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**CONSIDERATIONS ABOUT EXCHANGE CONTROLS,
CAPITAL FLIGHT AND COUNTRY RISK**

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ABSTRACT

This paper discusses the validity of exchange controls to prevent capital flight. We assume that the concepts of exchange control and capital flight are known. The tables presented were prepared in accordance with methodology available from the international economic literature for assessing capital flight. These methodologies, in general created during the 1970s and 1980s, reflect an international financial environment that has changed a lot, since then. Thus, capital flight estimates in conformance with those criteria do not indicate necessarily the best way to evaluate one economy, nowadays.

The presence of controls on cross-border transactions for political, ideological or other economical interests are partially presented in this study just to demonstrate that to avoid capital flight is not the unique reason for exchange controls. The paper does not take position in favor or against controls adopted for reasons not related to capital flight.

Opinions from various authors concerning the goals and consequences of exchange control regimes in the majority of developing countries, including Brazil, support the conclusion that exchange controls are ineffective to retain capital when economic and/or political indicators of one country signalize financial or political problems in near future.

Nevertheless, we discuss shortly the idea of controlling the international capital mobility to avoid world financial instabilities, which seems consistent with the role played by the International Monetary Fund, which has acted like central banks do in their domestic financial markets to face banking liquidity crises.

INTRODUCTION

The purpose of this paper is to complete an assignment for the Institute of Brazilian Issues – IBI, at the George Washington University, Washington, DC, USA, at the conclusion of the VI Minerva Course, November 1997.

The idea of writing about EXCHANGE CONTROLS AND CAPITAL FLIGHT was taken from a group study about the effectiveness of exchange controls in avoiding capital flight, that takes place during the normal activities of the VI Minerva Program. The group was assigned to answer the question Do Exchange Controls Prevent Capital Flight? At the same time we did researches to attend the assignment, Brazil was affected by the downward movement in capital markets across the world and consequently by capital flight.

As my professional activity at the Exchange Department of the Central Bank of Brazil was directly related to analyzing periodically the Brazilian exchange market and my part in the case study was to present a conclusion in order to answer the question Do Exchange Controls prevent Capital Flight? I was motivated by taking advantage of the happenings presents in newspaper headlines everyday during October and November/98, changing the first idea of writing about "transfer pricing" and money laundering.

The paper is divided in the following four chapters: THE FUNCTIONS OF EXCHANGE CONTROLS; THE NEGATIVE CONSEQUENCES OF EXCHANGE CONTROLS; WHY CAPITAL FLIGHT OCCURS (COUNTRY RISK); and ANSWERING THE QUESTION (CONCLUSION).

In the three first chapters the paper provides information and opinions from scholars about the functions and the consequences of exchange controls and the reasons why capital flight occurs in order to answer the question, in the forth. In Why Capital Flight occurs, the paper emphasizes the importance of the Country Risk evaluation as a determinant variable not only for capital flight but also for the shortage in capital inflow.

In each chapter the paper brings some considerations about the Brazilian experience, providing practical examples of using exchange controls. The case of Brazil is important because the country is suggested by some important authors as one good example of success in avoiding capital flight via exchange control policies.

Brazilian case becomes more important, maybe as a counter-example, insofar as the paper mentions that Brazilian economic authorities, especially under purposes from the Central Bank of Brazil, concluded at the end of the last decade for lifting part of the controls once the regime had failed in avoiding capital flight. The most impressive example of that is the creation of the Exchange Floating Market in which capital outflows operation can be carried out without any interference from the authorities.

THE FUNCTIONS OF EXCHANGE CONTROLS

What one government intends with restrictions on exchange transactions is, in general, related to development plans. The first goals are to lessen the negative effects of volatile capital flows and to protect infant industries. In that case, exchange controls structure is part of the macroeconomic policy.

I.1 – International Literature

Many authors have referred to the use of capital controls for developed countries in recent years. Nembhard, for instance, presents tables based on the Exchange Arrangements and Exchange Restrictions [IMF, annual reports 1975 and 1989], showing that among 17 OECD countries, only 3 (United States, Switzerland and Germany) had no kind of restriction at the end of 1975. By the end of 1989, 8 developed countries continued adopting some kind of Exchange Restrictions. Greenwood and Kimbrough [1985, quoted by Nembhard after analyzing the IMF summary tables on restrictions on the capital account, show that France, Italy, Japan, and the United Kingdom used controls virtually throughout the entire period from 1966 to 1982.

In effect, Nembhard argues that "there is a paradox between the use of capital controls in theory and in practice. Although mainstream theory suggests that controls are distortionary and ineffective and

should rarely be used – that only rent-seeking, mismanaged governments use them – sensible governments often with successful economies and almost every government in the world at some point, have used them, and some continue to do so".

Krugman [1987, quoted by Nembhard, asserts that capital controls can be justified as a second-best solution, when a government has fiscal problems or "is temporarily committed to the defense of a disequilibrium exchange rate". He demonstrates that when a country uses import controls to sustain a disequilibrium exchange rate, capital controls may improve welfare, and the exchange rate impact of import restrictions is greater.

Bhagwati [1978] , who classifies the exchange control regimes in five phases, shows us that we can also see exchange controls as a sequence of stages from the phase one to five, in a series liberating steps towards a completely open economy. Despite Bhagwati's book has been written twenty years ago, before the classical capital flight problems faced by Latin American countries in the 1980's, we understand that the idea of a sequence of stages of exchange controls continues being valid. It is not only because historically it was the case of practically all the nations, but also because we can not imagine a new country raising completely ready, politically and economically, in order to operate in phase five.

