net Change in Reserves</td>
<td>1.94</td>
<td>2.07</td>
</tr>
<tr>
<td>GDP Growth</td>
<td>7.96</td>
<td>7.96</td>
</tr>
</tbody>
</table>

MISCELLANIOUS

Estimations were calculated using the “plm” package for the R statistical software environment.