Barriers and Opportunities For Enhancing Capital Flows In the COMCEC Member Countries

COMCEC COORDINATION OFFICE
December 2013

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Acronyms

AREAER	Annual Report on Exchange Arrangements and Exchange Restrictions
BER	Business Environment Rankings
COMCEC	Standing Committee for Economic and Commercial Cooperation of the OIC
EU	European Union
FDI	Foreign Direct Investment
FPI	Foreign Portfolio Investment
GBI-EM	Government Bond Index – Emerging Markets
GCC	Gulf Cooperation Council
HIC	High-Income Country
IFI	International Financial Institution
IFRS	International financial reporting standards
IFZ	Industrial free zone
IIF	Institute of International Finance
IMF	International Monetary Fund
IPO	Initial public offering
LCD	Least developed country
LIC	Low-income country
LMIC	Lower-middle income country
MENA	Middle East and North Africa
MIC	Middle-income country
MSCI	Morgan Stanley Capital International
NBFC	Non-banking financial company
ODA	Official Development Assistance
OECD	Organisation for Economic Development and Co-operation
OIC	Organisation of Islamic Cooperation
PLC	Public limited company
QE	Quantitative easing
RRDC	Resource-rich developing country
SEC	Securities and Exchange Commission
SEZ	Special Economic Zone
SME	Small and medium-sized enterprises
SSA	Sub-Saharan Africa
UMIC	Upper-middle income country

INTRODUCTION

Increasing international capital flows can support long-term income growth through a better international allocation of savings and investments, allowing developing countries to run current account deficits. At the same time, however, managing them can be challenging, especially for small, open economies that are vulnerable to the negative effects that can arise from financial or monetary shocks in investor countries.

The Standing Committee for Economic and Commercial Cooperation of the Organization of the Islamic Cooperation (COMCEC) views strong and stable capital flows as a key contributor to economic development, and aims to achieve enhanced access to capital at competitive rates, diversified portfolios and increased investment opportunities amongst the Member States. As part of its mandate on financial cooperation, COMCEC wishes to promote the removal of institutional and regulatory barriers in order to further enhance capital flows both to the COMCEC Member Countries and between them.

In order to better understand the challenges which COMCEC Member States face in enhancing capital flows further, the COMCEC Coordination Office commissioned the Economist Intelligence Unit (EIU) to conduct a review of capital flow trends in the COMCEC countries, the barriers and opportunities affecting them in attracting financial capital flows in particular, and alignment of the COMCEC Member Countries with international frameworks on capital account liberalisation. The review includes conclusions and recommendations on the policies required to enhance capital flows, with examples of key actions that the COMCEC Member Countries have taken in this area.

DEFINITIONS

A capital flow arises through the transfer of ownership of a financial asset from one country to another. These assets are typically equity and debt instruments. These flows are recorded as inward or outward. Inward flows are non-residents investing in a country, for example a US investor buying an Indonesian company. Outflows measure the purchases of foreign assets by residents of the country.

Defining capital flows: not a straightforward task

Analysis of capital flows data is difficult when relying on different data sources, because data is often analysed using a range of closely related, yet different concepts. The Institute of International Finance (IIF) and the International Monetary Fund (IMF) are two of the best-known data sources for capital flows, yet their definitions differ in certain cases:

-- IIF data on foreign direct investment (FDI) excludes intercompany loans, since the IIF considers these to be debt rather than equity flows.

-- Flows by banks – which appear in a single category in the IIF dataset as '"Commercial Banks"' – are split into two categories in the IMF dataset: '"Portfolio Debt"' for banks' bond purchases and '"Other Debt Instruments"' for bank loans.
-- The IMF dataset has a statistical break from 2005-08, resulting from methodological changes implemented in 2012.

-- The IIF and IMF also differ in their treatment of countries. For example, South Korea is included in the IIF's sample of emerging markets but not part of the IMF's.

The focus of this study is on capital inflows, which are typically split into the following types:

Private inflows

- Foreign direct investment (FDI) – usually undertaken with the intention of making a greenfield investment, or new investment in a physical company-related structure where no previous facilities existed
- Portfolio equity – purchasing stocks in an enterprise, with no degree of managerial control
- Bond issuance – flows from non-bank sources into bond markets (bonds issued by companies or governments)
- Cross-border bank lending – lending from commercial banks, usually including bond purchases by commercial banks

Official inflows

- International financial institutional lending – loans from organisations such as the IMF, World Bank or regional development banks. These are often extended on concessional terms either through interest rates below those available on the market or by long grace periods, or a combination of these
- Bilateral lending – financing from bilateral creditors e.g. government-to-government loans

GROUPS

The 57 Member States of the Organisation of Islamic Cooperation have been analysed in this study according to particular groupings. The main grouping used is that applied by the World Bank, which divides countries into four income groups – the low-income group, lower-middle income group, upper-middle income group and high-income group – based on gross national income (GNI) per capita.

For the purposes of this study, the Member States were analysed according to their World Bank income grouping for the following sections of the study:

- Trends and current state of play with respect to capital flows
- Barriers to and opportunities for enhancing capital flows
- Conclusions and options for enhancing capital flows

A more in-depth review of the regulatory, legal and institutional frameworks, key stakeholders governing capital flows and the alignment of countries' practices with certain established international frameworks on capital account liberalisation was undertaken for eight COMCEC Member States. In order to provide a balanced perspective, the countries were selected to cut across the four World Bank income groups as evenly as possible, and across the OIC's three official regional groups: the Arab Group, Asian Group and African Group. Countries were selected through consultation with the EIU's regional directors and selection criteria were based upon the countries' relative success to date in attracting capital flows and the degree to which relevant institutions and regulations have been established.

The following eight COMCEC Member States are covered in more depth in this study. They are also indicated in the table below:

- Bahrain
- Bangladesh
- Indonesia
- Malaysia
- Mozambique
- Nigeria
- Turkey
- United Arab Emirates

World Bank income group	Countries
Low-income group US$1,035 or less	Afghanistan, **Bangladesh (Asia)**, Benin, Burkina Faso, Chad, Comoros, The Gambia, Guinea, Guinea Bissau, Kyrgyz Republic, Mali, **Mozambique (Africa)**, Niger, Sierra Leone, Somalia, Tajikistan, Togo, Uganda
Lower-middle income group US$1,036 to US$4,085	Cameroon, Côte d'Ivoire, Djibouti, Egypt, Guyana, **Indonesia (Asia)**, Mauritania, Morocco, **Nigeria (Africa)**, Pakistan, Senegal, Sudan, Syria, Uzbekistan, Yemen
Upper-middle income group US$4,086 to US$12,615	Albania, Algeria, Azerbaijan, Gabon, Islamic Republic of Iran, Iraq, Jordan, Kazakhstan, Lebanon, Libya, **Malaysia**, Maldives, Suriname, Tunisia, **Turkey (Asia)**, Turkmenistan
High-income group US$12,616 or more	**Bahrain**, Brunei Darussalam, Kuwait, Oman, Qatar, Saudi Arabia (Arab), **United Arab Emirates (Arab)**

METHODOLOGY

The study was undertaken using a desk review of relevant literature on capital flows, in-depth research by EIU country analysts for the country-specific sections using EIU data, external sources and their detailed knowledge of the country, and a series of stakeholder interviews (telephone and face-to-face) with the following officials, who we would like to thank for their participation:

- Marwan Barakat, chief economist, Banque Audi
- Margareta Drzeniek, director and senior economist, Global Competitiveness Network, World Economic Forum
- Harald Finger, deputy division chief, International Monetary Fund (IMF)
- Masataka Fujita, head, Investment Trends and Issues Branch, Division on Investment and Enterprise, United Nations Conference on Trade and Development (UNCTAD)
- Elena Ianchovichina, lead economist, Office of the Chief Economist, MENA, World Bank
- Kalman Kalotay, economic affairs officer, Division on Investment and Enterprise, United Nations Conference on Trade and Development (UNCTAD)
- Steve Kayizzi-Mugerwa, director, Research Department, African Development Bank (AfDB)
- Raja Teh, advisor on Islamic finance and banking, World Islamic Economic Forum

1 – CAPITAL FLOW TRENDS IN THE COMCEC MEMBER COUNTRIES

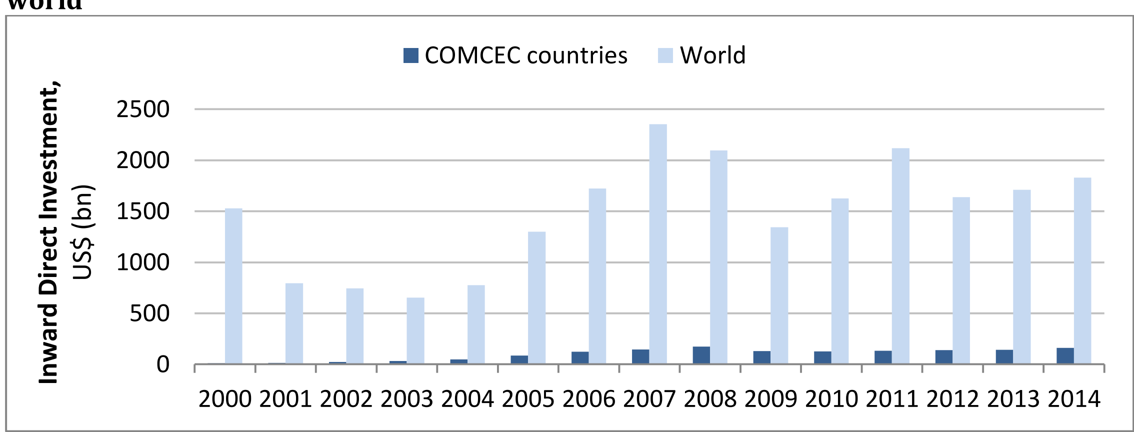
A volatile decade for global capital flows

Capital flows have increased markedly on a global level since the early part of the last decade. According to the *World Economic Outlook* published by the International Monetary Fund (IMF), net private capital flows to 143 emerging markets and five small open economies rose to $600bn in 2007, from $90bn in 2002. For its part, the Institute of International Finance (IIF), whose definition of capital flows differs slightly from that of the IMF, estimated that in 2007 the figure was around $780bn.

However, the unprecedented levels of private capital flows to developing countries that were seen during that time came to an abrupt halt in the second half of 2008 as capital markets seized up following the collapse of Lehman Brothers, a large US investment bank, and the world economy went into recession. Some of the portfolio capital flowed back to the major industrial countries that had been at the epicentre of the crisis in the first place. IMF data shows that the drop in net inflows to emerging economies in the second half of 2008 was accompanied by a rise in net inflows to advanced economies[1].

As for the share of capital inflows to the COMCEC Member Countries relative to global capital inflows, this has remained relatively small over the last decade or so. Figure 1.1 below shows how inward direct investment on a global level dropped off in 2009 after the global economic recession, rising strongly until 2011, when in 2012 it decreased once again.

Figure 1.1 Inward direct investments to the COMCEC Member Countries relative to the world

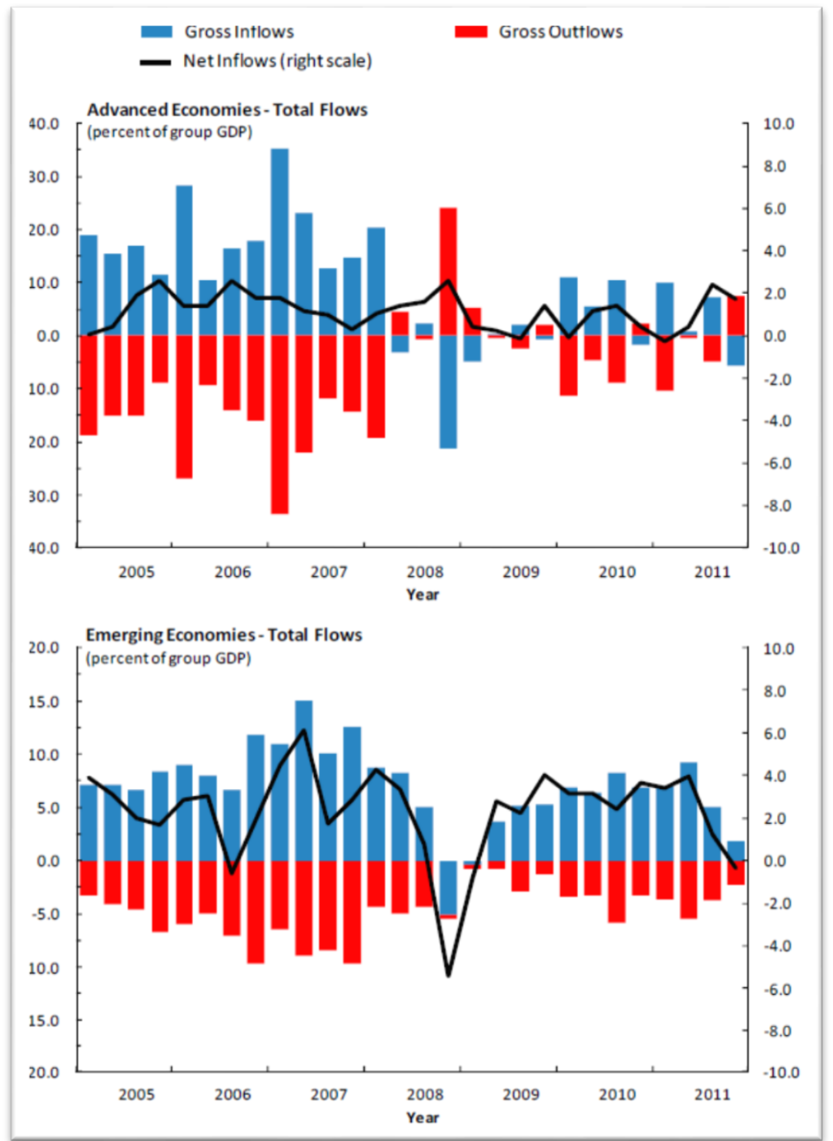


Source: EIU Country Data

Note: No global figure available for inward portfolio investment and medium and long term debt flows. COMCEC aggregate excludes Afghanistan, Brunei, Guinea-Bissau, Maldives, Somalia, Suriname, and Uzbekistan.

[1] Bluedorn, Duttagupta, Guajardo and Topalova, 'Capital Flows are Fickle: Anywhere, Anytime' August 2013, IMF Working Paper

Figure 1.2 The evolution of total gross and net capital flows



Source: 'Capital Flows are Fickle: Anytime, Anywhere', IMF, August 2013

Tentative recovery in capital flows to developing economies began in the spring of 2009 as monetary easing by key central banks in developed countries stabilised capital markets and a massive stimulus programme by the Chinese authorities began to drive recovery in global GDP. Yet while net private capital flows to developing countries grew to $950bn in 2010, they remained well below the pre-crisis peak levels reached in 2007, by approximately $300 billion[2]. Risk appetite remained fragile in the aftermath of the global financial crisis. Capital

[2] UN, 'World Economic Situation and Prospects 2011'
http://www.un.org/en/development/desa/policy/wesp/wesp_current/2011wespupdate.pdf

inflows to developing countries suffered another reversal as the European debt crisis worsened and global economic markets deteriorated sharply in the third quarter of that year.

Since 2011, however, private capital flows to developing countries have strengthened. This strong performance has taken place against a backdrop of a more favourable macroeconomic environment. More specifically:

- Growth prospects among emerging market economies – in particular those in Asia and Latin America – although lower than during the boom years, remain much brighter than those in the developed world.

- A drop in risk aversion in financial markets in the latter part of 2012, as the European Central Bank's Outright Monetary Transactions programme reduced the tail risk of a break-up of the euro zone, has led to strong rises in global stock markets and narrowing of risk spreads.

- Monetary conditions in developed economies have been extraordinarily easy, with the increase in the US money supply stemming from the US Federal Reserve's quantitative easing (QE) programme driving capital flows to emerging markets.[3]

Despite positive developments in private capital flows to developing countries, foreign direct investment (FDI) inflows fell 18% to $1.35trn in 2012, amid fragile economic conditions and policy uncertainty across the globe. Much of this drop-off was experienced in developed countries – for example Europe as a whole saw a 42% reduction in FDI in 2012 from the previous year, with Germany experiencing an 85% decrease from the previous year. Nevertheless, developing countries attracted more FDI than developed countries for the first time in 2012, accounting for 52% of global FDI flows. At the same time, developing countries have become a growing source of FDI outflows, accounting for a third of global FDI outflows in 2012[4].

During the last decade and a half there has been a shift in the composition of international debt flows. Not least, bond issuance and bank lending to developing countries have shifted since the global financial crisis. Some developing countries did not have access to foreign-currency bond markets and were therefore dependent upon bank lending for foreign-currency loans (many of them did not fulfil the institutional and legal requirements to issue international bonds); now, banks have tightened lending, while increased global liquidity, better growth prospects and stronger balance sheets have made the bond market more receptive to issues from emerging markets. Bond issuance now accounts for over half of debt flows to developing countries, compared to less than a third between 2005 and 2008. As countries including Bangladesh, Mozambique and Nigeria issue international bonds for the first time, experts believe this shift will continue for the foreseeable future.[5]

[3] "Capital Flows to Emerging Market Economies", Bank of International Settlements (BIS), January 2013
[4] *World Investment Report 2013,* UNCTAD
[5] World Bank blog, Dilek Aykut, March 2013, 'The changing landscape of international debt flows: rising bond issuance amid declining bank lending'

Although capital inflows to developing economies have been buoyant for much of the past decade, the short-term outlook for capital flows globally is uncertain. One of the key drivers of capital inflows in recent years – extraordinarily loose monetary policy in mature Western economies that "pushed" money into emerging markets – is likely to be reined in, albeit very gradually.[6] Emerging economies such as Brazil, India and Russia are growing much more slowly than expected and also face a number of specific policy challenges to achieve higher sustained growth, underscoring a need to undertake structural reforms if they are to fulfil their potential. This need to respond to policy challenges also applies to the COMCEC Member Countries in political transition and the fragile states that form a significant proportion of the COMCEC membership.

The combination of an uncertain global environment and the prospect of increased US bond yields as monetary stimulus is reined in suggest that inflows from private creditors (including banks) may suffer markedly. According to the IIF's June 2013 note on capital flows to emerging market economies,[7] a number of global trends may emerge in the short term, including:

- Portfolio equity flows may fall sharply in the remainder of 2013 on the back of revised growth expectations, possibly recovering in 2014;
- FDI inflows to emerging economies may continue falling in absolute terms, with 2014 inflows approximately 6% below the 2012 level, and Africa and the Middle East experiencing more buoyant capital flows than emerging Asian countries.

1.1. CAPITAL INFLOWS TO THE COMCEC MEMBER COUNTRIES – AN OVERVIEW

Table 1.1 provides a ranking of the 57 COMCEC Member Countries according to their 2010-12 capital inflows average, using proprietary data from the EIU. Total capital inflows comprise inward direct investment, inward portfolio investment and medium and long-term debt inflows and exclude IMF credit. Medium and long-term debt inflows are commercial bank loans, international bond issuance and officially guaranteed loans, defined as loans from official or private lenders to the public sector, or loans to the private sector guaranteed by the public sector.

Table 1.2 provides a similar ranking of the COMCEC Countries, divided into the four country income groups according to World Bank classifications based on 2012 gross national income per capita data.[8]

[6] Note previous cycles of US monetary tightening have contributed to emerging market crises, such as the Mexican tequila crisis of 1994

[7] "Capital flows to emerging market economies", *Research Note*, Institute of International Finance (IIF), June 2013

[8] Economies are divided according to 2012 GNI per capita, calculated using the World Bank Atlas method. The groups are: low income, US$1,035 or less; lower middle income, US$1,036 - US$4,085; upper middle income, US$4,086 - US$12,615; and high income, US$12,616 or more. Source: http://data.worldbank.org/about/country-classifications

Table 1.1: COMCEC Member Countries ranked by capital inflows (excluding IMF credit), and corresponding GDP per head

All Countries	2010-2012 Average	2012
	CAPITAL INFLOWS excluding IMF credit	GDP per head
	$ bn	$
1 Turkey	87.14	10,560
2 Indonesia	62.47	3,540
3 Kazakhstan	57.09	11,854
4 Saudi Arabia	33.89	24,600
5 Malaysia	31.46	10,387
6 Qatar	28.12	104,756
7 United Arab Emirates	25.73	51,330
8 Nigeria	15.72	1,540
9 Morocco	7.30	2,950
10 Kuwait	6.68	46,580
11 Lebanon	6.31	10,540
12 Egypt	6.14	3,150
13 Bahrain	4.91	24,310
14 Pakistan	4.58	1,250
15 Iran	4.46	6,000
16 Tunisia	4.11	4,150
17 Azerbaijan	3.40	7,442
18 Iraq	3.36	6,190
19 Mozambique	3.32	565
20 Syria	3.00	2,190
21 Bangladesh	2.75	758
22 Sudan	2.49	1,430
23 Jordan	2.43	4,600
24 Algeria	2.30	5,660
25 Oman	2.15	21,590
26 Albania	1.98	3,971
27 Turkmenistan	1.80	4,840
28 Chad	1.69	882
29 Libya	1.60	13,320
30 Uganda	1.57	596
31 Guyana	1.33	3,760
32 Uzbekistan	1.32	1,720
33 Cote d'Ivoire	1.25	1,200
34 Kyrgyz Republic	1.19	1,190
35 Gabon	1.10	10,250
36 Niger	0.99	356
37 Senegal	0.87	958
38 Guinea	0.82	522
39 Cameroon	0.78	1,220
40 Tajikistan	0.71	959
41 Sierra Leone	0.65	637
42 Mali	0.62	659
43 Burkina Faso	0.30	664
44 Yemen	0.23	1,540
45 Benin	0.21	792
46 Palestine	0.18	2,404
47 Mauritania	0.17	848
48 Togo	0.17	499
49 Djibouti	0.12	1,570
50 Gambia	0.10	596
51 Comoros	0.01	797
52 Afghanistan	n/a	n/a
53 Brunei	n/a	39,450
54 Guinea-Bissau	n/a	534
55 Maldives	n/a	n/a
56 Somalia	n/a	n/a
57 Suriname	n/a	8,980

Source: EIU Country Data

Table 1.2 COMCEC Member Countries ranked by capital inflows (excluding IMF credit), and corresponding GDP per head - by income group

By Income Group		2010-2012 Average CAPITAL INFLOWS excluding IMF credit ($ bn)	2012 GDP per head ($)
Low Income Group	1 Mozambique	3.32	565
	2 Bangladesh	2.75	758
	3 Chad	1.69	882
	4 Uganda	1.57	596
	5 Kyrgyz Republic	1.19	1,190
	6 Niger	0.99	356
	7 Guinea	0.82	522
	8 Tajikistan	0.71	959
	9 Sierra Leone	0.65	637
	10 Mali	0.62	659
	11 Burkina Faso	0.30	664
	12 Benin	0.21	792
	13 Gambia	0.10	596
	14 Comoros	0.01	797
	15 Afghanistan	n/a	n/a
	16 Guinea-Bissau	n/a	534
	17 Somalia	n/a	n/a
Low Middle Income Group	1 Indonesia	62.47	3,540
	2 Nigeria	15.72	1,540
	3 Morocco	7.30	2,950
	4 Egypt	6.14	3,150
	5 Pakistan	4.58	1,250
	6 Syria	3.00	2,190
	7 Sudan	2.49	1,430
	8 Guyana	1.33	3,760
	9 Uzbekistan	1.32	1,720
	10 Cote d'Ivoire	1.25	1,200
	11 Senegal	0.87	958
	12 Cameroon	0.78	1,220
	13 Yemen	0.23	1,540
	14 Mauritania	0.17	848
	15 Djibouti	0.12	1,570
Upper Middle Income Group	1 Turkey	87.14	10,560
	2 Kazakhstan	57.09	11,854
	3 Malaysia	31.46	10,387
	4 Lebanon	6.31	10,540
	5 Iran	4.46	6,000
	6 Tunisia	4.11	4,150
	7 Azerbaijan	3.40	7,442
	8 Iraq	3.36	6,190
	9 Jordan	2.43	4,600
	10 Algeria	2.30	5,660
	11 Albania	1.98	3,971
	12 Turkmenistan	1.80	4,840
	13 Libya	1.60	13,320
	14 Gabon	1.10	10,250
	15 Maldives	n/a	n/a
	16 Suriname	n/a	8,980
High Income Group	1 Saudi Arabia	33.89	24,600
	2 Qatar	28.12	104,756
	3 United Arab Emirates	25.73	51,330
	4 Kuwait	6.68	46,580
	5 Bahrain	4.91	24,310
	6 Oman	2.15	21,590
	7 Brunei	n/a	39,450

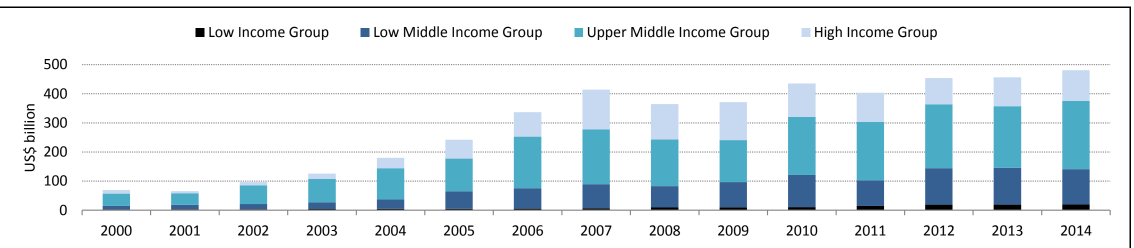
Source: EIU Country Data

Table 1.3 COMCEC Member Countries ranked by inward portfolio investment and by income group

By Income Group			2012 Inward portfolio investment (net of fc bonds) $ bn
Low Income Group	1	Bangladesh	0.21
	2	Burkina Faso	0.02
	3	Niger	0.01
	4	Benin	0.01
	5	Tajikistan	0.01
	6	Uganda	0.00
	7	Sierra Leone	0.00
	8	Mozambique	0.00
	9	Chad	0.00
	10	Comoros	0.00
	11	Gambia	0.00
	12	Guinea	0.00
	13	Kyrgyz Republic	0.00
	14	Mali	-0.24
	15	Afghanistan	n/a
	16	Guinea-Bissau	n/a
	17	Somalia	n/a
Low Middle Income Group	1	Indonesia	13.74
	2	Nigeria	12.07
	3	Syria	1.50
	4	Pakistan	0.81
	5	Morocco	0.17
	6	Cote d'Ivoire	0.16
	7	Cameroon	0.07
	8	Senegal	0.01
	9	Djibouti	0.00
	10	Uzbekistan	0.00
	11	Yemen	0.00
	12	Sudan	-0.01
	13	Egypt	-1.43
	14	Guyana	n/a
	15	Mauritania	n/a
Upper Middle Income Group	1	Turkey	33.84
	2	Malaysia	6.70
	3	Jordan	0.22
	4	Azerbaijan	0.02
	5	Albania	0.01
	6	Gabon	0.00
	7	Algeria	0.00
	8	Iran	0.00
	9	Libya	0.00
	10	Tunisia	-0.40
	11	Lebanon	-0.92
	12	Kazakhstan	-1.49
	13	Iraq	n/a
	14	Maldives	n/a
	15	Suriname	n/a
	16	Turkmenistan	n/a
High Income Group	1	United Arab Emirates	1.50
	2	Oman	1.37
	3	Bahrain	1.10
	4	Kuwait	0.84
	5	Qatar	0.52
	6	Saudi Arabia	0.21
	7	Brunei	n/a

Source: EIU Country Data

Figure 1.3: Share of capital inflows (excluding IMF credit) by income group, 2000-2014



Source: EIU Country Data

The bulk of capital inflows over the last decade have been to countries in the upper-middle income group (see Figure 1.3). Notable among the countries in this group is Turkey, which has been growing strongly and running large current-account deficits. The EIU expects Turkey to draw capital inflows of US$95.6bn in 2013, outstripping the US$86.6bn of capital inflows attracted by the top three countries in the high-income group – Saudi Arabia, Qatar and the UAE – combined.

Also notable among the upper-middle income countries is Kazakhstan, which received average capital inflows of US$17.7bn in 2008-12, equivalent to over 12% of GDP. FDI inflows alone averaged US$13.6bn during the period 2008-12, dominated by investment in energy and mining, sectors that require significant long-term capital commitments. According to official data, 22.9% of FDI in 2011 was directed to existing mining operations, while mineral exploration (largely oil) accounted for 37.8% of investments.

In third place in the upper-middle income group in terms of capital inflows is Malaysia. In 2012, Malaysia received just under US$30bn (US$29.7bn) in capital inflows – equalling the total combined capital inflows for the other nine countries within this group (US$29.6bn), illustrating that the other countries within this income group pale into significance when compared with the top three countries in attracting capital flows.

A comparative story

In 2012, Turkey was top in the COMCEC rankings, with net portfolio investments of US$36.5bn. Turkey and Malaysia are classified as upper-middle income economies by the World Bank; both these countries saw large capital inflows as a result of easier global liquidity conditions following the global financial crisis of 2008. Malaysia's focus on the development of financial markets in a phased manner has made it less vulnerable to the volatility in capital markets following the threat of tighter liquidity conditions looming ahead. Turkey, on the other hand, adopted a series of macro-prudential measures in 2010 to increase the resilience of the financial system to external shocks by increasing reserves; it also raised monetary policy effectiveness by introducing the separate management of domestic and foreign liquidity. The new monetary policy framework used weekly repo rates, interest rate corridors and other tools to manage credit, interest rates and liquidity. These measures have contributed further towards bolstering confidence in Turkey.