In his classification, phase one represents the most restrictive regime, characterized by the systematic and significant imposition of quantitative controls, in order to face unsustainable payments deficit, while phase five occurs when the exchange regime is virtually liberalized. In this stage there is full convertibility on current account and quantitative restrictions are not employed as a mean of regulating the balance of payments.

Moreover, we can also infer from Bhagwati and other authors that the exchange restrictions can be imposed for one country in order to face extraordinary problems reflected on its balance of payment, i.e. the route from phase one to five is not a straight journey. One country in phase four can suddenly impose some unwanted restrictions in response to unexpected financial and economic problems.

In a sequence, based on Nembhard [1996] and other authors, we present a range of arguments which have justified the use of controls for several countries around the world.

- To shelter a domestic economy from great outward and inward flows, balance of payments deficits or great fluctuations, differential interest rates, depletion of or instability of international foreign exchange reserves.
- To insulate and isolate domestic policies from international effects (particularly inflation and differential interest rates); to allow monetary policy to operate with some independence, to defend a fixed or managed float exchange rate (as an alternative to devaluation and exchange rate flexibility).
- To allow domestic full employment and desired social welfare programs and development programs; protect domestic production and/or employment and help maintain or increase domestic production.
- To keep domestic and foreign exchange finances under national social control, curtail capital flight, and direct domestic savings (and foreign borrowing) into productive domestic investment in accordance with development plans.

We can observe from this list that to prevent capital flight is not the most important purpose with capital controls. However, we have to take in mind that if capital flight occurs in great intensity all the other intentions can not be accomplished, what, virtually, transforms capital flight in the milestone of exchange controls.

I.2 – Brazilian Case

As a developing country, Brazil has historically adopted exchange controls in order to develop its own industry and to avoid its denationalization. In this sense, the most common restrictions have been imposed on international trade transactions, particularly via policies called import-substituting industrialization, and on foreign investment, both on inflows and outflows.

Although stimulated by credit facilities, which eventually compensated not favorable exchange rates, exporters have also faced, at the same time, complex rules, with a lot of variations, normally directed to maintain the foreign currency under the control of the Central Bank of Brazil – CBB.

Until today foreign capital inflows continue having to be registered at the CBB in order to assure the investors and lenders the right to return the principal and the interest (interest rates, profits and dividends) abroad. In some periods, however, the control was so strict that each exchange transaction, both inflow and outflow transactions relate to trade and capital had to be examined and "approved" by a CBB official servant in order to be carried out.

On the side of trade, the main restriction on imports, as well as on exports, has been exerted through the requirement of prior licenses to permit both trade and respective financial transaction from being carried out. Besides, heavy taxation has been imposed on various sorts of products, especially on automobiles, computers, and other products that are considered technologically advanced, which drastically increases the price of foreign product and discourage the transactions.

Bhagwati [1978] mentions as extreme examples of such protective use of quantitative restrictions on imports, the Indian rule of indigenous availability and the Brazilian law of similars, which virtually ruled out imports when local substitutes were available.

Mahon, Jr [1996] relates the existence of tight exchange controls system in Brazil and Colombia, especially on the exchange rate, to the pressure from the rural elite since coffee was their principal commodity. Analyzing the exchange policies and capital flight in those two countries the author comments:

"As in Colombia, Brazilian policy also came to reflect an attentiveness to exports and to the management of capital flows. A politically powerful rural elite, chronic coffee problems, and recurrent exchange crises shaped policy priorities. One side of this could be seen in a famous observation by one of the dictatorship's more orthodox finance ministers, Mario Henrique Simonsen: 'inflation wounds, but the balance of payments kills'. The emphasis on foreign exchange management over inflation fighting has characterized Brazilian policy under a variety of governments. The crawling peg and the controls reflected this and saw the country through the 'miracle' years (1968-73), encouraging the growth of new price-sensitive export producers. In the critical years of the debt cycle (1979-82), **as these priorities and most of the key policies endured, Brazil suffered relatively little capital flight**".

However, since the beginning of the 1990s, Brazil has been radically changing the rules on foreign capital and international trade in order to reinsert the country in the international community. A good example of the Brazilian exchange market liberalization is the creation of the Floating Market at the beginning of 1989, especially due to the rule known as CC5, which permits the outflow of capital without any intervention from the Central Bank of Brazil - CBB.

This process began to be more effective with the adoption of the Real Plan in July of 1994. Nowadays, the government's objective is to facilitate the imports in order to increase the competitiveness of industry, control inflation, and attract foreign capital to support new investments as well as to further privatization of state-owned companies and transitory current account deficits.

Despite, as we have learned from Bhagwati that the stages of exchange controls phases is not a straight sequence from phase one to phase five, during 1997 Brazil had to adopt some very imaginative restrictions on imports in order to control the current account deficit. Indeed, the amount of imports was increasing at a rate higher than expected due to the low cost of international capital. Through the very long maturity of payments, not correspondent with the kinds of products transacted, foreign exporters were conceding to Brazilian importers the opportunity to make money in the financial market via arbitrating the interest rates.

Because of this, since April, 1997, all imports with maturity of payments until 180 days have to be paid before the customer liberalization, and the other ones between 180 and 360 days have to be paid 180

days after the custom procedures. Only the imports with long-term maturity of payment continue being carried out without any restriction.

Concluding, as the most of authors researched base their opinions on the IMF annual report "Exchange Arrangements and Exchange Restrictions", it is appropriated to mention, in conclusion, that Brazil has traditionally taken at least seven pages of that report to describe its arrangements and restrictions on exchange transactions. Symptomatically, during the debt crises of 1980s, Argentina and Mexico, which were in more advanced degree of economic liberalization compared to Brazil at that time, jumped from their two or three pages of exchange control rules to something around seven, between 1982 and 1983, reflecting the tightening of controls.

