The state of play of capital flows in the COMCEC countries:

The barriers and opportunities

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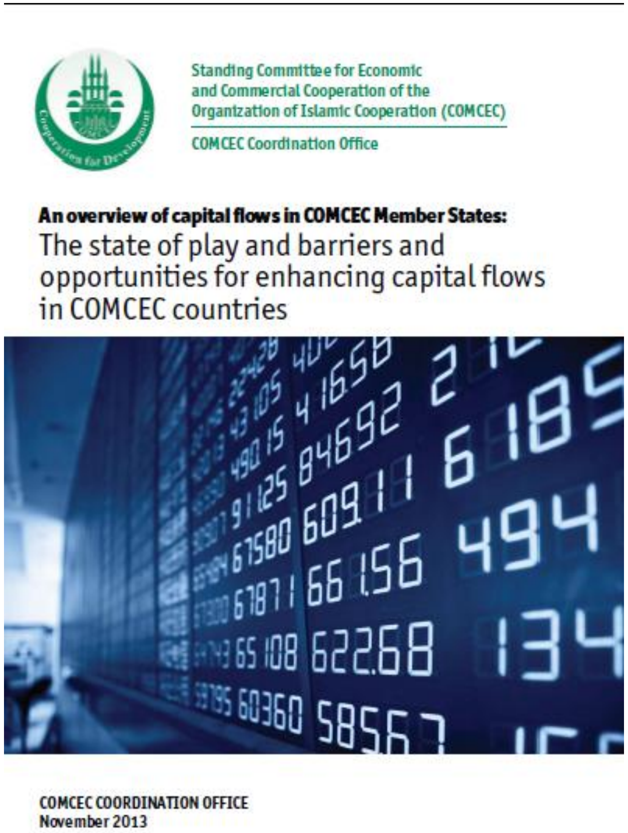


Standing Committee for Economic and Commercial Cooperation of the Organization of Islamic Cooperation (COMCEC)

COMCEC Coordination Office

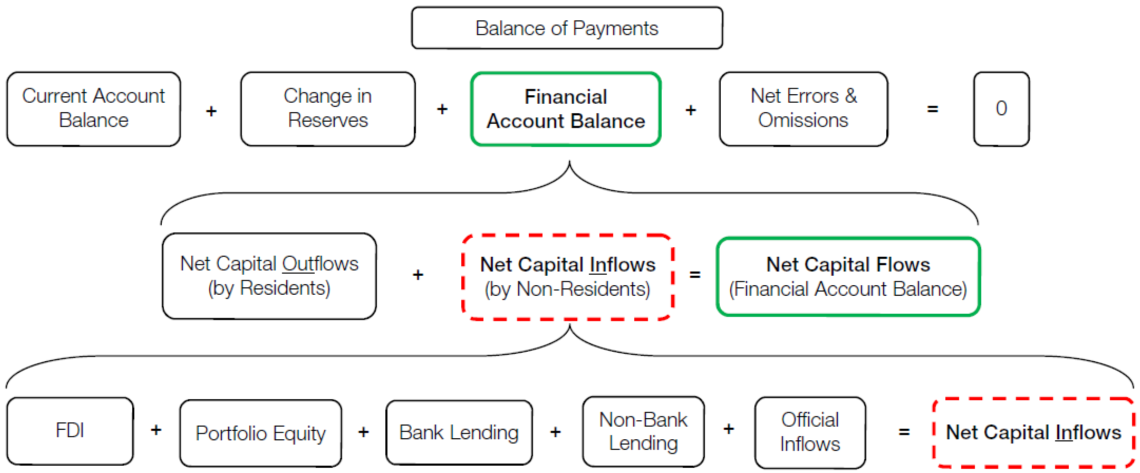
An overview of capital flows in COMCEC Member States:
The state of play and barriers and opportunities for enhancing capital flows in COMCEC countries

COMCEC COORDINATION OFFICE
November 2013

Capital flows - what are they?

"A capital flow arises through the transfer of ownership of a financial asset from one country to another" (IIF User Guide, 2013)

Chart 1:
Simplified Illustration of Capital Flows within the Balance of Payments



Capital inflow: when a non-resident invests in a country, whether through private or official inflows e.g. a US investor buys an Indonesian company

Capital outflow: when a resident invests or purchases foreign assets outside of its country e.g. the Indonesian investor buys some stock in a US company

Capital flows - what are they?