Figure 1.4: Composition of total capital inflows by income group, 2000-2014[9]

INCOME GROUP COMPOSITION

Low Income Group

M & LT debt inflows | Inward direct investment | Inward portfolio investment (net of fc bonds)

Low Middle Income Group

M & LT debt inflows | Inward direct investment | Inward portfolio investment (net of fc bonds)

Upper Middle Income Group

M & LT debt inflows | Inward direct investment | Inward portfolio investment (net of fc bonds)

High Income Group

M & LT debt inflows | Inward direct investment | Inward portfolio investment (net of fc bonds)

Source: EIU Country Data

1.2. TRENDS AMONG COUNTRY INCOME GROUPS

The COMCEC Member States in each of the four World Bank income groups form broadly homogeneous sets of countries, though with some differing characteristics, such as the level of natural resource endowment, level of political stability, or the development of the banking system. Least heterogeneous are the low-income and high-income groups, which have a large proportion of countries that are situated in the same geographical region and that share numerous socio-economic characteristics. For example, most nations in the low-income group are in Sub-Saharan Africa (SSA); all but one of the countries in the high-income group are hydrocarbon-exporting members of the Gulf Cooperation Council (GCC).

Low-Income Countries (LICs)[10]

Of the 17 countries in the low-income group, 13 are situated in SSA (the four that lie outside SSA are Afghanistan, Bangladesh, Kyrgyz Republic and Tajikistan). Compared with the other income groups, countries in the low-income group have tended to receive barely a fraction of global capital inflows (see Figure 1.3 and Figure 1.4).

Within SSA as a whole, it is possible to identify a number of notable trends in the last ten years that characterise the changing nature of private capital flows in the region:

- Inward FDI flows to SSA increased to about $37bn in 2011 from less than US$15bn in 2001, according to data from the United Nations Conference on Trade and

[9] Excludes IMF credit; includes EIU forecasts for 2013 and 2014

[10] Afghanistan, Bangladesh, Benin, Burkina Faso, Chad, Comoros, The Gambia, Guinea, Guinea Bissau, Kyrgyz Republic, Mali, Mozambique, Niger, Sierra Leone, Somalia, Tajikistan, Togo, Uganda

Development (UNCTAD), with following declines in 2009 and 2010 amid the global financial crisis. For the low-income group, inward FDI rose steadily even throughout the financial crisis, rising to $6.2bn in 2010 from $4.3bn in 2008 (it was middle-income countries in Sub-Saharan Africa that suffered the largest declines). In 2011, FDI inflows to SSA rebounded to close to the 2008 pre-crisis level.

- Amongst the LICs in SSA, Chad, Guinea and Mozambique were among the top five recipients of FDI inflows in 2011. The bulk of the FDI inflows to SSA are to natural-resource-rich developing countries (RRDCs),[11] a category that includes Chad, Guinea, and Mozambique. However, FDI flows to non-RRDCs have been growing faster than those to RRDCs, while the global economic turmoil that occurred in 2009-10 appears to have affected RRDCs more deeply. The precipitous decline in commodity prices in late 2008 and early 2009 may partly explain this.

Amongst the non-SSA countries within this income group, private capital inflows remain very low. As Figure 1.5 shows, three of the four non-SSA countries – Afghanistan, the Kyrgyz Republic and Tajiskistan – received less than $500m in FDI flows in 2012, a low amount relative to the rest of the group. Afghanistan sits within the top ten most aid-dependent countries in the world, based on average official development assistance (ODA) to GDP ratios for 2000-10 (36.9%), although it is projected to experience a significant drop in aid over the next few years. Despite relatively low levels of capital inflows, capital flows into Kyrgyzstan and Tajikistan recovered very quickly: in 2010, net capital inflows to these countries as a whole exceeded the 2004-07 average.[12] Kyrgyzstan was also one of four countries in the region that saw its portfolio investment liabilities increase in 2010.

In Bangladesh, capital flows are dominated by FDI. Recorded levels of portfolio investment, whether in equities or in debt, are somewhat low. Net portfolio inflows stood at US$240m and US$287m in fiscal years 2011/12 and 2012/13 respectively. Currently, total inflows are hovering just below the US$1bn mark. This increase (from $150m in the period 1998-2003) is largely a function of growing foreign involvement in manufacturing, energy and telecommunications. However, there is potential for Bangladesh to attract large greenfield foreign investments.

- Net bond flows[13] to SSA increased to US$7bn in 2007 from around US$2bn in 2001, but they turned negative in 2008 before rebounding to US$6bn in 2011. Levels have been buoyant in 2012 and 2013, according to the Overseas Development Institute (ODI)[14]. In September 2013, the Mozambique government agency EMATUM issued the country's first bond in international markets, apparently the only bond issuance among LICs in SSA.

[11] As defined in IMF (2012) Appendix 1
[12] E. Kurmanalieva, E. Vinokurov, "Trends in Post-Crisis Capital Flows in the CIS", *Euromoney Emerging Markets Handbook*, 2011
[13] Issues less redemptions
[14] "The changing nature of private capital flows to Sub-Saharan Africa", *Shockwatch Bulletin*, Overseas Development Institute, March 2013

- The more fragile states among the LIC economies, which form the bulk of this group,[15] may continue to rely heavily on ODA and FDI in the future. As shown in Figure 1.6, in both low-income and middle-income fragile states ODA forms a significant share – between 10% and 25% – of gross national income (GNI) and has been increasing since 2009. This is in stark contrast to non-fragile states (where ODA accounts for barely 5% of GDP) and is unlikely to decrease dramatically in the short to medium term[16].

Figure 1.5: FDI flows by range for the COMCEC Member Countries within the low-income group, 2012

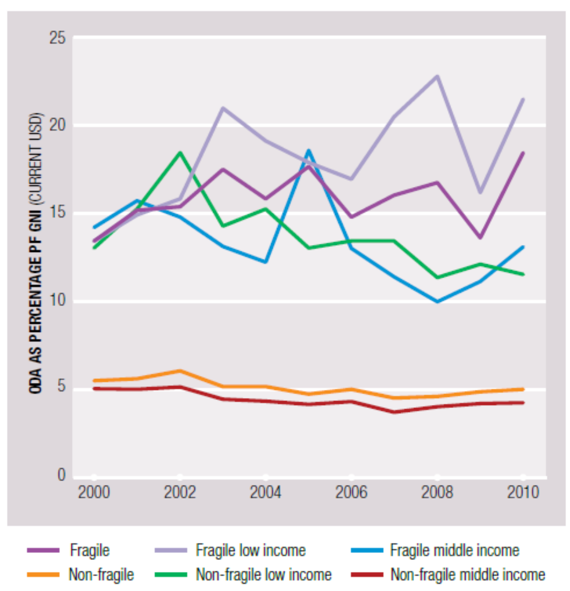
LIC (18)	FDI flows, 2012
Mozambique	>$3bn
Uganda	$1-1.9bn
Guinea	$0.5-0.9bn
Niger	$0.5-0.9bn
Sierra Leone	$0.5-0.9bn
Bangladesh	$0.1-0.9bn
Benin	$0.1-0.4bn
Chad	$0.1-0.4bn
Togo	$0.1-0.4bn
Kyrgyz	<0.5bn
Mali	$0.1-0.4bn
Somalia	$0.1-0.4bn
Tajikistan	<0.5bn
Afghanistan	<$0.1bn
Burkina Faso	<$0.1bn
Comoros	<$0.1bn
Gambia	<$0.1bn
Guinea Bissau	<$0.1bn

Source: UNCTAD World Investment Report 2013

[15] According to the OECD report "Fragile states 2013: Resource flows and trends in a shifting world", the following countries in the low-income group are defined as fragile states: Afghanistan, Bangladesh, Chad, Comoros, Guinea, Guinea-Bissau, Kyrgyz Republic, Niger, Sierra Leone, Somalia and Uganda

[16] "Fragile states 2013: Resource flows and trends in a shifting world", OECD, 2013

Figure 1.6: Aid dependency in fragile states - ODA as a percentage of GNI, 2000-10



Source: 'Fragile states 2013: Resource flows and trends in a shifting world', OECD, 2013

- In 2013 and 2014, the EIU believes capital inflows will remain composed of FDI and medium and long-term debt flows, a large proportion of which is likely to be officially guaranteed loans such as bilateral assistance.

Lower-Middle Income Countries (LMICs)[17]

Assuming FDI as a proxy, capital inflows to most countries in the lower-middle income group remain subdued; Indonesia stands out as a clear exception, attracting investment largely thanks to its vast mineral wealth, its major commodity export base and its large, young population (which totalled 250m in 2013). FDI has consistently formed a significant proportion of capital inflows since 2006, but the composition of capital flows into LMICs has begun to shift in the last decade, with portfolio investment and bond issuance growing in importance (see Figure 1.4).

[17] Cameroon, Côte d'Ivoire, Djibouti, Egypt, Guyana, Indonesia, Mauritania, Morocco, Nigeria, Pakistan, Senegal, Sudan, Syria, Uzbekistan, Yemen

Figure 1.7: Magnitude of FDI flows by range for COMCEC Member Countries within the lower-middle income group, 2012

LMIC (15)	FDI flows, 2012
Indonesia	$10-49bn
Nigeria	>$3bn
Uzbekistan	$1-4.9bn
Egypt	$2-2.9bn
Morocco	$2-2.9bn
Sudan	$2-2.9bn
Mauritania	$1-1.9bn
Yemen	<$1bn
Cameroon	$0.5-0.9bn
Guyana	$0.1-0.9bn
Pakistan	$0.1-0.9bn
Cote d'Ivoire	$0.1-0.4bn
Djibouti	$0.1-0.4bn
Senegal	$0.1-0.4bn
Syria	n/a

Source: UNCTAD World Investment Report 2013

The lower-middle income group, made up of Arab, African and Asian countries, is relatively heterogeneous. Nonetheless, a number of trends can be observed with respect to specific countries or sub-regions within this group:

- Capital flows into SSA have been more buoyant than those into the Middle East and North Africa (MENA) region. This is in part because SSA countries tend to be capital importers running current account deficits, while many of the MENA countries are capital exporters running large current account surpluses. Furthermore, SSA countries are in greater relative need of FDI to help develop their commodity resources.

- MENA capital flows continue to suffer from low investor confidence stemming from the "transition" effect visible since 2011. MENA countries within this group – Egypt, Morocco, Syria, and Yemen – have suffered significantly from uncertainties around domestic political developments. Private investment and confidence is being held back by political instability, while upcoming constitutional changes are resulting in a "wait and see" attitude among investors. Morocco remains promising among the MENA countries in this income group, managing the process of transition well[18] and taking steps to improve the investment climate and business environment. This has helped Morocco to attract flows that might otherwise have gone to Tunisia or Algeria.[19]

[18] A political reform process was initiated in March 2011. See for example the IMF Deauville Partnership Ministerial Meeting document, 'Arab Countries in Transition: Economic Outlook and Key Challenges', October 12, 2012
[19] Interview with Margareta Drzeniek, *Global Competitiveness*, World Economic Forum, September 10 2013

- Capital flows beyond FDI have become increasingly significant for the more-developed countries within SSA, such as Nigeria. The proportion of FDI to total private capital flows into SSA declined to 75% in 2011, from almost 100% in 2001. Furthermore, according to IIF data, portfolio inflows to Nigeria increased to US$11bn in the first three quarters of 2012, from US$3.8bn in the same period the year before.[20] Nigeria has good access to international debt markets and its stock market features in frontier market investment funds, which have been attracting growing interest in the past two years.

Upper-Middle Income Countries (UMICs)[21]

Similarly to the lower-middle income group, the upper-middle income group is a highly heterogeneous set of countries with widely differing characteristics with respect to political stability, natural resource endowment and macroeconomic and structural policies. However, some countries within this group share a number of common characteristics with respect to their capital flow situation, while others are emerging as success stories in attracting high levels of capital inflows. A number of trends are visible among countries in the upper-middle income group.

- Capital flows are subdued in the MENA countries in the upper-middle income group as they face spillover effects from unstable neighbours. These countries – Algeria, Iran, Iraq, Jordan, Lebanon, Libya and Tunisia – experienced weak growth in 2012 amid continued policy uncertainty, regional tensions, and other factors; they continue to face serious short-term risks. Lebanon and Tunisia have performed best at attracting capital inflows in 2013 (approximately US$5bn-6bn), although both have been dragged down by the Syria crisis and security concerns.

- Turkey is the leading COMCEC country in terms of capital inflows. According to EIU data, capital inflows to Turkey were over US$95bn in 2012, accounting for 45% of total capital inflows to the group. However FDI inflows to Turkey fell by 23% to $12.4bn in 2012, far below the $22bn recorded in 2007.[22] This is partly attributable to prolonged fiscal tightening in the EU, Turkey's largest market, which has dampened export-led FDI.[23]

[20] "The changing nature of private capital flows to Sub-Saharan Africa", *Shockwatch Bulletin*, Overseas Development Institute, March 2013
[21] Albania, Algeria, Azerbaijan, Gabon, Islamic Republic of Iran, Iraq, Jordan, Kazakhstan, Lebanon, Libya, Malaysia, Maldives, Suriname, Tunisia, Turkey, Turkmenistan
[22] *World Investment Report 2013,* UNCTAD
[23] "Capital flows to emerging market economies", *Research Note*, Institute of International Finance (IIF), June 2013

Figure 1.8: Magnitude of FDI flows by range for COMCEC Member Countries within the upper-middle income group, 2012

UMIC (16)	FDI flows, 2012
Malaysia	$10-49bn
Turkey	>$10bn
Iran	$1.0-9.9bn
Kazakhstan	>$5bn
Azerbaijan	$1-4.9bn
Iraq	$1-4.9bn
Jordan	$1-4.9bn
Lebanon	$1-4.9bn
Turkmenistan	$1-4.9bn
Algeria	$1-1.9bn
Tunisia	$1-1.9bn
Albania	$0.5-0.9bn
Gabon	$0.5-0.9bn
Maldives	$0.1-0.4bn
Suriname	<$0.1bn
Libya	

Source: UNCTAD World Investment Report 2013

High-Income Countries (HICs)[24]

All countries in the high-income group except Brunei belong to the GCC. These GCC economies are enjoying high economic growth on the back of historically high oil prices, expanded oil production, expansionary fiscal policies, and low interest rates. At the same time, however, the economies remain dependent on hydrocarbon extraction, while rising government spending has raised breakeven oil prices, implying heightened vulnerabilities. A number of patterns can be identified among countries in this group.

- The pattern of capital flows – particularly FDI – has been somewhat volatile over the past decade for GCC economies. For example, from 2000 to 2008 net investments by the GCC abroad were higher than net investments by foreigners in the GCC. As elsewhere, inflows into GCC countries have been affected by global conditions. In 2007, GCC countries' inward FDI peaked. In return, Bahrain, Kuwait, Qatar, Saudi Arabia and the UAE invested as much abroad as they received in the form of inward FDI.
  -
- According to UNCTAD, annual FDI inflows to the GCC averaged 6% of GDP between 2005 and 2011. Although data on the geographical distribution of inward FDI are limited, available data for Kuwait and Saudi Arabia suggest that a large share of FDI originated from within the GCC. However, over 23% of total FDI in Saudi Arabia came

[24] Bahrain, Brunei Darussalam, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates

from Europe in 2010[25], and within the high-income group, Saudi Arabia remained the country with the highest FDI flows in 2012.

Figure 1.9: Magnitude of FDI flows by range for the COMCEC Member Countries within the high-income group, 2012

HIC (7)	FDI flows, 2012
Saudi Arabia	>$10bn
UAE	$5.5-9bn
Kuwait	$1-4.9bn
Oman	$1-4.9bn
Bahrain	<$1bn
Brunei	$0.1-0.9bn
Qatar	<$1bn

Source: UNCTAD World Investment Report 2013

The UAE has recently become a regional hub for capital inflows, overtaking Saudi Arabia and Qatar in 2013. FDI inflows to the UAE have rebounded from the US$4bn recorded in 2009, amid Dubai's declining property market, to reach US$9.6bn in 2012. Despite this, inflows remain low relative to the period from 2004 to 2007, during which capital inflows had tripled[26]. Currently, the UAE and Saudi Arabia together account for 83% of FDI.

1.3. GLOBAL CARITAL OUTFLOWS- A SNAPSHOT

In the last decade, many emerging market companies have expanded rapidly, enabling some to start engaging in mergers and acquisitions (M&A) activity in other developing and developed countries. Gross FDI outflows from emerging market economies had risen to $205bn by 2006 from $43bn in 2002. By the end of 2006, the total holdings of foreign assets by major emerging market economies, excluding China, had reached $6.7trn, compared with $3.2trn in 2001.

The rise in foreign assets and foreign liabilities of many major emerging countries clearly shows that developing countries are playing an increasingly important role in financial globalisation.[27] According to the UNCTAD *World Investment Report (2013)*, developing countries now account for one-third of global FDI outflows – a proportion that is rising. In contrast, FDI outflows from developed countries as a whole fell by 23% in 2012, with outflows from 22 out of 38 developed countries declining.

[25] "Economic Prospects and Policy Challenges for the GCC Countries", IMF, October 2012
[26] Ibid.
[27] "Capital flows in emerging market economies", Bank for International Settlements (BIS), 2009

Following the financial crisis in 2009-10, global FDI outflows rose by 16% in 2011 to an estimated US$1.66trn. This surpassed pre-crisis levels, but remained 25% short of the 2007 peak. However, the growth of FDI outflows in 2011 did not translate into an equivalent expansion of productive capacity: much of the growth was owing to cross-border acquisitions and increased amounts of cash reserves in foreign affiliates, rather than to much-needed direct investment in new productive assets, for example through greenfield investment projects.[28]

According to the IIF,[29] there is now a significant 'rotation' taking place in the composition of emerging-market capital flows away from official reserve accumulation towards private-sector outflows into higher-yielding assets such as equity investments (both portfolio and direct). Indeed, the IIF expects that outward investment and lending by emerging-market residents – excluding reserve accumulation – will reach $1trn in 2013, almost ten times the $103bn average in 2000-2003.

[28] http://unctad.org/en/PublicationsLibrary/webdiaeia2012d19_en.pdf UNCTAD Global Investment Trends monitor, April 2012
[29] "Capital flows to emerging market economies", *Research Note*, Institute of International Finance (IIF), June 2013

Capital Outflows by Income Group

The table below presents the outward portfolio investment and outward direct investment for all COMCEC Member Countries in 2012.

Figure 1.10: Capital outflows of the COMCEC Countries, 2012

All Countries	2012	2012
	Outward portfolio investment	Outward direct investment
	$ bn	$ bn
1 Bahrain	2.74	-0.92
2 Turkey	2.65	-4.07
3 Senegal	0.23	-0.01
4 Jordan	0.05	-0.01
5 Egypt	0.02	-0.21
6 Mozambique	0.01	0.01
7 Guinea	0.01	0.00
8 Kyrgyz Republic	0.01	0.00
9 Benin	0.00	0.11
10 Chad	0.00	-0.01
11 Comoros	0.00	0.00
12 Gambia	0.00	0.00
13 Iran	0.00	-0.43
14 Sierra Leone	0.00	0.00
15 Tajikistan	0.00	0.00
16 Tunisia	0.00	0.00
17 Uganda	0.00	0.00
18 Gabon	0.00	-0.07
19 Pakistan	-0.01	-0.09
20 Togo	-0.01	-0.04
21 Niger	-0.01	0.23
22 Morocco	-0.02	-0.36
23 Cameroon	-0.02	-0.19
24 Yemen	-0.03	0.00
25 Sudan	-0.03	0.00
26 Cote d'Ivoire	-0.04	-0.03
27 Burkina Faso	-0.07	0.01
28 Albania	-0.11	-0.33
29 Mali	-0.16	0.35
30 Azerbaijan	-0.28	-0.60
31 Bangladesh	-0.32	-0.00
32 Algeria	-0.50	0.04
33 Libya	-0.50	-0.31
34 Oman	-0.71	-1.37
35 Uzbekistan	-0.80	n/a
36 Lebanon	-1.11	-0.61
37 Nigeria	-1.80	-1.54
38 Syria	-2.60	-0.01
39 Saudi Arabia	-4.09	-4.40
40 Malaysia	-5.21	-13.02
41 Indonesia	-5.47	-5.31
42 Qatar	-7.61	-1.84
43 Kazakhstan	-15.12	-2.68
44 United Arab Emirates	-17.20	-2.86
45 Kuwait	-26.77	-7.67
46 Afghanistan	n/a	n/a
47 Brunei	n/a	n/a
48 Djibouti	n/a	0.00
49 Guinea-Bissau	n/a	n/a
50 Guyana	n/a	0.00
51 Iraq	n/a	-0.09
52 Maldives	n/a	n/a
53 Mauritania	n/a	n/a
54 Palestine	n/a	n/a
55 Somalia	n/a	n/a
56 Suriname	n/a	n/a
57 Turkmenistan	n/a	n/a

Source: EIU Country Data

Low-Income Countries

Capital outflows from low-income countries, many of which are based in SSA, have been relatively low in recent years. FDI from African countries as a whole fell in 2011 to an estimated US$2.1bn, compared with US$5bn in 2010. Apart from declines in outflows from Egypt and Libya, traditionally important outward investors of the region, the total was also pulled down by major divestments among multinational corporations from South Africa, another major outward investor.

A significant proportion of the capital outflows from SSA is illicit. For example, over the three decades ending in 2009, real cumulative illicit outflows from SSA were more than double those from North Africa.[30] The per-capita loss of illicit capital from fuel-exporting countries over the period 1980-2009 (US$1,631) was slightly more than three times the outflow per capita from non-fuel-exporters (US$441). Heavily indebted poor countries lost US$480 per person through illicit financial flows.

Lower-Middle Income Countries

With the exception of Indonesia, capital outflows in the lower-middle income group remain limited in volume, displaying a somewhat volatile pattern over the past five years. Since 2011 both capital inflows and outflows have suffered a drop in countries such as Syria and Egypt, with political crises still lingering. In Africa, resource-intensive and fast-growing economies such as Nigeria display a marked imbalance between capital inflows and outflows, with inward FDI in line with that of mid-sized developed economies and outflows at much lower levels. The group outlier is Indonesia, with outward FDI close to US$5.5bn in 2012. Some Indonesian businesses such as Salim and Lippo have played a role in driving the country's outward FDI. Although investment remains mostly regional, some firms have invested in more distant emerging markets in Latin America (Raja Garuda Mas), Africa (Kalbe Farma), the Middle East (Bakrie, Salim) and Central Asia (Bakrie, Salim).[31]

Upper-Middle Income Countries

The upper-middle income group is characterised by a number of prominent countries in terms of their volume of capital outflows. Total outward FDI from East and South-east Asia has increased modestly in the last year. Outflows from Malaysia have increased, in part as Malaysia has emerged as a significant investor in SSA. Among North-South deals, Malaysia ranked alongside South Africa and China in the top three investors until the 2004-06 period. The ranking of countries for the period 2007-09 was similar, with Malaysia accounting for 10.6% of all South-South deals – second among the so-called "South countries" investing in the South.[32] (Russia ranked top with 11.6% of all South-South deals, and India third with 8.3%).

[30] "Illicit Financial Flows and the problem of net resource transfers from Africa: 1980-2009", African Development Bank and Global Financial Integrity, 2013
[31] M. Carney and M. Dielemann, "Indonesia's missing multinationals: business groups and outward direct investment", *Bulletin of Indonesian Economic Studies,* 2011
[32] http://rsbf.org.sg/media/docs/research-briefs/SIEMS_Monthly_Briefing_2011-04_eng.pdf

Turkey has emerged as a significant investor, with its outward investment rising by 73% in 2012 to a record US$4bn. In the previous year, outward FDI had increased to $2.3bn from $1.5bn, representing a 60% rise year on year. The 67% average increase over the period 2010 to 2012 has been attributed in part to a location shift in its investments away from developed and transition economies to developing countries in North Africa and West Asia in particular, and the Islamic Republic of Iran. Turkish enterprises have also shown renewed interest in some least developed countries (LDCs), with greenfield projects recently announced in Rwanda and Yemen.[33]

High-Income Countries

The strong rise in oil prices since the end of 2010 has increased the availability of funds for outward FDI from a number of oil-rich countries. Outflows from Bahrain, Kuwait, Qatar and the UAE increased in 2011, while those from Saudi Arabia decreased, although they remained at a relatively high level.[34]

Compared with other oil-exporting countries, GCC nations invest a considerable amount of FDI abroad in relation to the inward FDI they receive.[35] Much of these outflows are attributable to the accumulation of foreign assets by GCC states, and the GCC's strong support of countries whose balance of payments are under pressure owing to high oil import bills and a drop in export earnings, as a result of political change.

[33] *Global Investment Trends Monitor*, UNCTAD, April 2012
[34] Ibid.
[35] M. Peeters, (2011) "The Changing Pattern in International Trade and Capital Flows of the Gulf Cooperation Council Countries in Comparison with other Oil-Exporting Countries", European Commission Economic Papers, No. 415, June 2010

2 – LEGAL AND INSTITUTIONAL FRAMEWORKS IN THE COMCEC MEMBER COUNTRIES

The characteristics of COMCEC Member Countries vary significantly across regions and income levels. Regional groupings are heterogeneous in terms of their income composition and their degree of adherence to international frameworks for capital account liberalisation.

The clearest similarities are to be found among those COMCEC Member Countries that are included in the World Bank's high-income group, many of which are concentrated in the Middle East. The region has been developing competitive practices to attract international investors, and a number of common characteristics can be seen among these countries. For example, in many cases, capital controls are limited, ownership of publicly listed companies is restricted to a non-controlling share, and GCC-based investors enjoy preferential treatment.

On a more general basis, membership of or proximity to regional blocs with advanced legislation around capital markets appears to be positively correlated with institutional advancements. Turkey is an example of this: the country's proximity to the EU has paved the way for significant institutional and financial sector development. Turkey has implemented several principles included in the OECD Code of Liberalisation, and its Capital Markets Law has brought it in line with several provisions of EU legislation. Free movement of capital, one of the basic requirements for EU membership, has been introduced.

External shocks have also played a role in driving reforms around capital markets and investment infrastructure. The 1997-98 Asian financial crisis highlighted several shortcomings in Asian financial markets, most notably the underdevelopment of domestic bond markets and deficiencies in corporate governance, transparency and financial regulation. Capital account openness in underdeveloped regulatory frameworks seriously damaged these economies, owing to the volatility of short-term capital inflows that were financing longer-term projects.

Following the crisis, a significant number of countries engaged in joint initiatives and reform processes. Overall, financial safeguard mechanisms and macro prudential frameworks were enhanced. These countries also improved their capacity to issue debt through a number of initiatives, notably the Asian Bond Markets Initiative and the Asian Bond Funds, which strengthened these markets' capacity to issue debt and mitigated the fact that major global credit rating agencies do not yet rate many bond issuers in Asia.[36]

There are fewer similarities in trends among countries in the lower-income groups. Overall, among these countries, governments retain a greater degree of control around international capital flows. Measures are in place to ensure that foreign capital is channelled properly and an emphasis is placed on FDI vehicles. However, national institutions tasked with developing capital markets and attracting international investors have the potential to slow the approval of planned projects. For example in Mozambique, the processes required to obtain investment licences may slow the flow of international investment.

[36] http://www.adbi.org/files/2012.03.26.book.gfc.financial.reform.regulation.asia.pdf

Among some developing countries, governments use investment promotion agencies as a tool to control FDI and capital flows as a whole. Where legislative frameworks may adhere to international frameworks in principle, implementation is absent in some cases. Internationally accepted frameworks such as the OECD Code of Liberalisation offer general provisions, but require further institutional development that is lacking among some countries in the lower income group.

The rest of this chapter will give an in-depth view of the legal, institutional and policy frameworks in place for capital flows in eight COMCEC member states - two countries within each of the four World Bank income groups, which are also spread out geographically across the OIC's three regional groupings of the COMCEC members – the Arab group, Asian group and African group. These countries were chosen by the Economist Intelligence Unit as a result of their relative success in attracting capital flows, and because they have well-established frameworks and institutions governing capital flows that could serve as valuable examples to other member states.

2.1. LOW-INCOME COUNTRIES

Bangladesh

Laws regulating capital inflows

Investments in the People's Republic of Bangladesh are reasonably well protected by law and by practice. Major laws covering foreign investment include the Foreign Private Investment Act of 1980, the Industrial Policy of 1991, the Bangladesh Export Processing Zones Authority Act of 1980, and the Companies Act 1994. In addition, foreign investors are also required to follow the regulations of the Bangladesh Bank (BB, the central bank), and the National Board of Revenue in taxation and customs matters.

Furthermore, the country's Foreign Investment Act includes a guarantee of national treatment. National treatment is also provided in bilateral investment treaties for the promotion and protection of foreign investment which have been concluded with at least 14 countries: Belgium, China, France, Germany, Italy, Malaysia, the Netherlands, Pakistan, Romania, South Korea, Thailand, Turkey, the UK and the US.

Separate bilateral agreements on avoidance of double taxation have been signed with more than 20 countries to date: Belgium, Canada, China, Denmark, France, Germany, India, Italy, Malaysia, the Netherlands, Japan, Pakistan, Poland, Romania, Singapore, South Korea, Sri Lanka, Sweden, Thailand, the UK and the US. Double-taxation treaty negotiations are also under way with other countries, including Australia, Cyprus, Finland, Indonesia, Iran, Nepal, Norway, the Philippines, Qatar, Spain and Turkey.

There is no restriction on the repatriation of capital invested in Bangladesh. Foreign companies, including banks, insurance companies and other financial institutions, are free to remit their post-tax profits to their country of origin without prior approval of the central

bank. No permission is needed for remittances of dividend income to non-residents on their investments in Bangladesh.

A number of foreign companies have made high-profile investments in Bangladesh in recent years. In the telecommunications sector alone, these include Bharti Airtel of India, Singapore Telecommunications, Global Telecom Holding of Egypt (formerly Orascom Telecom Holding), Telenor of Norway, and Warid Telecom International, which is based in Abu Dhabi.

