

Capital flight

The new debt strategy, with its increased emphasis on debt reduction, also calls on debtor countries to adopt policies that will encourage their residents to reverse outflows of flight capital. This note examines some of the causes of capital flight and the various approaches that have been made to measure it.

What is capital flight?

The term 'capital flight' inevitably carries pejorative overtones. In practice, however, it is difficult to distinguish those resident outflows which appear damaging to the domestic economy of a developing country from those that would be associated with the normal process of growth and diversification of the portfolios of resident investors in response to changes in risks and expected yields. Investment abroad of the proceeds of illicit activity—the evasion of taxes and exchange controls, drug trafficking, corruption, etc—clearly qualifies as flight capital but represents only a part of the total. More generally, flight capital might be regarded as a response to 'abnormal' risks in the domestic economy or a 'desire to place assets beyond the control of local authorities'.⁽¹⁾ Such definitions suggest that much of capital flight should be seen more as a response to inappropriate macroeconomic and structural policies than an independent problem.

At the macroeconomic level, policy shortcomings would include overvalued exchange rates and excessive fiscal deficits (usually associated with high rates of inflation). At the structural level, interest rate ceilings, and other financial market distortions which discourage local financial intermediation, also provide a strong incentive to shift assets abroad. Distortionary tax regulations and allocative mechanisms such as import licensing typically confer benefits on particular groups which then seek a safe harbour abroad for their wealth. The longer-term unsustainability of such policies increases the relative risks attached to domestic investment. Moreover, the costs of tax increases and policy reforms may fall disproportionately on holders of local assets.

Measuring capital flight

By its very nature, capital flight is hard to measure. Numerous data problems confront attempts to calculate both the flows and the stocks outstanding.

Most attempts to measure capital flight rely on one or a combination of three approaches:

- By using a direct measure of selected financial assets held abroad by the private sector (usually bank deposits only). Such measures are clearly subject to the criticism that they exclude 'flight' assets held in other forms (eg real estate). Furthermore, deposits held for the benefit of a resident of a developing country may well be recorded under a different nationality. The method also does not distinguish deposits held for normal commercial purposes (eg import financing or as collateral or as a hedge against foreign currency borrowing) from 'flight' deposits.
- By adding together selected private sector capital outflows (usually excluding direct investment) as shown in the debtor country's balance of payments statistics. Such approaches often include the 'errors and omissions' entry on the grounds that, in the main, this item is likely to represent unrecorded capital outflows. (Being a residual item, 'errors and omissions' will, however, reflect the net effect of all measurement errors in the balance of payments accounts and not just the mis-recording of private sector capital flows.) In some studies, account is also taken of the fact that recorded increases in the stock of external debt typically exceed recorded balance of payments inflows associated with them. It is argued that the discrepancy must be matched by a corresponding unrecorded balance of payments outflow and this is accordingly added to the estimate of flight capital derived from balance of payments data. Improvements in the accuracy and coverage of debt statistics over time and the effect of exchange rate movements on the value of debt suggest that such adjustments need to be treated with some caution. A further possible adjustment involves the use of partner country trade statistics to estimate outflows associated with the underinvoicing or underrecording of exports (including illicit trade—in firearms or narcotics, for example) and/or the over-invoicing of imports.⁽²⁾ Apart from such attempted adjustments for specific items, this method as a whole is, like the first one, unable to distinguish 'flight' from 'normal' flows.

(1) These, similar definitions have been suggested respectively by D R Lessard and John Williamson, *Capital flight and world debt*, Institute for International Economics, 1987 and by M P Dooley, 'Capital flight: a response to differences in financial risks', IMF Staff Papers, September 1988.

(2) If, for example, an export is underinvoiced and an amount representing the difference between the payment for full value and the invoiced value is deposited abroad but is unrecorded, no item in the balance of payments will be affected. In particular, there will be no increase in the 'errors and omissions' category which might point to an unrecorded resident outflow. A study by S K Gulati (in Lessard and Williamson, *Capital flight and world debt*), suggests that in some cases the incentive to underinvoice imports in order to circumvent import controls or to evade customs duties has outweighed the capital flight incentive to underinvoice exports. Underinvoicing of imports, however, could be regarded as a further symptom of flight from domestic financial assets—in this case into goods.

- A third approach attempts to subtract an estimate of the stock of assets resulting from 'normal' flows from the total stock derived by one or more of the variants of the second method described above. 'Normal' assets are identified as those which yield a reported income stream that is recorded in the balance of payments. Capitalising recorded income using a market rate of return enables a 'normal' stock to be estimated and a resulting stock of flight capital to be derived. Recorded income is not always reported or for that matter ever remitted by the investor. In some cases the former is calculated from estimated asset stocks by applying rates of return; applying the third method without adjusting for this may lead to an underestimate of the flight capital component.

