**Some Lessons for Managing Capital Flows in Vietnam and Mozambique**

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1. **Introduction (to be revised)**

Capital inflows allow, in general, recipients to increase consumption and investments, what contributes for poverty reduction, increase of standard of living, and generate sustained growth. However the effective use and management of these inflows presents great challenges because a large surge can be a source of stress, leading to appreciation of the exchange rate which may hurt some exporting sectors, volatility of inflation, overheating of the economy.

The objective of this paper is to discuss the determinants, impacts and the management of capital inflows to Mozambique

The paper is organized in four sections. After this short introduction, is presented a summarized literature review. The third section, presents the trends, composition and management of capital inflows in Mozambique. The fourth and last section presents the conclusion and its policy implications.

**2. Literature Review**

***2.1. Concepts***

Capital inflows are defined as the increase in net international indebtedness of the private and the public sectors during a given period of time, and are measured--albeit imprecisely—by the surplus in the capital account of the balance of payments. Therefore, except for errors and omissions, the capital account surplus equals the excess of expenditure over income (i.e., the current account deficit) plus the change in official holdings of international reserves. Thus, increases in capital inflows are identified with wider current account deficits and/or reserve accumulation (Reinhart, Calvo, and Leiderman, 1994).

According to Obadan (2004), capital flow can be defined as movement of financial resources from one country to another. Capital inflows easing the constraints of low domestic saving and investments contributes a lot in boosting economic growth and help de countries to cushion shocks. However, the author states that capital flows tend to display a boom and bust pattern and in a world of increasingly integrated financial markets and high financial mobility, the volatility of capital flows and sudden loss of market confidence have often resulted in severe financial crises with significant domestic and international effects.

The capital flows can be disaggregated in three main types: Official Development Assistance, Export Credits, and Foreign Private Flows.

Official flows: “Official flows include official development assistance (ODA), and other official development flows (ODF). ODA consists of official grants or loans with acceptable grant elements from agencies of government or multilateral institutions aimed at supporting economic development or welfare objectives. ODFs are also loans from official lenders (government or multilateral agencies), they however are less concessionary than grants” (Okojie, 2005).

Export credits: These are credits designed to finance specific purchases of goods or contractors’ services, the importer agrees to postpone payment to a later date. Such claims may be short-term, usually up to three to six months. In recent years, long-term export credits have developed with maturities up to ten years (Obadan, 2004). Export credits are provided either directly by the exporters or contractors, or through commercial banking channels, or by official institutions or agencies of the exporters’ government (suppliers’ credit, buyers’ credit, and official export credit) (Okojie, 2005).

Foreign private flows: “These comprise international bank loans and bond issues, private export credit, foreign private direct investment, and portfolio investment. International commercial bank lending usually takes the form of Euro credits extended through the Eurocurrency/Eurodollar market. They are rolled over credits from bank consortia in which the major banks of the major industrial countries participate. International bond markets deal in medium- and long-term credits through the issue of bonds. Foreign direct investment (FDI) is a form of capital flow in the area of equity participation, and it is aimed at acquiring lasting and controlling interest in an enterprise operating in an economy other than that of the investor. Portfolio investment refers to the holding of transferable securities, equity shares, debenture bonds, promissory notes and other money market instruments issued in the domestic markets of other countries. Portfolio investors do not exercise management functions; they are only entitled to dividend and/or interests” (Okojie, 2005).

***2.2. Determinants of Capital Flow***

The determinants of capital flow can be divided in external and internal. External determinants are related with External factors which a given country can’t control effectively and internal factors, on the other hand, are most often related to domestic policy.

Examples for "small" open economies external factors that contribute for capital inflow are: (i) reduce of international interest rates and, (ii) a rest-of-world recession, which may reduce profit opportunities in the financial centers. These factors are likely to have an important "cyclical" or reversible component (Reinhart, Calvo, and Leiderman, 1994).