Besides these successes, there have been a number of high-profile failures. These include the decision by India's Tata Group to suspend discussions over a US$3bn investment programme because of the failure to reach decisions on key issues; and the suspension of Asia Energy's share listing in London after the government of Bangladesh announced the suspensions of the company's operating licence in Bangladesh. Confidence has been dented by the failure of efforts to sell the state-owned Rupali Bank to Prince Bandar bin Sultan bin Abdulaziz al Saud of Saudi Arabia in 2007; and by the withdrawal of US$1.2bn in loans for a US$3bn bridge across the Padma River.

Institutions overseeing capital flows

A number of Bangladeshi stakeholders and institutions have an interest in, or responsibility for, the country's capital flows. These include the BB, which fulfils the routine functions of a central bank, including the formulation and implementation of monetary and credit policies, the regulation and supervision of financial institutions, and the implementation of the Foreign Exchange Regulation Act. It is independent, but the Ministry of Finance holds considerable sway in regulating the country's nascent capital markets. The Bangladesh Securities and Exchange Commission, in practice answerable to the finance ministry, is the country's capital market regulator.

For its part, the finance ministry is one of the most powerful ministries in Bangladesh. The ministry's Bank and Financial Institutions Division (BFID) deals with law and policy issues related to banks, non-bank financial companies (NBFCs), capital markets, and the insurance and microcredit sectors. The BFID also co-ordinates the formulation and review of policies. Other responsibilities include monitoring the utilisation of foreign loans and other types of assistance.

A further stakeholder is the Board of Investment, which is attached to the prime minister's office. Its official mandate is "to promote and facilitate investment in the private sector both from domestic and overseas sources with a view to contribute to the socio-economic development of Bangladesh". Much of its activity to date has centred around dealing with procedural issues related to the raising of foreign capital by domestic firms.

The Investment Corporation of Bangladesh (ICB) is tasked with developing the country's capital markets. In practice it appears to focus on promoting Bangladeshi investments among the Bangladeshi diaspora. The ICB's subsidiary ICB Asset Management Company Limited launched the ICB AMCL First non-resident Bangladeshi (NRB) Mutual Fund in March 2007. The total issue size was Tk100m (US$1.3m). More recently, the ICB has been involved in developing another fund, the Bangladesh Fund, with an initial size of US$640m.

Debt and equity instruments

The Dhaka Stock Exchange is the main bourse in the People's Republic of Bangladesh; a secondary bourse operates in the port city of Chittagong. At around 25% of GDP, stock market capitalisation is somewhat lower than in other countries in the region. As of end-2012, there were 513 securities listed on the Dhaka and Chittagong exchanges, including 240 stocks, with a total market capitalisation of US$29bn.

Bangladesh has a small bond market at an early stage of development. The government offers at least three types of bonds targeted at NRBs: Wage Earners' Development Bond, US Dollar Investment Bonds and US Dollar Premium Bonds. The rates offered are attractive for individual investors. The funds the government raises in this way form a very small part of its outstanding domestic debt.

Policy initiatives to attract capital flows

The government provides generous tax incentives for foreign investors. A lower tax rate applies to listed domestic companies as opposed to unlisted companies. The latter policy is meant to make listing more attractive. However, it has had limited success. This is in the main because many family-owned businesses prefer to avoid the higher scrutiny that comes with listing. The government has been looking into raising international capital for investment (including debt/equity, the national currency, the taka, or in foreign currencies), by the government, sub-sovereign entities such as municipalities or private-sector companies. But unlike other countries with a large diaspora such as Israel and India, Bangladesh has been unable to launch a diaspora bond.

Mozambique

Laws regulating capital inflows

Laws and regulations governing capital flows into the Republic of Mozambique have evolved substantially since the liberalisation of the economy from the late 1980s, and the end of the civil war in 1992, as Mozambique gradually opened up to foreign investors and aligned its regulations to international standards. The current legal framework for capital account transactions was introduced relatively recently: the Law on Foreign Exchange, Law 11/09 of March 11th was enacted in 2009 and its regulations, as laid down in Decree 83/10 of December 31st, were approved in 2010.

While there are no general restrictions on FDI, the stakes foreign investors can own in media companies, private security firms and game hunting concessions are limited. Furthermore, Law 15/11 of August 10th, the Law on Public-Private Partnerships, Large Scale Projects and Company Concessions, requires that 5-20% of all such undertakings be owned by Mozambican nationals. A new mining code and a new hydrocarbons code, expected by 2014, are likely to add similar provisions for direct investment in the mining and hydrocarbons sectors.

Institutions overseeing capital flows

All capital account transactions are subject to the authorisation of the foreign exchange authority, Banco de Moçambique (BDM, the central bank). These include foreign direct investment, fixed asset investment, operations relating to securities and other instruments transacted on the money and capital markets, and the physical import and export of money.

The terms and conditions under which authorisations are granted for each type of capital transaction are set out in Decree 83/10. All capital account operations are to be effected through the banking system. Although BDM must theoretically respond to applications for authorisation within 15 working days, it can suspend the process if it considers that it needs additional information, potentially leading to uncertainty about the actual duration of the process. The administrative processes of this regulatory framework may have had a dampening effect on capital inflows to Mozambique.

In addition to the Law on Foreign Exchange, FDI inflows are governed by the Law on Investment, Law 3/93 of June 24th 1993, and its regulations set out in Decree 43/09 of August 2009, designed to attract foreign investment into Mozambique. The Law on Investment established the investment promotion centre, Centro de Promoçãos de Investimentos (CPI), under the authority of the Ministry of Planning and Development (MPD). In 2007 (Decree 75/07 of December 24th) Mozambique created the Gabinete Das Zonas Económicas de Desenvolvimento Acelerado (GAZEDA), a mirror organisation of the CPI, to focus on Special Economic Zones (SEZs) and Industrial Free Zones (IFZs).

Application for investment licences are directed to the CPI (or to GAZEDA for firms wishing to invest in SEZs), according to the size and type of the planned investment. Under Decree 43/09 the authorities are required to approve or reject an investment proposal within 30 working days. In practice, however, applications may lead to further negotiations about the exact nature of the projected benefits to investors. Investment licences have contractual value and offer foreign investors a number of guarantees in terms of treatment and protection, as well as fiscal incentives.

Debt and equity instruments

Mozambique's tiny stock exchange, the Bolsa de Valores de Moçambique (BVM), established in 1999, has only four listed companies. Cervejas de Moçambique (CDM), a subsidiary of South Africa's SABMiller, was the first company to be listed. CDM, which floated 25% of its shares in 2001, is also the largest company by market capitalisation (about US$461m) and the most traded one. Companhia Moçambicana de Hidrocarbonetos (CMH), a state-owned oil and gas company floated 10% of its shares in 2009. Its current market capitalisation is about US$6m. Construção e Serviços (CETA) the country's largest engineering and construction group, was admitted to list 25% of its share in 2012, but they are not currently traded as the company is considering reprivatising. The market for debt securities is slightly more developed, with eight short-term commercial debt securities and 20 medium- to long-term debt securities being traded (issued by both the government and private companies). Activity is generally weak: in 2012 the exchange, which is open for only a few hours a week, registered barely 191trades. Total market capitalisation (including both company shares and debt securities) is about

US$1.1bn. Owing to capital controls, as well as the exchange's restricted size and poor liquidity conditions, the BVM has hitherto failed to attract much interest from international investors.

While bond inflows have been inexistent throughout the last decade, in September 2013 a government agency, EMATUM, issued a seven year government-guaranteed US$500m bond, the country's first in international markets, at a yield of 8.5%. Mozambique has thereby joined the ranks of African countries such as Zambia, Tanzania and Rwanda, which have recently raised debt on international capital markets.

Policy initiatives to attract capital flows

Fiscal incentives for direct investors have made a significant contribution to boosting capital inflows in Mozambique. These incentives, which are specified in the 2009 Code of Fiscal Benefits, Law 4/09 of January 12th (which replaced the 2002 Code of Fiscal Benefits) have helped to pave the way for a number of mega-projects in Mozambique. Furthermore, the investor protection guarantees contained in the Law on Investment have strengthened investor confidence significantly, and have helped Mozambique to be ranked 49th of 186 countries in the investor protection category of the World Bank's 2013 *Doing Business* report.

Notwithstanding these advantages, direct investors in the Republic of Mozambique are also exposed to potentially less favourable economic regulations, including those governing labour. Labour regulations, in particular the 2007 Labour Law, Law 23/07 of August 1st, limit the proportion of expatriate staff a company can employ to 5% of the total (or in some cases 10%). And according to regulations governing land rights, all land is owned by the state and cannot be sold, transferred or mortgaged. Firms can be granted permits to use land, known as Direito de uso e aproveitamento da terra (DUAT).

2.2 LOWER-MIDDLE INCOME COUNTRIES

Indonesia

Laws regulating capital inflows

Foreign holdings of listed shares and mutual funds are permitted, following a gradual opening up to foreign investment in the past decade. Closed-end investment trusts were introduced in Indonesia in 1995, followed by open-ended funds in 1996. (No data regarding foreign investments in such funds are published.) In general, the government is keen to diversify the number and type of investors in the domestic securities market.

Venture-capital firms have yet to recover from the effects of the 1997-98 Asian financial crisis. In 2012, the Indonesian Capital Market and Financial Institutions Supervisory Agency, Bapepam-LK, introduced new guidelines and regulations, stipulating that foreign investors may hold up to 85% in such firms. Venture-capital firms are allowed to provide financial backing to companies in a variety of ways, including equity participation and convertible-bond

issues. If investee firms become publicly listed, venture-capital firms are required to dispose of their shareholdings within 36 months of the listing.

Many venture-capital firms provide conventional lending rather than equity capital. These firms often make lending decisions based on collateral rather than cash flow, in effect acting as a bank. Moreover, current regulations and tax rules do not recognise equity financing, which is a crucial element of developed venture-capital industries. Many firms, except for joint-venture companies, are owned by the government or are part of large business groups, creating a situation where ownership and capital management are structurally linked.

Institutions promoting investment and stock exchanges

Indonesia's government encourages foreign individuals and corporations to invest in Indonesian securities, including through the Indonesia Stock Exchange (IDX). As of September 2013, 479 companies were listed on the IDX, all of which were domestic. Market capitalisation stood at US$367bn, which makes the IDX reasonably moderate among Asia's major exchanges, equivalent in size roughly to that of Thailand.

The government's investment promotion agency is the Indonesia Investment Coordinating Board (BKPM), which acts as an intermediary between the government and the business community and is mandated with increasing the levels of both domestic and foreign investment. The BKPM is also responsible for maintaining the Negative Investment List (DNI), which identifies the sectors that are wholly or partially closed to foreign investment.

Debt and equity instruments

Government bonds include rupiah- and US dollar-denominated Treasury bonds, which are regulated by the 2002 Sovereign Debt Securities Law. The IDX is permitted to trade government bonds as well as corporate bonds. Government bonds had previously changed hands through over-the-counter trading offered by banks and securities firms. According to the Ministry of Finance, at end-June 2012 banks held just under 40% of the total of around Rp800trn (US$75bn) in outstanding government bonds; foreigners held around 30%.

Since mid-2006, Indonesian citizens have been able to buy retail state bonds (ORIs) from the finance ministry, which offer a higher yield than bank deposits. The bonds are sold by designated sales agents to individual purchasers without an auction process, and are subject to a final withholding tax of 15%, compared with a 20% levy on regular deposits. Foreigners can buy retail state bonds on the secondary market or through nominated locals.

The Indonesian government issued its first US dollar-denominated sukuk bond in 2009. As the country has the world's largest Muslim population, the government is committed to Islamic finance and the issuance of sukuk bonds; it now holds one or two such sales a year. Most recently, it raised US$1.5bn from rupiah-denominated sukuk bonds issued in September 2013. In addition to US dollar and yen-denominated conventional bonds, the authorities are considering launching bonds denominated in Chinese renminbi and South Korean won.

The corporate bond market, which is based at the IDX, has expanded markedly in recent years. Generally, there are no restrictions to foreign and domestic investments in corporate bonds. Indonesian companies are permitted to sell and list foreign-currency-denominated debt in the domestic market, although most firms continue to sell such debt, usually in US dollars and euros, in London and Singapore.

Policy initiatives to attract capital flows

Investors in the Republic of Indonesia have seen progress in the country's efforts to improve business conditions. For instance, in late 2011, parliament passed legislation creating the Financial Services Authority (OJK) to monitor and regulate the country's financial system. In January 2013, the OJK replaced the Bapepam-LK and assumed the role of watchdog for the banking system from the central bank, Bank Indonesia (BI). The OJK has inherited existing rules governing the movement of capital from BI and Bapepam-LK.

In the past two years Indonesia has introduced several measures aimed at increasing the stability of the financial account and the local currency, amid high volumes of capital inflows and rapid domestic credit growth. For example, in mid-2011 parliament mandated that the Indonesian rupiah be used for all financial transactions within the country. Locally based banks have limits imposed on their foreign-currency activities, and all businesses must comply with foreign-exchange reporting requirements. Foreign companies must repatriate earnings through BI, and export profits must be deposited in a local-currency bank account. Indonesia otherwise has liberal rules regarding capital transfers and the repatriation of profits; all major currencies are freely convertible.

In June 2012, BI launched a one-month programme offering US-dollar term deposits. The facility is targeted at Indonesian financial institutions that have parked US dollar funds with overseas lenders, to help ensure that US dollars are available in the onshore market. When launching the facility, BI said it might unveil further, though unspecified, measures to ease volatility in the foreign-exchange market; but strict foreign-exchange controls are not likely to be introduced in the near future.

Nigeria

Laws regulating capital inflows

The financial regulatory environment in Nigeria has benefited significantly from the liberalisation of the capital and foreign exchange markets in the mid-1990s. Foreigners can invest and participate in any enterprise in Nigeria, although restrictions apply to both local and foreign investors with respect to certain industries involved in national security, such as firearms, ammunition, military apparel and coastal and inland shipping.

The Nigerian Investment Promotion Commission Act 1995, which is the main law regulating foreign investment in the country, allows 100% foreign ownership of firms. It also guarantees unconditional transferability of dividends or profit, and capital repatriation in the event of

liquidation. The law protects foreigners against expropriation of their property and assets. However, enterprises with foreign ownership must obtain a business permit and expatriate quota (to employ non-Nigerians) from the Ministry of Internal Affairs. Every company with foreign participation must also register with the Nigerian Investment Promotion Commission (NIPC). Investors who wish to provide funds from overseas must obtain a Certificate of Capital Importation from the Nigerian bank that will handle the funds.

Institutions overseeing capital flows

In the processes of establishing a business in Nigeria, investors will encounter a number of government agencies, including the corporate affairs commission, the immigration services, the customs service and the federal inland revenue service as well as the ministries of finance and internal affairs. Investors can deal with these agencies in one place, the One-Stop Investment Centre, run by the NIPC, which is the main government agency charged with facilitating foreign investment in Nigeria. The NIPC was established in 1995 to encourage, promote and co-ordinate investments in Nigeria. Its duties include liaising between investors and government agencies, and facilitating pre-investment site visits.

The Nigerian Stock Exchange (NSE) and the Securities and Exchange Commission (SEC) are the main institutions governing the capital market, while the Central Bank of Nigeria (CBN) is the most important regulator of capital flows. Although the law permits the free movement of capital through authorised dealers, changes in the monetary policies of the CBN can affect the ease of financial flows in and out of the country.

Recent central bank governors have generally favoured market-oriented reforms, but they have intervened in the markets when they believe that currents of capital flows were detrimental to the stability of the local currency, the naira. In February 2007 the CBN restricted foreign investors from buying government bonds with a maturity of under one year, and in September 2008 it stipulated that proceeds from selling government securities could only be repatriated after one year. These restrictions affected capital flows and were lifted in July 2011 by the regulator.

Similarly, in early 2009, the regulator restricted banks' foreign-exchange operations, limited banks' foreign-exchange margins, and restricted foreign-exchange sales by oil firms and government agencies in efforts to combat currency speculation and stabilise the naira. The CBN also restricted deposit and lending rates to dampen competition between banks. The financial limitations were widely criticised, leading the CBN later to reverse these capital controls.

As part of plans to diversify Nigeria's oil-dependent economy and boost trade and investment in Nigeria, the Ministry of Trade and Investment was created in June 2011, led by the former finance minister Olusegun Aganga. In its first six months the ministry helped pave the way for new investment commitments in both the oil and the non-oil sector, of some US$31bn, including US$13bn from international investors, notably from the US, China and Indonesia.

The Bureau of Public Enterprises (BPE) which implements official policy on privatisation and commercialisation is another organisation set up to boost non-oil growth. Foreign investors

bought many of the 122 state enterprises that were privatised between 1999 and 2012; several foreign firms are involved in the ongoing sale of state electricity generation and distribution companies, Nigeria's biggest privatisation exercise to date.

Debt and equity instruments

There has been remarkable growth in the Nigerian Stock Exchange (NSE) since it was established as the Lagos Stock Exchange in 1960, the year of Nigeria's independence. The bourse now has approximately 5m investors and is the third-largest in Africa by total market capitalisation, which stands at about US$114bn (including both equity and debt securities). The NSE trades 196 equities with market capitalisation totalling around US$75bn. Many of the listed firms are subsidiaries of multinational companies that have been in Nigeria for many decades, such as Cadbury, Guinness, Nestlé and Unilever. However, by far the biggest company on the bourse by capitalisation is the indigenous Dangote Cement, with market capitalisation of around US$21bn. The most actively traded equities on the NSE tend to be financial sector shares.

Nigeria's debt market is dominated by federal government securities, which account for about 80% of the roughly US$38bn total capitalisation of the bond market. There are 57 bonds traded on the exchange, including about 18 corporate bonds and a local-currency bond issued by the International Finance Corporation, the World Bank's private-sector arm, in February 2013 to support the development of Nigeria's capital market.

Policy initiatives to attract capital flows

Few legal restrictions are placed on foreign investors. The government is keen to boost investment in Nigeria and offers incentives to investors, particularly in areas deemed crucial to the development of the economy. Fiscal incentives are available to companies that are granted pioneer status, including exemption from income tax for up to five years, tax free dividends during the holiday period and investment allowances.

Companies operating in preferred industries can also benefit import duty exemptions. There is a 20% tax credit for five years for firms that attain set minimum levels of local raw sourcing and utilisation. Specific sectorial incentives apply to companies in manufacturing, agriculture, solid minerals, petroleum, gas, telecommunications, electricity, tourism and transport. Nigeria also operates a number of export processing zones in different parts of the country in which investors enjoy generous tax exemption.

Practical reforms in Nigeria: bolstering investor confidence by strengthening the financial system

Following the 2008-09 banking crisis, Nigeria's financial authorities issued a raft of new guidelines and regulations to strengthen the country's financial system and bolster investor confidence. Among the changes were the following:

--Compulsory adoption of December 31st as the common year-end for bank reporting, enabling more accurate comparison of the performance of different lenders;

--Mandatory retirement of bank CEOs after ten years and the compulsory change in external auditors after ten years;

--Adoption of International Financial Reporting Standards (IFRS) by all publicly listed and significant public interest entities, including banks, from 2012;

--Reforms to improve the efficiency and depth of the capital market as well as boost investor confidence, including extending trading days, permitting short selling and introducing market making;

--Updated stock exchange technology, including the NASDAQ OMX trading platform.

The raft of new regulations and initiatives introduced by Nigeria's financial regulators in the past three years has set off what appears to be a reform momentum that can lift investor confidence in the country's capital markets and economy.

2.3. UPPER-MIDDLE INCOME COUNTRIES

Malaysia

Institutions and laws overseeing capital markets

The Securities Commission (SC), which falls under the purview of the Ministry of Finance, is the main regulator of capital markets in Malaysia. It licenses capital markets and supervises exchanges, clearing houses and central depositories. It is the registering authority for prospectuses of corporations; the approving authority for corporate bond issues; the regulator for matters relating to securities and derivatives contracts, mergers and acquisitions and unit trust schemes; and the licensing and supervising authority. The SC was established on March 1st, 1993 under Securities Commission Act 1993 and has investigative and enforcement powers. Apart from its regulatory activities, the SC has the task of promoting the development of the securities and derivatives markets in the country.

Before 1993, overseeing the securities industry was distributed between the Registrar of Companies, the Capital Issues Committee, the Panel on Take-overs and Mergers, the Foreign Investment Committee, Bank Negara Malaysia (BNM, the central bank), the Ministry of Trade and Industry and the Kuala Lumpur Stock Exchange (KLSE). The Sixth Malaysia Plan (1991-95) highlighted the need for a single regulatory body with a broad overview of capital markets and the SC was formed in 1993 to promote the development of capital markets, streamlining the regulations governing the securities markets, and speeding up the process of processing and approving corporate transactions.

Until 2007, legislation governing the securities industry consisted of the Securities Industry Act 1983, the Securities Industry (Central Depository) Act 1993, the Companies Act 1965, the Securities Commission Act 1993 and the Futures Industry Act 1993. The Capital Markets and Services Act 2007 (CMSA) which came into force on September 28th 2007 after being passed by parliament in May 2007, consolidates the Securities Industry Act 1983, the Futures Industry Act 1993 and Part IV of the Securities Commission Act 1993, which deals with fund raising activities. The CMSA is supported by the Capital Markets and Services Regulations 2007, the Licensing Handbook and the Guidelines on Regulation of Markets; all these documents come into effect concurrently with the CMSA. The CMSA also introduced a single licensing regime, according to which intermediaries hold a Capital Markets and Services Licence rather than multiple separate licences thereby reducing administrative and compliance costs.

The development of financial markets

The government regards Malaysia's financial services industry as an important engine of economic growth, identifying it in the Tenth Malaysian Plan (10MP) as one of 12 sectors expected to drive economic activity under the government's Economic Transformation Programme in the 2011-20 period. The authorities expect the financial sector to grow by 8-11% per year, increase its share of GDP to 3%, and create 275,000 new jobs in the sector by 2020. The 10MP aims to broaden the variety of financing options available, boost the development of capital-market subsectors such as fund management, venture capital and private equity, broaden the scope of services offered by Islamic banks, and promote further consolidation and rationalisation in the insurance sector.

Malaysia's financial institutions have weathered the recent volatility in global financial markets well. They had negligible exposure to securities related to US subprime borrowing, to sovereign debt of troubled euro zone countries or to the affected financial institutions of other countries. More than 90% of the assets of local banks and insurance companies are denominated in the local currency, the ringgit. The strong capital position of banks, coupled with ample liquidity in the financial system, provided Malaysia's financial sector with a buffer against the 2008-09 global crisis. The relatively healthy state of the financial sector is largely the result of reforms implemented following the 1997-98 Asian financial crisis.

The central bank, Bank Negara Malaysia (BNM), is the regulator of banks, insurance companies and licensed intermediaries such as money brokers and insurance brokers. It has encouraged the development of financial services that conform with Islamic law. Malaysia's Securities Commission oversees firms that participate in the financial markets, as well as those active in fund management, corporate-finance and investment advice, and financial planning.

Bursa Malaysia (BM) is the second largest stock exchange among the emerging bourses of South-east Asia, behind Singapore's exchange. In 2009, the capital markets regulator, the Securities Commission, issued revised listing regulations, partly with the aim of enticing more foreign companies to list on BM. The authorities would like to see more financial products offered, although it has often proved hard to generate sustained interest in such products. For example, only three of the ten products offered on BM's derivatives exchange record regular turnover.

The development of Malaysia's financial sector in the 2012-20 period is being guided by the second Capital Market Masterplan (CMP2), unveiled by the Securities Commission and other authorities in 2011; it is being guided by the second Financial Sector Masterplan (FSM2), launched by BNM in the same year. According to CMP2, the Malaysian authorities plan to continue pursuing the policies of gradual liberalisation coupled with the effective oversight that characterised the first versions of these master plans.

Among other things, CMP2 and FSM2 allow for the deepening of international financial links and the expansion of the role of Malaysia's financial sector in regional financial integration. The Islamic finance sector has already been strongly promoted, and additional incentives in this area are expected to be introduced in the coming period as Malaysia seeks to cement its status as a global hub for sharia-compliant finance. Enhanced regulations to improve corporate governance also feature prominently in CMP2.

BNM is undertaking a comprehensive review of the legislation governing financial institutions and payment systems under the central bank's purview to take account of the changing financial landscape and of recent regulatory developments. The pieces of legislation under review are the Payment Systems Act 2003, the Insurance Act 1996, the Banking and Financial Institutions Act 1989, the Takaful Act 1984 and the Islamic Banking Act 1983. BNM has said that the purpose of the review is:

- to ensure an effective and efficient legislative framework for the regulation and supervision of financial institutions and the oversight of payment systems;
- to align legislation with more principle-based and differentiated approaches to regulation and supervision, based on risk;
- to enhance BNM's ability to take appropriate enforcement, remedial, intervention and resolution actions in order to promote institutional stability;
- to achieve a more consistent legal framework across the various financial sectors in common areas; and
- to strengthen provisions to support effective regulation and supervision of market conduct.

The Malaysian government has drawn up amendments to the Anti-Money Laundering Act to cover more categories of financial institution and designated non-financial businesses, such as real estate agents, electronic-money issuers, dealers in precious metals and stones, and leasing and factoring companies. Some minor amendments to the act took effect in 2009-11, and further, amendments are expected.

Turkey

Laws regulating capital inflows

Foreign investors in the Republic of Turkey are not, in principle, subject to a separate legal or tax regime. However, the Foreign Direct Investment Law,[37] dating from 2003, makes FDI subject to a declaration rather than to authorisation. The law also provides explicit guarantees that: (a) foreign investors are subject to equal treatment with domestic investors unless stipulated by international agreements and other special laws; (b) foreign direct investments are not to be expropriated or nationalised, except in the public interest and upon compensation in accordance with the due process of law, and (c) foreign investors are free to transfer profits, proceeds from sale or liquidation and other related funds through the banking system.

Turkey's capital markets are governed by the Capital Markets Law, which was most recently renewed by the country's parliament in 2012, to bring it more closely into line with EU norms and strengthen investor protection.[38] There are no restrictions on foreign portfolio investors trading in the Turkish capital markets. Non-resident individuals and legal entities, including investment trusts and funds, are free to buy and sell all kinds of securities and other instruments. Foreign investors can also use Turkey's markets to hedge currency risk. All securities transactions – as well as portfolio management, investment consultancy and underwriting activities – are required to be conducted through an institution established and licensed in Turkey.

Institutions overseeing capital flows

The General Directorate of Incentive Implementation and Foreign Capital at Turkey's Economy Ministry[39] is responsible for FDI policy matters, such as bilateral agreements on the protection of investments. Under the Capital Markets Law, capital markets are regulated by the Capital Markets Board (CMB or SPK, in its Turkish acronym). Among its many functions, the CMB[40] regulates, licenses and/or supervises financial markets, financial market participants and companies which have multiple shareholders and/or which offer shares to the public and/or whose shares are traded on the stock exchange, together with their securities issues or offerings.

Other actors that play a role in Turkey's capital flows include the Under Secretariat of the Treasury, operating under the Prime Ministry, which is responsible for sovereign debt management, including domestic and international bond issuance; for multilateral external economic relations; and for regulating certain institutional investors – namely insurance firms and private pension funds. The Ministry of Finance is responsible for taxation; the Central Bank oversees monetary policy, including lira and foreign-currency reserve requirements; the

[37] See http://www.economy.gov.tr/upload/380BE181-C6CE-B8EF-37B940FAAD239BA2/FDI_Law.pdf for an English translation.
[38] An English translation of the law is available at http://cmb.gov.tr/displayfile.aspx?action=displayfile&pageid=87&fn=87.pdf&submenuheader=null . For one short commentary, see http://www.internationallawoffice.com/newsletters/detail.aspx?g=903d8f05-131d-4f88-883a-e55f44d0376c
[39] More information on the work of the Economy Ministry is available at its website: www.economy.gov.tr,
[40] More information on the CMB is available at its website: : www.cmb.gov.tr

Banking Regulation and Supervision Agency (BDDK) is responsible for bank regulation and supervision, including prudential requirements, provisioning and open position limits.

Beyond these actors, a number of further stakeholders have interests in Turkey's capital flows. Among them are the Union of Banks (TBB), the Union of Participation Banks (TKBB), and the Association of Capital Market Intermediary Institutions (TSPAKB), the official professional organisation of the 140 or so banks and brokers engaged in the capital markets. (In line with the new Capital Markets Law, a Capital Markets Association – TSPB – is to be set up; the association will also include asset management firms and other capital market institutions.)

Debt and equity instruments

Borsa Istanbul (BIST) is the main securities market of the Republic of Turkey, and itself is a publicly-owned company subject to private law, in accordance with the Capital Markets Law of 2012. Stocks, bonds, funds and other instruments are traded.[41] It is the successor to the Istanbul Stock Exchange, which dates back to 1985. It also incorporates the more recent and fast-growing Futures and Options Market (VOB), previously a separate institution based in Izmir. Thus Borsa Istanbul brings together all the exchanges operating in the Turkish capital markets under a single roof.

In July 2013 Borsa Istanbul signed a partnership with the NASDAQ OMX Group, giving it access to the US group's technologies for trading, clearing, market surveillance and risk management. Borsa Istanbul sees the agreement as a step towards increasing its regional or global presence and strengthening Istanbul's position as a regional capital markets hub.