Table A
External debt and non-bank deposits with banks abroad
\$ billions; end-1988

	Total debt(a)	External deposits(b)	Ratio of external deposits to debt
Argentina	59.6	11.7	0.20
Brazil	114.1	16.2	0.14
Chile	19.4	4.3	0.22
Colombia	17.1	5.8	0.34
Mexico	100.4	24.5	0.24
Nigeria	30.5	8.9	0.29
Peru	19.0	2.3	0.12
Philippines	28.9	4.0	0.14
Venezuela	35.8	15.9	0.45
Total	424.8	93.5	0.22

(a) Source: IBRD, *World Debt Tables 1989 First Supplement*.

(b) Source: *International Financial Statistics*, June 1989.

Table A provides a comparison of the external debt of a selected number of developing countries together with the deposit liabilities to non-bank residents of those countries as reported by banks in industrial countries and offshore centres to the IMF. On average at end-1988, overseas deposits were equal to about 22% of external debt but with a good deal of variation between countries. On this measure, Venezuela, Nigeria and Colombia have experienced the largest outflows relative to their external indebtedness, while outflows from Brazil and the Philippines has been relatively modest. In terms of absolute amounts, cumulative capital flight from Mexico has been much the highest of the group.

Table B
Non-bank private sector capital flows^(a) 1978-87^(b)
\$ billions annual averages; figures in italics include errors and omissions
(- = outflow)

	1978-82		1983-86		1987	
Argentina	-2.9	-3.0	0.3	0.2	-0.5	-0.3
Brazil	-0.3	-0.2	-0.5	-0.8	-5.5	-6.3
Chile	—	—	0.1	0.2	-0.4	-0.5
Colombia	-0.1	—	-0.3	-0.5	-0.2	-0.1
Mexico	-1.7	-5.1	-1.4	-2.3	-1.9	-1.0
Nigeria	-0.0	-0.1	-1.5	-1.5	-1.7	-1.8
Peru(c)	—	0.2	—	-0.2	—	-0.2
Philippines	-0.5	-0.6	-0.2	-0.1	-0.4	-0.3
Venezuela	-2.1	-2.2	-0.9	-1.0	-1.2	-1.4
Total	-7.7	-11.8	-4.3	-6.0	-11.8	-11.9

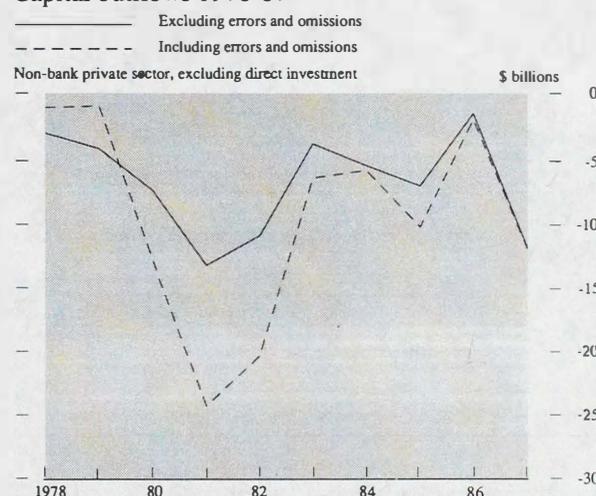
Source: IMF, *Balance of Payments Yearbook*.

- (a) Excluding direct investment: figures may not sum to totals because of rounding.
 (b) In general, detailed balance of payments figures for the sample of countries are not available beyond 1987.
 (c) In the case of Peru, no flows are identified for the categories included in this measure of private sector outflows.

(1) The method adopted follows that described by Dooley, *Capital flight*.

A flow measure of capital flight based on the second approach is given for the same group of countries in Table B with annual movements in the overall total being shown in Chart 1. (The inclusion of 'errors and omissions' as a capital flow can, of course, be questioned for reasons discussed above.)

Chart 1
Capital outflows 1978-87^(a)



Source: IMF *Balance of Payments Yearbook*.