Examples of policies (internal factors) that would attract long-term capital inflows are: (i) successful price stabilization programs, as these may be accompanied by improved fiscal policy fundamentals and greater macroeconomic stability, (ii) institutional reforms, such as the liberalization of the domestic capital market, and (iii) policies that credibly increase the rate of return on domestic investment projects (tax credits, debt-equity swaps, etc.). But domestic policies may also attract capital of a highly "reversible" nature. Such policies include: (i) not-fully-credible trade liberalizations and price stabilization programs--these are likely to induce a consumption boom and increase international indebtedness in the short run, or (ii) tariff cuts under downward price rigidity— inducing (temporarily) excessively high prices of domestic goods and, hence, a current account deficit on the expectations that the relative price of importables with respect to domestic goods will increase over time (Reinhart, Calvo, and Leiderman, 1994)..

Ndikumana (2003) indicates four main reasons that constrain private capital inflows to developing countries, mainly the Africans, as follow: weakness of the macroeconomic environment, underdeveloped financial system, high country risk, and exchange rate misalignment.

1. Weak macroeconomic environment: The weakness of the macroeconomic environment in African countries is a result of a range of factors, including low resource endowment, exogenous shocks, and misguided macroeconomic policies that have accentuated the adverse effects of exogenous shocks (Ndikumana, 2003).
2. Underdeveloped financial systems: The level of sophistication of the financial system is an important determinant of both the ability of a country to attract international capital and the ability of the financial system to withstand shocks to global capital flows. With the exception of a few countries (South Africa, Egypt, Morocco, and probably Kenya, Mauritius, and Nigeria), most African countries have underdeveloped financial systems (Ndikumana, 2003). The following features are especially worth emphasizing:

* Size and depth: In most African countries, financial systems are still shallow. With the exception of South Africa, African financial markets offer a limited range of financial products. Bank lending is predominantly short term, government securities are mostly of short maturity, banks in many countries do not issue credit cards (issued in only 15 sub-Saharan countries in 1997), and inter-bank lending is still underdeveloped (Gelbard and Leite 1999).
* Low stock market development: The majority of African countries do not have active stock markets, and most of the active stock markets are still small and illiquid, including long-established stock markets, such as the Egyptian Stock Exchange (Ndikumana, 2001).
* Poor performance: African banking sectors are still characterized by inefficiencies in credit allocation and poor loan repayment enforcement mechanisms, which result in high proportions of non-performing loans. Gelbard and Leite (1999) report an average share of non-performing loans of over 20 percent in a sample of 38 sub-Saharan countries in 1997.
* Weak regulatory and supervision framework: The institutional environment for financial development is still inadequate in many African countries. Some of the basic requirements for effective banking supervision (e.g., modern banking laws, central bank autonomy) and prudential regulation (e.g., establishment and enforcement of minimum bank capitalization ratios, deposit insurance) are still nonexistent in many countries (Gelbard and Leite, 1999).

1. High country risk: Africa has traditionally been considered as being “atypically risky” and a “capital hostile environment” (Collier and Pattillo, 2000). Surveys reveal that, in the opinion of investors (foreign as well as local), the most important obstacles to investment are fear of political instability and the risk of policy reversal. Weak and volatile macroeconomic fundamentals also contribute to high country risk. These include high and variable inflation rates, exchange rate instability, and chronic fiscal deficits. Another important factor of high investment risk in Africa is effective distance as perceived by international investors, which is influenced by geographic distance, transactions costs, and cultural/psychological distance. African countries can improve their risk ratings through sustained economic reform. It should be noted, however, that international rating agencies tend to rate Africa as being riskier than is warranted by objective conditions (Haque et al. 2000).

For the World Bank (1997), one of the main reasons for the surge of capital flows to developing countries is the tendency to global financial integration.

International investors penetrate markets in the developing world in search for high returns investments opportunities as well as a way of minimizing risk through portfolio diversification. At the same time, recent economic reforms undertaken by developing countries have contributed to attracting private capital (Singh, 1999).

According to Ndikumana (2003), capital flight can be interpreted as the outcome of portfolio choice as private actors seek to maximize returns on assets and minimize risks by holding their assets abroad. Capital flight can also arise through illegal acquisition and use of national resources for private enrichment by private individuals and public officials. Therefore controlling capital flight requires not only improvement of the macroeconomic conditions to ameliorate incentives for domestic investments, but also reform of the political and legal systems to improve accountability.