Policy initiatives to attract capital flows

The General Directorate of Incentive Implementation and Foreign Capital at Turkey's Ministry of the Economy supports the work of the Coordination Council for the Improvement of the Investment Environment (YOIKK) and the Investment Advisory Council (IAC).[42] YOIKK brings together public and private sector representatives to recommend improvements in business conditions, while the IAC is a platform for multinational companies and international institutions to provide Turkey with advice about its investment environment. Turkey also has an Investment Support and Promotion Agency, attached to the Prime Ministry, to promote foreign investment. Investment incentives, including tax breaks, apply to foreign and domestic investors equally. The International Investors Association (YASED) is a business association of international companies in Turkey, which lobbies for improvements in the investment environment.[43]

[41] Fuller details are to be found at http://borsaistanbul.com/en/products-and-markets
[42] Until 2011, these duties rested with the Undersecretariat of the Treasury.
[43] Websites of the institutions mentioned in this paragraph, which also contain much practical information for investors, especially foreign direct investors, are as follows: www.yoikk.gov.tr, www.invest.gov.tr and www.yased.org.tr .

2.4. HIGH-INCOME COUNTRIES

Bahrain

Laws regulating capital inflows

The Kingdom of Bahrain has no capital controls on the amount of foreign currency allowed to be moved in and out of the country. The Central Bank of Bahrain (CBB) acts as a *de facto* regulator of capital controls, as it is responsible for maintaining the peg of the Bahraini dinar to the US dollar (at BD0.376:US$1), which it has enforced since 1980. The peg is a central pillar of the central bank's monetary policy; hence keeping the channels for capital flows into the country open is vital in order to maintain currency stability. As a consequence, Bahrain's monetary and exchange rate policies serve in effect as the kingdom's capital control regulations.

Foreign companies investing in Bahrain fall under the 2001 Commercial Companies Law, which is enforced by the Ministry of Commerce (MoC). Businesses that include foreign capital are subject to the same laws and obligations covering reporting requirements and capital structure as local businesses.

Institutions overseeing capital flows

As the institution responsible for maintaining the value of the dinar, the Central Bank of Bahrain monitors the country's balance of payment positions and intervenes to support the dinar while also providing a foreign-exchange facility for the local banking system to buy and sell US dollars and dinars.

The MoC is the coordinating body for establishing businesses in Bahrain and foreign firms are required to apply to the MoC and the relevant authority for their industry to begin operations. For example, to establish a financial business, firms must apply to the CBB, which serves as regulator for the sector, or to the Telecommunications Regulatory Authority for a mobile phone operation.

Debt and equity instruments

Considering the importance of the financial sector to Bahrain's economy, compared with its peers the country has a relatively small stock market, the Bahrain Bourse. As of mid-September 2013, it had a market capitalisation of US$17.5bn. This compares with nearly US$100bn for the Abu Dhabi Securities Exchange or US$417bn for the Tadawul in Saudi Arabia. The Bourse is heavily geared towards financial services companies (banks and investment managers), although it also lists some local industrial entities, including a share of state-owned Aluminum Bahrain.

Bahrain also has a deep local debt market. The government routinely issues Bahraini dinar denominated Treasury bills to finance its investment programmes, helping to soak up some of the liquidity in Bahrain's banking system. In addition, the Bahraini government is a regular

issuer of euro bonds with which it provides full and detailed prospectuses (several government-linked entities, such as Mumtalakat, the sovereign wealth fund, have also tapped international markets on the back of sovereign support). Bahrain most recently issued a sovereign euro bond in 2012 when it sold a US$1.5bn ten-year conventional bond with a coupon of 6.125% which according to the central bank was four times oversubscribed.

Policy initiatives to attract capital flows

To further attract foreign capital inflows, Bahrain levies no corporation tax outside of the hydrocarbons sector; there is also no capital gains tax. These policies are unlikely to be changed in the future unless there is a significant decline in the performance of the Bahraini government's main revenue source, hydrocarbons production. Even then, Bahrain would be unlikely to make itself less competitive on a tax basis compared with its regional peers in the Gulf.

The economy is much smaller in Bahrain than in neighbouring Qatar and Saudi Arabia, meaning it lacks a significant domestic market with which to attract foreign inflows of capital. As such, the kingdom has prioritised acting as a financial hub for the Gulf region, although it is facing increasing competition, including from Dubai and Qatar. Bahrain's attractiveness relative to its peer is that the country in effect acts as a free zone, allowing funds and investment to enter and leave the country without restrictions and making it an effective base for operations in the Gulf region.

However, the government of Bahrain does impose some limitations on the flow of foreign capital into property investments in the country. Notably, only local and GCC nationals are allowed to own property. Foreigners and foreign companies are, however, allowed to own property in a number of new developments and in areas of the Bahrain Financial Harbour. Foreign ownership of land is allowed without restriction in the Bahrain International Investment Park, an industrial zone which applies exemptions to import duties and has no workforce restrictions.

Bahrain has an open policy towards FDI. Foreign firms can own 100% of a company based in Bahrain provided it does not operate in a sector subject to restriction. These sectors include the print media, and Hajj and umra travel (pilgrimage services). In businesses active in import/export and other trade, a minimum 51% of the ownership must be held by Bahrainis if the foreign investor is from outside the GCC; if the foreign investor is from the GCC, a Bahraini partner is required, but no ownership requirement is stipulated.

To further streamline the process of setting up a business, Bahrain has established the Bahrain Investors Centre (BIC) as a "one-stop shop" that assists with all aspects of establishing a firm. Regulatory authorities are accessed through the BIC and it has ready links with local financial firms to aid the process of setting up corporate financial services.

The Bahrain Economic Development Board (EDB) was established in 2000 and is specifically tasked with targeting inward investment and promoting various sectors (including financial services, manufacturing, telecommunications) whose development the government is

encouraging. The EDB also has offices overseas to promote the open nature of Bahrain's economy to international capital flows.

UAE

Laws regulating capital inflows

The Federal Companies Law (1984) stipulates a 49% cap on foreign ownership of locally registered companies, in addition to non-tariff barriers such as a requirement to partner with a UAE national in order to establish a business. Other relevant legislation includes the Commercial Agencies Law (1981), requiring a local commercial agent to distribute products; the Federal Industry Law (1979), mandating 51% UAE ownership of industrial projects; and the Public Tenders Law (1975), allowing only UAE nationals or entities majority-owned by UAE partners to bid for public-sector contracts.

Limited foreign ownership is often seen as an added cost of doing business in the UAE. However, free zones permit 100% foreign ownership in addition to tax-free status. Furthermore, foreign investors can in some cases circumvent the legislation by negotiating individual agreements with their Emirati partners. Most commonly, foreign investors offer annual cash payments in return for retaining management control and profits.

In early 2013, policy-makers rejected proposed measures to ease foreign investment limits outside free zones; these measures were excluded from the latest draft of the Commercial Companies Law (CCL) approved by the Federal National Council in May 2013. However, in light of the decision by Morgan Stanley Capital International (MSCI) to upgrade the UAE to emerging market status, there may be fresh efforts to promote further equity investment before the upgrade takes effect in May 2014.

The new CCL makes the establishment of limited liability companies (LLCs) more attractive by removing minimum capital requirements (Dh300,000 (approximately US$82,000)) in Dubai and Dh150,000 (US$41,000) in Abu Dhabi); increasing the maximum number of shareholders to 75 from 50; and removing the cap on the number of managers permitted. Notably, the new CCL enables the pledging of shares, which is set to ease the raising of debt financing.

For public joint-stock companies (JSCs), the new CCL allows for the possibility of different share classes, such as preference shares. The proposed legislation encourages initial public offerings by allowing founders to retain ownership of 30-70% of a JSC company's capital (compared with 20-45% under existing law), thereby dampening concerns among founders about losing majority control when listing shares on the stock exchange.

Since 2011 the UAE federal government has intensified its efforts to boost the employment of UAE nationals in the private sector. This was reflected in the new CCL, which maintains the requirement of hiring a local agent for foreign companies opening branches in the UAE. Majority Emirati representation remains obligatory on boards of directors of publicly-held companies, and the chairman of a joint-stock company must be a UAE national. Small and medium-sized enterprises (SMEs) are exempt, although local hiring is expected to facilitate procedures in dealing with government ministries.

Institutions overseeing capital flows

With its numerous free zones, the emirate of Dubai attracts the vast majority of capital inflows to the UAE. In order to start a business, registration with Dubai's Department of Economic Development is required. Financial services firms setting up in the Dubai International Financial Centre (DIFC) must seek approval from the Dubai Financial Services Authority (DFSA), a wholly independent regulatory body. The DFSA collaborates with international regulators on a continuous basis, and in 2013 it entered into 26 co-operation agreements with EU and European Economic Area (EEA) securities regulators for the supervision of fund management activity.

Outside of the DIFC, financial-services firms are overseen and regulated by the Central Bank of the UAE. The Emirates Securities and Commodities Authority (SCA), headquartered in Abu Dhabi, is the general governing body for the stock exchanges, securities, and commodities listed in the UAE (excluding the DIFC).

Foreign investment funds require approval from the SCA in accordance with the UAE Investment Funds Regulation (2012). Investment funds established in the DIFC are also treated as "foreign" funds, but an amendment issued in March 2013 introduced exemptions that retain access to government, brokerage and investment manager clients.

Debt and equity instruments

There are three stock exchanges in the UAE—the Dubai Financial Market (DFM), the Abu Dhabi Securities Exchange (ADX) and NASDAQ Dubai. The DFM and the ADX initiated merger talks in 2010, but progress has been slow. The DFM and NASDAQ Dubai consolidated some of their operations in July 2010. All three stock exchanges suffer from a lack of liquidity, with a few large stocks accounting for the bulk of trading. By forging a merger, the exchanges are hoping to create a single and more attractive regional and international trading platform, which would position the UAE as a market offering exposure to the oil-rich Gulf region.

All banks, as well as companies operating in the DIFC and those listed on the Abu Dhabi Securities Exchange and Dubai Financial Market, are required to publish financial statements according to International Financial Reporting Standards (IFRS). This is not required for unlisted companies, but is encouraged as a best practice. This promotion of IFRS encourages investment by boosting transparency and facilitating the comparability of financial information.

Policy initiatives to attract capital flows

Free zones remain the primary tools to encourage capital inflows. The DIFC offers financial firms highly attractive incentives, such as unrestricted foreign ownership and zero taxation on profits. A new financial free zone in Abu Dhabi was decreed in April 2013. The zone, referred to as the Global Marketplace of Abu Dhabi, will allow 100% foreign ownership of businesses and a 50 year tax exemption on profits.

There are no restrictions on foreign ownership of shares on the NASDAQ Dubai exchange, located in the DIFC. By contrast, the Dubai Financial Market and Abu Dhabi Stock Exchange, permit foreigners to own up to 49% of publicly listed UAE companies. Separate rules may apply for nationals of other GCC states.

3 – COMPLINACE WITH INTERNATIONAL FRAMEWORKS GOVERNING CAPITAL ACCOUNT LIBERALISATION AMONG THE COMCEC MEMBER COUNTRIES

While the meaning and understanding of the liberalisation of private capital flows continues to evolve over time, liberalisation in its most generic sense is widely understood as the elimination of barriers, direct and indirect, to capital flows. Among the various international instruments and frameworks aiming to ease restrictions and boost international private capital flows, three frameworks stand out.

OECD Code of Liberalisation of Capital Movements

The first international framework is the *Code of Liberalisation of Capital Movements* of the Organisation for Economic Co-operation and Development (OECD). The OECD has historically played a key role in fostering progressive liberalisation of current and capital account operations among its members. The concept of liberalisation, as described in the Code, focuses on the equal treatment of non-resident-owned assets and the removal of restrictions to the liquidation of all non-resident-owned assets.

Specifically, the Code builds on three key principles:[44]

- **Standstill**: Subscription to the general undertaking of liberalisation and avoidance from taking new restrictive measures or introducing more restrictive measures;
- **Non-discrimination**: Granting the benefit of liberalisation measures to all other adherents and applying remaining restrictions in a non-discriminatory fashion;
- **Transparency**: Reporting up-to-date information on barriers to capital movements and trade in services which might affect the Code's obligations and the interests of other adherents.

The framework's general undertakings are outlined in Article I. According to the Code, "members shall progressively abolish between one another, in accordance with the provisions of Article II, restrictions on movements of capital to the extent necessary for effective economic co-operation."[45] This tenet, usually referred to as the "rollback" principle, allows member countries to achieve liberalisation progressively and cumulatively. The second tenet is an obligation towards non-discrimination. Countries adhering to the Code are expected to grant the benefit of open markets to residents of all other member countries alike, without reciprocity requirements or any other discrimination.[46] Countries undergoing a process leading to a special system of regional integration (such as the EU) are partly exempted and the non-discrimination principle does not need to be extended automatically. The third tenet aims to ensure that full information is readily available to members.

[44] http://www.oecd.org/daf/inv/investment-policy/Codesinfosheet2012bis.pdf
[45] http://www.oecd.org/daf/inv/investment-policy/CapitalMovements_WebEnglish.pdf
[46] http://www.oecd.org/daf/inv/investment-policy/44784048.pdf

Reservations are possible, even if their introduction is strictly regulated. Article VII of the Code allows for a series of derogations, allowed when a country's "economic and financial situation justifies such a course". In particular, in case of balance-of-payments crises or a serious depletion of national monetary reserves, a country can temporarily suspend the application of measures of liberalisation listed in the Code. This derogation procedure needs to be clearly documented following the procedure outlined in Articles XIII through XV and can only be temporary, requiring review by the OECD every six months. Article XIV outlines special provisions for members in the process of economic development, mandating that the organisation shall have special regard to the effect that the economic development of the member has on its ability to carry out its obligations.

These provisions are supplemented by the *Code of Liberalisation of Current Invisible Operations*, which provides a detailed framework for cross-border services. In addition to requiring the removal of restrictions on current invisible transactions and transfers, the Code requires that liberalisation measures be applied to signatories in a non-discriminatory way.

In June 2012 the OECD Council delegated full decision-making powers to the Investment Committee, extending its membership to non-members willing and able to meet the standards of adherence. The Investment Committee is in charge of overseeing the operation of the Codes, acting as a forum for discussion and exchange of information, addressing questions of interpretation of their legal provisions, reviewing country measures, and assessing their conformity with the Code obligations.[47]

Articles of Agreement of the International Monetary Fund

The IMF has, by its Articles of Agreement, a mandate to oversee the international monetary system. In addition to its surveillance activities, the Articles mandate the fund to "assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade" (Article I). Capital movements are also an important part of the Fund's mandate. Under Article VI, members are free to "exercise such controls as are necessary to regulate international capital movements". This option is, however, limited by Article VII, which provides that any action in this sense must be no more restrictive than necessary and limited in time.

As capital markets have become more closely integrated, the Fund's approach has evolved. Global capital flows increased to a peak of about 20% of global GDP in 2007 from an average of less than 5% in the 1980-99 period.[48] In September 2011, the International Monetary and Financial Committee (IMFC) called for "further work on a comprehensive, flexible, and balanced approach for the management of capital flows, drawing on country experiences." In a call on the Fund to "play a key role in contributing to an orderly resolution of the current crisis and prevention of future crises,"[49] the IMFC enabled the crystallisation of a process aimed at identifying best practices in capital account opening. These best practices in capital account

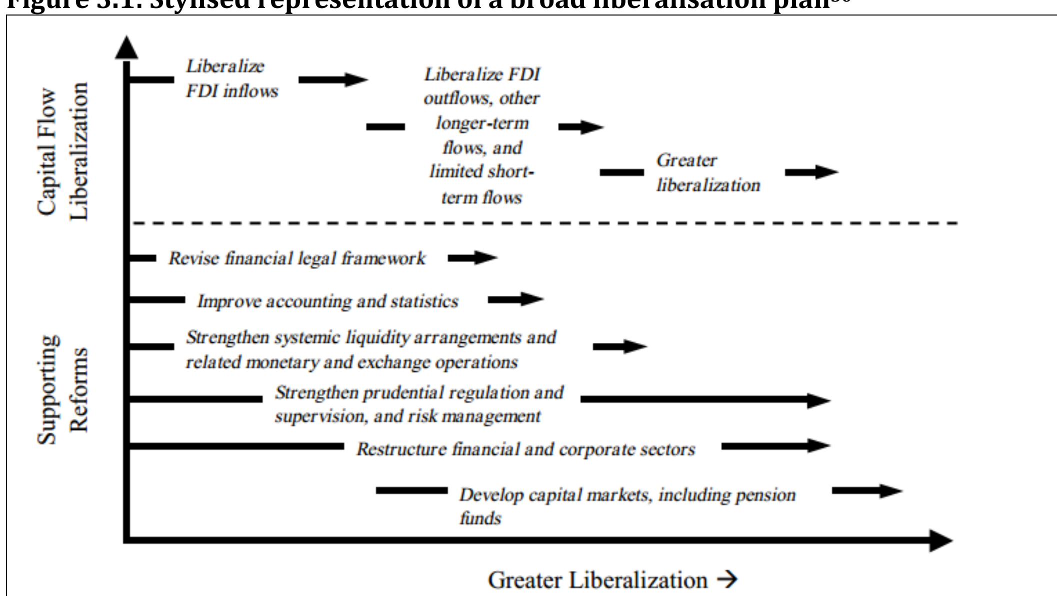
[47] http://www.oecd.org/daf/inv/investment-policy/Codesinfosheet2012bis.pdf
[48] http://www.imf.org/external/pubs/ft/survey/so/2012/POL120312A.htm
[49] http://www.imf.org/external/np/cm/2011/092411.htm

opening are outlined in what has become known as the 'institutional view', which outlines the importance of a number of factors to ensure that the risks associated with opening are adequately mitigated.

The institutional view stresses the importance of identifying "thresholds" of financial and institutional development that must be in place as a country liberalises. In this sense, there should be "no presumption that full liberalisation is an appropriate goal for all countries at all times" and that the correct sequencing of capital markets liberalisation is considered a priority in policy design and implementation.

The result is a framework for phased capital flow liberalisation. The first phase of the liberalisation process is FDI flows, which are considered stable and strongly correlated with growth. As investments have longer time horizons and capital is "locked" in the receiving country, FDI inflows provide a sound basis for long-term planning and decrease volatility. The second phase of the liberalisation process is the liberalisation of FDI outflows and long-term portfolio flows. As supporting reforms are implemented, greater liberalisation becomes safely viable.

Figure 3.1: Stylised representation of a broad liberalisation plan[50]



The sequencing of these phases should be based on country-specific circumstances and on levels of institutional development. In particular, the institutional view includes assessments of the following factors:[51]

- Macroeconomic and financial sector vulnerabilities
- Institutional and market development

[50] http://www.imf.org/external/np/pp/eng/2012/111412.pdf
[51] http://www.imf.org/external/np/pp/eng/2012/111412.pdf

- Design and effectiveness of existing controls
- Ability of the financial and non-financial sectors to handle large, volatile capital flows and to manage risks related to international capital flows and exchange rate flexibility
- Authorities' capacity to efficiently administer and enforce controls

The IMF is playing an increasing role in providing advisory services to countries in the process of undertaking capital account liberalisation.

Treaty on the Functioning of the European Union

The third international framework is the *Treaty on the Functioning of the European Union* (TFEU), which establishes the free movement of capital as a binding obligation among members of the EU, as well as between EU members and third countries. Article 63 of the Treaty stipulates that "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited".

Similarly to the OECD Code, the Treaty contains a number of exceptions. These exceptions allow countries to withhold pre-existing restrictions (Art. 64 (1) TFEU) and to introduce restrictive measures if justified by public policy or public security reasons (Art. 65 (1b) TFEU). Nevertheless, the European Court of Justice has made it clear in its rulings that these exceptions must be "construed narrowly and the measures taken must be suitable, proportionate, transparent, and subject to judicial review" and "those grounds must…be interpreted strictly, so that their scope cannot be determined unilaterally by each Member State without any control by the Community institutions".[52] These provisions have yet to be used in the history of the EU.

3.1. APPLICABILITY OF FRAMEWORKS AMONG THE COMCEC MEMBER COUNTRIES

In its 2012 *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER), which assesses exchange and trade arrangements, the IMF highlights an easing of measures limiting foreign transactions among its member countries. According to the report, the number of IMF member countries accepting the obligations of Article VIII, Sections 2(a), 3, and 4, increased to 168 when Mozambique accepted them as of May 2011.[53] Restrictions have continued to decline, current account openness has increased, and a number of changes have been effected in a broader effort to strengthen countries' financial regulatory frameworks, implementing lessons learned from the financial crisis and addressing capital flow volatility risk.

[52] http://ec.europa.eu/internal_market/capital/third-countries/treaty_provisions/index_en.htm
[53] http://www.imf.org/external/pubs/nft/2012/eaer/ar2012.pdf

The degree to which COMCEC Member Countries adhere to the three frameworks outlined above varies significantly. Despite a trend towards general alignment with the main liberalisation principles of the frameworks, actual implementation among countries varies and tends to match individual states' degree of institutional development and exposure to the global economy. In this sense, lessons around sequencing appear to be gaining ground.

However, country performance is diverging more markedly in the implementation of supporting reforms, particularly as regards financial sector development and capital markets development. In the design and implementation of these reforms, which are decisive in attracting portfolio investment, higher-income countries appear to be faring better than their lower-income peers.

3.1.1. LOW-INCOME COUNTRIES

Bangladesh

Bangladesh's system of strict capital controls goes back to the time when East Pakistan was a province under British control. Strict exchange controls are still in place, although regulations have been significantly relaxed since then, and since Bangladesh became independent from East Pakistan in 1971.

The IMF's 2012 *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER) classifies Bangladesh as being in the top third on its "Restrictiveness Index" (Bangladesh's neighbours India and Myanmar also fall into this category). According to the report, the Bangladeshi authorities restrict payments or transfers of interest from deposits or bonds. The IMF notes that Bangladesh maintains an exchange restriction on the convertibility and transferability of proceeds of current international transactions in non-resident accounts denominated in the local currency, the taka.

Bangladesh does not treat all non-resident-owned assets in the same way irrespective of the date of their formation, as set out in the OECD Code. However, the country has adhered to the Code's objective of not making existing regulations more restrictive.

Bangladesh declared full current-account convertibility in 1994; the taka is freely convertible in the current account. The capital account is virtually fully open to inflows and outflows of non-resident-owned equity and longer-term debt funds; however, the capital account remains restricted for resident-owned investment abroad and for non-resident-owned short-term capital flows.

Bangladesh appears unlikely to remove these remaining restrictions on the capital account in the foreseeable future. In some respects, its relative isolation from international capital markets has meant that the repercussions of the global financial crisis on Bangladesh's economy, its banking sector and financial markets have been extremely limited, for example.

Some features of Bangladesh's securities markets set it apart from other countries such as the current rules governing the pricing of initial public offerings (IPOs) - the lottery method of share allocation of oversubscribed IPOs is in contrast to the widespread practice of allocating shares on a pro rata basis. This has the potential to dampen the appetite of institutional investors to participate in the country's securities markets.

Mozambique

According to Mozambique's Law on Foreign Exchange, all capital account transactions must have prior approval from the central bank. Under current regulations, these controls are permanent. In line with this, Mozambique has yet to adhere to international frameworks on capital liberalisation and has further room for alignment with the requirements of such standards. In general terms, however, capital movements do receive authorisation and are not subject to discriminatory taxes.

In its 2012 *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER), the IMF notes that Mozambique has controls in place for all types of capital account transactions that are tracked. Mozambique also has specific provisions in place for institutional investors, commercial banks and other credit institutions. However, the AREAER defines capital controls in their broadest sense, meaning it reports that a majority of countries – even OECD members – as controlling at least some capital transactions.

Benchmarked against the OECD's *Code of Liberalisation of Capital Movements*, Mozambique's regulations have the potential to slow long-term and short-term capital flows. There is openness with regard to FDI, however. As highlighted by the World Bank's *Investing Across Border*s indicators, most economic sectors in Mozambique are fully open to foreign investors – in contrast to many of its peers. Nevertheless, although Mozambique's regulation of capital flows is transparent, the central bank maintains discretionary powers in its assessment of applications.

In the current context, it appears that there is much scope for Mozambique to adhere to the OECD Code. For now, Mozambique has implemented capital controls with the aim of insulating the economy from volatile and potentially destabilising capital flows, and the authorities have not signalled any intention to move away from this in the short term.

3.1.2. LOWER-MIDDLE INCOME COUNTRIES

Indonesia

At Indonesia's latest Article IV consultation with the IMF, in September 2013, the Fund praised the government for the passage of legislation that created the Financial Services Authority (OJK) and the accompanying plan to transfer supervision of capital markets to the new organisation.

However, the IMF also warned about the risks to regulation and supervision in the transition phase from the central bank to the OJK. It described the need for clarifications in the legislation as to which of the two institutions would be responsible for a new macroprudential policy framework. It is not yet clear whether the current challenges that Indonesia is facing – a weakening currency, depreciating foreign-exchange reserves, a widening current-account deficit and slowing growth in FDI inflows – could have been managed differently during the transition from the central bank to the OJK. The IMF also noted that loose monetary policy had amplified the effects of capital outflows in 2012.

The Fund continues to push for a deepening of financial markets as a solution to one of the economy's most pressing problems: providing funds for public and private investment. Following the 1997-98 Asian financial crisis, local companies remain wary of taking on new debt, meaning bank credit remains low and many firms finance expansion through retained earnings. The IMF proposes the development of the government bond market and the pension and mutual funds industries.

Following recent regulation imposing stricter limits on foreign investment in Indonesia's mining sector, the Fund restated its belief in the importance of an open trade and investment regime. It argues that policy should be created to ensure that economic openness is maintained in conjunction with industrial policy; and it suggests that the government's oft-stated ambition to move up the value chain could be achieved "naturally… with greater investment in human capital, reduction in the costs of doing business, and deepening of financial markets."[54]

Beyond this, the architecture of Indonesia's capital account fares well in respect of the OECD's *Code of Liberalisation of Capital Movements*. Nevertheless, the recent moves by Indonesia to limit foreign holdings in the mining sector are not fully aligned with Article 1 b i of the OECD Code, given that Indonesia was not facing any of the clauses of derogation listed in Article 7 when the regulations were imposed.

Nigeria

Over the past decade, Nigeria's regulatory and legal frameworks relating to capital flows have been largely aligned with international standards on capital liberalisation, with the notable exception of the global financial crisis in 2008-09, when temporary restrictions were enforced. At present, the country is mostly in line with international frameworks on capital liberalisation, including the OECD *Code of Liberalisation of Capital Movements*.

Significantly, though, the central bank has shown that it will curtail the movement of capital if it considers it necessary to defend the naira and maintain monetary stability. For example, in May 2012 the regulator stopped Nigerian banks from recapitalising their foreign subsidiaries, stating that capital demands by regulators in host countries were putting enormous pressure on the capital base of parent banks.

In recent years, the number of Nigerian banks with foreign subsidiaries has grown as domestic lenders have gained confidence and developed international ambitions. Currently, at least six

[54] 2012 IMF Article IV report: http://www.imf.org/external/pubs/ft/scr/2012/cr12277.pdf

of Nigeria's 21 commercial banks have subsidiaries, mostly located in West Africa; several Nigerian insurance companies have also opened offices in other parts of Africa over the past decade. The expansion of Nigerian financial institutions into other West African countries is transforming Lagos into a major financial centre. However, this movement towards regional integration is likely to slow if Nigeria's financial authorities continue to limit the capacity of banks to deploy their capital abroad.

3.1.3. UPPER-MIDDLE INCOME COUNTRIES

Malaysia

Following the Asian financial crisis of 1997-98, Malaysia adopted strong measures to reverse the subsequent sharp decline in economic growth, to stem the flow of domestic savings into foreign markets, and to support the recovery of the banking sector, which had been hit by high levels of non-performing loans. Where Malaysia had previously had fairly open financial markets, these measures represented a reversal of some of the country's liberal policies. To stabilise the exchange rate and stem speculation, the ringgit was pegged to the US dollar, and selective capital controls were introduced. The restrictions on capital markets were in line with the OECD's Article 7b) of the Clauses of Derogation. Some capital controls were eased in 1999 as financial markets stabilised. Once economic growth had stabilised, Malaysia's economy was back on track towards liberalisation.

Since 2001 financial markets have been the focus of the Malaysian government's attention through the Financial Sector Masterplan (FSM) and the Capital Market Masterplan (CPM). The FSM had three stages: the first focused on capacity-building, the second promoted deregulation and the third targeted deeper global integration. The FSM2 and the CMP2 will now target the entrenchment of the liberalisation of the financial sector, the further strengthening of infrastructure in the sector and the closer integration of domestic and global financial institutions.

Malaysia's progress towards capital and financial markets liberalisation is in line with the IMF's institutional guidelines on capital flows, particularly regarding the stipulation that liberalisation should be well planned, timed and sequenced. Faced by risks associated with inflow surges or disruptive outflows, Malaysia has used macroeconomic policies and sound financial supervision and regulation as well as capital flow management measures in line with IMF and OECD recommendations.

Turkey

The Republic of Turkey's attitude to free capital flows has been influenced by its close integration into Western alliances and institutions on the one hand, and by its long-standing need to import capital – and hence attract foreign investors – on the other. Turkey was a founder member of the OECD in 1961. Its Association Agreement with the European Union

(previously the European Economic Community) dates back to 1963. Turkey was quick to take part in the movement towards economic liberalisation in the 1980s.