II – THE NEGATIVE CONSEQUENCES OF EXCHANGE CONTROL REGIMES

In the prior chapter, we summarize the main arguments used by governments and scholars to support the adoption of exchange controls. Upon all of them it makes salient that one that takes a stand for an economy insulated from a supposed negative international competitiveness in order to provide one government with the tools necessary to guide the development of its country.

Since controls, however, are enforced against the willingness of the population and the market agents, participants devise a lot of ways to bypass them, reducing their effectiveness. These ways are always based on illegal actions which, commonly, involve part of the government staff and undermine the confidence of the residents and international investors in one country.

Without exception of any country, the adoption of exchange controls for a long time stimulates the rising of corruption, smuggling and other sorts of crimes, negatively affecting the government institutions as well as its employees. These facts tend to be more common if the restrictions are not felt to be morally justified by the citizens.

II.1 – International Literature

Bhagwati [1978], despite recognizing that the bureaucrats generally sought to follow fair-share rules in their choice criteria for awarding licenses among competing claimants, notes that the breakdowns in the honesty and integrity were not uncommon. As a consequence, the incidence of illegal transactions under exchange control regimes is equally common. Those illegal transactions are divided by this author in three broad classes as following:

- *Those that relate to abuses in awarding, claiming, and disposing of licenses.* In India, the following abuses are cited by the Estimates Committee of the Indian Parliament:
 - Applying for licenses on the basis of forged essentiality certificates of the Director of Industries or certificates obtained by misrepresentation;
 - Applying for licenses on the basis of forged quota certificates or such certificates obtained by false or forged documents of past imports;
 - Applying for licenses on the basis of false turnover by producing certificates from a Chartered Account obtained by misrepresentation on in collusion with the Chartered Accountant; and
 - Applying for licenses on the basis of imports or exports which do not qualify for establishment of quota.
- *Those pertaining to illegal trade transactions such as smuggling and faked invoicing.* Both quantitative restrictions and tariffs set up incentives to smuggle goods through illegal channels and to fake invoices on trade through legal channels if the illegal transaction yields profit.

There seem to be fairly impressive evidence of underinvoiced imports in the case of two countries, Turkey and the Philippines, that relate to tariffs, and Turkey and Pakistan in response to import premiums under QRs.

- *Those relating to capital flows, including both **capital flight** abroad and inward flows seeking better exchange rates in the black market.* When the faked invoicing is related to **capital flight**, this phenomenon represents a demand for illegal foreign exchange that is fed by the supply created by phenomena such as "leaked" inward remittances and capital flows and primarily by underinvoicing exports and overinvoicing imports.

Varman-Schneider [1991], referring to "Corruption, Bribery and Capital Flight" in India writes that "the history of Indian economy reflects some of the ills that have beset the country: widespread graft and corruption, waste, tax evasion, economic mismanagement and stagnation, and political strife. ... These included sales of import and industrial licenses at huge premiums, smuggled raw materials, speculative hoarding of key commodities, real state transactions, usurious lending and other fruits of corruption".

Dunn Jr., Robert M. and Ingram, James C., presents the following opinions about the consequences of exchange restrictions, which are adopted in order to avoid expenditures on nonnecessities:

Those residents who are denied legal access to foreign exchange will not only be displeased, but they will probably start looking for illegal sources of funds. In particular, they are likely to be willing to pay a premium for foreign exchange in one illegal or street market.

The existence of this premium provides a strong incentive for exporters and other recipients of foreign exchange to divert their funds from the legal market and foreign tourists are likely to be approached by large numbers of people offering very attractive rates for local money on the street.

As a result, the flow of foreign exchange into legal reserves is likely to stagnate or decline as more business is diverted to the illegal market. Officials of the central bank or finance ministry may be offered bribes to allow the purchase of foreign exchange at the legal rate for what should be illegal transactions.

The attractions of a regulated exchange market for a developing country facing payments deficits are obvious, but the record of such control systems is poor. Enforcement is difficult and frequently produces a decline in respect for law.

II.2 – The Brazilian Case

Although Brazil is mentioned by many authors as an example of country with relative efficiency in its exchange controls, most of the facts reported by Bhagwati and Varman-Schneider, for the most part also took place in Brazil, especially during the 1980s, despite the strictness of the exchange controls.

Overinvoicing and underinvoicing practices involving Brazilian international trade are reported by various authors. Study developed by Bhagwati, comparing the Brazilian statistics for exports with those one from respective partnership countries shows that the exports from Brazil presented nearly 14% of underinvoicing in transactions with the OECD countries and 4.1% in transactions with the United States and Canada for the year of 1967.

Meyer, Arno and Bastos Marques, Maria Silvia, in "A Fuga de Capital no Brasil" (FGV/IBRE), assert that exports from Brazil to the European Union, United States and Japan were systematically (12%) lower than the respective imports from that countries during the period of 1985-1987. At the same time, a comparison between the Brazilian imports from the same countries and in the same period were systematically lower (13%) than the respective exports informed by those countries. These facts indicate a practice of underinvoicing in both exports and imports in order to promote capital flight and to avoid taxation over imports.

Accordingly, comparisons made by Jessica [1996], covering the period between 1960 and 1987, indicates for the first seven years of the 1980s discrepancy around 4,9% in imports and 3,7% in exports..

A parallel market for American dollars operates daily especially in the big cities like Sao Paulo and Rio de Janeiro. In accordance with poor statistics eventually published by newspapers, the amount carried out daily is around US\$ 30 million US dollars in both cities, which represents approximately 3% of the amount of transactions in the regular markets for the same period.