***2.3. Impacts of Capital Flow***

According to Sikdar (2006), the benefits of capital inflow may be summarized as follows:

1. External capital can supplement domestic savings and stimulate economic growth;
2. International borrowing and lending enable countries to neutralize fluctuations in income and attain smooth consumption streams. This improves welfare. However, as to the developing countries, capital inflows have been markedly pro-cyclical so that the gap between boom-time and bust-time consumption was actually widened and not narrowed;
3. The lenders gain from higher return and better international portfolio diversification.

According to the same author although Capital Inflow benefits mentioned above they may cause adverse effects to the economic because it may lead to: (i) Real exchange rate appreciation; (ii) Excessive accumulation of foreign exchange reserves (FER); (iii) Widening of current account deficit; (iv) Monetization; and (v) Financial crisis.

1. Real Exchange Rate Appreciation

A large capital inflow can potentially cause a real exchange rate appreciation because, by one hand, it causes excess of foreign exchange reserves and consequently the appreciation of nominal exchange rate. By the other hand, it causes an increase in demand for non tradable goods causing a rise in the relative price of non tradable goods and an expansion of non tradable output. The increase in the relative price of non tradable culminates in an appreciation of the real exchange rate, which implies a loss of international competitiveness that hurts the tradable sector and consequently the exports. According to Williamson(1995) these real exchange rate effects are known as the ‘Dutch disease’, a term originally used to describe the difficulties faced by manufacturing in the Netherlands following the development of natural gas on a large scale which triggered a major appreciation of the real exchange rate. The term is now commonly used to refer to any situation in which a natural resource boom, large foreign aid or capital inflow, causes a real exchange rate appreciation that jeopardizes the prospects of manufacturing.

1. Excessive Accumulation of FER.

How much FER should a country hold at any point in time to counter speculative attack on its currency? There is no unique answer. However, from a macroeconomic viewpoint, government policies in a demand-deficient situation should try to ensure that the economy’s expenditure on capital accumulation is met through domestic, not foreign finance. FDI can be beneficial if it leads to additional investment which cannot otherwise be undertaken or if it acts as a vehicle of better technology or other positive supply-side factors.

1. Widening of Current Account Deficit (CAD).

Although Williamson’s rule of thumb suggests a safety limit of 40% for the debt-gross domestic product (GDP) ratio, Mexico’s crisis started when it was ‘only’ 8%. Prudent fiscal policy is by itself not enough to avert crisis, as demonstrated by the experience of East Asia. However, with public deficit under control, the financial system can handle inflows better (Sikdar, 2006).

1. Monetization.

The heavy capital inflows of the 1990s have been accompanied by slightly higher levels of inflation in Asia, while inflation has fallen in Latin America due to sharp real appreciation of currencies (Sikdar, 2006).

1. Financial crisis.

Increased openness to international capital flows has been associated with an increasing frequency of financial crises (Kaminsky and Reinhart, 1999; Bordo and Eichengreen, 1999). Kaminsky and Reinhart (1999) established, for five industrial and fifteen major emerging economies over the period 1980–1999, a 10 to 15% annual probability of a balance-of-payments (BoP) crisis. One-third of these crises are ‘twin’ banking and currency crises. Pure currency crises have declined as countries have moved towards more flexible exchange rate systems but banking crises have loomed larger with the dismantling of capital controls and regulations. The average cost of an emerging market currency crisis is estimated at 8% of forgone GDP, rising to as high as 18% when a banking crisis occurs simultaneously. For Indonesia in 1997 the cost was more than 30%. According to one estimate each percentage point fall in growth raises the poverty rate by 2 percentage points (Sikdar, 2006).

For preventing financial instability, regulations that limit the exposure of banks to the volatility of equity and real estate markets, as well as ensuring risk-based capital adequacy are in order; but the flip side is that these policies may promote disintermediation, which refers to new institutions that develop to bypass these restrictions. Moreover, greater control on banks may amount to a reversal of the trend of financial liberalization currently in progress in developing countries.