Turkey has performed well in terms of its adherence to the OECD *Code of Liberalisation of Capital Movements*. From 1962 to 1985, Turkey benefited from a special dispensation. Thereafter, however, in parallel with the steps it had begun to take towards liberalising capital movements, Turkey began to adhere to the obligation to eliminate reservations for all measures that limit or restrict operations listed in the Code. Turkey went on rapidly to establish full current-account convertibility and capital-account liberalisation in the 1980s, liberalising outward direct investment and portfolio investment at the same time, and achieving Article VIII status under the IMF's Articles of Agreement in 1992. Although the ebb and flow of short-term capital inflows has contributed to economic instability on a number of occasions, subsequent changes in legislation and regulation have been overwhelmingly in the direction of liberalisation.[55]

Turkey's reservations regarding the OECD Code are quite limited in number. For example, with respect to FDI, limited reservations or conditions are in force concerning mineral prospecting rights and media companies, suggesting lingering concerns about sovereignty and security. More generally, foreign investors in productive assets are expected to establish domestic legal entities; then they are treated in the same way as other domestic companies. With respect to financial investments, the few legal and regulatory limitations are mainly of a prudential nature, affecting insurance assets and trade financing, for example, as well as domestic sales of foreign securities.[56]

In recent years, Turkey has continued to take steps to liberalise capital movements – even in the areas where it has made reservations to the OECD Code. In October 2010, new rules on the registration of public offerings and sales of foreign securities in Turkey abolished the requirement to conduct public offerings of foreign stocks in Turkey through depository receipts. Since March 2011, foreigners have been permitted to own up to 50% of two media companies, compared with 25% of one media company previously. Finally, a law of May 2012 eased various restrictions on the acquisition of real estate in Turkey by foreign individuals and companies.[57]

As a candidate member of the EU, Turkey is required to adhere to the Treaty on the Functioning of the European Union, including prohibiting restrictions on the movement of capital. In this context, the 2013 Progress Report of the European Commission states that the acquisition of real estate by foreigners in Turkey remains to be fully liberalised in line with the *acquis communtaire* (the body of EU law), and that restrictions on foreign ownership persist in

[55] "*International capital flows: Structural reforms and experience with the OECD Code of Liberalisation of Capital Movements*" - Report from the OECD to the G20 Sub-Group on Capital Flow Management June 2011

[56] Turkey's reservations are noted on pages 126-129 of the OECD Code of Capital Movements 2013 at http://www.oecd.org/daf/inv/investment-policy/CapitalMovements_WebEnglish.pdf

[57] For details see 'The OECD Freedom of Investment Process: Inventory of investment measures taken between November 15th 2008 and February 15th 2013' at http://www.oecd.org/daf/inv/investment-policy/FOIinventorymeasures_March_2013.pdf

radio and TV broadcasting, transport, education and electricity generation and distribution. The Commission does not, however, make any criticisms related to movements of financial capital, such as portfolio investments.

Policy pays off: how the introduction of pragmatic policies put Turkey at the top of the table

Insofar as Turkey's experience in attracting capital flows represents the achievement of a policy goal, two factors which merit highlighting are:

--Policy-makers' understanding of the importance of attracting foreign investment, setting aside considerations of nationalism or sovereignty, and empathising with the interests of the investor. Foreign investors are almost always treated equally with domestic investors in Turkey, under the same laws, and without any discrimination. International arbitration is accepted. In 2001, a harsh IMF belt-tightening programme was preferred over external debt default or restructuring. Despite the volatility of the lira, capital controls have not been considered since they were liberalised in 1989.

While foreign investments have sometimes faced legal difficulties, and problems may persist in areas such as work permits, there have also been many cases of favourable treatment. In some respects, such as taxation of securities earnings, conditions for foreign investors are arguably more attractive than for local investors. Policy-makers have sought to facilitate foreign investments because they are convinced that they are good for their own economy.

--The professionalism and competence of government bodies with responsibilities in areas related to capital movements. By and large, areas such as public debt management, bank and utilities regulation, capital markets regulation and general business law and regulations have been the reserve of qualified technocrats, both in terms of day-to-day implementation and in terms of the development of policies, laws, regulations and institutions.

With respect to capital markets, for example, this has made it possible to overhaul the Capital Markets Law and to establish the Borsa Istanbul, its technology agreement with NASDAQ OMX, and its ongoing effort to encourage entrepreneurs to list their companies on the stock exchange, and to introduce various innovations in trading.

3.1.4. HIGH-INCOME COUNTRIES

Bahrain

With respect to international standards on capital account liberalisation, Bahrain can be considered to be setting something of a benchmark for the other countries in this World Bank income group and beyond. Given its relatively low level of natural resources compared with its high-income and GCC peers, Bahrain has long had to adopt more innovative policies to support

the development of its economy. As a result, it has served as a regional financial services centre since the 1970s (when it displaced Lebanon) and has a long history of acting as a non-hydrocarbons industry hub.

In the IMF's 2012 *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER), Bahrain displays five restrictions on the movement of capital: bilateral payment arrangements, controls on capital market securities, direct investment, real estate transactions and specific provisions on commercial banks. Among its peers in the high-income country group, Bahrain, the UAE, and Oman have the fewest capital account restrictions; the restrictions that foreign firms face when operating in or trading across Bahrain's borders are relatively low and are unlikely to act as a significant deterrent to capital flows.

Furthermore, Bahrain displays strong adherence to the OECD's *Code of Liberalisation of Capital Movements*. In particular, the kingdom appears highly compliant with several of the Code's general undertakings; it allows the liquidation of non-resident owned assets without restriction and seems unlikely to introduce any restrictions on the movement of capital. Still, Bahrain is not fully compliant with the OECD Code's assessment of operations in real estate or capital market transactions given the country's restrictions on non-Bahraini ownership of property, or limitations on foreign ownership of equities on the local capital market.

Because of Bahrain's high reliance on foreign capital flows for economic growth and a policy commitment to continually improve regulations, the country appears unlikely to depart significantly from its adherence to either the IMF's or the OECD's international standards and guidelines for capital account liberalisation.

UAE

Free trade zones in the UAE, such as the Dubai International Financial Centre (DIFC), adhere to many of the principles of the OECD *Code of Liberalisation of Capital Movements*, such as unrestricted foreign ownership and foreign establishment of a business. Outside of these designated areas, however, foreign ownership of UAE-registered companies is limited to 49%, and in order to establish a business, foreign investors must find a local partner to hold a majority share.

In some cases, limits on foreign ownership of certain companies may be below 49%; in the case of a Dubai-based developer Union Properties, for example, the limit is 15%. Furthermore, insurance companies must be 75% owned by a UAE national or 100% owned by a UAE corporation, and a UAE national services agent or sponsor is required for branch offices and representative offices of foreign companies.

A draft version of the new Companies Law had contained a clause relaxing foreign business ownership limits, but this was removed by the Federal National Council in February 2013. The final version of the legislation, approved in May 2013, places greater focus on legal requirements for local businesses. A new investment law planned for debate in late 2013 is expected to focus on foreign investment, and may address foreign ownership.

Foreign ownership of land is generally restricted, although the rules of individual emirates may specify freehold or leasehold rights for non-GCC nationals. No foreign-exchange controls apply to restrict the repatriation of profits or capital.

Developing capital markets in Malaysia: a history of successful regulations

Malaysia adopted a very structured approach to developing its capital markets. The first Capital Market Master Plan (CMP1) was the guiding force for the development of the capital market from 2001 to 2010. According to the Bank Negara Malaysia (BNM, the central bank), since 2000, the growth of the Malaysian capital market outpaced the growth of the economy, expanding from RM718bn ($223bn) to RM2trn ($623bn), an annual compound growth rate of 11%.

Rapid expansion and strong regulatory oversight were key to the growth of the capital market. In 2000, Malaysia's capital markets primarily comprised equities and government debt securities and under the aegis of the master plan, CPM1, the private debt securities market and markets for investment management were developed. This was accompanied by the development of an Islamic capital market (ICM). The CMP1, which was governed by 152 recommendations, provided a comprehensive roadmap for the orderly growth and diversification of Malaysia's capital market. Its strategic focus included initiatives to promote the growth of the investment management industry, enhance market and intermediation competitiveness and provide a strong regulatory regime, among others, along with the goal of establishing Malaysia as the centre of an international Islamic capital market.

According to the central bank, 95% of the recommendations in the CMP1 had been enacted by the end of 2010. The key foundations of the capital market were the development of conditions that promoted the rapid growth of industry, and the establishment of a strong regulatory and institutional framework that provided investor protection in line with international standards. In terms of Shariah compliance, the central bank believes Malaysia leads the way in providing the most consistent and comprehensive regulatory framework.

The important component of the development of Malaysia's capital markets was the move from a narrow capital market to a broad capital market. In the 1990s, Malaysia's capital market was relatively narrow and infrastructure projects were largely funded by the banking system; the mismatch in maturity was identified by the central bank as a source of systemic risk during the 1997-98 Asian financial crisis. Structural changes under the CMP1 focused on changing the channels of savings mobilisation and intermediation to reduce funding vulnerabilities.

The expansion of the capital markets has been accompanied by the diversification of financing sources, and a balance between debt and equity assets was actively sought to strengthen the resilience of the financial system.

The growing sophistication of financial intermediation was accompanied by deregulation and liberalisation which, according to the central bank, lowered friction costs, increased economies of scale, and expanded distribution channels.
The consolidation of exchanges and clearing houses, followed by the demutualisation and listing of the exchange, the reduction of transaction costs, the upgrading of market infrastructure (including new trading platforms) and the consolidation of stockbrokers were all steps leading to the evolution of the capital market.

Not surprisingly, during the CMP1 the ICM expanded by 13.6% annually from RM293.7bn in 2000 to slightly over RM1trn ($US312bn) in 2010. According to the central bank, at the end of 2010, more than half of Malaysia's capital market assets were Shariah-compliant. Malaysia is also credited with the innovation and the launch of new ICM products and structures such as the exchangeable sukuk, the sovereign sukuk and Islamic REITs.

4 – ENHANCING CAPITAL FLOWS AMONG THE COMCEC MEMBER COUNTRIES- OPPORTUNITIES AND OBSTACLES

The opportunities to enhance capital flows among the COMCEC Member Countries – and the obstacles that they must overcome in order to do so – are wide-ranging and, are closely associated with the presence of a number of "pull factors" in recipient countries. These internal factors include a country's institutions, policies, structural reform, and macroeconomic fundamentals. The degree of development of these factors determines the strength of the financial systems, rule of law, transparency, taxation regimes and political stability, which ultimately influence investor confidence – and sway decisions by investors.

4.1. HOW REFORMS CAN AFFECT CAPITAL FLOWS

Macroeconomic and financial stability, transparency and effective structural policies have a significant role to play in supporting investor confidence in the context of capital flows. For many countries, structural reforms help economies to better absorb capital flows. Such reforms may include steps to deepen domestic bond and equity markets, develop financial products without undue risk, and strengthen financial regulation and supervision, while streamlining rigidities.[58]

In the case of FDI – in general terms a longer-term form of investment that is often linked to infrastructure – large-scale funds are required to be committed over a long period. Local bond markets that are well developed and integrated are able to facilitate the raising and intermediation of such resources. Deep capital markets help to increase the absorptive capacity of the recipient country, and are particularly crucial in offsetting volatility that can be caused by sudden inflow surges.

In this context, regulatory frameworks are highly significant in fast-growing economies, where investors may have reservations about the rule of law and may question whether domestic and international rulings are upheld.

Examples of measures to enhance capital flows can include opening up privatisation programmes to foreign investors; opening up more sectors to investment and reducing sector restrictions; raising standards of treatment of foreign affiliates –for example, through guarantees of legal protection, free transfer of profits and repatriation of capital and FDI-specific laws that ensure foreign companies are treated in the same way as domestic ones.

The implementation of supporting reforms depends largely on the existence of appropriate government institutions and political will. Having measures in place to help overcome administrative barriers is important to ensure a level playing field for all investors; barriers can provide an opening for corrupt practices and can increase transaction costs of investment

[58] http://www.imf.org/external/np/pp/eng/2012/111412.pdf IMF (2012), 'The liberalisation and management of capital flows: an institutional view'

operations, as investors who lack political connections, local partners or the financial resources to hire economic and legal advisors may be discouraged from investing.

Policies to promote investment by improving the image of the recipient country can also be effective in informing investors who may have inaccurate perceptions of the country, particularly if it is located in close proximity to economies that are politically unstable.

4.2. THE ROLE OF COUNTRY ENDOWMENT AND INVESTOR MOTIVATION

Having in place a favourable policy framework is not the only key to attracting capital flows, however. The fundamental endowment of a country can also heavily influence investors. These characteristics include:

- Demographics, such as a large, growing and young population – Indonesia and Turkey are two examples of countries with favourable demographics
- Natural resource endowment – Nigeria, Kazakhstan, Indonesia, most of the oil-exporting (GCC) states, and much of SSA contain plentiful mineral reserves; and
- Proximity to large markets – Four billion people live within an eight-hour flight range of the UAE, for example

Literature commonly refers to foreign investors having three main motivations. While these are often associated with FDI, they are also highly relevant to other forms of investment, such as portfolio investment. The three motivations are as follows:

- Market-seeking – the investor may aim to sell goods or services in the recipient country and may be motivated by the size and location of the economy
- Resource-seeking – the investor may be driven by the opportunity to exploit natural resources or other strategic assets in the recipient country; and
- Efficiency-seeking – the investor may be drawn to the recipient country by the opportunity to exploit labour or infrastructure to achieve cost savings.

The likely motivations of foreign investors may have a bearing on individual countries' choices of measures to enhance capital flows. For example, if the motivation to invest is resource-seeking, as it may be in the case of FDI, the foreign investor may have little choice in terms of selecting a location with solid regulation or political stability. In such cases, natural resources may attract investors even in the absence of an attractive policy environment, although it is clear that countries rich in natural resources that have a favourable business environment will still prevail over those countries which do not have such measures in place.

In the case of efficiency-seeking motivations, the host country faces even more competition and more pressure to ensure it has appropriate political and economic frameworks in place.

Investors have more choice in this regard, and will be more driven by the degree to which the host country has infrastructure, skills, a regulatory framework and a robust investment strategy in place.

4.3. THE IMPORTANCE OF SEQUENCING

Furthermore, sequencing of policies and reforms is an important consideration for recipient countries. Much literature has supported this theory, suggesting that countries that are deemed to have followed a proper sequencing of reforms – eliminating macroeconomic imbalances and, in some cases, achieving a high degree of trade openness – may benefit all the more from capital account liberalisation, and in turn also attract capital flows that are that much stronger.

For low-income countries and certain lower-middle income countries, tackling fundamental issues such as corruption or poor governance may be a higher priority than "discussing achieving macroeconomic stability".[59] Having a fully open capital account may achieve little if institutional development remains at an early stage, as is the case in Djibouti.[60]

For its part, the IMF calls for a threshold approach that requires certain financial and institutional development thresholds to be reached before moving ahead with further measures to liberalise capital flows.[61] In this context, attracting long-term, stable FDI flows before attracting short-term, volatile portfolio capital flows may be a favoured option among countries that have not fully achieved strong financial and institutional capacity.

The types of policies required to draw foreign portfolio investment (FPI) and the types of policies required to draw FDI are often different, though complementary. In a research paper cited at an OECD forum in 2002,[62] the author writes that stable macroeconomic policies, rule of law, good governance, financial disclosure and transparency are key to attracting both FPI and FDI. However, where good infrastructure, education and health levels may be sufficient to attract FDI, policies governing more advanced factors may be required to attract FPI. These factors include the following:

- Strong and well regulated markets able to withstand volatility
- Institutions that can identify, monitor and manage business risks effectively
- Adequate capital to safeguard against losses
- Sound competition in the financial sector

[59] Interview with an official in the MENA division, IMF, September 9th 2013
[60] Ibid.
[61] "The liberalisation and management of capital flows: an institutional view", IMF, 2012
[62] K. Evans, "Foreign portfolio and direct investment – complementarity, differences and integration", OECD Global Forum on international investment, 2002

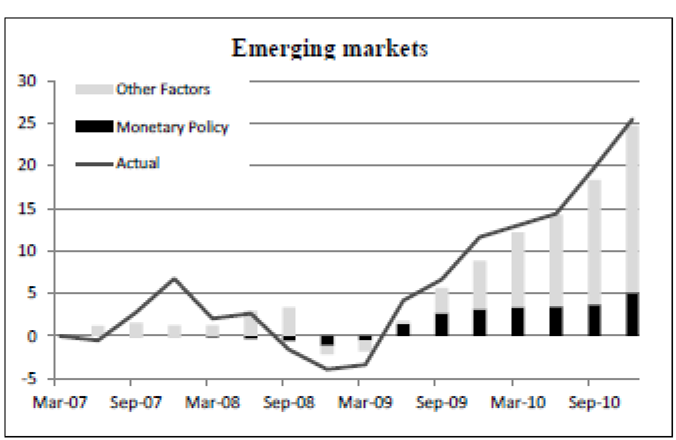
- Solid guarantees of financial institutions and implicit government support
- Non-excessive regulation
- Regulators with a sound understanding of exchange rate risk, credit risk, liquidity risk and other risks.

4.4. GLOBAL LIQUIDITY AS A DRIVER OF FINANCIAL FLOWS

Besides internal factors driving capital inflows to developing economies, external factors may also play a role. Economists who hold the "external factor view" argue that capital inflows to developing economies rise when financing conditions in investor countries ease. In these cases, it is portfolio investment flows in particular that are strengthened by favourable liquidity conditions and a benign macroeconomic environment across the globe; by contrast, FDI inflows are more dependent on internal factors in the recipient country.

The role that external factors play in driving capital flows is highlighted by Figure 4.1 below, from analysis undertaken by the European Central Bank showing that quantitative easing (QE) policies of the US in recent years boosted portfolio capital inflows to many emerging countries.

Figure 4.1: The cumulative impact of US quantitative easing and other control variables on equity portfolio flows[63] to emerging countries



Source: "On the international spillovers of US quantitative easing", European Central Bank Working Paper, June 2013

A number of drivers may explain this phenomenon, such as low interest rates in developed economies, which encourage investors to search elsewhere for higher yields, or low interest

[63] Expressed as a percentage of assets under management in the country of destination

rates, in developed economies, which encourage borrowers in developing markets to borrow in international currencies rather than in their own domestic currency.[64]

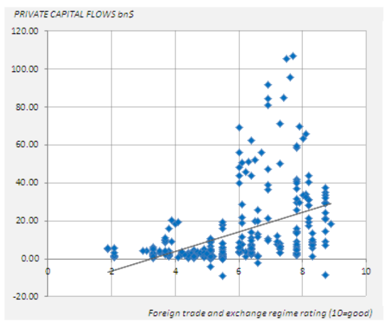
However, recent data indicates a reversal in portfolio equity flows and reduced bond inflows on a global level since March 2013,[65] as investors have started to price in a tighter monetary stance on the part of the US Federal Reserve. In time, it is likely that the boost to emerging market capital inflows from global monetary policy will fade, as the interest rate differential between emerging markets and mature economies continues to narrow. As such, solid fundamentals are an increasingly urgent priority for recipient countries. Countries expecting to attract private capital inflows will increasingly need to count on solid fundamentals at home rather than favourable liquidity conditions globally.

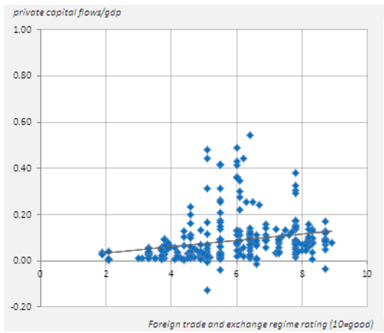
What is the relationship, if any, between the Business Environment Rankings of the EIU and private capital flows?

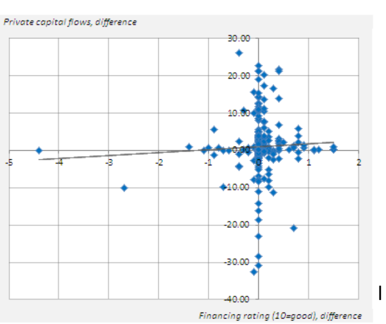
The EIU conducted a preliminary data analysis of its Business Environment Rankings (BER)[66] scores to ascertain what insights, if any, could be drawn on the determinants of private capital flows. The EIU selected five BER categories for this analysis, based on their possible relevance to private capital flows:

- Macroeconomic environment – this category includes factors such as average inflation, average budget balance, external stability and exchange rate volatility.
- Market opportunities – includes GDP growth, GDP per head, share of world merchandise trade and profitability.
- Policy and attitudes towards foreign investment – consisting of government policy towards foreign capital, availability of investment protection schemes and risk of expropriation of foreign assets.
- Foreign trade and exchange regimes – including capital account liberalisation, tariff and non-tariff protection and transactions on the current account.
- Financing – covering the health of the banking sector, stock market capitalisation and quality of financial regulation.

As a first step in this analysis of BER scores, we looked at the relationships between capital flows and BER







[64] "Capital Flows and emerging market economies", Bank for International Settlem l System, 2009.
[65] , "Capital Flows to Emerging Market Economies", Institute for International Finance (IIF) research note, June 26 2013
[66] See Appendices for the BER methodology

scores across all time periods for the pool of COMCEC Countries. Three BER categories – foreign trade and exchange regime (shown here), market opportunities, and financing – revealed the trend that higher BER scores related to higher levels of private capital flows.

Does economic size matter?

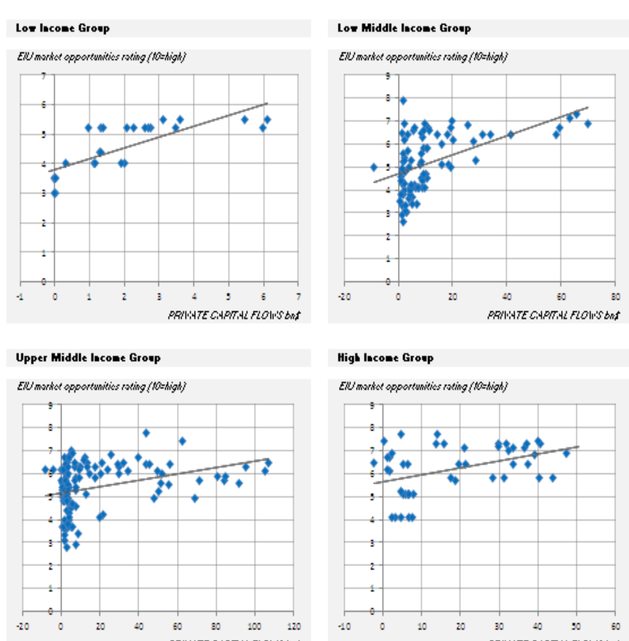
To explore whether the size of the economy is a factor in attracting capital flows, we examined private capital flows in relation to GDP. As can be seen with the foreign trade and exchange regime categories (shown here), there is a positive relationship when private capital flows are viewed as a share of GDP.

Does an improving business environment induce growth in private capital flows?

The next step was to seek evidence that a changing business environment attracts capital flows. In the data analysis we tracked the change in a BER category and the change in capital flows. The financing category (see right), shows a moderately positive relationship, implying that an improving financial environment induces capital flows. The picture was less clear, however, for the other BER categories.

Does the apparent effect of the business environment depend on the level of income?

The EIU conducted further analysis on the basis of the World Bank's four income categories – low-income, lower-middle income, upper-middle income, and high income. This enabled analysis of the influence of the business environment for high and low income countries. The three BER categories – foreign trade and exchange regime, market opportunities, and financing – were more relevant for lower income countries. The macroeconomic environment and policy towards foreign investment showed no such pattern across income groups.



Caveats

The data analysis discussed here is preliminary in nature and does not allow firm conclusions to be drawn about the causality of the BER scores examined here. While this analysis can point towards potential relationships, a more sophisticated regression analysis would need to be undertaken to be able to make more conclusive statements about the causal link between BER scores and private capital flows.

Conclusions

Caveats notwithstanding, the preliminary analysis conducted here provides initial evidence of the likely influence of a business environment (BER) category on private capital flows. This analysis suggests that it is the areas of *financing, market opportunities* and the *foreign trade and exchange regimes* that are most likely to influence capital flows. The link between these areas of the business environment and capital flows seems intuitive. In terms of financing, for example, it is unlikely that private capital will be attracted to countries with poor financial regulation and unsound banks. In terms of market opportunities, solid GDP growth indicates the potential for attractive returns on capital in a given country. And in terms of the foreign trade and exchange regime, funds are attracted to markets where the movement of capital is free and trade protection is at a minimum.

4.5. THE POTENTIAL EFFECT OF ENHANCED CAPITAL FLOWS ON ECONOMIC GROTH WITHIN COUNTIRES

Enhanced inflows of capital are normally expected to raise the pace of growth of an economy by increasing the availability of capital, which together with land and labour is one of the three classic factors of production, and often the scarcest. Capital inflows may also support economic growth in less obvious ways. Direct investment may not only allow the recipient country to make fuller use of its natural and human resources, but may also result in opportunities for the development of the domestic management and technical skills base, and for the acquisition of technology. Export-oriented foreign investment may allow an economy to gain entry points into new foreign markets. In highly-integrated industries like automotives, for example, manufacturers investing in a country effectively bring their global markets along with them. Official and private lending can provide borrowing countries not only with a larger pool of capital but also with longer-term financing options than are currently available, making it possible to finance long-term investments, including infrastructure investments improving economic competitiveness, the investment climate and overall quality of life. Efforts to meet the demands of foreign investors and financiers for legal protection and efficient, transparent business environments can further stimulate investment by domestic individuals and enterprises raising economic efficiency. Similarly, the presence of foreign portfolio investors can play a large part in the development and deepening of domestic capital markets.

For the reasons above, increasing capital inflows can support economic growth, even in countries without capital shortages, such as Saudi Arabia, the UAE, Kuwait, Qatar, Kazakhstan and several other oil-producing COMCEC Member States. These countries can also benefit enormously from capital outflows as they diversify their holdings and achieve higher returns than would be possible confined only to their domestic markets. This provides a clear opportunity for closer linkages between capital rich and capital importing nations within the network of the COMCEC Member States.

More widely, capital inflows are driven by the profit motive and necessarily lead to future outflows of principal and interest or of dividends and repatriated capital. In addition, their

impact on economic growth is thought to vary depending on the type of flows: FDI is often considered more beneficial than portfolio equity, and portfolio equity more beneficial than bond issuance and borrowing. This however is highly contingent on the needs of the country and the areas of its competitive advantage. Within the context of FDI, greenfield investment in export-oriented industries is typically considered more beneficial for spreading wider economic development than acquisitions from the local public or private sector of existing, domestic market-oriented productive assets, or of real estate. On the other hand, foreign capital investments in primary industries using specific technologies and skills which have to be imported, and employing relatively few native staff, have notoriously low multiplier effects in the domestic economy, limiting their impact on broader economic development. Many of the COMCEC Member Countries which permit foreign investment in oil and gas therefore aim for compensation in the form not only of royalties and taxation but also through offset deals, as well as making additional efforts to attract foreign investment in other sectors. It must be noted that some offset agreements tend to have a tarnished reputation, however, due to allegations of corruption or mismanagement.

Capital flows are also by nature irregular. They are easily affected by general international liquidity tightening and depressed commodity prices (such as affected most COMCEC Member Countries in 2009). The perception of bubbles and financial sector weakness (as in the Asian crisis of 1997 or the Kazakhstan housing credit market a decade later), or of an excessive current account deficit, can also affect the strength of capital flows, as can damaged investor confidence (e.g.: in the countries currently undergoing political transitions, and their neighbours). Strong capital inflows –and especially short-term flows of financial capital – tend to cause a country’s currency to strengthen, asset prices to inflate and interest rates to decline. When strong capital inflows weaken, a sharp and disruptive correction may ensue, and a boom cycle can turn into a bust cycle. The difficulty of managing these cycles in an open economy with a large current account deficit has caused Turkey, which attracts the highest capital inflows of all COMCEC Countries, to pay more attention to increasing domestic savings.

Finally, the impact of capital inflows on growth appears to be greatest not simply in countries with the lowest current GDP levels, but in countries with adequate social and human capital as well as administrative, legal and financial institutions able to cope satisfactorily with such capital movements. In the light of these considerations, no country can turn its back on the potential benefits of capital inflows, but each country may wish to adopt a strategy and targets that take account of its existing conditions, its capital needs, and the types of flows which it is most likely to attract.

4.6. OBSTACLES AND OPPORTUNITIES AMONG THE COMCEC MEMBER COUNTRIES

Drawing on the discussion of capital flows among the COMCEC members, it is possible to identify a number of barriers to stronger capital flows among these countries, as well as a number of opportunities to enhance capital flows among them. These barriers and opportunities are analysed below in accordance with the World Bank's classification by country income groups.

4.6.1. LOW- INCOME CONUNTRIES

Barriers

The barriers that a country faces to enhancing capital flows are related not just to institutions and policy frameworks, but also to the fundamental characteristics and asset endowment of that country. In the low-income group of the COMCEC Members, most countries face a number of challenges in each area. Attracting financial capital flows presents an acute challenge, given that many of these countries attract rather moderate levels of FDI.

Eleven of the 17 member states in the low-income group are classified by the OECD as fragile states. The OECD remarks that a fragile state "has weak capacity to carry out basic governance functions, and lacks the ability to develop mutually constructive relations with society. Fragile states are also more vulnerable to internal or external shocks such as economic crises or natural disasters."[67]

In addition, only three of the 17 countries in the lower-income group are defined by the IMF as being resource-rich developing countries (RRDCs) – Chad, Guinea and Niger – suggesting that the majority of the countries in this group have few assets that are attractive from an investor perspective and that they are increasingly locked out from international trade.

Despite the fact that several fragile states are making progress in lessening their dependence on aid by reforming their tax administration and policies, further tax potential remains, in particular among those endowed with abundant natural resources. The barriers to attracting capital flows remain plentiful and challenging.

General barriers

- ***Government controls on capital transactions.*** Mozambique has implemented capital controls with the aim of insulating the economy from volatile and potentially destabilising capital flows; the authorities have not signalled any intention to review this policy choice in the foreseeable future. Requiring approval for all capital account transactions may add complexity to these transactions.

[67] Fragile states 2013: Resource flows and trends in a developing world", OECD, 2013.