Despite the small sum transitioned daily, the parallel market receives great attention from the media and has had the power to influence the people's expectations about the country's economy. Independently of the amount of transactions, the premium is reported daily by all newspapers and TV news as an important economic index.

A specific and autonomous market – Floating Market – was created in 1989 for tourism operations in order to attract to official market the transactions carried out in the parallel and illegal market. At that time, the premium was above 100% and the people were stimulated to deviate their foreign currency to the illegal market.

A lot of cases of International travel only with the purpose to obtain the right to purchase foreign currency are reported by the Brazilian media. During the 1980s even a round trip between Porto Alegre (Brazil) and Montevideo (Uruguay), no more than 300 miles far from the first city, permitted profits in foreign currency which were diverted to the parallel market.

The use of forged licenses and other documents required to support the payment of imports, in order to gain the premium between the markets, are equally reported by the newspapers based on punishment by the monetary authority published in the Brazilian official newspaper, *Diario Oficial da Uniao*. It demonstrates that the same practices reported by Bhagwati as taking place in India have occurred in Brazil practically with the same features.

Summarizing, in our point of view, the description made by Dunn Jr., Robert M. and Ingram, James C. concerning one economy under exchange restrictions fits Brazil almost perfectly, despite it has never reached that kind of deterioration we can imply from their prediction.

In addition, for the better understanding of the Brazilian Case during the over past 20 years, we insert the tables below and respective comments as following:

Table II.1 – It presents the estimate of capital flight (KF) in Brazil between 1971 and 1987. We can observe that at the end of the 1980s KF in Brazil began to be more consistent probably in response to tightening in exchange controls. At that period, Brazil centralized the exchange transactions in its central bank and almost all the remittances had to be approved. Consequently, the international market interrupted its investment and loans to Brazil. Besides, Brazil defaulted in meeting its foreign currency obligations insofar as the payments made by private sector via the CBB could not be converted to foreign currency and remitted abroad, what can indicate that the outflow was comprised largely by domestic capital.

Moreover, it is important to emphasize that after a record of 4.75% of GNP in KF in 1977, year in which Brazilian public sector borrowed a huge amount of capital in the European market, the scenario became uncertain and only in 1987 and 1988 it presented the same pace.

Taking the 1996 Brazilian's GDP [US\$ 750 billions], if repeated nowadays, that 4.75% of KF occurred in 1977 would represent something like US\$ 35.6 billions a year. Otherwise, the percentages of KF estimated for 1986-87, around 2.85%, would represent an amount near US\$ 21.4 billions a year, what would be unsustainable for any developing country.

Table II.1.1 - It presents the estimates of KF in six selected countries. As we can see, the figures from Brazil are not so significant as those relate to Mexico and Venezuela, for instance. This kind of difference is the reason why various authors mention Brazil as a country with low level of KF. It is important to point out that the existence of exchange control, especially on capital market, as mentioned by Mahon, Jr, reduced the presence of "hot-money" in Brazil and consequently the possibility of sources to finance KF.

Nowadays, with a more active and open capital market, stimulated by a privatization plan, Brazil shows more sensibility to international. In fact, as a result of the Asian crisis, Brazilian stock market assets suffered a huge devaluation, and the Brazilian international reserves were reduced by about US\$ 8 billions in no more than two weeks of outflows that took place in Oct-97. Besides, the CBB had to almost double the basic interest rate, in order to face the attack against the *Real*, and to signalize the consistence of its exchange rate.

Table II.1.2 – This table shows the underinvoicing in exports and overinvoicing in imports during the period of 1970-85. The net impact of misinvoicing as a way to promote capital flight is absolutely no significant insofar as the final result after that period is an inflow of US\$ 562 millions. However, the practice of misinvoicing in both sides of the international trade operations indicates the failure of the exchange and fiscal controls.

Table II.2 – It shows selected items of the Brazilian Balance of Payments of 1986-96, in order to update the estimates available in the economic literature, which do not go besides 1988. We have to inform that this table presents some inconsistency due to different sources of data. Also, we have had difficult in repeating the same figures presented by some authors researched concerning to years before 1986, what we think is due to modifications in official balance of payments from one year to another. Besides, differences between figures comprised in reports issued by IMF and World Bank for the same title was the commonest problem we faced in our research.

Table II.3 – This table, which was built based on table II.2, intends to give some idea about the behavior of the international capital concerning to Brazil since the end of the last decade. The same warning about the vicious of the figures related to prior table has to be considered for this one too.

As we can observe, based on World Bank measure, after 1987 Brazil continues presenting a tendency of KF although the inflow were very low as shown in table II.2. Only since 1994, when Brazil adopted its stabilization plan called Real Plan and began effectively to open its economy and reduce the controls the international capital began to stay in the country. Despite the situation has been completely reverted in the last two years, when inflows reached huge amounts, in accordance with World Bank measure the total inflow held inside the country in the last eleven years is only US\$ 6.804 billions.