- Inflows are a lot more varied and tend to be the focus of much of the literature and research on capital flows

Net Capital Outflows (by Residents) + **Net Capital Inflows (by Non-Residents)** = **Net Capital Flows** (Financial Account Balance)

FDI + Portfolio Equity + Bank Lending + Non-Bank Lending + Official Inflows = **Net Capital Inflows**

Private inflows:

- Greenfield investment / new investment in physical company-related structure that didn't exist before
- Purchasing stocks in an enterprise – no managerial control
- Lending by commercial banks, including banks purchasing bonds
- Bonds being issued by companies or governments (non-banks)

Official inflows:

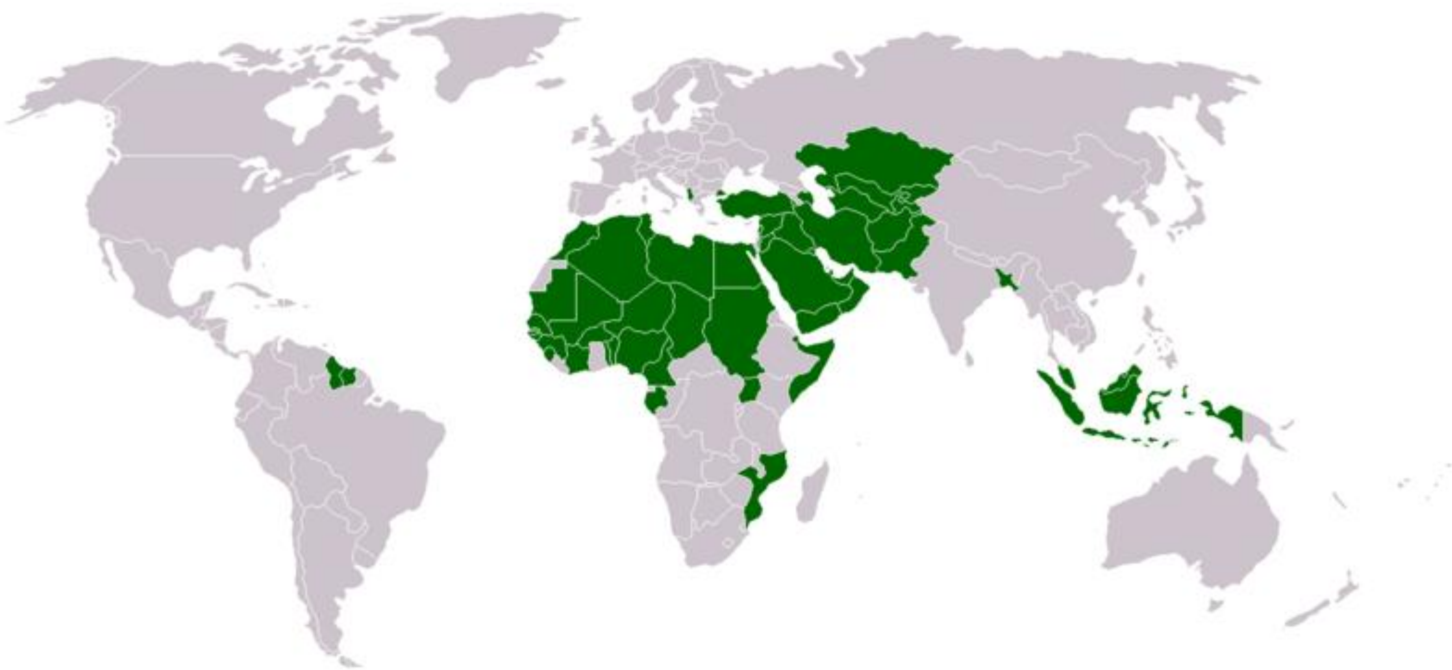
- IFI lending (WB, IMF) – concessional loans
- Bilateral (government-to-government) lending

Capital flows – definitional differences

- Analysing capital flows data is not very straightforward, because different organisations differ in their definitions of certain concepts
- This explains difficulties in comparing capital flow data and why capital flows estimates vary quite significantly depending on the source
- The IMF and IIF are both well-known data sources for capital flows, yet they look at certain types of flows quite differently:

Flow	IIF	IMF
FDI	Excludes intercompany loans (sees as debt and not equity)	Includes intercompany loans
Bank flows	Defined as "Commercial Banks"	Split into "portfolio debt" and "other debt instruments"
Emerging countries	Includes South Korea	Excludes South Korea

The COMCEC countries – analysing a broad membership



- The 57 COMCEC countries are a diverse set of countries with very different levels of economic development, financial sector maturity and characteristics
- This makes assessing capital flows across the membership very challenging

Assessing the COMCEC countries in groups

In order to provide a more structured approach to analysing trends, opportunities and barriers to enhancing capital flows in COMCEC countries, we assessed the countries by World Bank income grouping:

Low income group

< US$ 1,035

- Afghanistan
- Bangladesh
- Benin
- Burkina Faso
- Chad
- Comoros
- Gambia
- Guinea
- Guinea-Bissau
- Kyrgyz Republic
- Mali
- Mozambique
- Niger
- Sierra Leone
- Somalia
- Tajikistan
- Togo
- Uganda

Low-middle income group

US$ 1,036- $4,085

- Cameroon
- Côte d'Ivoire
- Djibouti
- Egypt
- Guyana
- Indonesia
- Mauritania
- Morocco
- Nigeria
- Pakistan
- Senegal
- Sudan
- Syria
- Uzbekistan
- Yemen

Upper-middle income group

US$4,086 - $12,615

- Albania
- Algeria
- Azerbaijan
- Gabon
- Iran
- Iraq
- Jordan
- Kazakhstan
- Lebanon
- Libya
- Malaysia
- Maldives
- Suriname
- Tunisia
- Turkey
- Turkmenistan

High income group

> US$12,616

- Bahrain
- Brunei
- Kuwait
- Oman
- Qatar
- Saudi Arabia
- United Arab Emirates

How did we deliver the project?