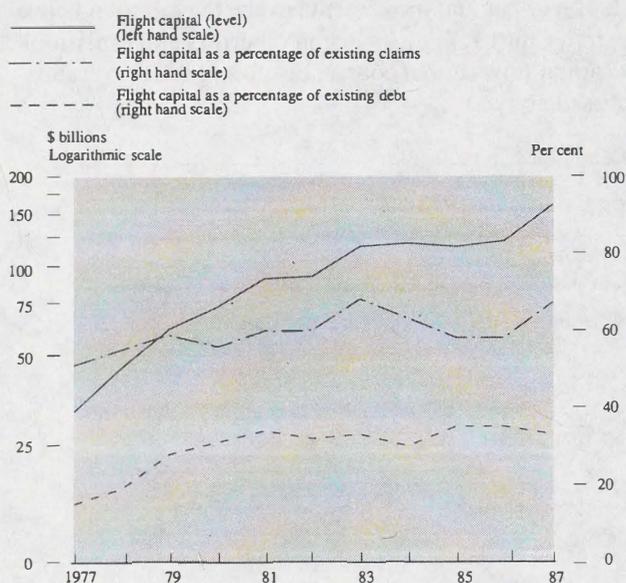
(a) Nine developing countries - see Table B.

In the five years prior to the onset of the debt crisis, there was a large increase in recorded outflows; moreover, total 'errors and omissions' for the group as a whole swung from a 'surplus' of over \$3 billion in 1979 to a 'deficit' of over \$11 billion in 1981. Virtually all the outflow over this period was accounted for by Mexico, Argentina, and Venezuela. The contribution from 'errors and omissions' was particularly large in the case of Mexico and Venezuela but not in that of Argentina or Brazil.

During the period 1983-86 both outflows were much reduced. The overall decline since 1982 appears to reflect two developments: a sharp fall in commercial bank lending has reduced access to external sources of finance for, *inter alia*, capital flight and in some countries some progress has been made in macroeconomic and structural policy reform under the auspices of IMF and World Bank programmes. In a number of countries, however, including Brazil and Nigeria, outflows have increased recently, so that in 1987 the total matched the average in 1978-82 (in nominal dollar terms). Nevertheless, outflows from the three countries which accounted for most of the capital flight in the earlier period have continued on a much reduced scale. With the exception of 1985, the contribution from 'errors and omissions' has been fairly modest.

Chart 2 shows an estimate of the stock of flight capital for seven countries for the period 1977-87 based on the third method, ie after deduction of estimated 'normal' capital outflows.⁽¹⁾ After allowing for differences in country

Chart 2
Accumulated capital flight 1975-87^(a)



(a) Seven countries: Argentina, Brazil, Chile, Mexico, Peru, Philippines, and Venezuela.

coverage, the increase in stock between end-1977 and end-1987 is much greater than the cumulative outflow (inclusive of 'errors and omissions') shown in Chart 1. Nevertheless, the series displays the same broad pattern: a rapid rise in outflows until 1982 with an abrupt slowdown thereafter, at least until 1987. Expressed as a percentage of external debt, the stock of flight capital has remained remarkably stable since 1981 but at a higher level than indicated by the external deposit figures given in Table A. In contrast, there has been more variation in the share of total assets representing flight capital.

In 1987, the estimated stock of flight capital on this measure rose sharply—by much more than is suggested by the corresponding flow figure given in Table B. The rise can be attributed to both an increase in total external assets and an increase in the share represented by flight capital. The latter change partly reflects a significant fall in recorded investment income in a number of countries, notably Brazil, Venezuela and Argentina, which outweighed increases recorded by Mexico and the Philippines.⁽¹⁾ It is also attributable to an increase in identified external liabilities whose associated inflow was unrecorded in the balance of payments; under this approach the discrepancy is assumed to be matched by an unrecorded outflow contributing to the stock of external assets. Such estimates clearly rely heavily on the accuracy of recorded overseas investment income, and the initial estimates for 1987 may well be subject to revision. Moreover, exchange rate changes in 1987 will have tended to raise the value of the stock of debt measured in dollar terms and these valuation changes will have contributed to the estimated increase in the stock of flight capital.

Given these statistical factors, some doubt must be attached to the size of the change in 1987 although probably not to its direction.

Dooley has suggested that the co-existence of large private resident outflows and heavy public sector external borrowing in the years prior to the debt crisis can be explained by the differences in risks as perceived by residents on the one hand and foreign banks on the other. While residents were concerned that real returns on domestic assets denominated in local currency were threatened by inflation and/or by the prospect of higher taxation in the event that steps were taken to correct unsustainable exchange rates and fiscal deficits, overseas creditors did not face any exchange rate risk and their loans generally had a government guarantee.