- ***Perception of high risk among investors***. Governance and transparency remain areas for improvement in a number of countries in the lower-income group, while some also suffer from security and fragility issues and are "idiosyncratic in nature.[68]" Together, these factors may make them less attractive targets for portfolio capital investment. At the same time, countries that are performing well relative to their peers, such as Mozambique, continue to suffer from misperceptions among investors.

- ***Rule of law, transparency and uncertainty.*** Additional barriers are the rule of law, transparency and uncertainty, factors that are largely related to political stability. In Bangladesh, for example, the volatile political environment occasionally leads to the rescinding of contracts and reversal of policies, creating an element of uncertainty for investors. Among some countries within this group, legal frameworks and consistency of application of the law remain areas with potential for improvement.

Barriers relating to financial stability and institutional capacity

- ***Lack of a forward market.*** A major barrier to portfolio capital flows in some low-income countries is government regulation on securities that does not allow hedging of foreign currency positions. This in turn leaves fund investors fully exposed to currency risk, acting as a potential disincentive to direct investors to commit funds.

- ***Underdeveloped capital markets.*** Among some countries in the low-income group, further capital market development is desirable. In Mozambique, for example, three companies are listed on the stock exchange, which was established in 1999. Trading activity remains focussed on government debt securities, limiting the scope for foreigners to invest.

- ***Weak enforcement of regulations and lack of capacity.*** Few of the low-income countries have set up a central securities depository, which would facilitate the transfer of stocks, and financial supervision remains an area with scope for improvement. Few companies have properly audited accounts, and financial literacy is often extremely weak.

- ***Non-membership of economic blocs:*** Mozambique has attracted relatively less investment relative than smaller economies such as Benin, Burkina Faso, Mali and Niger. One reason is that Mozambique is not part of the West African Economic and Monetary Union (known by its French acronym UEMOA) or the CFA franc zone, which facilitate regional cross-border investment among members.

<u>Opportunities</u>

While specific barriers to enhancing capital flows are evident among numerous countries within the lower-income group, opportunities to enhance capital flows tend to be specific to

[68] Interview with official from MENA Division, IMF, September 9th 2013

individual countries. These relate to certain reforms and policies at the country level or to wider characteristics of the country.

General opportunities

- ***Mega-projects send positive signals to investors.*** The existence of natural resources in countries such as Mozambique, Chad and Niger allow for the development of mega-projects, as is the case in Mozambique. These are often large, foreign-owned, capital-intensive and export-oriented projects that attract investment, sending a signal to investors that the country is a safe destination for investors and is able to manage investment projects competently.

- ***Reducing dependence on concessional financing boosts investor confidence.*** Cutting dependence on financial support from IFIs such as the IMF and receiving policy support only (in the form of the IMF's Policy Support Instrument, for example) signals to markets and lenders the Fund's confidence in a country's policymaking. This opportunity is available to several countries in the low-income group.

- ***Diaspora are often sizable and offer potential for raising funds.*** Many developing countries have a large, well-educated diaspora that represents a promising source of investment in the recipient (home) country. Governments have been keen to leverage funds from their diaspora in the past but success has been fairly limited to date.

Opportunities relating to financial stability and institutional capacity

- ***Advantageous fiscal regimes.*** Tax-efficient regimes have a strong potential to boost capital flows. For example in Bangladesh, tax on interest from bonds and deposits is 10% , and on dividend income it is zero – such conditions are conducive to a deepening of the country's capital markets. In Mozambique, a highly advantageous fiscal regime for investment licence holders has been established, allowing them to bypass the country's corporate tax regime.

- ***National treatment.*** Specific investment-related regulations, properly implemented, have the potential to help build robust credentials for investor protection. These regulations include providing equal treatment to foreign investors, guarantees on issues such as expropriation, dispute settlement and profit repatriation – as has been the case with the adoption of the Law on Investment in Mozambique.

- ***Potential for international bond issuance.*** Several developing countries have issued bonds on international markets or are in the process of doing so. The rapid scaling up of bond flows, particularly in Africa, over the last three years suggests that bond flows are likely to be an important source of external finance for emerging African economies that are graduating out of poorest economy status. Bonds are also popular

where there is a clear plan for the government to use the bond receipts to invest in infrastructure.[69]

4.6.2. LOWER-MIDDLE INCOME COUNTRIES

Barriers

Given the heterogeneity of the COMCEC members within this income group, the obstacles and challenges the group faces are diverse and not necessarily applicable to all countries concerned. For example, Indonesia faces challenges in reducing its dependence on natural resources as the main draw of capital flows. And Morocco, despite progress in attracting inflows through a series of economic reforms, remains exposed to spillover effects from less stable regional neighbours, diminishing its attractiveness as an investment location.

Conversely, Nigeria's recent surge in capital flows does not necessarily reflect improvements in the country's economic environment relative to other developing countries: it is ranked 120th of 140 countries in the World Economic Forum's *Global Competitiveness Report 2013-14,* and 131st out of 185 countries in the World Bank's 2013 *Ease of Doing Business* index (see Appendix for further data). However, investors are keen to gain a foothold in Nigeria's large domestic market, which appears capable of sustained growth.

A number of the general barriers that lower-middle income countries face are similar to those encountered by countries in the low-income group:

General barriers

- ***Rule of law, transparency and uncertainty.*** Issues relating to the rule of law, transparency and uncertainty permeate all income groups except the high-income one. In this group, for example, Indonesia's policy environment has potential for improvement; and capital flows into Nigeria's oil and gas sector, the mainstay of the economy, have been hampered in recent years by uncertainty caused by the delay in the passing of the Petroleum Industry Bill (PIB).

- ***Weak enforcement of regulations and lack of capacity.*** Issues such as an underdeveloped infrastructure – especially electricity supply in the case of Nigeria – and registering property, paying taxes and enforcing contracts are also widespread throughout many of the LMICs and represent persistent challenges for investors.

- ***Over-dependence on natural resources.*** Both the Nigerian and the Indonesian economies are heavily reliant on commodity exports, meaning that their attractiveness to foreign investors is linked to the outlook for commodity prices. Portfolio inflows to Indonesia, for example, have risen and fallen in line with global commodity prices. The

[69] "The changing nature of private capital flows to Sub-Saharan Africa", *Shockwatch Bulletin*, Overseas Development Institute, 2013

volatility inherent in these countries' capital accounts itself represents a further challenge to them.

- ***Political instability and impact on investor confidence.*** A number of countries within this group – mainly in the MENA region – are either facing political upheaval and subsequent transition, or are dealing with spillover effects from such countries. Domestic political transitions have been long, complex and contested; these domestic and regional tensions pose medium-term challenges to countries such as Morocco, as they implement planned social and economic reforms.

- ***Economic nationalism.*** Populist policies to boost domestic jobs and investment – often aimed at winning elections – risk driving foreign capital away. Restrictions on foreign mining companies in Indonesia are one example. A number of sectors in Indonesia are also becoming subject to laws placing heavy restrictions on foreign ownership of local businesses.[70]

Barriers relating to financial stability and institutional capacity

- ***Underdeveloped capital markets.*** Despite rising portfolio inflows in many LMICs, most countries' stock markets are modest in size. The 191 companies listed on the Nigerian Stock Exchange have a total market capitalisation of US$95.3bn, compared with the US$903bn market capitalisation of the 800 or so stocks listed on the Johannesburg Stock Exchange in South Africa. The number and type of bonds available in local capital markets are still very limited, dampening the growth of foreign portfolio inflows.

- ***Reticence among companies to use the stock market.*** Relatively few business owners in LMICs are prepared to list their companies on the stock exchange, fearing loss of control and exposure to public scrutiny. The number of listed stocks in Nigeria, for example, has not grown for a decade or more. This culture is shared by many of the countries within this group, which represents a sizable barrier to deepening their capital markets.

- ***Restrictions on the use of capital abroad.*** In 2012 the Nigerian authorities put regulation in place to prevent the country's banks from recapitalising their foreign subsidiaries. Yet Nigeria's ambitions to establish Lagos as a regional financial hub may be at risk if the financial authorities continue to constrain the capacity of banks to use their capital to operate abroad.

<u>Opportunities</u>

General opportunities

- ***Demographic dividend is a major asset in developing markets.*** In countries such as Indonesia and Nigeria, which possess large, young, fast-growing populations, the

[70] *The Economist*, August 24th 2013

domestic markets in non-tradable sectors such as construction and renewable energy can be attractive to investors. Capital flows to non-tradable sectors appear to be somewhat insulated from poor economic conditions and largely immune to political instability.[71]

Opportunities relating to financial stability and institutional capacity

- ***Policies to promote financial stability and transparency.*** Government efforts to introduce policies that improve financial stability and transparency in the country can contribute significantly to raising investor confidence. In Nigeria, this has been aided by the creation of the Excess Crude Account to save oil windfall revenue, and the enactment of the Fiscal Responsibility Act of 2007, which sets the framework for prudent fiscal management and discourages extra-budgetary spending.

- ***High domestic borrowing costs enhance the appeal of international capital markets.*** High domestic borrowing costs are leading both government and private companies in LMICs to raise capital in the international markets. Between January 2011 and August 2013, four Nigerian banks issued Eurobonds totalling US$1.45bn. In 2011 Nigeria issued its first foreign-currency sovereign bond, with the aim of creating benchmarks for future sovereign borrowing.

- ***Reforms to improve efficiency and depth of the capital market.*** LMICs have opportunities to draft in capital-market-oriented reforms that are practical and have the potential to boost investor confidence considerably. Nigeria has done this, extending the number of stock exchange trading days, permitting short selling, drafting in a system of regulated market makers, and adopting the NASDAQ OMX trading platform. The result: improved investor perceptions of the country as an investment destination.

4.6.3. UPPER-MIDDLE INCOME COUNTRIES

Barriers

The barriers faced by COMCEC Country Members in the upper-middle income group are diverse and reflect – similarly to the lower-middle income group – the heterogeneous nature of the states within the group. Despite being in a higher income bracket than the LMICs and the LICs, numerous countries in this group – such as Algeria, Iran, Iraq, and Libya – have yet to fulfil their potential, with banking sectors dominated by the state and shallow financial markets.[72]

[71] Interview with official from the MENA Region Office of the Chief Economist, World Bank, September 6th 2013
[72] Ibid.

FDI and other inflows to these countries remain relatively weak, in part because reform remains at an early stage, including reform of large state-owned enterprises. Algeria – which has a large land mass, a rich natural resource base and relative political stability – has significant untapped potential, despite high energy prices. There is scope for development in the state's financial markets, regulatory environment, and institutional frameworks.

Other nations are succeeding in attracting significant private capital flows – including Turkey (US$95bn in 2013), Kazakhstan (US$52bn) and Malaysia (US$29bn),[73] yet each of the countries in the upper-middle income group faces country-specific challenges, some of which are outlined below.

General barriers

- ***Rule of law, transparency and uncertainty.*** Investors consistently cite uncertainty around the repatriation of profits as a major barrier to investment.[74] In some UMICs, the tendency of governments to interfere in the economy in efforts to protect domestic interests creates further uncertainty among foreign investors. In Kazakhstan, for example, fears of government involvement in oil and gas contracts present a significant obstacle to promoting further investment in the sector.

- ***Unattractive taxation regimes.*** Governments in UMICs such as Kazakhstan have attempted to increase taxes in certain sectors, including the energy sector, in order to support the country's economic diversification efforts. While powerful multinationals may hold some sway over local governments in such situations, foreign investors with fewer resources may face uncertainty and instability. [75] This may attract corrupt practices and regulatory capture.[76]

- ***Low levels of business integration.*** Some countries fail to capitalise on economic reforms that they push through owing to a lack of technical expertise and technological capacity. In Tunisia, efforts to bolster FDI by attracting multinational companies to assemble export goods in the country have floundered because a lack of technological know-how has left MENA-based companies with poor links to global supply chains.

Barriers relating to financial stability and institutional capacity

- ***Restrictions on foreign ownership.*** A number of countries in this income group routinely impose restrictions on foreign ownership, which can differ by sector. In Kazakhstan, the National Security Law states that foreign investors may not hold more than 49% of a long-distance or international communications operator that owns land

[73] EIU country data, 2013

[74] Interview with official from *Global Competitiveness*, World Economic Forum, September 10th 2013

[75] "Doing business in Kazakhstan: reach, relevance and reliability", Deloitte, 2013.

[76] Regulatory capture describes the situation when regulated industries are able to influence their regulator so that regulation that ostensibly serves the public interest actually supports the interest of the industry concerned

communication lines; foreign investors' equity stakes in media companies are limited to 20%, and in domestic and international air transportation services, to 49%.[77]

- ***Limited development of equity markets.*** Among many countries in the upper-middle income group, a barrier to increased capital flows is the limited development of the equity markets. Some markets, such as the Beirut Stock Exchange, are characterised by a narrow range of securities, limited liquidity, and low market capitalisation. In Lebanon, this situation reflects, at least in part, high levels of private sector lending, which in turn are a function of buoyant bank deposit levels.[78]

- ***Business perceptions of the stock market.*** Perceptions of the stock market in business may hold back its development. In many cases, businesses are concerned about the costs and reporting requirements associated with a public listing; they also worry about the disclosure and transparency that is a requirement of a public listing. Not least, company owners worry about losing control if they take their business to market.

Opportunities

General opportunities

- ***Technocratic government and skilled human resource capacity.*** A number of UMICs have technocratic governments that have undertaken a series of structural reforms with the aim of developing a competitive economy led by the private sector. Public financial management reforms, banking regulation reforms and market liberalisation all create new opportunities for private investment. In Malaysia, following reforms, the financial services industry is now viewed as an important engine of economic growth.

Opportunities relating to financial stability and institutional capacity

- ***Transparency is relatively high.*** A number of countries within the upper-middle income group can bolster investor confidence with high levels of transparency. In a ranking of transparency based on regulatory and legal measures in 97 places, Malaysia is ranked 22nd while Turkey is ranked 34th. This is ahead of peers in their own group, and ahead of the highest ranked HICs, Dubai (46th) and Abu Dhabi (59th).[79]

- ***Shelter from currency risk.*** The COMCEC Member Countries in the upper-middle income group have opportunities to provide investors with a degree of shelter from currency risk. For one thing, currencies in these countries tend to be stable, liquid and freely convertible – in some cases the Gulf currencies are pegged to the US dollar; and

[77] "Doing business in Kazakhstan: reach, relevance and reliability", Deloitte, 2013.
[78] Interview with Chief Economist, Banque Audi, September 11th 2013
[79] Jones Lang LaSalle Global Transparency Index, available at: http://www.joneslanglasalle.com/GRETI/en-gb/Pages/Global-Transparency-Index-Rankings.aspx

for another thing, there is no shortage of hard currency in the region.[80] Foreign investors may find it straightforward to hedge exposure to these currencies.

- ***Liberal foreign equity participation measures.*** Many countries within the high-income group encourage foreign equity participation through liberalised regulation, while maintaining some limitations on foreign ownership in particular sectors, such as the media. In Jordan, for instance, many domestic businesses actively seek engagement with foreign partners as a way to increase their competitiveness and access new international markets.[81]

4.6.4. HIGH-INCOME COUNTRIES

Barriers

With the exception of Brunei, the countries in the high-income group are oil exporting members of the GCC. Some have attracted high levels of capital inflows as they have begun opening up their regimes. However, a number of barriers to enhancing capital flows remain.

General barriers

- ***Limited market size.*** For some countries in the group, their small size limits their absorption capacity. As investment locations, their attractiveness may relate more to investors with an efficiency-seeking motivation rather than to investors with either market-driven or resource-driven considerations. Notable here are Bahrain, Oman and Kuwait, whose populations range from 1m to 3.5m.

- ***Human resource constraints.*** Although foreign investors tend to have a positive view of labour laws across the GCC states, human resource constraints do have a significant negative impact on investors' perceptions of the countries as places to do business. For example, European companies state that they have difficulties finding qualified local staff.[82] At the same time, however, local governments are putting growing pressure on private companies to hire increasing proportions of local nationals.

- ***Political climate continues to be unsettling.*** In some cases, high-income countries are experiencing periods of political instability, or are suffering from the spillover effects of tensions in neighbouring countries which may have a negative effect on private capital flows. In Bahrain, for example, inward portfolio investment fell to US$419m in 2012 from US$2.7bn a year earlier.

Barriers relating to financial stability and institutional capacity

[80] OECD, 'Investment security in the Mediterranean (ISMED) Support Programme, June 2013 http://www.oecd.org/mena/investment/Issue1_June2013.pdf
[81] http://photos.state.gov/libraries/jordan/231771/PDFs/jordan_ics_e.pdf
[82] M. Bossdorf, C. Engels and S. Weiler, EU GCC Invest Report 2013

- ***Limited access for foreign investors.*** Although GCC states promote foreign investment through pro-business policies – particularly in the free zones that are focussed on attracting foreign investment – a number of countries in this group have limits on foreign ownership. Numerous restrictions apply to foreign investments in listed securities via the Abu Dhabi Securities Market (ADX) and Dubai Financial Market (DFM), and also to direct foreign ownership of local businesses. In some cases, company by-laws prohibit foreign ownership entirely.[83]

- ***Small size and high concentration limits choice.*** GCC stock markets remain relatively modest by international standards, with potentially 'concrete ramifications', as Deutsche Bank states.[84] Firstly, it clearly limits the choice at the disposal of investors: with a total of 660 listed companies, the GCC bloc is on a par with modest national stock markets such as Poland's. Investor choice is further limited by the fact that trading in shares is often illiquid.

- ***Governments and families in control.*** The state plays an active role in business in the GCC region. Governments and government-affiliated vehicles hold more than one-third of all company equity in the bloc. Much of the remainder is in the hands of large, powerful, family-owned conglomerates. This concentration of economic power may breed perceptions of nepotism and vested interests which could be viewed as a significant disadvantage by foreign investors operating in the region.

Opportunities

General opportunities

- ***Legal systems are well regarded.*** Most legal and regulatory frameworks in GCC countries have a solid reputation, with foreign firms able to settle disputes satisfactorily through local courts, and foreign rulings being upheld without a hitch. Furthermore, the countries in this high-income group impose no restrictions on using international arbitration bodies.

- ***Abundance of hydrocarbons.*** Oil and gas remain a key stabilising factor for the GCC's financial markets. In the past decade, the region has focussed on economic diversification away from hydrocarbons, however oil and gas income has proved valuable, especially amid turbulent economic conditions.[85] Some GCC states have been able to accumulate vast wealth and governments have been able to cushion the impact of the global economic downturn somewhat, bolstering the region's reputation as a stable investment destination.

- ***Progress on reform has been significant.*** The GCC economies have made solid progress in establishing effective financial market regulation and oversight as well as

[83] M. Bossdorf, C. Engels and S. Weiler, EU GCC Invest Report 2013
[84] "GCC financial markets: long-term prospects for finance in the Gulf region" Deutsche Bank, November 14th, 2012
[85] Ibid.

keeping a strong grip on market abuse and financial fraud. Intensifying that commitment by ensuring full participation in the reform processes and by committing resources to regulation and market supervision will be crucial to achieving the region's goals of financial development and economic diversification.

Opportunities relating to financial stability and institutional capacity

- ***Policies have been innovative.*** Several GCC authorities have been charged with fostering an investor-friendly environment. Bahrain owes its success in attracting foreign capital inflows to policy innovation on the part of government authorities that have demonstrated a commitment to transparent regulation of the financial system. And Saudi Arabia launched the Saudi Arabian General Investment Authority (SAGIA) in 2000 to "act as a gateway to investment in Saudi Arabia" by creating a pro-business environment, providing services to investors and fostering investment in key sectors of the economy such as energy, transportation, and information and communications technology (ICT).

- ***Unrestricted foreign-currency movement.*** In Saudi Arabia, financial policies facilitate the free flow of private capital; currency can be transferred in and out of the kingdom without restriction, with limits only on bulk cash.[86] For its part, Bahrain's attractiveness is that the entire country acts as a free zone, with no controls on the amount of foreign currency allowed to be moved in and out of the country, and no restrictions on repatriating profits earned from local operations in Bahrain.

- ***Free zones have attracted foreign investors.*** Even among high-income countries that impose tight restrictions on foreign ownership, such as the UAE, the governments have established a number of free trade zones that offer investment incentives not available in non-designated areas. These incentives include 100% foreign ownership of businesses, no minimum capital investment requirements, no personal or corporate income tax and no restrictions on profits or capital.

[86] M. Bossdorf, C. Engels and S. Weiler, EU GCC Invest Report 2013

5- CONCLUSION

Capital flows have become more significant in developing countries over the past decade or so, although in absolute terms, inflows remain well below the pre-crisis peak.

Developing countries- many of which are COMCEC Members – have also become more attractive as investment locations as a result of the easy global financing conditions facilitated largely by quantitative easing in the US as well as a stimulus programme by the Chinese authorities —with relatively low interest rates in advanced economies, and high investor risk appetite "pushing" money into emerging markets. Within these emerging markets, gross outflows have been too small to offset the sharp rise in gross inflows during such conditions, so that net flows are largely driven by foreign investors.

Although FDI has played a significant role in driving capital flows, developing countries have been finding other ways to attract capital flows, for example through bond issuance. In Africa, the size of the international bond market may still be small, but recent activity has led to African countries raising the largest ever amount of hard currency from international capital markets, breaking a record set in 2010[87]. Uganda, Mozambique and Cameroon are all expected to issue bonds for the first time in the next years and despite concerns that the higher interest rates arising from a tightening of US monetary policy will have an impact on portfolio inflows to African economies, sentiment remains positive that investor interest will stay strong, thanks to the bright macroeconomic outlook for Africa over the short to medium term.

Looking across the OIC membership as a whole, capital flows actually remain relatively low for the majority of the countries. Of the 48 countries that belong to the low-income, lower-middle income and upper-middle income groups (which together account for 97% of the overall OIC population), only seven countries have capital inflows totalling over $10bn. Challenges remain across all the income groups to attract stable capital flows, although progress has been made to some degree in overcoming the various barriers. Nonetheless, across all the income groups, there are some countries that are fragile states and others which face political transition and the need to implement structural reform to overcome factors such as corruption, weak governance and low institutional capacity. These factors tend to affect investor confidence quite significantly, and to offset the positive aspects feeding into a country's investment potential.

With respect to each of the income groups, a number of key issues can be identified in relation to attracting capital flows although it must be stressed that these are not necessarily specific to a particular income group alone.

[87] See for example the FT, 'Africa bond issues soar to record sums', October 8 2013
http://www.ft.com/cms/s/0/7f11fab8-2f61-11e3-ae87-00144feab7de.html#axzz2jfa0QoCj

Low Income Group

Improving the rule of law, reducing political uncertainty and strengthening institutional capacity are all well-documented challenges and are crucial to ensuring a move away from the dependence on official development assistance (ODA) and remittances from diaspora abroad that is characteristic of many of the countries within this group.

For those countries experiencing increasing capital inflows, attention needs to be paid to the shift in the composition of flows that is being witnessed. Bond issuance has become popular as a means of raising international capital, but countries will need to be aware of the volatility of certain capital flows and manage the potentially negative impacts that could stem from a decline in such capital flows in the event of an economic crisis.

In those countries which are natural-resource rich, managing illicit capital outflows remains a significant issue. The per capita loss of illicit capital from fuel-exporting countries over the period 1980-2009 (US$1,631) was slightly more than three times the outflow per capita from non-fuel-exporters (US$441). Heavily indebted poor countries lost US$480 per person through illicit financial flows. A number of measures could be taken to address this. First, authorities could introduce policies to restrict the absorption of illicit financial flows, such as requiring regular reporting to the Bank for International Settlements (BIS) of detailed cross-border deposit data by sector, maturity and country of residence, entering into automatic tax information exchange agreements, and improving the capacity and resources of tax authorities. Second, policies to curtail illicit financial outflows from Africa could be developed or implemented – such as resource-rich countries complying with the Extractive Industries Transparency Initiative (EITI), which advocates verification and full publication of payments made by companies and revenue received by governments from oil, gas and minerals. Other countries less rich in natural resources can focus on strengthening legal institutions, empowering regulatory agencies to oversee public procurement, imports and exports and developing initiatives to combat money-laundering[88].

Lower-Middle Income Group

Private investment and confidence in many of these countries is being held back by the on-going political transition, the short planning horizons for governments in a number of countries and upcoming constitutional changes. At the same time, those countries with plentiful natural resources are demonstrating a continuing reliance on primary commodities and will need to intensify efforts to diversify their economies to avoid the pitfalls of declining global commodity prices. Furthermore, reducing state involvement and avoiding policies of economic nationalism will help significantly to win investor confidence. For example, reluctance to buy Uzbek assets in Uzbekistan has been attributed to an 'illiberal' business climate and the tight control of capital flows by the state. As in other countries, there are regulations and laws which set out the right of foreign investors to move funds freely in and out of the country, but the degree to which this is actually allowed to take place in practice without arbitrary restrictions remains an issue. Decisions to restrict currency conversion can

[88] "Illicit Financial Flows and the Problem of Net Resource Transfers from Africa: 1980-2009", African Development Bank and Global Financial Integrity, 2013

occur on an ad hoc basis, creating a climate of uncertainty that is of significant concern for investors. Similarly, the introduction of policies that favour national suppliers and heavily restrict foreign ownership of local businesses can also serve to deter investors from otherwise promising locations.

Upper Middle Income Group

Dealing with the effects of political transition is also an issue for some of the countries in this group. However, many of the countries in this group – such as Lebanon, Tunisia and to some degree Jordan – have both relative macroeconomic stability and a young and educated workforce, and there is much potential for attracting capital flows when assessing fundamentals such as these.

In most cases, improving governance and aspects of the business environment to ensure the simple, transparent and even-handed treatment of companies is an important priority, as well as ensuring that adequate regulation is both developed and implemented properly to allow for the smooth functioning of the private sector. Alongside this, the reform of the financial sector is also required to further enhance capital flows. Malaysia and Turkey have been notably successful in achieving such goals, and other countries within this group could learn some valuable lessons in this respect. It is also likely that driving forward a shift in culture and attitude towards the use of the stock market as a means for raising capital will have a positive impact on attracting portfolio capital. Countries such as Lebanon, for example, have a strong, highly liquid conservative banking system that plays a major role in providing funding to the private sector and although positive in some respects, this has weakened the appeal of the stock market, which remains under developed and with low levels of market capitalisation.

High Income Group

Countries within this group typically have significant hydrocarbon wealth combined with relatively small populations (with the exception of the UAE), which are advantageous characteristics in terms of limiting demands on government spending. Most of them have put in place impressive reforms to establish effective financial market regulation and oversight and have a raft of measures to ensure a pro-business environment such as the establishment of free trade zones that offer plentiful investment incentives. They also tend to have well-regarded legal systems, which reinforce the confidence of foreign firms in being assured that business disputes will be handled transparently and without a hitch. The challenges faced by this group are perhaps less onerous than those confronting the other income groups, but there is a still a need to relax the constraints that require domestic participation and to address bureaucratic inefficiencies such as the visa requirements for those wishing to work in the country, which is particularly important for Saudi Arabia, for example, where a home-grown well-qualified workforce is somewhat limited.

Putting Into Practice

The following table summarises the various policy factors which countries may seek to address in order to enhance financial capital flows. The framework is based on satisfying

certain macroeconomic and financial system preconditions, which can in turn facilitate some of the practical recommendations which are made within each of the sections.

The degree to which each of these policy recommendations is applicable to each of the COMCEC Member Countries depends on a number of factors. A country's ability to both attract capital flows and benefit from them depends on its degree of economic development, the extent to which it has followed sequencing of reforms, and the reform phase they are currently in.

The table lists a set of policy recommendations and provides an indication – for each country within a specific income group – of how urgent a priority the recommendation may be, and how significant the barriers are to implementing the recommendation.