- Literature review
  - OECD, IMF, IIF, BIS, World Bank, ODI
- Review of EIU and non-EIU data sources
  - IMF, EIU Country Data
- Country analysis and accompanying desk research
  - Legal, regulatory, institutional frameworks and key players
- Stakeholder interviews
  - World Bank, IMF, UNCTAD, WIEF, WEF, Banque Audi, AfDB
- Quality assurance check with senior economists at EIU
  - Review by Director of Country Risk Service and chief economist, EIU

Why are capital inflows important?

- Enhancing domestic capital
  - Country can make fuller use of its natural and human resources
  - Opportunities to develop domestic management and technical skills base
  - Technology acquisition

➡ **broad multiplier effects**

- Market access and financing options
  - Export-oriented foreign investment can help gain entry points to new markets
  - Larger pool of capital also brings more longer-term financing options

➡ **competitiveness**

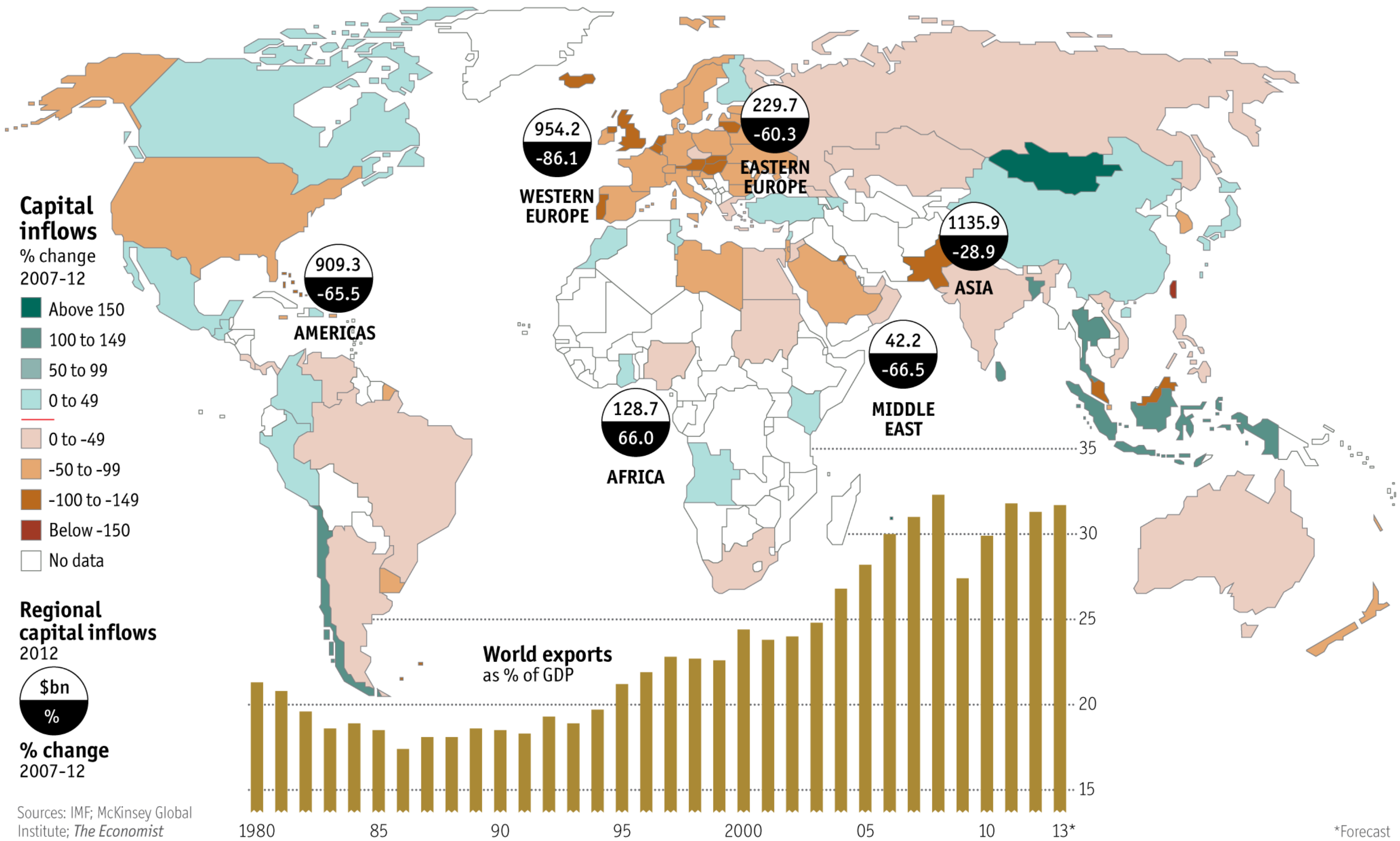
- Meeting higher standards and demands of foreign investors
  - Improvements in legal protection offered, e.g. judicial system
  - Improvements in providing efficient, transparent business environments