***2.4. Management of Capital Flow***

The management of capital flow is an important issue for policy makers particularly in the countries that receive considerable capital inflow because it has many implications to economic performance as follow:

1. A huge capital inflows may lead to a real exchange rate appreciation, which may affect negatively the export sector particularly in export oriented countries and sudden stop or flight of capital flow may lead to a depreciation of exchange rate which may rise the imports prices and this may affect negatively countries with high imports dependence;
2. Capital inflows may not be properly intermediated and may lead to a misallocation of resources;
3. The "hot money" variety of inflows could be reversed on short notice and possibly lead to a domestic financial crisis. These concerns have often led the authorities to react to the capital inflows by implementing a broad variety of policy measures (Reinhart, Calvo, and Leiderman, 1994).

According to the stated above the management of capital flows a related with policy that may orient the capital inflows for economic development of a certain country. These policies may be divided in Monetary and Exchange Rate Policy, Fiscal Policy and Trade Policy.

*2.4.1. Monetary and Exchange Rate Policy*

A country with poorly functioning domestic credit markets and concerns about inflation and banking sector vulnerability is likely to prefer sterilization unless, or until, the fiscal costs become exorbitant. Sterilization may allow a tighter grip on liquidity and sudden capital outflows can be met by a loss of reserves without affecting credit to the private sector. In addition, if the credibility of the monetary authorities is not well established and is linked to the performance of the monetary aggregates, there may be grounds for sterilizing in order to curb the growth of these aggregates. The sharp across-the-board accumulation in reserves attests to an active policy of intervention; in most instances, the intervention was sterilized. However, difficulties arise when the fiscal costs of sterilization are large and threaten to jeopardize the credibility of existing policies. In addition, in some instances (Colombia and Malaysia) sterilization policies have driven up domestic interest rates, further stimulating capital inflows (Reinhart, Calvo, and Leiderman, 1994).

Under those circumstances, Reinhart, Calvo, and Leiderman (1994) argue that there are three major monetary policy options: (i) allow the exchange rate to float, (ii) increase marginal cash/deposit requirements, and (iii) resort to unsterilized intervention.

a) Floating exchange rates

This option has the advantage of making money supply and domestic credit exogenous with respect to capital inflows. The main disadvantage of a pure float is that massive capital inflows may induce a steep nominal and real appreciation of the domestic currency which may hurt strategic sectors of the economy, like nontraditional exports. According to Reinhart, Calvo, and Leiderman (1994), to avoid the exchange rate volatility associated with a pure float while still limiting the impact of capital inflows on the money stock, several countries (Chile, Colombia, Malaysia, Singapore among others) have allowed for some appreciation of the nominal exchange rate.

b) Increasing Marginal Reserve Requirements

Increasing the reserves requirements leads to a reduction money and credit expansion as it reduce the capacity for banks lend money consequently the multiplication of bank deposits without costs of sterilized intervention. Reinhart, Calvo, and Leiderman (1994), argue that this policy would be especially relevant in those countries where capital inflows have taken the form of substantial increases in local bank accounts.

c) Non-Sterilized Intervention

This option runs the risk of generating a vulnerable financial system. Such an option becomes more attractive, the smaller are the capabilities (or willingness) of the banking system to increase lending to the private sector. Non-sterilized intervention, however, does allow capital inflows to exert a downward pressure on domestic interest rates. This will have the advantage of slowing down capital inflows and of lowering the fiscal cost of the outstanding domestic credit (Reinhart, Calvo, and Leiderman, 1994).

*2.4.2. Fiscal policy*

One fiscal policy reaction to capital inflows could be its tightening. While this policy is not likely to stop the capital inflow, it may lower aggregate demand and curb the inflationary impact of capital inflows. In addition, to the extent that it reduces the government's need to issue debt, a tighter fiscal stance is also likely to lower domestic interest rates. In that context, higher taxes may be less effective than lower government expenditure. Often when credit is widely available--as is the case when the country is subject to massive capital inflows--individuals' expenditures can be largely independent of their tax liability. In contrast, lower government expenditure--particularly when this expenditure is directed to the purchase of non-traded goods and services--has a direct impact on aggregate demand, which is unlikely to be offset by an expansion of private sector demand (Reinhart, Calvo, and Leiderman, 1994).