Table II.1

BRAZILIAN CAPITAL FLIGHT ESTIMATES (1971-1987)

BROAD MEASURE – WORLD BANK

year	(1)n	(2)r	(3)m	kf/gnp
1971	-158.0	-395.0	-223.0	-0.32
1972	-20.0	-47.7	-231.0	-0.03
1973	-270.0	-605.4	-810.0	-0.34
1974	1,327.0	2,730.5	983.0	1.27
1975	-262.0	-489.7	523.0	-0.21
1976	-2,396.0	-4,218.3	-2,865.0	-1.59
1977	8,229.0	13,579.2	7,939.0	4.75
1978	2,425.0	3,725.0	1,964.0	1.24
1979	1,410.0	1,991.5	2,170.0	0.64
1980	2,597.0	3,359.7	3,340.0	1.12
1981	-214.0	-252.7	13.0	-0.08
1982	3,007.0	3,337.4	3,249.0	1.17
1983	1,096.0	1,170.9	781.0	0.56
1984	2,585.0	2,656.7	1,770.0	1.3
1985	2,431.0	2,431.0	3,171.0	1.12

1986	7,762.0	7,557.9	7,612.0	2.89
1987	8,354.0	7,873.7	8,562.0	2.86
TOTAL	37,903.0	44,404.7	37,948.0	
1971-80	12,882.0	19,629.8	12,790.0	
1981-87	25,021.0	24,774.9	25,158.0	
(1)n = nominal figures of capital flight				
(2)a = (1)n deflated by US GNP (1985=100)				
(3)am - (1)n adjusted by an estimate of misinvoicing				
KF/GNP - ratio in millions of US\$				
Source: Nembhard, Jessica Gordon [1996]				

Table II.1.1			
CAPITAL FLIGHT ESTIMATES			
VARIOUS METHODOLOGY - 1976/84			
COUNTRY	WORLD BANK	MORGAN	CUDDINGTON
Argentina	22,400	25,000	16,000
Brazil	18,700	17,300	-100
S.Korea	7,600	3,500	2,800
Mexico	53,600	53,400	36,200
Philippines	5,000	3,700	3,700
Venezuela	30,500	29,600	13,100
Source: Lessard and Williamson in "Capital Flight and Third World Debt"			
Table II.1.2			
CAPITAL FLIGHT THROUGH MISINVOICING			
BRAZIL - 1970-85			US\$ millions
ANO	under of	over of	net impact
	exports	imports	
1970	47	-129	-82
1971	81	-158	-77
1972	8	-283	-275
1973	-274	-607	-881
1974	-82	-436	-518
1975	712	628	1340
1976	-590	76	-514
1977	119	-662	-543
1978	-130	-583	-713
1979	1,108	-252	856

1980	1,098	220	1318
1981	551	-227	324
1982	1,432	-1,559	-127
1983	204	-865	-661
1984	621	-2,623	-2002
1985	3,011	-1,018	1993
TOTAL	7916	-8478	-562

Source: Lessard and Williamson in "Capital Flight and Third World Debt"

BALANCE OF PAYMENTS - BRAZIL - Selected items (1986 - 1996)								
	Current	Net Foreign	Short-Term	Portfolio	Banking	Change	Errors	Change
	Account	Direct	Capital	Investment	System	in	and	in
	Surplus	Investment			Foreign Assets	Reserves	Omissions	Debts
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
1986	-3,746	284	1,124	-16	1,399	4,848	56	6,032
1987	-1,159	834	734	61	1,432	-698	-805	9,986
1988	4,156	2,629	447	189	1,763	-1,682	-833	-7,678
1989	1,002	608	734	-58	2,356	-539	734	1,995
1990	-3,823	324	-1,329	104	2,805	-295	-328	7,932
1991	-1,450	89	-4,101	578	1,038	567	876	472
1992	6,089	1,924	1,701	1,704	2,836	-14,348	-1,386	12,039
1993	20	801	3,193	6,651	8,424	-8,457	-1,119	9,777
1994	-1,153	2,035	-536	7,280	15,035	-6,595	334	2,569
1995	-18,136	3,475	13,423	2,294	8,834	-13,034	2,093	10,961
1996	-24,347	9,671	-354	6,040	9,904	-8,270	973	7,485

sources: (a) and (b) FMI-Balance of Payments Statistic Yearbook until 1995 (1987 and 1996 reports)

other figures from The Central Bank of Brazil reports

Notes:	(e) Commercial banks assets			
	(f) Change in gross reserves(- = increase)			
	(h) Total external debt, public and private.			

CAPITAL FLIGHT ESTIMATES - BRAZIL (1986 - 1996)					
	International	External	W BANK	MORGAN	CUDDINGTON
year	Reserves	Debt	(h+b+a+f)	(h+b+a-e+f)	(-g - c)

	(i)	(j)			
1985	11,608	105,170			
1986	6,760	111,202	7,418		-1,180
1987	7,458	121,188	8,964	8,931	71
1988	9,140	113,511	-2,575	-2,906	386
1989	9,679	115,506	3,067	2,474	-1,468
1990	9,973	123,439	4,139	3,689	1,657
1991	9,406	123,910	-322	1,445	3,225
1992	23,754	135,949	5,704	3,906	-315
1993	32,211	145,726	2,141	-3,447	-2,074
1994	38,806	148,295	-3,144	-9,755	202
1995	51,840	159,256	-16,734	-10,533	-15,516
1996	60,110	166,741	-15,461	-16,531	-619
Total			-6,804	-22,727	-15,632
Sources of columns (i) and (j) The Central Bank of Brazil					
Other columns based on table x.x, in accordance with methodology presented					
In "Capital Flight and Third World Debt"					

III – WHY CAPITAL FLIGHT OCCURS

The main reason we can point out as cause of capital flight, is **risk**. In this case, it is changing in a level of **domestic risk** or, from the side of the lender, **country risk**.

Political and economic elements are considered for specialists to assess the risk of one country. Regularly, institutions like Moody's, International Investor, Euromoney, Economist Intelligence Unit, and Standard and Poor's prepare country ratings which influence the foreign investor's confidence. International banks and big investors have their own structure to assess the risk and can cause problems to one country when they decide to go out or not to lend more money. The figure III.1 below gives idea about how political and economic elements are considered in country risk assessment.