➡ **increased economic efficiency**

Importing more technologies and skills tends to have low multiplier effects in domestic economy and limits impact on broader economic development

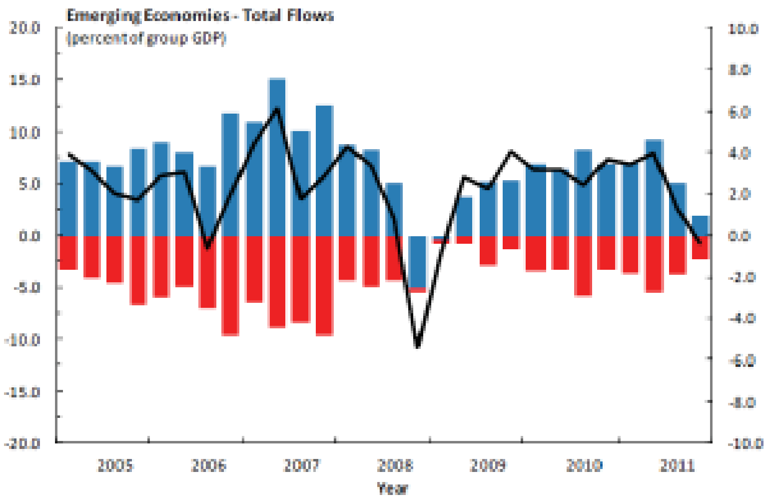
What has been happening globally?

- Africa has bucked the trend between 2007 and 2012



Global trends

- Prior to the global crisis in 2008, capital flows were dominated by cross-border banking flows and flows among developed economies
- Capital flows reached historical highs in mid-2007, before crashing downwards as a result of the global economic downturn
- Since spring 2009, capital flows have rebounded, driven largely by bounce-back in portfolio investment from advanced economies to developed economies, as well as flows between emerging economies themselves
- The rebound hasn't reached pre-crisis levels though – compare net private capital flows to developing countries of $950bn in 2010, to more than $1200bn in 2007.
- Private inflows to developing countries may soon take a hit as US monetary stimulus is reined in



IMF, August 2013

Trends in COMCEC countries – a group-level overview

Low income

Fraction of global capital inflows
Bulk of inflows are FDI flows to resource-rich countries
Starting from low levels of capital flows
ODA still dominates in most countries
Portfolio capital near non-existent
Bond flows have been buoyant

Lower middle income

Portfolio investment and bond issuance growing in importance but still small
Big hitters (Indonesia and Nigeria) are natural resource-rich
FDI flows for most countries subdued
Private investment held back by political transition concerns

Upper middle income

Big gap between Malaysia and Turkey and all others in the group
FDI flows also subdued for many in this group
Similar political transition issue to LMICs
Portfolio inflows remain low for most

High income

Dominated by oil exports
Until 2008, outflows exceeded inflows
Capital inflows much lower than 2004-07
UAE and Saudi Arabia main FDI recipients; rest of group similar magnitude to UMICs

Country-specific capital flows performance

Country	Capital flows trends	Notes
Mozambique	Inflows more than doubled in 2005-09, averaging US$436m per year. Reached record of US$5.2bn in 2012 In relative terms, FDI inflows into Mozambique averaged 10% of GDP over the past decade, a record among COMCEC LICs. Second largest FDI destination in Africa, behind only Nigeria.	Success at attracting FDI is almost unequalled among its regional, low-income or post-conflict peers in COMCEC. Received the largest nominal amount of FDI inflows in 1998-99, 2001-03 and in 2011-12, ranking second or third in several other years
Indonesia	Annual total for combined foreign direct investment (FDI) and portfolio investment stood at just US$1.3bn in 2002, rising to US$34.3bn in 2012 Although the value of FDI attracted in the second quarter of 2013 was a record high at US$6.5bn, the pace of growth in inflows was the slowest in two years.	Rash of economically nationalistic policies in sectors of interest to foreign investors has filtered through into FDI inflows
Malaysia	Net portfolio investments surged from approx. US$5,300m in 2007 to over $US20,000m in 2012 Attracted significant capital inflows over last 10-15 years – inward direct investment averaged 3.3% of GDP in the 1998-2012 period Significant capital outflows too: from 2006-2012 outward direct investment averaged 33.5% of GDP.	Gained from the capital that flooded Asian markets in search of higher yields Put in place reforms in the financial sector that resulted in resilient financial markets and enhanced corporate governance
UAE	Inward FDI flows peaked in 2007 at US$14.2bn but dropped to low of US$4bn in 2009, as a result of the collapse of the UAE's property market. FDI flows since picked up, reaching US$9.6bn in 2012although inflows do not compare with the massive amounts witnessed from 2004 to 2008.	UAE remains a safe haven amid regional unrest but flows not reached the peak levels in 2007