*2.4.3. Trade policy*

Trade policy measures can help to insulate the export sector from real exchange rate appreciation. A possibility is an increase both export subsidies and import tariffs in the same proportion--so as to avoid creating further relative discrepancies between internal to external terms of trade--and announce that those subsidies/tariffs will be phased out in the future. Indeed, if the private sector perceives these measures as transitory, agents are likely to substitute future for present expenditure, contributing to cool off the economy and to attenuate the real exchange rate appreciation. The fiscal cost of this package need not be large and static distortions are not increased, since such trade policy does not change initial relative price distortions between exports and imports (Reinhart, Calvo, and Leiderman, 1994).

The main criticism to this policy is related to the fact that its effectiveness depends on the private sector believing that those subsidies/tariffs will be phased out in the future.

*2.4.4. Banking regulation and supervision*

Regulation that limits the exposure of banks to the volatility in equity and real estate markets could help insulate the banking system from the bubbles associated with sizable capital inflows. In this vein, risk-based capital requirements in conjunction with adequate banking supervision to insure such requirements are complied with could help insulate the domestic banking system from the vagaries of capital flows.

1. **Managing capital inflows: some experiences from Vietnam**

***3.1 Economic fundamentals and financial sector development***

Vietnam started its economic reform from the end of 1980s. Since then, the economic reform in Vietnam could be divided into several phase based upon its reform nature. The first phase is from 1989 to 1996. The second phase is from 1997-2000. The third one is from 2001 to 2006 and the forth one is from 2007 up to now.

The first phase, from 1989 to 1996, can be characterized as the fundamental steps to transform from a planning economy into a market-oriented economy. Dinh Hien Minh et al (2009) have summarized the major reform measures in this period as follows:

1. In the agricultural sector: households were assigned land for agricultural production (previously, land was gathered in the agricultural cooperative). Households became the independent production unit. Agricultural products are permitted to trade freely in domestic market.
2. Price reform: controlling goods and service prices by the Government were removed. This led to the abolishment of the dual price system. In general, prices of many goods were liberalized.
3. Exchange rate management: Vietnam Dong was devaluated; dual exchange rate system was also removed.
4. Budget: Government cut the subsidies for SOEs and carried out the budget expenditure restructuring and tax reform.
5. Trade liberalization: Many trade restrictions such as tariff, trading rights were removed.
6. FDI encouragement: The first Foreign Investment Encouragement Law was promulgated in 1988 then was amended in 1996 to encourage the inflow of foreign direct investment.
7. Financial reform: joint stock banks were allowed to operate in the countries; interest rate policy was implemented to ensure the positive real interest rate.
8. SOE reform transforming the ownerships of some SOEs through equitization process; cut the direct subsidies to SOEs;
9. Private sector: A number of laws were promulgated to facilitate the operation of the private sector.
10. Integration into the world economy: Vietnam started its process of integration into the world economy. The country signed the Framework Agreement on cooperation with the European Union (EU) and became full member of the Association of South East Asian Nations (ASEAN) in 1995. Vietnam also committed to implement ASEAN Free Trade Area agreements in 2006. Vietnam also submitted her application to join the World Trade Organization (WTO) and of the Asia Pacific Economic Cooperation (APEC) forum.

The second period is from 1997-1999, a period shaped by the financial crisis in many East Asian countries. This serious crisis has caused the reform process to slightly slowdown in Vietnam. The structural reforms, including SOE reform, became sluggish and inconsistent in this period (Dinh Hien Minh et al 2009). The focus has shifted from reforming the economy into implement measures in order to mitigate the negative impacts of the regional financial crisis. Vietnam also carried out some measures to control the import of some consumer goods in order to curb the sizeable current account deficit in 1997. After observing some signs of stagnation, the Government has implemented the stimulus packages to foster the investment and consumption. However, in this phase, Vietnam continued her efforts to integrate into the world economy. The country became APEC member in 1998 and started its process to join the WTO.