5.1. ACHIEVING THE RIGHT POLICIES TO ENHANCE CAPITAL FLOWS

Policy recommendations	High priority	Degree of obstacle	Medium priority	Low priority
Change in general investor perception of risk and business environment • Organise face-to-face investor road shows to improve investor perception • Disseminate information on country data, people, lists, potential joint venture partners	LICs and LMICs – important because it helps to change investor perception of the country	Low – especially if there are well-educated government officials with good networks and good language skills		
Development and implementation of guidelines and regulations relating to the financial markets • Change date for end of year reporting • Introduce mandatory requirements of bank CEOs changing after ten years • Stipulate compulsory change in external auditors after ten years • Require adoption of International Financial Reporting Standards (IFRS)	LMICs – need to have confidence in the country properly implementing; transparency important		LICs – although important, other measures need to be in place before	UMICs / HICs – likely to have strong existing guidelines and regulations, and sound financial authorities. Much of this has been adopted already
Improvement in efficiency and depth of the capital market • Extend trading days • Permit short selling • Introduce regulated market making • Update trading	LICs, LMICs and UMICs – depends on the development of the stock exchange in the country; probably less necessary for LICs that have no stock market	High – potentially expensive to adopt technology platforms; extending trading days may imply resource costs. The cost of meeting stock exchange		HICs – many of the countries within these groups have put such measures in place

technology of exchange • Improve stock market infrastructure e.g. establish a central securities depository • Enhance transparency of exchange by regularly issuing market trading reports • Reduce transaction fees • Give private companies more incentives to list their shares on the stock exchange		requirements and the loss of control do not appeal to investors		
Improvement in business environment through policies to enhance political effectiveness • Establish a one-stop shop investment centre • Build online functionality (e.g. form submission capacity in addition to information provision) • Facilitate the registration of different company types, as well as branches	LICs and LMICs – very important to overcome inefficiency, and bureaucracy – potentially very powerful for countries with low score on inefficiency, bureaucratic burden	Medium –	UMICs – some countries already doing this and effectiveness is variable	HICs
Identification and elimination of policy barriers relating to mobility and treatment of foreign capital flows • Open or eliminate limits to foreign ownership • Institutionalise equal treatment of foreign capital to domestic capital • Facilitate the free flow of private capital and unrestricted repatriation of profits • Set transparent processes for state procurement and public-private investment • Facilitate opportunities for hedging of currency risk • Set up investment promotion committees to tackle barriers in the country • Partner with regional or COMCEC Member States exchanges • Promote domestic investment in the stock market by favouring institutional investors	LICs and LMICs – regional integration can bring scale and liquidity, and countries can learn from best practices	High – removing capital controls in lower-income countries can be politically challenging		UMICs and HICs – eliminating capital controls and allowing hedging of currency risk tends to be more feasible in countries with higher liquidity

• Introduce investor protection guarantees				
Introduction of investor-friendly fiscal measures such as: • Exemption from import duties • Investment tax credits • Large corporate income tax deductions • Sector-specific (e.g. mining) additional tax benefits • Region-specific (e.g. country's interior, urban periphery) additional tax benefits • Cash grants for greenfield or knowledge-based investments • Setting up Special Economic Zones with industry-targeted infrastructure • Setting up free trade zones	UMICs – tax incentives often already established in most of these countries but not as well widely implemented as in HICs		LICs / LMICs – has worked very well in Mozambique to attract FDI. Has also worked well in GCC	HICs – most of these measures already in place

The report demonstrates that there are number of points to consider:

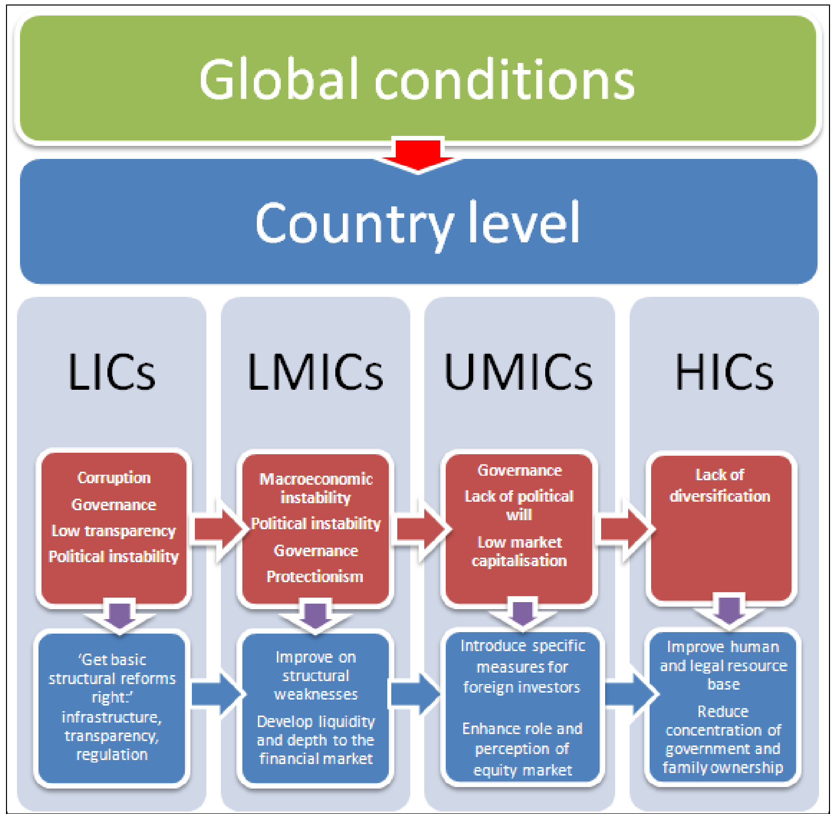
- Enhancing capital flows can be positive for economic growth and development but capital account liberalisation needs to be undertaken in a sensible manner and certain macroeconomic and financial system preconditions need to be in place before the benefits of international capital mobility can be fully realised

- The COMCEC Member States comprise a very wide set of heterogeneous countries, where some similarities can be drawn between countries within a particular income group. There is no “one size fits all” approach in terms of identifying barriers, opportunities and hence ways to enhance capital flows

- What COMCEC Member Countries do often share within a given income group are where they are currently positioned in terms of achieving levels of political stability and economic development and therefore what reforms they need to be prioritising first in order to attract more capital flows.

The diagram below demonstrates the following in the context of attracting financial capital flows:

Figure 5.1: Factors to address in attracting capital flows and potential means for attracting them



- Global macroeconomic and liquidity conditions tend to affect financial capital flows (such as bonds and portfolio investment) more so than foreign direct investment

- Beneath this, at the country level, countries face a number of barriers to attracting financial capital flows – either general constraints or ones specifically linked to financial stability and institutional capacity

- As a result, the policy recommendations and reforms that a country within a particular income group needs to tackle and address differ – and achieving a proper sequencing of these reforms is essential to both attracting capital flows and making the most of them

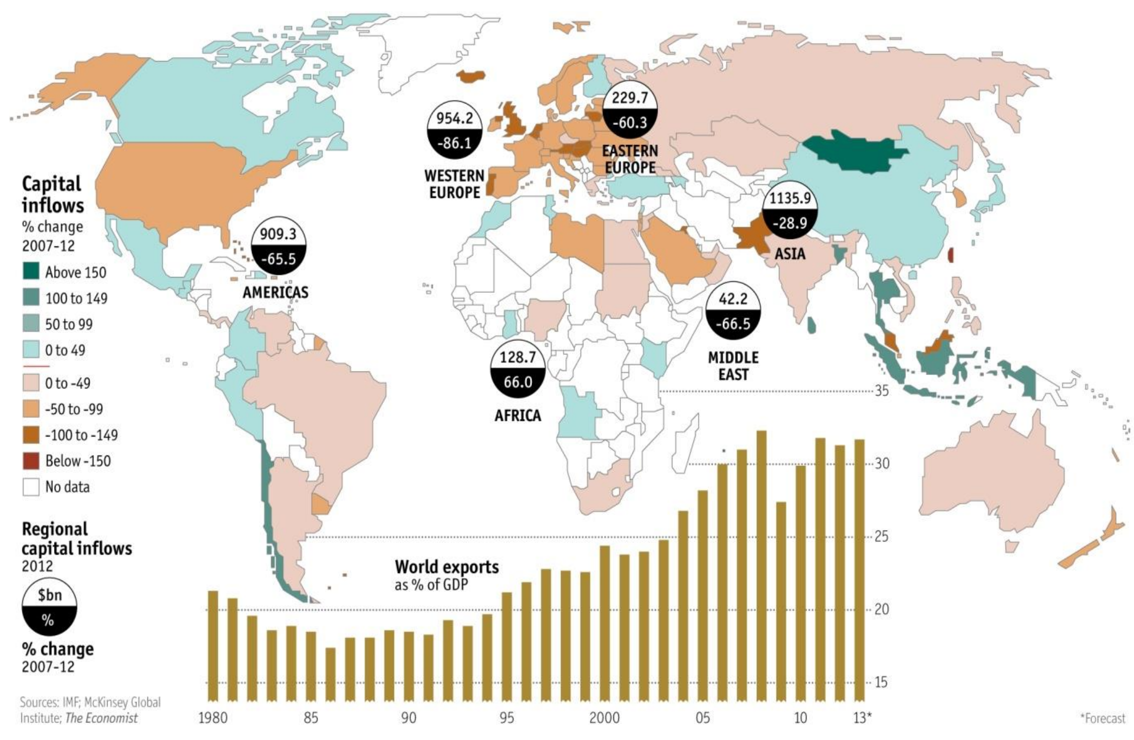
APPENDICES

Appendix 1: Capital inflows by country, US$bn, 2000-2013

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Afghanistan	AF	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Albania	AL	0.281052	0.317451	0.2931	0.3249	–	–	–	–	2.056613	2.068679	1.9555	2.1485	1.8285	1.85
Algeria	DZ	1.4966	2.1523	2.6729	2.5734	3.0041	2.3198	2.611	2.285	3.2671	2.9541	2.3043	2.6001	1.989	2.43
Azerbaijan	AZ	0.436	0.365924	1.607165	3.553136	3.8668	2.207148	-0.0939	-4.1739	0.7291	1.2884	3.3667	3.6032	3.2332	3.0895
Bahrain	BH	0.9561	0.5497	2.1822	2.4351	2.2769	4.4891	6.2539	4.3365	6.7491	3.3227	7.57	2.5	4.652816	4.6122
Bangladesh	BD	1.1417	0.906	0.7104	1.2191	1.51102	1.810874	1.939397	1.8866	2.972979	2.2751	2.0658	2.7051	3.69684	4.232
Benin	BJ	0.107676	0.173962	0.084152	0.115522	0.150698	0.091502	0.142294	0.303955	0.225269	0.24271	0.2446	0.17241	0.21212	0.21265
Brunei	BN	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Burkina Faso	BF	0.119379	0.172098	0.165021	0.160016	0.263791	0.251474	0.388563	0.25257	0.346633	0.328321	0.3333	0.2244	0.4051	0.3745
Cameroon	CM	0.513274	0.336957	0.764292	0.516774	0.352	0.471622	0.217396	0.424962	0.303627	1.243156	0.901	0.4374	1.014	1.2338
Chad	TD	0.075448	0.09096	0.138607	0.204315	0.12943	0.131987	-0.1773	-0.0187	0.3312	1.1428	1.9974	1.9102	1.159	1.286
Comoros	KM	0.0021	0.0116	0.0122	0.0096	0.0032	0.0033	0.004	0.0128	0.0064	0.0143	0.004	0.007	0.01	0.02
Cote d'Ivoire	CI	0.3873	0.2886	0.56361	0.2891	0.356	0.4861	0.5398	0.748824	0.681113	0.816005	1.132121	1.437334	1.681323	2.0838
Djibouti	DJ	0.01327	0.017657	0.03674	0.04662	0.065778	0.0487	0.172	0.2344	0.27678	0.1674	0.0717	0.1347	0.16	0.184
Egypt	EG	2.0733	2.5196	0.5847	0.8369	2.2939	10.7417	10.8846	11.3853	3.5966	8.5546	19.3292	-9.0824	8.1717	15.9482
Gabon	GA	0.006838	-0.0696	0.0786	0.1992	0.513565	0.3454	0.3562	1.3592	0.3171	0.29493	0.6435	1.2148	1.4424	1.3027
Gambia	GM	0.073302	0.067918	0.099787	0.0548	0.1005	0.09899	0.12262	0.12206	0.11366	0.122241	0.106	0.07918	0.11662	0.11862
Guinea	GN	0.0809	0.124179	0.099145	0.1386	0.0484	0.1979	0.1993	0.470985	0.472571	0.092	0.1338	0.9886	1.341	1.203
Guinea-Bissau	GW	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Guyana	GY	1.165787	1.1252	1.179115	1.224658	1.192736	1.164339	1.054524	0.7365	0.8524	1.0019	1.1638	–	–	–
Indonesia	ID	2.363218	2.705656	7.162748	10.85474	14.4554	25.776	27.9278	33.9145	31.1224	41.6694	58.3951	59.3169	69.71285	63.2491
Iran	IR	1.6635	3.0027	5.4608	5.2616	5.071	5.8866	3.3711	3.1474	2.6959	3.4482	3.8919	4.3661	5.11	4.31
Iraq	IQ	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Jordan	JO	1.080964	0.791835	0.5372	1.0635	0.9598	2.5723	3.6407	3.3063	3.1086	2.575	3.0811	2.0778	2.523	3.9023
Kazakhstan	KZ	4.026	7.6593	7.3792	9.7114	17.8228	17.9077	43.9557	45.8978	55.8321	48.0334	69.2818	50.6156	51.369	52.2256
Kuwait	KW	2	-0.0012	2.7346	0.9038	3.6991	3.5087	4.552	16.0837	5.3777	7.995033	6.8262	6.563378	6.641139	5.3711
Kyrgyz Republic	KG	0.177989	0.144184	0.151536	0.192392	0.331698	0.192493	0.425434	0.490912	1.303512	0.851408	1.0875	1.4451	1.0349	1.0416
Lebanon	LB	–	–	7.8004	6.0554	7.3806	6.4507	8.5157	8.55904	8.28475	10.8269	5.7293	6.5229	6.6695	6.0395
Libya	LY	0.441	0.167	0.445	0.543	0.807	1.688	2.814	5.519	5.2069	2.62	3.2453	0.5001	1.0503	2.061
Malaysia	MY	7.564	7.0171	10.1599	9.2834	21.0847	6.9894	20.8308	24.2434	-8.3299	14.5014	29.7876	34.8589	29.722	29.184
Maldives	MV	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Mali	ML	0.27351	0.380276	0.639675	0.48026	0.368068	0.628968	0.183865	0.161012	0.463504	0.6999	0.3654	0.5496	0.957	1.0401
Mauritania	MR	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Morocco	MA	1.9073	1.3554	1.5485	4.1243	2.627	4.1804	4.4937	6.7186	7.7564	6.5173	5.038192	7.1508	9.7238	10.3786
Mozambique	MZ	0.329664	0.413768	0.63612	0.56116	0.567998	0.453895	0.534363	0.74812	0.9583	1.49527	1.396726	2.6066	5.9716	5.4652
Niger	NE	0.104367	0.117344	0.173396	0.162888	0.160691	0.24449	0.161744	0.18255	0.381957	0.7494	0.92279	1.0357	1.0327	0.8833
Nigeria	NG	1.2933	1.2576	1.9547	2.1308	2.1535	6.2454	8.4316	9.2099	9.9312	9.5506	10.8221	16.0392	20.2998	18.1488
Oman	OM	0.5731	0.7435	0.297	0.3365	0.9146	3.2204	3.4193	5.5358	2.1021	2.2847	2.2128	0.8027	3.4289	–
Pakistan	PK	1.6988	2.870873	2.780446	2.010584	3.983554	4.8417	8.8626	10.6459	12.08367	9.934107	6.74753	4.1446	4.4852	4.3039
Palestine	PS	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Qatar	QA	4.704	1.741	2.618	2.951	3.7783	7.4481	13.0585	24.1213	15.9688	37.218	40.7938	29.8237	13.735	19.4796
Saudi Arabia	SA	1.908	1.354	1.116	2.29246	4.7788	14.1817	21.0945	36.633	47.4061	39.142	39.9988	31.8383	29.8472	33.5441
Senegal	SN	0.229723	0.246826	0.281058	0.266461	0.42284	0.497628	0.520994	0.848	1.029971	1.053557	0.714546	1.2728	0.6807	0.5787
Sierra Leone	SL	–	0.152733	0.112469	0.071713	0.185673	0.162088	0.099205	0.1269	0.141717	0.197083	0.349857	0.871331	0.788855	0.772
Somalia	SO	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Sudan	SD	0.4087	0.5958	0.758	1.4341	1.7243	2.527	3.7758	2.7476	3.0855	2.7932	2.7847	2.33	2.355	2.46
Suriname	SR	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Syria	SY	0.525135	1.799729	1.614849	1.66467	2.47774	2.687676	1.902272	3.090514	3.468258	4.5186	3.3526	3.2533	2.39553	2.9288
Tajikistan	TJ	–	–	0.07168	0.10139	0.405738	0.191008	0.500006	0.6236	0.7552	0.574355	0.9161	0.736	0.518	0.517
Togo	TG	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Tunisia	TN	2.6452	1.9057	2.1853	1.9936	2.253	1.8676	4.8074	3.1558	3.6403	3.2987	3.0365	3.5511	5.7463	5.9673
Turkey	TR	23.43735	24.36265	38.54306	41.7461	44.82012	65.10626	87.36476	93.0908	84.35332	50.0203	71.1898	84.9482	105.2959	95.582
Turkmenistan	TM	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Uganda	UG	0.391188	0.506641	0.33185	0.5554	0.50856	0.59642	0.91604	1.3103	1.034	1.3638	0.9198	1.4822	2.3103	2.7936
United Arab Emirates	AE	2.114	3.22	2.14579	8.8554	20.5022	32.043	36.0041	50.6302	43.9056	40.4536	17.4803	28.3597	31.3506	33.6
Uzbekistan	UZ	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Yemen	YE	0.1437	0.4582	0.2638	0.0664	–	–	1.4738	1.3073	1.8398	0.4608	0.2468	-0.612	1.20375	0.8396

Source: EIU *Country Data*

Appendix 2: Global view of change in capital inflows from 2007 – 12, *The Economist*, October 14 2013



Appendix 3: A comparison of global rankings related to the business environment and the COMCEC Country performance

World Economic Forum – Global Competitiveness Report

The Global Competitiveness Report (GCR) is a study prepared yearly by the World Economic Forum. The report presents the findings of the Global Competitiveness Index, which measures countries' competitiveness on the basis of factors of productivity and growth. The study uses a framework of 12 "pillars of competitiveness", namely: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication and innovation. The final scoring acknowledges that certain factors of competitiveness are more relevant to some countries than to others; therefore it assigns different weights to categories according to an initial classification of the countries by "stages of economic development". The report draws data from leading international organisations and also from the findings of its own "Executive Opinion Survey". The 2013-2014 edition covers 148 countries.

Global results:

In its latest edition, the top 10 is formed by 6 European countries (Switzerland, Finland, Germany, Sweden, the Netherlands and the United Kingdom), 3 Asian countries (Singapore, Hong Kong SAR and Japan) and the United States.

OIC Countries:

42 countries analysed in the present study are covered by the GCR. Of the OIC group of countries it is Qatar that fares the best, it is ranked 13th out of 148 countries. It is followed by United Arab Emirates (19th), Saudi Arabia (20th), Malaysia (24th) and Brunei (26th). Qatar stands out globally for the efficiency of its financial market (ranked 2nd in the entire index). The success of these countries, as measured by the index, greatly contrasts the situation of countries like Burkina Faso, Mauritania, Sierra Leone, Yemen, Guinea, and Chad, which are found in the bottom 10 of the global ranking.

World Bank - Doing Business Report

The Doing Business Report is a yearly study conducted by the World Bank, aimed at evaluating the regulatory environment for businesses. The study produces a final ranking based on an average of 10 topics assessments: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. Data is obtained through research of the laws in place and consultations. In the 2013 edition the study covered 185 economies.

Global results:

In 2013 Singapore was at the top of the list, followed by Hong Kong, New Zealand, United States and Denmark. Norway, United Kingdom, Korea, Georgia and Australia followed behind.

OIC countries:

Doing Business covers 53 of the 57 countries analysed in this study. Of the OIC countries Malaysia is the best ranked, in the 12th position out of 185 countries. It is followed by Saudi Arabia (22nd), UAE (26th), Qatar (40th) and Bahrain (42nd). These OIC countries are, similarly, the top ranked of the group in the Global Competitiveness Index. Some OIC countries are also at the bottom of the global ranking, specifically, Benin, Niger, Cote d'Ivoire, Guinea, Guinea-Bissau and Chad are within the last 10 positions.

Global Competitiveness Report vs. Doing Business Report:

While both studies essentially look at factors of economic growth, their scope is different. Doing business is an assessment specifically focusing on the details of regulations affecting businesses. Global Competitiveness Index focuses on the long term drivers of economic growth and encompasses dimensions that go beyond the institutional or regulatory, considering infrastructure, human capital and broader considerations of the environment such as macroeconomic performance, innovation, technology and market development.

The Economist Intelligence Unit – Business Environment Rankings

The business rankings model examines ten separate criteria or categories, covering the political environment, the macroeconomic environment, market opportunities, policy towards free enterprise and competition, policy towards foreign investment, foreign trade and exchange controls, taxes, financing, the labour market and infrastructure. Each category contains a number of indicators which are assessed by the Economist Intelligence Unit for the last five years and the next five years.

Almost half of the indicators are based on quantitative from national and international statistical sources, while the other indicators are qualitative in and are drawn from a range of data sources and business surveys, frequently adjusted by the Economist Intelligence Unit, for 2008-2012. All forecasts for the qualitative indicators covering 2013-2017 are based on Economist Intelligence Unit assessments.

Indicators are scored on a scale from 1 (very bad for business) to 5 (very good for business). Aggregate category scores are derived on the basis of simple or weighted averages of the indicator scores within a given category.

OIC countries:

Though the BER individual ratings are not combined into a single index by calculating a simple average of 5 relevant areas (market opportunities, macroeconomic environment, financing, foreign trade and exchange regime and policy environment for foreign investment)89 it is possible to establish that those some of the countries rated highest by the EIU are also the best performers in the two previously discussed indexes (Qatar, United Arab Emirates, Saudi Arabia, Malaysia and Brunei). 23 of the analysed OIC countries are covered by the BER.

[89] See attached table

A summary of the COMCEC Country performance against the Global Competitiveness Index, Doing Business report and the EIU's *Business Environment* Rankings

	World Economic Forum	World Bank	Economist Intelligence Unit
(Sorted by highest to lowest ranked in WEF - Global Competitiveness Index)	Global Competitiveness Index 2013-2014 - Overall Ranking (out of 148)	Doing Business Report 2013 - Ease of Doing Business Rank (out of 185)	EIU Business Environment Rankings 2013 - Average (Where 10 is highest)*
Qatar	13	40	7.74
United Arab Emirates	19	26	7.5
Saudi Arabia	20	22	6.98
Malaysia	24	12	7.64
Brunei	26	79	n.a.
Oman	33	47	n.a.
Kuwait	36	82	7.1
Indonesia	38	128	6.6
Azerbaijan	39	67	5.14
Bahrain	43	42	7.08
Turkey	44	71	6.66
Kazakhstan	50	49	5.74
Jordan	68	106	6.32
Morocco	77	97	5.78
Iran	82	145	3.5
Tunisia	83	50	5.66
Albania	95	85	n.a.
Algeria	100	152	4.94
Guyana	102	114	n.a.
Lebanon	103	115	n.a.
Suriname	106	164	n.a.
Libya	108		5.1
Bangladesh	110	129	5.96
Gabon	112	170	n.a.
Senegal	113	166	n.a.
Cameroon	115	161	n.a.
Gambia	116	147	n.a.
Egypt	118	109	5.68
Nigeria	120	131	5.4
Kyrgyz Republic	121	70	n.a.
Cote d'Ivoire	126	177	n.a.
Uganda	129	120	n.a.
Benin	130	175	n.a.
Pakistan	133	107	5.3
Mali	135	151	n.a.
Mozambique	137	146	5.22
Burkina Faso	140	153	n.a.
Mauritania	141	167	n.a.
Sierra Leone	144	140	n.a.
Yemen	145	118	n.a.
Guinea	147	178	n.a.
Chad	148	184	4.16
Afghanistan	n.a.	168	n.a.
Comoros	n.a.	158	4.22
Djibouti	n.a.	171	n.a.
Guinea-Bissau	n.a.	179	n.a.
Iraq	n.a.	165	n.a.
Maldives	n.a.	95	n.a.
Niger	n.a.	176	n.a.
Palestine	n.a.	n.a.	n.a.
Somalia	n.a.	n.a.	n.a.
Sudan	n.a.	143	n.a.
Syria	n.a.	144	n.a.
Tajikistan	n.a.	141	n.a.
Togo	n.a.	156	n.a.
Turkmenistan	n.a.	n.a.	n.a.
Uzbekistan	n.a.	154	n.a.

Sources: World Economic Forum, "The Global Competitiveness Report 2013-2014"[90].

[90] Available at: http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf; World Bank, "Doing Business 2013" Available at :http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB13-full-report.pdf The Economist Intelligence Unit, Business Environment Rankings

Appendix 5: Adherence to IMF standards on capital controls
Low income group

Low Income Group adherence to IMF standards		
	# of capital account transaction controls	Article VIII convertibility
Afghanistan	3	No
Bangladesh	13	Yes
Benin	12	Yes
Burkina Faso	12	Yes
Chad	13 (2 not regulated)	Yes
Comoros	10	Yes
Gambia	3	Yes
Guinea	11	Yes
Guinea-Bissau	12	Yes
Kyrgyz Republic	10	Yes
Mali	12	Yes
Mozambique	13	Yes
Niger	13	Yes
Sierra Leone	10 (1 not regulated)	Yes
Somalia	n/a	No
Tajikistan	10	Yes

Source: IMF Annual Report on Exchange Arrangements and Exchange Restrictions

Lower-middle income group

Lower middle Income Group adherence to IMF standards		
	# of capital account transaction controls	Article VIII convertibility
Cameroon	13 (2 are not regulated)	Yes
Cote d'Ivoire	12	Yes
Djibouti	8	Yes
Egypt	7	Yes
Guyana	4	Yes
Indonesia	11	Yes
Mauritania	10 (2 are not regulated)	Yes
Morocco	12	Yes
Nigeria	6	No
Pakistan	12	Yes
Senegal	12	Yes
Sudan	7 (2 are not regulated)	Yes
Syria	11	No
Uzbekistan	13	Yes
Yemen	4 (1 is not regulated)	Yes

Source: IMF Annual Report on Exchange Arrangements and Exchange Restrictions

Upper-middle income group

Upper middle Income Group adherence to IMF standards		
	# of capital account transaction controls	Article VIII convertibility
Albania	7	No
Algeria	13	Yes
Azerbaijan	7	Yes
Gabon	13 (2 are not regulated)	Yes
Iran	11	Yes
Iraq	5	No
Jordan	4	Yes
Kazakhstan	10	Yes
Lebanon	11	Yes
Libya	13 (1 is not regulated)	Yes
Malaysia	12	Yes
Maldives	7 (1 is not regulated)	No
Suriname	13	Yes
Tunisia	12	Yes
Turkey	10	Yes
Turkmenistan	11	No

Source: IMF Annual Report on Exchange Arrangements and Exchange Restrictions

High income group

High Income Group adherence to IMF standards		
	# of capital account transaction controls	Article VIII convertibility
Bahrain	4	Yes
Brunei	5	Yes
Kuwait	7	Yes
Oman	5	Yes
Qatar	7	Yes
Saudi Arabia	11	Yes
United Arab Emirates	5	Yes

Source: IMF Annual Report on Exchange Arrangements and Exchange Restrictions

Appendix 6: The EIU Business Environment Rankings, forecast period 2013-17

Low income group

EIU Business Environment Rankings		
(out of 10)		
	Foreign trade and exchange controls	**Policy toward foreign investment**
Bangladesh	6.4	5.5
Chad	4.6	4.2
Comoros	5.5	5.1
Mozambique	6	4.6

Source: EIU Country Forecasts; data for 2013-17 forecast period. Afghanistan, Benin, Burkina Faso, Gambia, Guinea, Guinea-Bissau, Kyrgyz Republic, Mali, Niger, Sierra Leone, Somalia and Tajikistan, which belong to this group, are not covered by the EIU Business Environment Rankings.

Lower middle income group

EIU Business Environment Rankings		
(out of 10)		
	Foreign trade and exchange controls	**Policy toward foreign investment**
Egypt	5.5	6.4
Indonesia	7.8	5.1
Morocco	6.9	6
Nigeria	4.2	4.6
Pakistan	5.1	6.9

Source: EIU Country Forecasts; data for 2013-17 forecast period. Cameroon, Cote d'Ivoire, Djibouti, Guyana, Mauritania, Senegal, Sudan, Syria, Uzbekistan and Yemen, which belong to this group, are not covered by the EIU Business Environment Rankings.

Upper middle group

EIU Business Environment Rankings		
(out of 10)		
	Foreign trade and exchange controls	**Policy toward foreign investment**
Algeria	4.2	4.2
Azerbaijan	5.1	4.2
Iran	2.8	1.9
Jordan	7.3	7.3
Kazakhstan	6.9	4.2
Libya	3.7	3.7
Malaysia	8.7	7.8
Tunisia	6.4	6
Turkey	7.8	6.4

Source: EIU Country Forecasts; data for 2013-17 forecast period. Albania, Gabon, Iraq, Lebanon, Maldives, Suriname and Turkmenistan, which belong to this group, are not covered by the EIU Business Environment Rankings.

High income group

EIU Business Environment Rankings		
(out of 10)		
	Foreign trade and exchange controls	Policy toward foreign investment
Bahrain	7.8	7.8
Saudi Arabia	8.2	5.1
Qatar	8.2	7.8
United Arab Emirates	8.7	7.3
Kuwait	7.3	6.9

Source: EIU Country Forecasts; data for 2013-17 forecast period. Brunei, which belongs to this group, is not covered by the EIU Business Environment Rankings.

Appendix 7: EIU Business Environment Rankings methodology

Business environment rankings methodology

Outline of the model

The business rankings model measures the quality or attractiveness of the business environment in the 82 countries covered by *Country Forecasts* using a standard analytical framework. It is designed to reflect the main criteria used by companies to formulate their global business strategies, and is based not only on historical conditions but also on expectations about conditions prevailing over the next five years. This allows the Economist Intelligence Unit to use the regularity, depth and detail of its forecasting work to generate a unique set of forward-looking business environment rankings on a regional and global basis.

The business rankings model examines ten separate criteria or categories, covering the political environment, the macroeconomic environment, market opportunities, policy towards free enterprise and competition, policy towards foreign investment, foreign trade and exchange controls, taxes, financing, the labour market and infrastructure. Each category contains a number of indicators which are assessed by the Economist Intelligence Unit for the last five years and the next five years. The number of indicators in each category varies from five (foreign trade and exchange regimes) to 16 (infrastructure), and there are 91 indicators in total.

Almost half of the indicators are based on quantitative data (for example, GDP growth), and are mostly drawn from national and international statistical sources (see sources below) for the historical period (2008-2012). Scores for the forecast period (2013-2017) are based on Economist Intelligence Unit forecasts. The other indicators are qualitative in nature (for example, quality of the financial regulatory system), and are drawn from a range of data sources and business surveys, frequently adjusted by the Economist Intelligence Unit, for 2008-2012. All forecasts for the qualitative indicators covering 2013-2017 are based on Economist Intelligence Unit assessments.