What have COMCEC countries been up to to boost capital flows?

LICs

- **Mozambique –** investor protection guarantees instilled within Law on Investment; fiscal incentives for direct investors driving mega-projects
- **Bangladesh –** lower tax rates offered to listed domestic companies to improve attractiveness of listing; no restriction on repatriation of capital invested

LMICs

- **Nigeria –** issued raft of guidelines and regulations to strengthen country's financial system and bolster investor confidence; major growth in Nigerian Stock Exchange since 1960 establishment

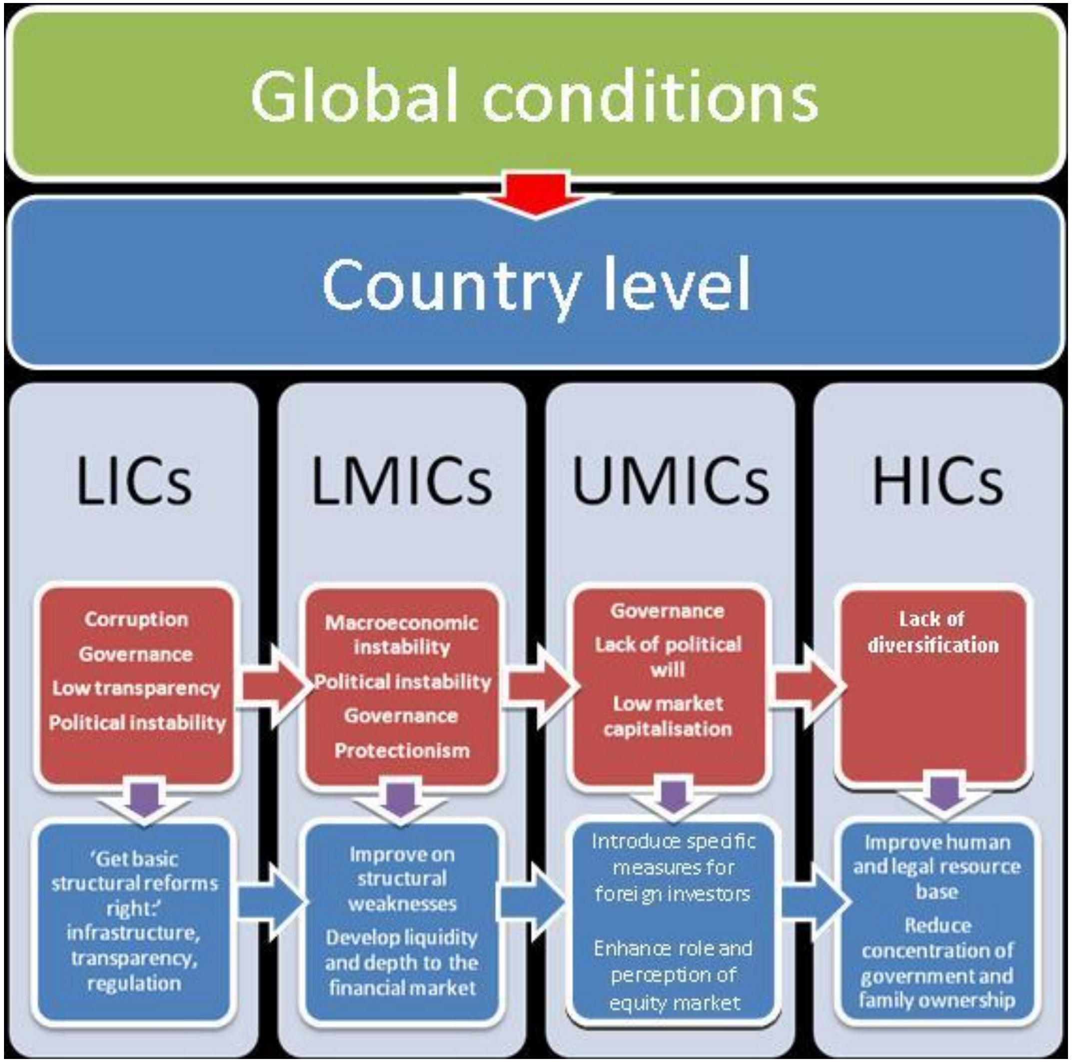
UMICs

- **Turkey –** introduction of new commercial code and a capital markets law are likely to help attract more FDI and enhance competitiveness. New Development Plan also likely to deepen reform effort during 2014-18
- **Malaysia –** firmly established itself as a leader in Islamic finance and has been commended for product diversification and strong development of financial system