In summary, capital moves from one country to another looking for profit and the possible minimum financial or political risk. The loss of confidence as a consequence of negative economic performance or for political instability increases the sensation of risk what stimulates the investors, including residents, to put their money abroad, moved by fears and suspicion.

As a consequence of problems faced presently by many Asian countries, especially Thailand and Malaysia, the position of the Malaysia Prime Minister stood out against the kind of foreign investors that he called manipulators, instead of speculators or investors, received great attention in the American media.

Figure III.1	
CRITERIA FOR ASSESSING COUNTRY RISK	
SELECTED AGENCIES	
RATING	CRITERIA FOR RATINGS
AGENCY	
Institutional	Information provided by 75-100 leading international banks

investor	who grade each country on as scale of 0-100, with 100 representing least chance of default.
	Individual responses are weighted using a formula that gives more importance to responses from banks with greater worldwide exposure.
	Criteria used by the individual banks are not specified.
Euromoney	Assessment based on three main indicators:
	Analytical indicators (40%):
	- Political risk (15%)
	- Economic risk (10%)
	- Economic indicators (15%)
	(debt service/export, external debt/GDP, balance of payments/GDP)
	Credit indicators (20%):
	- Payment record (15%)
	- Rescheduling (5%)
	Market Indicators (40%)
	- Access to bond markets (15%)
	- Selldown on short-term paper (10%)
	- Access to discount available on forfeiting (15%)
Economist	Medium-term lending risk (45%)
Intelligence	
Unit	Total external debt/GDP, total debt serving ratio, interest payments ratio, current account/GDP, savings/investment ratio, arrears on international bank loans, recourse to IMF credit, and the degree of reliance on a single export.
	Political and Policy risk (40%)
	Short-term trade risk (15%)
Source: Nadeem U.Haque, Manmohan S.Kumar, Nelson Mark, and Donald J. Mathieson	
in "The Economic Content of Indicators of Developing Country Creditworthiness" - IMF Working Paper (WP 96/9)	

The Wall Street Journal published in Oct 1997 an article where Mahathir Mohamad, the Malaysia Prime Minister, calls the big international investor George Soros "a moron". He also received space in the media due to his statement in Hong Kong during the World Bank 1997 annual meeting that currency trading was "unnecessary, unproductive and immoral", and his repeated threats to outlaw foreign exchange dealings in Malaysia. His opinion expresses the disgust with the movement of the international capital that goes easily from one country to another provoking serious problems to developing economies, like Malaysia.

Relate to capital flight, there is, in our opinion, a logical economic assumption that has to be considered. In the case of substantial outflow movement, we have a concentration of demand for exchange currency and consequently unexpected supply of domestic currency at the same level determining a devaluation of the exchange rate.

The devaluation tends to attract other investors who are influenced by the idea that the domestic currency can not return to the old equilibrium price. Under this belief are only two possibilities for the domestic currency: stays in its new price consolidating the primary losses for foreigner investors or increases its devaluation, which represents the worst scenario for investors, whose capital decreases indirectly in their currency.

At this moment, to maintain their investments in one country, foreign investors' confidence in its economy has to be strong and supported by really trusting figures, especially those that signalize the behavior in short and medium-run terms. The tendency is to put their money abroad running quickly away from the increased risk to have their assets reduced not only by the normal forces of the market but also by political measures, in order to restrict outward movements of capital, for instance.

Consequently, the important point is that when the money is coming into the borrowing country it provokes a demand for domestic currency overevaluating it and reducing the international competitiveness of that country's economy, negatively affecting the export performance. As a consequence, the host country becomes dependent from that capital.

When a concentrated outflow movement takes place, the country is suddenly put in a dependence of money from exports, which responds slower than capital does, provoking tightening of exchange controls, defaults, losing of international creditworthiness, capital flight, and other economic structural problems.

III.1 – International Literature

Cuddington presents the following macroeconomic determinants of capital flight:

- Exchange rate overvaluation, and hence the expectation of major exchange rate realignment;
- High interest rates in the US acting as a 'magnet' for foreign capital; and
- The disbursement of new loans to LDCs.

The first determinant we discussed above extensively. About the second one, it seems easy to agree that since investors seek high profit and low risk, the increases in interest rates paid by US Bonds, that is a reference of low credit risk paper in international markets, tends to deviate the money to American financial market.

Regarding the third factor, as supported by other authors as well, would be the major or, at least, a prerequisite for capital flight because new loans increase the availability of foreign exchange needed to effect capital outflows. This kind of relationship between increases in indebtedness and in capital flight is called Asymmetric Risk.

About this third point, Varman-Schneider [1991] asserts that "interest in asymmetric risk associated with developing countries was stimulated when capital-importing countries experienced an asymmetric

development in the net foreign asset positions of the public and private sectors. The public sector in capital-importing countries increased its net foreign liabilities by \$ 534 billion during 1971-84, while at the same time the private sector strengthened its net foreign asset position by \$ 161 billion".

Varman-Schneider continues: "It is generally believed that domestic investors were aware of differences in risks involved in investing at home and abroad". As we can conclude, the asymmetry of risk is in the fact that the more the risk of the country the less the risk of the investors who put their money abroad

Under this opinion, there is an assumption that a dual and contrary movement is necessary to support capital flight movements for a long term. One carrying capital into the country (as a consequence of a public-sector borrowing for example) and other outward supported by the previous borrowing. This idea makes sense with the fact that in general, credits from international organization like IMF are taken just to permit one country to meet their financial compromises.