Calculating the rankings

The rankings are calculated in several stages. First, each of the 91 indicators is scored on a scale from 1 (very bad for business) to 5 (very good for business). The aggregate category scores are derived on the basis of simple or weighted averages of the indicator scores within a given

category. These are then adjusted, on the basis of a linear transformation, to produce index values on a 1-10 scale. An arithmetic average of the ten category index values is then calculated to yield the aggregate business environment score for each country, again on a 1-10 scale.

The use of equal weights for the categories to derive the overall score reflects in part the theoretical uncertainty about the relative importance of the primary determinants of investment. Surveys of foreign direct investors' intentions yield widely differing results on the relative importance of different factors. Weighted scores for individual categories based on correlation coefficients of recent foreign direct investment inflows do not in any case produce overall results that are significantly different to those derived from a system based on equal weights.

For most quantitative indicators the data are arrayed in ascending or descending order and split into five bands (quintiles). The countries falling in the first quintile are assigned scores of 5, those falling in the second quintile score 4 and so on. The cut-off points between bands are based on the average of the raw indicator values for the top and bottom countries in adjacent quintiles. The 2008-2012 ranges are then used to derive 2013-2017 scores. This allows for intertemporal as well as cross-country comparisons of the indicator and category scores.

Measurement and grading issues

The indices and rankings attempt to measure the average quality of the business environment over the entire historical or forecast period, not simply at the start or at the end of the period. Therefore in the forecast we assign an average grade to elements of the business environment over 2013-2017, not to the likely situation in 2017 only.

The scores based on quantitative data are usually calculated on the basis of the numeric average for an indicator over the period. In some cases, the "average" is represented, as an approximation, by the recorded value at the mid-point of the period (2010 or 2015). In only a few cases is the relevant variable appropriately measured by the value at the start of the period (for example, educational attainments). For one indicator (the natural resources endowment), the score remains constant for both the historical and forecast periods.

Sources

The main sources used for the historical period scores include CIA, *World Factbook*; Economist Intelligence Unit, *Country Risk Service*; Economist Intelligence Unit, *Country*

finance; Economist Intelligence Unit, *Country Commerce*; Encyclopaedia Britannica, *Annual Yearbook;* Freedom House, *Annual Survey of Political Rights and Civil Liberties;* Heritage Foundation, *Index of Economic Freedom*; IMF, *Annual Report on Foreign Exchange Restrictions*; International Institute for Management Development, *World Competitiveness Yearbook*; International Labour Organisation, *International Labour Statistics Yearbook*; UN Development Programme, *Human Development Report*; UN, *Monthly Bulletin of Statistics*; UN, *Energy Statistics Yearbook*; Social Security Administration, *Social Security Programs Throughout the World*; World Bank, *World Development Report, World Development Indicators and Doing Business*; World Economic Forum, *Global Competitiveness Report*.

Weights

The overall business environment score is derived as an unweighted average of the ten category scores. Alternative weights based on the correlation coefficients of FDI inflows in 2007-2011 with the individual category scores did not yield markedly different results. The use of average business survey results (which tend to vary widely) yielded similar rankings to the equal-weight method. The use of equal weights is in part a reflection of ignorance about the relative importance of various determinants of business decisions. It may be supported by empirical findings on the importance of policy complementarities, which suggest that economic performance depends on good policies being applied across the board, that is, very good polices in one area cannot offset poor policies in another. The equal-weight method is likely to be a closer reflection of the latter point than a weighting system that assigned above-average significance to some categories.

The weights for deriving category scores from individual indicators are in four cases based on correlation coefficients between indicators and average inflows of FDI in 2005-2009 and on business survey results. For the remaining six categories, all indicators have equal weights in deriving category.

Market opportunities

▯	GDP at PPP	0.16
▯	GDP per head at PPP	0.10
▯	GDP growth	0.16
▯	Share of world trade	0.14
▯	Growth of exports	0.08
▯	Growth of imports	0.08

⍰	Natural resources	0.14
⍰	Investment efficiency	0.06
⍰	Regional integration	0.04
⍰	Proximity	0.04
Labour market		
⍰	Industrial disputes	0.10
⍰	Unit labour costs	0.14
⍰	Schooling/skills	0.12
⍰	Technical skills	0.08
⍰	Local managers	0.05
⍰	Health of work force	0.08
⍰	Language skills	0.05
⍰	Labour flexibility	0.08
⍰	Labour laws	0.10
⍰	Wage regulation	0.10
⍰	Hiring foreigners	0.05
⍰	Cost of living	0.05
Tax regime		
⍰	Corporate tax	0.20
⍰	Marginal income tax	0.08
⍰	Value-added tax	0.08
⍰	Social security contributions	0.12
⍰	Investment incentives	0.12
⍰	Fairness of tax system	0.20
⍰	Tax complexity	0.20

Business rankings questionnaire

This questionnaire is composed of quantitative and qualitative indicators. The purely quantitative indicators are denoted by a single asterisk (*). Indicators with a double asterisk (**) are partly based on data. All other indicators are based on qualitative assessment.

I Political environment

Ia. Political stability

1. What is the risk of armed conflict (civil or external) during the forecast period?

° Very low ↓ Low → Moderate ↑ High ← Very high

2. What is the risk of significant social unrest during the forecast period?

° Very low ↓ Low → Moderate ↑ High ← Very high

Consider: large-scale demonstrations and inter-ethnic, racial or religious clashes; levels and direction of change of income inequality and unemployment; opposition to the IMF; serious labour disputes.

3. How clear, established and accepted are constitutional mechanisms for the orderly transfer of power from one government to another?

° Very clear, established and accepted

↓ Clear, established and accepted

→ One of the three criteria is absent

↑ Two of the three criteria are absent

← Not clear, not established, not accepted

To distinguish between 4 and 5, score 5 if mechanisms in place prior to 1970, 4 otherwise.

4. Assess the impact on business of the relations between the government and opposition

° Relations are smooth and present little risk to business

↓ Relations can be fraught, with some moderate risk to policy predictability

→ Fraught relations and risks to political stability and policy predictability

↑ Relations are poor and this poses major risks for business

← Conflict between government and opposition poses risks of major political disruptions

Consider the impact of government-opposition relations on the predictability of the business and policy environment; the risk of major political disruptions; the extent to which governing and opposition forces engage in populist rhetoric.

If the country is authoritarian, with latent or suppressed opposition, then score according to the risk (5 very low to 1 very high) that the government's efforts to suppress opposition could lead to serious disturbances in the policy and business environment.

5. Assess the threat of politically motivated violence (terrorism) to the conduct of government and business.

° None ↓ Low → Moderate ↑ High ← Very high

6. Assess the threat of international disputes and tensions to the economy and/or polity during the forecast period.

° None ↓ Low → Moderate ↑ High ← Very high

Ib. Political effectiveness

7. Is the present or prospective government likely to implement open, liberal and pro-business policies for nationals and foreigners?

° Strongly yes ↓ Yes → Inconsistently ↑ No ← Strongly no

8. Assess the effectiveness of the political system in formulating and executing policy.

° Very high ↓ High → Moderate ↑ Low ← Very low

Consider: tensions between the legislative and executive branches of government; instability in government formation; cohesion of the legislature.

9. Assess the quality of the bureaucracy and its ability to carry out government policy.

° Very high ↓ High → Moderate ↑ Low ← Very low

Consider: the amount of red tape encountered by business and the country’s administrative procedures.

10. Assess the degree of transparency and fairness of the political system (including the judiciary).

° Very high ↓ High → Moderate ↑ Low ← Very low

Consider: the freedom of the press; the separation between the state and the ruling party; the consistency of the application of the law.

11. Assess the efficiency of legal system

Assess the speed and efficiency of the legal system

° Very high ↓ High → Moderate ↑ Low ← Very low

Consider length of legal cases and time required to enforce contracts through the courts. Historic data from World Bank Doing Business, supplemented by business survey data and EIU assessments.

12. Assess the pervasiveness of corruption among public officials.

° Very low ↓ Low → Moderate ↑ High ← Very high

Consider: how long the regime or government has been in power; the number of officials who are appointed rather than elected; the frequency of reports or rumours of bribery (the perception of degree to which public officials are involved in corrupt practices such as the misuse of public office for private benefit, accepting bribes, dispensing favours and patronage for private gain).

13. Is crime a problem for government and business?

° Strongly no

↓ No

→ Somewhat of a problem

↑ Yes

← Strongly yes

Consider the impact on business of organised crime and of violent crimes. Guide (violent crimes per 100,000 inhabitants). Score 5 if less than 27; score 4 if 27 to 58; score 3 if 59 to 89; score 2if 90 to 179; score 1 if more than 170.

Historical scores based on: incidence of violent crime, adjusted on the basis of business people's

impressions on security of property and persons, and Economist Intelligence Unit assessment.

II Macroeconomic environment

***1.** Average annual inflation

° If less than 3%

↓ If between 3% and 10%

→ If between 10.1% and 20%

↑ If between 20.1% and 40%

← If more than 40%

***2.** Average budget balance/GDP

° If surplus or deficit less than 0.5% of GDP

↓ If deficit between 0.5% and 3% of GDP

→ If deficit between 3.1% and 5% of GDP

↑ If deficit between 5.1% and 7% of GDP

← If more than 7% of GDP

***3.** Average government debt/GDP

° If less than 40% of GDP

↓ If between 40% and 60% of GDP

→ If deficit between 60.1% and 80% of GDP

↑ If deficit between 80.1% and 100% of GDP

← If more than 100% of GDP

***4.** Exchange-rate volatility; measured by the coefficient of variation of annual NCU:SDR rates

° If less than 0.05

↓ If between 0.05 and 0.09

→ If between 0.091 and 0.12

↑ If between 0.121 and 0.3

← If more than 0.3

***5.** External stability; measured by current-account balance/GDP

° If surplus or deficit of less than 1% of GDP

↓ If deficit between 1% and 2.5% of GDP

→ If deficit between 2.6% and 4% of GDP

↑ If deficit between 4.1% and 5% of GDP

← If deficit more than 5% of GDP

6. Assess the quality of macroeconomic policymaking

° Exemplary record of consistently prudent and successful policymaking

↓ Macroeconomic policies are solid, but could benefit from some reforms

→ Suboptimal fiscal/monetary policy mix; increases exposure to external shocks

↑ Macroeconomic policies are inconsistent with sustained stability

← Very serious deficiencies in policymaking

Consider the quality of fiscal and monetary policy management. Is it prudent, consistent and credible? Is the mix appropriate? Does monetary policy need to be excessively tight to offset fiscal laxity?

7. Assess the extent and depth of the institutional underpinnings for macroeconomic stability

° Long-established and strong; independent central bank

↓ Solid institutional underpinnings; central bank formally autonomous, but subject to political pressure

→ Moderate institutional underpinnings; central bank subject to strong political pressure

↑ Weak institutional underpinnings, central bank not independent

← Very weak institutional underpinnings; governments dictate monetary policy

Consider the degree of independence of the central bank. How strong are informal pressures on the monetary authorities to prioritise short-term growth over stability. Consider the track record of successful implementation and commitment to IMF programme. If part of a currency union, question refers to the common monetary authority.

8. Assess the risk of a steep decline in asset prices (property, shares, bonds)

° Very high ↓ High → Moderate ↑ Low ← Very low

III Market opportunities

***1.** GDP at PPP, 2000 constant prices, average during the period

° If more than US$900bn

↓ If between US$281bn and US$900bn

→ If between US$146bn and US$280bn

↑ If between US$40bn and US$145bn

← If less than US$40bn

***2.** GDP per head at PPP, 2000 constant prices, average during the period

° If more than US$26,500

↓ If between US$17,010 and US$26,500

→ If between US$9,010 and US$17,000

↑ If between US$4,000 and US$9,000

← If less than US$4,000

***3.** Average annual GDP growth

° If more than 6%

↓ If between 4.1% and 6%

→ If between 2.1% and 4%

↑ If between 1.1% and 2%

← If less than 1%

***4.** Share of world merchandise trade

° If more than 2%

↓ If between 0.81% and 2%

→ If between 0.41% and 0.8%

↑ If between 0.2% and 0.4%

← If less than 0.2%

***5.** Average annual rate of growth of exports of goods and non-factor services

° If more than 11%

↓ If between 9.1% and 11%

→ If between 5.1% and 9%

↑ If between 2% and 5%

← If less than 2%

***6.** Average annual rate of growth of imports of goods and non-factor services

° If more than 11%

↓ If between 9.1% and 11%

→ If between 5.1% and 9%

↑ If between 2% and 5%

← If less than 2%

***7.** The natural resource endowment (based on World Bank estimates of monetary value (US$ bn in 1990 prices) of countries' natural resources endowments)

° Very rich: if more than US$1trn

↓ Rich: if between US$501bn and US$1trn

→ Fair: if between US$151bn and US$500bn

↑ Poor: if between US$50bn and US$150bn

← Very poor: if less than US$50bn

8. Profitability (proxied by the inverse of the incremental capital output ratio—ICOR; equals average real GDP growth over the period divided by the average ratio of fixed investment in GDP, in current prices, multiplied by 100)

° If more than 23

↓ If between 16.1 and 23

→ If between 7.1 and 16

↑ If between 4 and 7

← If less than 4

9. The extent of regional integration.

° The country belongs to an economic union. There is freedom of movement for goods, people and capital (eg the EU).

↓ The country is part of a free trade area (eg NAFTA), and there are few sectoral restrictions. Or the country enjoys a very high level of preferential access to a major regional trade area.

→ The RTA is formally a free trade area, but there are a large number of sectoral and other restrictions (eg

Mercosur or ASEAN). Or the country enjoys considerable preferential access to a major regional trade area.

↑ Formally may be a member of a trade regional grouping, but in practice, intra-bloc trade remains significantly restricted and any preferential access to major regional trade areas is limited.

← Not member of any regional trade grouping.

10. Proximity to major world markets (air distance to US, EU or Japan; in km)

° Very close: if less than 1,000km

↓ Close: if between 1,000and 1,600km

→ Moderately close: if between 1,599 and 3,400

↑ Far away: if between 3,399 and 6,000

← Very far away: if more than 6,000km

IV Policy towards private enterprise and competition

1. Degree to which private property rights are guaranteed and protected

° Very high: private property guaranteed by state and efficient contract enforcement

↓ High: private property guaranteed but enforcement sometimes imperfect

→ Moderate: property rights recognised but enforcement lax

↑ Low: inadequate protection

← Very low: protection non-existent or very low, predominantly state ownership

2. Level of government regulation (mainly licensing procedures) on setting up new private businesses

° Very low: regulations straightforward and applied uniformly to all

↓ Low: simple licensing procedures, fairly simple regulations, applied uniformly most of the time

→ Moderate: haphazard application of regulations, complicated licensing, can be significant hindrance

↑ High: major barriers to opening business, government quotas, complex and expensive licensing procedures

← Very high: discouragement of new business, random application of regulations

3. Freedom of existing businesses to compete

° Very high ↓ High → Moderate ↑ Low ← Very low

4. Government policy on actively promoting competition and curbing unfair business practices

° Very good: unrestricted entry to almost all markets; effective enforcement of well-drafted competition policy

↓ Good: significant actions to reduce monopoly power and promote competitive environment

→ Fair: some actions to curb monopoly power; reduction of entry restrictions

↑ Poor: competition policy and legislation exist; little enforcement action

← Very poor: no effective competition institutions or legislation

5. Protection of intellectual property

° Very good ↓ Good → Fair ↑ Poor ← Very poor

Consider: how strict and well-enforced the regulations are. How efficient are the courts in dealing with transgressors? Can the injured party gain an injunction? Does protection extend to patents, trademarks and service marks?

6. Price controls

° Very few or none

↓ In a few areas, usually including energy and some utilities

→ In some areas, including energy, agricultural products and some household staples

↑ In a significant number of industrial sectors as well as utilities

← Extensive

7. Distortions in the business environment arising from special interest groups' lobbying of government

° Very low ↓ Low → Moderate ↑ High ← Very high

8. Degree to which state control and ownership of enterprises distorts the business environment

° Very low ↓ Low → Moderate ↑ High ← Very high

9. Degree of protection of minority shareholders' rights

° Very high ↓ High → Moderate ↑ Low ← Very low

Consider legislation, corporate governance rules and commitments, publicised cases of the abuse of minority shareholders' rights

V Policy and attitudes towards foreign investment

1. Government policy towards foreign capital

° Very encouraging: investment encouraged, almost no restrictions on activity

↓ Encouraging: restrictions on investment in certain areas such as natural resources and utilities

→ Fairly encouraging: some restrictions in addition to utilities

↑ Restrictive: extensive restrictions, investments examined on a case-by- case basis

← Very restrictive: investment banned or heavily discouraged

Consider: restrictions on fields of activity and ownership shares, whether effective treatment is fair and equitable, the ease and speed of registration procedures.

2. Openness of national culture towards foreign influence

° Very open ↓ Open → Fairly open ↑ Fairly closed ← Closed

3. Risk of expropriation of foreign assets

° Non-existent ↓ Very low → Low ↑ Moderate ← High

Consider: outright nationalisation or creeping expropriation in which progressive restrictions or local ownership requirements strip foreign investor of control.

4. Availability of investment protection schemes

° Very good ↓ Good → Fair ↑ Poor ← Very poor

Consider: the extent of country coverage of investment protection schemes.

5. Assess the degree to which the authorities favour domestic interests over foreign companies.

° No favouritism; level playing

↓ Some strictly limited favouritism

→ Moderate degree of favouritism

↑ High degree of favouritism

← Very high degree of favouritism

Consider factors such as government's proclivity to promote "national champions", and anti-foreign collusion between government and domestic business groups.

VI Foreign trade and exchange regimes

1. Capital account liberalisation

° Full liberalisation

↓ Almost all capital flows free; a few sectors excepted; minor administrative procedures

→ Inward and outward investment allowed, but there are significant regulatory restrictions to capital mobility

↑ Special government approval required for any outward investment; heavy restrictions on inward flows

← Tightly controlled capital flows

****2.** Tariff and non-tariff protection (measured by average tariff levels; if non-tariff barriers such as trade quotas, licensing and import inspection are significant, score is reduced by at least 1 point)

° Very low: if average tariff less than 5%

↓ Low: if average tariff between 5% and 10%

→ Moderate: if average tariff between 10.1% and 15%

↑ High: if average tariff between 15.1% and 20%

← Very high: if average tariff more than 20%

***3.** Openness: actual trade as % of GDP versus “expected” trade (“expected” trade based on pooled regression relating share of trade in GDP to geographic size, population and location relative to potential trading partners)

° Very high: if more than 1.5

↓ High: if between 1.17 and 1.5

→ Moderate: if between 0.91 and 1.16

↑ Low: if between 0.6 and 0.9

← Very low: if less than 0.6

4. Assess the speed and complexity of conducting cross-border trade

° Few border delays; simple and brief documentation

↓ Some border delays and non-trivial documentation requirements

→ Considerable delays and extensive documentation required

↑ Lengthy delays and onerous documentation requirements

← Very long border delays and extremely complex bureaucracy

Consider border delays for exports and imports; complexity and extent of required documentation. World Bank Doing Business for historic scores.

5. Transactions on the current account

° Full IMF Article 8 convertibility

↓ Currency almost fully convertible; minor restrictions still in place

→ High degree of formal liberalisation, but significant restrictions

↑ Partial liberalisation; multiple exchange rates

← Very restricted

VII Tax regime

****1.** Corporate tax burden

° Very low: if top corporate tax less than 25%

↓ Low: if top rate between 25% and 30%

→ Moderate: if top rate between 30.1% and 35%

↑ High: if top rate between 35.1% and 40%

← Very high: if top rate more than 40%

Consider: how exemptions or the operation of the system may affect the scores based on official tax rates. If foreign and domestic firms face different tax regimes, consider separately for each. Consider special incentives and allowances for foreign-owned firms, as well as very significant transfer pricing tolerated by governments. Final

scores for corporate tax burden should be an average of the two regimes.

***2.** The top marginal personal income tax rate

° Very low: if less than 35%

↓ Low: if between 35% and 40%

→ Moderate: if between 41% and 49%

↑ High: if between 50% and 55%

← Very high: if more than 55%

***3.** Value-added tax

° Very low: if VAT rate less than 10%

↓ Low: if tax rate between 10% and 15%

→ Moderate: if tax rate between 15.1% and 20%

↑ High: if top rate between 20.1% and 24%

← Very high: if top rate more than 24%

***4.** Employers' compulsory social security contributions

° Very low: if less than 7%

↓ Low: if between 7% and 14%

→ Moderate: if between 14.1% and 22%

↑ High: if between 22.1% and 30%

← Very high: if more than 30%

5. Assess the degree to which the fiscal regime encourages new investment

° Very high ↓ High → Moderate ↑ Low ← Very low

6. Assess the consistency and fairness of the tax system

° Very high ↓ High → Moderate ↑ Low ← Very low

7. Assess the complexity of the tax system

° Very simple ↓ Simple → Moderately complicated ↑ Complicated ← Very complicated

Consider the number of taxes that have to be paid and the time taken to process tax payments. Word Bank Doing Business for historic data and business surveys.

VIII Financing

1. Health and soundness of the banking sector.

° Banking system is very sound. Liquidity is ample and well-managed. Capital adequacy ratios are on average above recommended levels or the structure of assets carries little risk.

↓ Banking sector is broadly sound. Regulation and capital adequacy are in line with official recommended guidelines. A few banks may need government support.

→ Moderate risks: Some banks have had to write off major liabilities. Government has bailed out a few banks, but capital adequacy ratios are within the norm and there is little foreign-exchange risk.

↑ Significant risks of systemic failure in the banking system. There is major state intervention to maintain banks afloat.

← High risk of systemic failure.

Based on capital adequacy, asset quality, liquidity and sensitivity to market risk; exposure to foreign exchange risk.

***2** Financial depth; stockmarket capitalisation (US$ per head)

° If more than US$12,000

↓ If between US$5,001 and US$12,000

→ If between US$501 and US$5,000

↑ If between US$100 and US$500

← If less than US$100

****3.** Degree of distortion in financial markets

° Very low: real interest rates consistently low and positive; low differential between deposit and lending rates

↓ Low: positive real interest rates, but differential between deposit and lending rates is at least 5%

→ Moderate: single-digit negative real interest rates

↑ High: double-digit negative real rates and large deposit-lending rate differentials

← Very high: severe disruptions in credit market

Consider: interest-rate controls; negative real interest rates; differential between deposit and lending rates; credit market disruptions.

4. Quality of the financial regulatory system

° Very good ↓ Good → Fair ↑ Poor ← Very poor

5. Access of foreigners to local capital market

° Very good ↓ Good → Fair ↑ Poor ← Very poor

6. Access to medium-term finance for investment

° Very good: easy access to foreign and domestic financial markets for the entire range of financial instruments

↓ Good: reasonable access, but impaired in at least one category, usually equity finance

→ Fair: access to foreign markets mainly for foreign-owned firms. Can tap domestic bank finance, but limited availability of other vehicles

↑ Poor investment mainly self-financed. Limited bank finance

← Very poor: acute shortage of investment finance

IX Labour market and skills

****1.** Incidence of strikes; working days lost per 1,000 population per year

° Very low: if less than 2

↓ Low: if between 2 and 10.5

→ Moderate: if between 10.6 and 32

↑ High: if between 32.1 and 60

← Very high: if more than 60

***2.** Labour costs adjusted for productivity (costs measured by average hourly dollar earnings in manufacturing; productivity proxied by GDP per head at PPP)

° Very low: if index (US=100) less than 30

↓ Low: if between 30 and 60

→ Moderate: if between 60.1 and 120

↑ High: if between 120.1 and 160

← Very high: if more than 160

Sources for wage data: US Department of Labor, *International Labor Comparisons*; UNIDO, *Industry and Development*; International Labour Office, *International Labour Statistics Yearbook*.

***3.** Availability of skilled labour; mean years of schooling

° Very good: if more than 11

↓ Good: if between 9 and 11

→ Fair: if between 7 and 8.9

↑ Poor: if between 4 and 6.9

← Very poor: if less than 4

4. Quality of work force (flexibility, adaptability, initiative)

° Very high ↓ High → Moderate ↑ Low ← Very low

5. Degree of restrictiveness of labour laws on hiring and firing practices

° Very low ↓ Low → Moderate ↑ High ← Very high

6. Extent of wage regulation

° Very low: wages determined by supply and demand; no wage regulation; no minimum wage law or law not enforced

↓ Low: wages determined mainly by supply and demand; some minimum wage regulations for specific sectors

→ Moderate: some controls including strict minimum wage law

↑ High: extensive wage controls; government influence extensive

← Very high: government determines wage structure

7. The hiring of foreign nationals

° Very easy

↓ Easy

→ With some difficulty

↑ With great difficulty

← Almost impossible

Consider: immigration barriers; rules on employment of local nationals; unofficial barriers

***8.** Cost of living (mid-1998 base; index New York=100)

° Very low: if lower than 88

↓ Low: if between 89 and 93

→ Moderate: if between 94 and 100

↑ High: if between 101 and 115

← Very high: if more than 115

9. Assess the availability and quality of local managerial staff

° Very good ↓ Good → Fair ↑ Poor ← Very poor

10. Assess the degree to which language skills of the workforce meet the needs of business

° Very high ↓ High → Moderate ↑ Low ← Very low

If English is the native language score 5, except if there is evidence that poor foreign language skills of the workforce have had an adverse impact on business

11. The health of the workforce (based on average life expectancy)

° Very good: if life expectancy higher than 77

↓ Good: if between 75 and 77

→ Moderate: if between 70 and 74.9

↑ Poor: if between 65 and 69.9

← Very poor: if less than 65

12. The technical skills of the workforce

° Abundant supply, at a reasonable cost, of technically skilled professionals; full range of training and development programmes

↓ Reasonable supply of technically skilled labour; some availability of training and development programmes

→ Technically skilled available but at a high price; training for fraction of workforce. Older workers resistant to new technology

↑ Widespread shortage of technical skills; few technical education opportunities

← Multinationals need to import all but the most basic technical skills

X Infrastructure

Xa ICT infrastructure

***1.** Fixed line telephone density: phone lines per 1,000 population

° Very high: if more than 480

↓ High: if between 351 and 480

→ Moderate: if between 121 and 350

↑ Low: if between 40 and 120

← Very low: if less than 40

****2.** Reliability of telecoms network: faults per 100 phone lines per year

° Very good: if less than 13

↓ Good: if between 13 and 23

→ Fair: if between 24 and 56

↑ Poor: if between 57 and 100

← Very poor: if more than 100

Historical scores adjusted on the extent to which network meets business needs. Where data on faults unavailable, average waiting time for instalment of new lines is used as a proxy measure of quality.

***3.** The costs of international phone calls (US$ per 3 minutes to US)

° Very low: if lower 0.7

↓ Low: if between 0.7 and 1.75

→ Moderate: if between 1.76 and 2.5

↑ High: if between 2.51 and 4

← Very high: if more than 4

Based on cost of 3-minute call to the US (for US, cost of call to Europe).

***4.** Mobile phones penetration, susbscribers per 100 inhabitants

° Very high: if more than 80

↓ High: if between 60 and 80

→ Moderate: if between 30 and 59

↑ Low: if between 10 and 29

← Very low: if less than 10

***5.** Number of internet users, per 100 inhabitants

° Very high: if more than 45

↓ High: if between 30 and 44

→ Moderate: if between 15 and 29

↑ Low: if between 5 and 14

← Very low: if less than 5

***6.** Number of Broadband subscribers, per 100 inhabitants

° Very high: if more than 9

↓ High: if between 5 and 9

→ Moderate: if between 0.5 and 4.9

↑ Low: if between 0.1 and 0.49

← Very low: if less than 0.1

***7.** Stock of personal computers (per 1,000 inhabitants)

° If more than 170

↓ If between 80% and 170%

→ If between 20 and 79.9%

↑ If between 3 and 19.9%

← If less than 3

***8.** Technological infrastructure, the share of expenditure on R&D in GDP

° If more than 1.8%

↓ If between 1% and 1.8%

→ If between 0.5% and 99%

↑ If between 0.1% and 49%

← If less than 0.1%

9. The availability and quality of the local research infrastructure

° Very high ↓ High → Moderate ↑ Low ← Very low

Consider the quality of domestic research institutions; the extent of university-industry cooperation; the availability of

scientists and engineers and the availability of skilled researchers

Xb Transport and other infrastructure

****10.** Road density: km of paved roads per million population

° Very high: if more than 10,000

↓ High: if between 5,401 and 10,000

→ Moderate: if between 1,401 and 5,400

↑ Low: if between 500 and 1,400

← Very low: if less than 500

Historical scores adjusted on the basis of: business surveys on the extent to which country's road network meets business requirements.

***11.** Annual production of electricity per head; kwh per head

° Very high: if more than 7,000

↓ High: if between 4,501 and 7,000

→ Moderate: if between 2,501 and 4,500

↑ Low: if between 750 and 2,500

← Very low: if less than 750

12. The infrastructure for retail and wholesale distribution

° Very good ↓ Good → Fair ↑ Poor ← Very poor

Historical scores based on: data on retail outlets per million population and Economist Intelligence Unit assessment.

****13.** Extent and quality of rail network; rail density: km per million population

° Very high: if more than 750

↓ High: if between 351 and 750

→ Moderate: if between 161 and 350

↑ Low: if between 70 and 160

← Very low: if less than 70

14. Assess the quality of the ports infrastructure

° Very good ↓ Good → Fair ↑ Poor ← Very poor

15. Assess the quality of the air transport infrastructure

° Very good ↓ Good → Fair ↑ Poor ← Very poor

Consider reputation for efficiency, quality of service to passengers, safety record of main carriers. Extent and quality of airport infrastructure

***16.** Rents of office space (US$ per sq metre per month)

° Very low: if less than US$20

↓ Low: if between US$20 and US$28

→ Moderate: if between US$28.1 and US$33

↑ High: if between US$33.1 and US$50

← Very high: if more than US$50