HICs

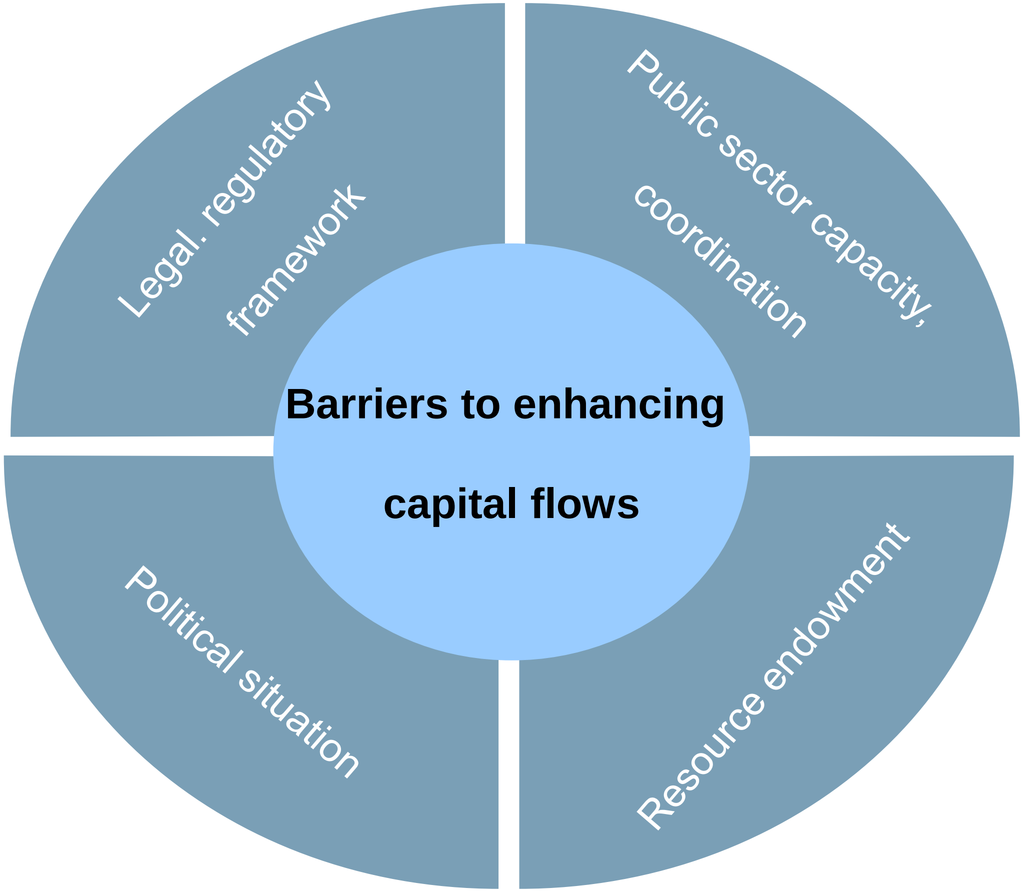
- **UAE –** creation of free zones permitting full foreign ownership and independent regulatory body that collaborates with international regulators

How are the barriers different for COMCEC countries?



- group analysis
- sequencing is important
- global factors can help to create more opportunities
- some barriers are identical across groups – the means to address the challenges are what differs though

Challenges – it starts off broad…



Low-income countries – what are the issues?

Mainly sub-Saharan Africa and a few fragile states in Central and South Asia

Portfolio investment near non-existent, FDI stronger in resource-rich countries, aid dependence still high

Legal and political risk	Relates to rescinding of contracts, reversal of policies and uncertainty around the application of law and upholding of judicial decisions.
Institutional capacity	Relates to capacity to carry out basic governance functions and ensure enforcement of regulations and adequate financial supervision
Economic and financial constraints	Relates to government controls on capital, underdeveloped capital markets, high levels of aid flows and potential disruption

Lower middle-income countries – what are the issues?

Diverse set covering countries across Asia, Africa and the Middle East

Growing portfolio activity and high FDI inflows in Indonesia and Nigeria, but the rest are far behind

Legal and political risk	Relates to rescinding of contracts, reversal of policies and uncertainty around the application of law and upholding of judicial decisions. **Political transition**
Institutional capacity	Relates to capacity to carry out basic governance functions and ensure enforcement of regulations and adequate financial supervision
Economic and financial constraints	Relates to government controls on capital, underdeveloped capital markets, **business culture**, **economic nationalism and disincentives to investors**

Upper middle-income countries – what are the issues?