After 1982 those guarantees ceased to be credible and new loans dried up. The dearth of external financing since then has meant that the only way further capital flight could be financed (other than by drawing on limited existing foreign assets or by defaulting on debt service) was through improvements in the trade balance. The trade performance of the most highly indebted countries has in fact improved significantly since 1982, despite a deterioration in their terms of trade, largely as a result of a correction of overvalued exchange rates and the deflation of domestic demand (the latter at some considerable cost in terms of new investment). The extent of the improvement has, however, not always been sufficient to finance scheduled interest payments on external debt. Hence, the financing of resident outflows on the scale seen before 1982 could only have been effected by even greater current account adjustment. That process in turn might well have involved the adoption of policies which would have significantly improved incentives for residents to retain their wealth at home.⁽²⁾

Does capital flight damage highly indebted countries?

There is a general presumption that capital flight is a bad thing. But it would be more accurate to describe it as a symptom of bad policies. Developing countries typically face constraints on both the level of domestic savings available for domestic investment and the amount of foreign exchange available for imports. With capital scarce, the rate of return on domestic investment should be high, but inappropriate policies, for example price controls, may well drive a significant wedge between the private returns to the investor and the social returns to the country at large.

A combination (frequently seen in highly indebted countries) of domestic fiscal distortions and an overvalued exchange rate can provide huge incentives

(1) The stock of 'normal' assets is defined in this approach as the flow of recorded income, capitalised at a risk-free interest rate. A loss of confidence might well dissuade residents from remitting interest and dividends on their overseas investments. Under this method, such decisions effectively transform 'normal' assets into flight capital.

(2) Strengthened policies would also encourage foreign workers to remit home a higher proportion of their earnings. The retention of such earnings abroad because of a lack of confidence can also be regarded as part of the capital flight problem.

to wealth holders to switch their assets abroad and ultimately lead to politically destabilising shifts in the distribution of wealth and income. For example, domestic subsidies paid to local firms increase the wealth of their owners. Interest income on foreign assets may be untraceable, or at most taxed only lightly, giving investors a strong incentive to hold such wealth abroad. This incentive will be further increased if they are permitted to obtain foreign currency at an overvalued official exchange rate. In the absence of domestic adjustment this outflow will have to be financed by foreign borrowing or by drawing on reserves. It is unlikely that interest payments on such borrowing (or the loss of income on reserves) will be matched by remittances on the overseas asset. This imbalance will ultimately require adjustment measures, the costs of which may well fall largely on those who are unable to put their assets out of the reach of the tax authorities or who see the real value of their savings eroded by a combination of inflation and low nominal interest rates. If depreciation is also part of the belated adjustment it will benefit those residents who were earlier able to obtain their foreign currency cheaply.

How can capital flight be reversed?

In common with the Baker Plan, the debt reduction proposals outlined in March by US Treasury Secretary Brady, and which are now to be applied in the case of Mexico, place heavy emphasis on strong economic adjustment designed to secure, among other things, a reversal of capital flight and hence a further relaxation of the external financing constraint on the most heavily indebted developing countries. Convincing evidence of sustained economic adjustment, with a lasting realignment of exchange rates, interest rates and fiscal policy, is likely to be a precondition for repatriation on a significant scale. Given the history of failed reform efforts, it is perhaps not surprising that recent reforms that might be expected to promote reflows of flight capital have, in this respect, met with only modest success so far.

In the first instance, rather than inducing a reflow of earlier flight capital, adjustment programmes may still be able to achieve the equally important task of preventing further capital flight. Even if an adjustment programme is successful over the longer term, repatriation will be limited where the motivation behind flight was tax evasion or any other illegal activities. Also, where flight capital has been invested in illiquid assets such as property, the prospects for liquidation are unlikely to be great.

Exchange controls might be seen as a way of reducing capital flight. In the past the largest outflows did occur in countries which had no restrictions on outward capital movements at the time (Argentina, Mexico, Venezuela), while capital flight was more modest in Brazil, Chile and Colombia which did impose restrictions. Nevertheless, experience seems to suggest that in the absence of sound macroeconomic policies the presence of controls is unlikely to have much more than a marginal impact and they may be difficult to enforce. Mexico's attempt to impose controls in 1982 failed.

The conjunction of capital flight with heavy external borrowing represents financial intermediation taking place abroad rather than within the local economy. Measures to encourage the development or deepening of local capital markets with financial instruments suited to local conditions might induce savers to invest more of their wealth in the domestic economy. To make an effective contribution to the problem, however, such measures would have to go hand in hand with more fundamental macroeconomic policy reforms.

The loss of tax revenue on income from overseas assets is a factor contributing to the fiscal problems of highly indebted countries. An improvement in collection practices and greater co-operation with foreign tax authorities would reduce the scope for tax evasion.