Interestingly, Mahon, Jr [1996] begins his book with the following observations about the Mexican crises during the 1980s and at the end of 1994:

"When Jesús Silva Herzog flew to Washington in August 1982 and explained that Mexico could not meet its impending debt obligations, the immediate cause of his predicament was a rapid and massive capital outflow. A few years later, in November 1985, the minister again faced a crippling flight of capital. During negotiations over debt rescheduling two months afterward, foreign bankers confronted him with the question, **"How can you ask us to help you when you can't even get your own nationals to keep their money in Mexico?"**"

In addition, Mahon, Jr [1996] continues describing other step of Mexico's economy history which completes an interesting panel about the behavior of the residents in order to reduce their risks of losses: A decade later, in the midst of another financial crisis, the head of Mexico's umbrella group for big business lamented that Mexican nationals were moving their capital out of the country much more quickly than were foreign investors.

Otherwise, nowadays, with the high degree of capital's mobility, it is very difficult to identify who is the owner of the capital circulating around the world. Mexicans and other Latin American country residents whose countries presented huge amount of capital flight during the 1980s are supposed to have great fortune looking for high profit and low risk in the international market.

Therefore, the central banks and other institutions involved with balance of payments analyzes in all the nations can not affirm consistently which capital comprises the outflow movements. This kind of difficult is deeper in open economies with intense relationship in the international financial community.

For Glyn [1986], quoted by Varmon-Schneider, capital flight occurs when foreign creditors pull their capital out from a country whenever there is a danger of political and economic instability that could lead to the imposition of exchange controls. Domestic residents in general have less to lose than foreigners from the introduction of exchange restrictions.

In conclusion of this part, we present a list of vicious raised by Varman-Schneider [1991], which commonly characterize the political relationship in developing economies and contribute to capital flight:

- The structure of political institutions in many developing countries (giving rise to many sources of distortion and instability in the economy);
- The influence of political institutions on economic institutions;
- In many developing countries long-term objectives are forsaken for short-term objectives (with important implications for the investment climate in the country);
- Policy announcements of the government commonly is not credible by the market;
- The absence of adequate measures of checks and balances (dictatorial regimes);
- Frequent changes in government regimes (each regime adheres to its own ideology);
- Central banks in developing countries should avoid excessive accumulation of foreign exchange reserves (it amounts to a poor country lending abroad and deprives the country of reserves for domestic investment. Moreover, there is the

- danger that it signals or actually supports a disequilibrium exchange);
- Overvalued exchange rates in turn motivate capital flight since they lead anticipations of a depreciation in the exchange rate and residents transfer assets abroad when the transactions are still favorable to them

III.2 – The Brazilian Case

As we have noted before, Brazil is mentioned by many authors as an example of developing country with low capital flight. Therefore, the material explaining the reasons for capital flight in Brazil provided by the economic literature is not sufficiently rich. In general, the specialists in capital flight have preferred to concentrate their studies in our neighbors Mexico and Argentina. As a result, studies concerning capital flight from Brazil, generally, emphasizes discussions over the amounts instead of on its determinants.

Accordingly, the following opinions exemplify our position above. We begin with Lessard and Williamson:

"... among Latin American countries, at least, there is an exact correspondence between the countries that had no exchange control at the turn of the decade [1980] and those that suffered capital flight on a massive scale. Argentina, Mexico, Uruguay, and Venezuela all experienced massive outflows; in all of them the outflows were perfectly legal. In contrast, outflows were relatively modest from Brazil, Chile, Colombia, and Peru, all of which maintained restrictions."

Mahon, Jr [1996], who makes a study concerning mobile capital and development in Latin American, compares the capital flight phenomena in Argentina, Mexico, Venezuela, Brazil, Chile e Colombia and concludes that the different behavior in this six countries during the 1980s can be explained by their different exchange policies.

In the case of Brazil, he suggests that capital flight is related to overevaluated exchange rate, in order to stimulate exports, and to its exchange control regime, especially on capital flow. Also in this case, however, some determinants are examined by the reversal in order to explain why the amounts of capital flight in Brazil's case differ from the other countries in the study.

Mahon, Jr, who understand the low level of capital flight in Brazil was due to the government intervention (see quotation related to footnote number 4), presents the question "So what accounts for the difference among the six countries considered here?" and answers:

"The short answer is: the presence of exchange policies that were originally designed to promote exports and to attenuate destabilizing capital flows. Import-substituting industrialization had a bias toward currency overvaluation that hurt exports and tended to keep them confined to those best established followed depreciation. It also featured exchange control (especially on capital account), justified as a way to reduce market volatility and stabilize the incentives to new exporters".

On the other hand, Nembhard points out high inflation and economic instability as cause of capital flight in Brazil. But she also emphasizes that Brazil presents low level of capital flight in consequence of the effectiveness of governmental intervention in the economy with capital control being one of the instruments to accomplish the general intervention.

Her following opinions stresses her position in favor of controls and demonstrates that also in this case the causes of capital flight in Brazil are analyzed incidentally: :

"Both South Korea and Brazil have reputations for having relatively low levels of capital flight, particularly before the 1980s. In the capital flight literature, of countries with foreign debt and relatively large economies (and for Brazil high inflation), estimates for South Korea and Brazil are typically among the lowest.

Brazil's capital flight estimates generally support this author's thesis that a functioning set of government intervention policies (a government intervention triad) which uses capital controls can help to curb capital flight. For example, Brazilian capital flight increased significantly in the 1980s when the government intervention triad began to break down.

published by the Brazilian newspaper "Folha de Sao Paulo", Roberto Campos, a former Brazilian Minister of Finance, presents as the main reason for Brazilian classifications the constants failures by the Brazilian government in meeting the obligations, both domestic and international.