Diverse set covering countries across Asia, Africa and the Middle East

Growing portfolio activity and high inflows in Malaysia, Turkey and Kazakhstan, but the rest are far behind

Legal and political risk

Relates to rescinding of contracts, reversal of policies and uncertainty around the application of law and upholding of judicial decisions. Political transition

Institutional capacity

Relates to capacity and **technical expertise to fully implement** economic reforms and develop financial system

Economic and financial constraints

Relates to government controls on capital, underdeveloped capital markets, business culture, economic nationalism and disincentives to investors, **success of banking sector holds back equity markets**

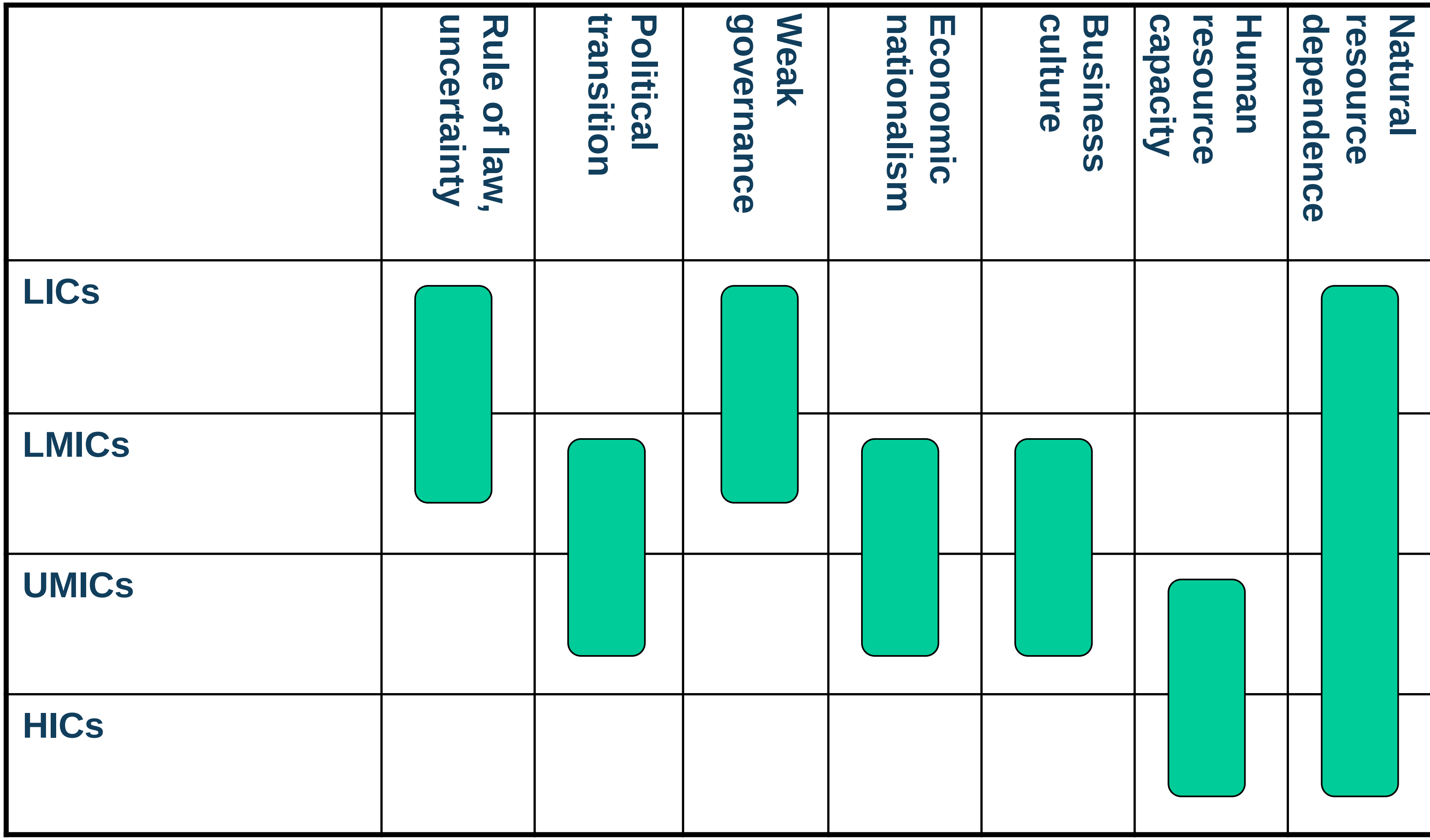
High income countries – what are the issues?