The period from 2000-2006 is the period that Vietnam’s government made its efforts to further accelerate the reform and integration process. Reforms were carried out in various aspects from SOE reform, private sector development, investment and trade liberalization. Legal reforms that facilitate the operation of a market economy were also implemented. A number of important and breakthrough laws such as the Enterprise Law (then unified Enterprise Law) and a unified investment Law has been promulgated in this period. These legal reforms have created a level playing field for domestic and foreign investors. In this period, Vietnam also made some important progress in integrating in the world economy. For the first time, Vietnam have signed the bilateral trade agreement with the US (in 2000 and taking effective in 2001). Vietnam, as a member of ASEAN, also signed a number of free trade agreements such as ASEAN - China Free Trade Area (ACFTA) in 2002, ASEAN – Korea Free Trade Area (AKFTA) in 2006. The country also seriously implemented its commitments in AFTA. And most importantly, in this period, Vietnam have concluded the bilateral and multilateral negotiations and carried necessary institutional internal reforms to access the WTO.

The next period is from 2007 to 2010, the one that marks Vietnam as a member of the WTO. Since early 2007, Vietnam becomes the member of the WTO. This has profound impacts on the economic reform process of the country. Vietnam has accelerated its integration effort by signing the ASEAN – Japan Comprehensive Economic Partnership (AJCEP), the ASEAN-Australia-New Zealand Free Trade Agreement (AANZFTA), and the ASEAN-India Free Trade Agreement (AIFTA). Internally, the country also implemented deeper reform such as SOEs reforms. Various laws were either promulgated or amended to suit to the new situation. However, this period is shaped by the global economic crisis, which in turns has made the country spare her efforts to ensure the macroeconomic stability and creating a foundation for further development.

*3.1.1 Economic growth and economic structure*

The above mentioned reforms have significantly contributed to the economic growth of Vietnam. In general, the growth rate is around 7% since 1989, although the rates slightly are different from periods to periods. In the period from 1989-1996, and 2000-2006, the growth rate is 7.5% while that figures for two periods 1997-1999 and 2007-2010 are 6.2% and 6.75 %, respectively. Among the sectors, the industrial and construction sectors grew very high, at around 9-10% per annum, except for the period 2007-2010, when the growth rate of this industry is only 7.3. The slowdown of industrial construction growth rate is attributed to the economic recession in the world economy. This also reflects the fact that the Vietnam’s economy have much more integrated into the world economy than that in 1997-1999 when the East Asian financial crisis did not have big impact on the growth of industrial and construction sector. The service sector also experienced a uneven growth rate. While it grew rather fast in 1989-1996, the sector growth rate dropped to 4.8% in the subsequent period and little bit bounded back in 2000-2006 (with average growth rate of 7%) and slightly increased to 7.6%. The growth rate agricultural sector gradually declined from 4.1% in 1989-1996 to only 3.3% in the period 2007-2010.

**Table 3.1: GDP growth and economic structure, 1986-2010**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **1986-1988** | **1989-1996** | **1997-1999** | **2000-2006** | **2007-2010** |
| **Economic growth (%, 1994 prices)** |  |  |  |  |  |
| GDP | 4.16 | 7.51 | 6.23 | 7.5 | 6.7 |
| Agriculture - forestry – fishery | 1.83 | 4.11 | 4.36 | 3.9 | 3.3 |
| Industry – construction | 8.13 | 9.28 | 9.55 | 10.2 | 7.3 |
| *- Manufacturing* | *-* | *5.76* | *10.34* | *-* | *-* |
| Services | 3.69 | 8.73 | 4.82 | 6.9 | 7.6 |
| **Economic structure (%, current prices)** |  |  |  |  |  |
| GDP | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Agriculture - forestry – fishery | 41.6 | 33.4 | 25.7 | 22.4 | 21.0 |
| Industry – construction | 27.1 | 26.6 | 33.0 | 39.4 | 40.7 |
| *- Manufacturing* | *-* | *14.5* | *17.1* | *-* | *-* |
| Services | 31.3 | 40.0 | 41.3 | 38.3 | 38.3 |

*Source:* DinhHien Minh *et al* (2009) and calculation based upon GSO data.

Different rate of growth have resulted in the structural change in Vietnam’s economy. While the agricultural share in total GDP have reduced from 33.4% in the period 1989-1996 to only 21% in 2007-2010, the industrial and construction sector have increased its share in the total GDP to 40.7% in 2007-2010 from 26.5% in 1989-1996. The service sector, interestingly, contributed the rather same proportion to the GDP in the whole period (around 40%).