IV ANSWERING THE QUESTION

Among the authors we have researched, only Nembhard supports the clear position in favor of exchange controls, in line with other macroeconomic goals, as a way to avoid capital flight. The others in general remark of the negative consequences of exchange control, mainly through illegal operations and corruption, and do not see the exchange control as a solution to retain money inside the countries.

Even Nembhard, however, recognizes that the general economic instability, high levels of inflation, and uncertainty in the exchange rate in the 1980s in Brazil thwarted its ability to adequately control capital flight (which had managed to do in the previous decades). Such high levels of economic instability are believed to be so disruptive that they render capital controls useless. Moreover, this author mentions that "both the economic conditions that may encourage capital flight and capital flight itself increased or worsened in the 1980s in part because of the lack of consistency and coordination of Brazil's capital control system, and because Brazil's intervention triad in general was weakened".

In fact, although not agreeing with the general understanding that takes capital flight as a response to economic conditions, we can imply from the Nembhard's opinion that the validity of capital controls is a dependent variable of macroeconomic conditions. She affirms that exchange controls themselves do not work well if the governmental intervention does not produce good economic conditions in order to stimulate the maintenance of the capital inside the country. In other words, her position would be in accordance with the majority if there was not an ideological vies suggesting that policymakers can avoid economic problems.

Sometimes we can see questions like the following, presented by Bhagwati, that reflects partial effectiveness in exchange controls: "Whether, of course, such flight is still below the level that would occur in the absence of exchange control is an issue that is difficult to settle empirically. We would be inclined to assume that the extra costs of illegal methods of capital outflow tend to reduce its level". This kind of interrogation does not mean, off course, agreement with control policies insofar as the author presents a lot of negative consequences of exchange controls.

On the other hand, we can imply from the various opinions a common sense about "hot-money" which does not create roots in one country and can go out with exchange control or not. Eventually, countries try to avoid huge inflow of this kind of money via taxation or exchange barriers like compulsory deposit, as a classical example of Chile at the beginning of this decade and Brazil, during the Real Plan.

In Chile, at the beginning of this decade, financial authorities imposed a compulsory deposit of 20% over all inflows to the Chilean capital market to reduce the risk of the "hot" money that is invested within the country to profit upon the difference of interest rates. Accordingly that, between August, 1995 and June, 1997, Brazil charged with aliquots of IOF, varying between zero and 7% (discounted from the principal value at the moment of entrance, as a toll), many sort of capital inflows. The aliquot decreased in accordance with increases in maturity.

That kind of attitude were attempts to reduce the amount of money that, conversely, can also run quickly out from one country in a concentrated outflow movement causing macroeconomic problem. That kind of phenomenon was faced by many Asian countries, in particular Thailand, Malaysia, South Korea (that is receiving a financial support from IMF near US\$ 50 billions as circulated in various newspapers). In the same domino's effect, Hong Kong and Brazil were affected as well.

Therefore, authors like Basevi [1985], quoted by Nembhard, suggests that in a world of flexible money and financial markets, and rigid labor and product markets, overshooting reactions of the exchange and interest rates imply that "free trade and perfect capital mobility are a second best solution". He proposes that "efficient international capital markets and freedom of choice in the international allocation of investment are consistent with – and indeed may require – taxation of international capital movements in order to be conducive to the most efficient overall functioning of an economy".

Despite the complexity of this matter to be discussed in this paper, the idea makes sense with the existence of the International Monetary Fund as an organism involved with stabilizing currencies and economies in general. Since the IMF has been expected to act like a world central bank, helping countries with financial problems due to capital flight as well as do central banks with their banks, it [or other similar organism under a new framework] should have to have certain power over international capital mobility. Indeed, as one central bank establish domestic rules to orient its financial market, in order to avoid bankruptcy, we imply we should have international rules with the same purpose concerning countries in this era of total globalization.

About Brazil, we note that the amounts of capital flight presented in the tables included in third chapter occurred under rigid exchange control regimes, i.e. in the case of Brazil the exchange controls did not prevent capital flight. Every time the economic conditions were not able to generate confidence about its future, the capital went away despite the controls.

Moreover, we can imply that the Brazilian authorities had the same opinion at the end of 1980s insofar as we note that, officially, the Floating Market was created in order to, among other important reasons (as to reduce the Parallel Market, for instance), to bring back resident's money invested abroad.

A common feature in all studies is the acceptance that capital flight is a response to an unstable and uncertain political and/or economical environment. There are fears and suspicions. Instability and uncertainty could arise due to domestic macroeconomic policies, deterioration in the external climate, and/or exogenous political shocks. It is motivated by a desire to avoid domestic financial market.

The conclusion, therefore, is that capital flight is a response to increases in country risk, affecting both international and domestic capital. The form that international investors and part of the residents use to put their money abroad when the sensation of financial crisis take over the minds can vary from country to country in accordance with the level of controls that is adopted. The more tightened and strict is the control the more is the possibility of illegal transactions.

In conclusion, one important lesson we have to take from the large cases of capital flight since the beginning of the 1980's is that one economy can not be evaluated correctly during the affects of this phenomenon. The movement of capital in specifically concentrated periods of time is more an indicative of the sensibility of investors to short-term problems as well as the facility of transferring money across the world. The capital investors who work arbitrating interest rates and speculating in stock markets and the newspaper headlines taking advantage of their decisions are not the better way to analyze the perspective of one economy in long-terms.

CONSIDERATIONS ABOUT EXCHANGE CONTROLS, CAPITAL FLIGHT AND COUNTRY RISK

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