All wealthy oil exporters mainly bordering the Persian Gulf, excepting Brunei

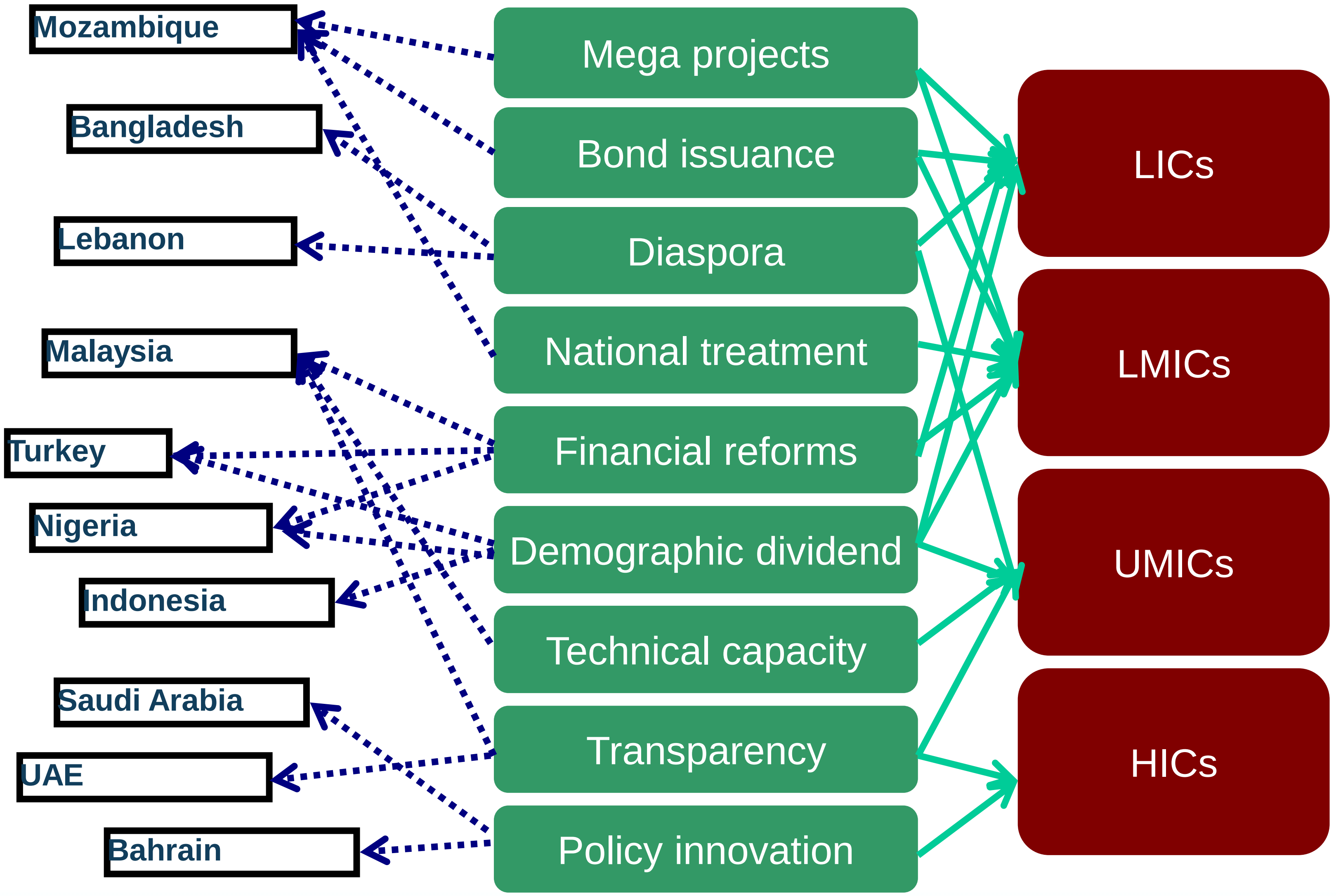
Inflows recovering towards pre-crisis levels, capital outflows are significantly large relative to inflows

Legal and political risk	Relates to **spillover effects** from unstable neighbours
Institutional capacity	Relates to **human resource capacity in general**
Economic and financial constraints	Relates to **limited market size and absorptive capacity, concentrated ownership, over-dependence on hydrocarbon wealth, continued limits on foreign ownership**

Barriers can transcend countries, richer or poorer



The opportunities are there though and some have taken them….



But there is still some work to be done…

- Change general investor perception of risk and business environment
  - roadshows, information dissemination

- Develop and implement guidelines and regulations relating to financial markets
  - international reporting standards, auditing

- Improve efficiency and depth of the capital market
  - update trading technology, incentives for listing

- Improve the business environment through policies to enhance political effectiveness
  - one-stop shops, online functionality

- Identify and eliminate policy barriers relating to mobility and treatment of foreign capital flows
  - open up more to foreign ownership, relax capital controls prudently

- Introduce investor-friendly fiscal measures
  - free trade zones, tax benefits

Key contacts

Thank you!

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