* + 1. *Trade*

Figure 3.1 below presents the changes in merchandise export and import of Vietnam during 2000-2010. Both export and import generally tended to increase. Total export of Vietnam have increased from USD 2.4 billion in 1990 to USD 14.5 billion in 2000 and to approximately USD 62.7 billion in 2008, i.e. an increase of 20% per annum. Export per capita have also increase from mere USD36 in 1999 to USD187 in 2000 and USD724 in 2008, i.e. a twenty-fold increase over the period of 18 years. Import growth was little bit faster, especially during the period from 2000 up to now. Import value grew around 21% per annum, from USD 2.7 billion to USD 15.6 billion in 2000 and USD 80.7 billion in 2008.

**Figure3.1: Export, import and balance of trade of Vietnam, 2000-2010**



*Source:* GSO.

The global financial crisis in 2008, however, has caused negative impact on Vietnam’s trade performance in 2009. The export have reduced from 62.7 billion USD in 2008 to only USD 57.1 billion while import value declined to USD69.9 billion from USD80.7 billion in 2008. But in 2010, the trade performance has bounded back rather strongly. Merchandise export rose to USD 72.2 billion while import value also increased to USD 84.8 billion.

Because the growth rate of import is higher than that of export, Vietnam has experienced continuous trade deficit. The trade deficit has increased from USD 1.2 billion in 2000 to USD 5.1 billion in 2006. The trade deficit further increased after Vietnam accessed to the WTO. In 2008, trade deficit have peaked at USD 18.0 billion in 2008 and slightly reduced to USD 12.9 billion and USD 12.6 billion in 2009 and 2010.

* + 1. *Investment*

In the last two decade, Vietnam has considered investment as the key driver of growth. The country made attempts to promote investment activities. Consequently, total investment went up in both nominal and real terms. During the period 1996 to 2010, investment rose from VND 74.3 billion VND to VND 400.2 billion. The average growth rate of investment in this period was high at 12.8%, nearly 6 percentage point higher than the GDP growth. At the current price, investment increased from VND 87.4 billion in 1996 to more than VND 830 billion in 2010.

**Table 3.2: Structure of investment, 1996-2010**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **1996** | **2000** | **2005** | **2006** | **2007** | **2008** | **2009** | **2010** |
|  | *Current prices (trillion VND)* | | | | | | | |
| Total | 87.4 | 151.2 | 343.1 | 404.7 | 532.1 | 616.7 | 708.8 | 830.3 |
| State | 42.9 | 89.4 | 161.6 | 185.1 | 198.0 | 209.0 | 287.5 | 316.3 |
| non-State | 21.8 | 34.6 | 130.4 | 154.0 | 204.7 | 217.0 | 240.1 | 299.5 |
| FIE | 22.7 | 27.2 | 51.1 | 65.6 | 129.4 | 190.7 | 181.2 | 214.5 |
|  | *Share (%)* | | | | | | | |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| State | 49.1 | 59.1 | 47.1 | 45.7 | 37.2 | 33.9 | 40.6 | 38.1 |
| non-State | 24.9 | 22.9 | 38.0 | 38.1 | 38.5 | 35.2 | 33.9 | 36.1 |
| FIE | 26.0 | 18.0 | 14.9 | 16.2 | 24.3 | 30.9 | 25.6 | 25.8 |
|  | *Constant prices (1994, trillion VND)* | | | | | | | |
| Total | 74.3 | 115.1 | 213.9 | 243.3 | 309.1 | 333.2 | 371.3 | 400.2 |
| State | 36.5 | 68.1 | 115.2 | 126.6 | 131.9 | 128.6 | 173.1 | 179.8 |
| non-State | 18.5 | 26.3 | 62.8 | 72.9 | 92.5 | 89.3 | 92.8 | 107.6 |
| FIE | 19.3 | 20.7 | 35.9 | 43.8 | 84.7 | 115.3 | 105.4 | 112.8 |
|  | *Growth (%)* | | | | | | | |
| Total | 14.9 | 15.3 | 13 | 13.7 | 27 | 7.8 | 11.4 | 7.8 |
| State | 34.2 | 16.2 | 9.6 | 9.9 | 4.2 | -2.5 | 34.6 | 3.9 |
| non-State | 3.8 | 9.7 | 17.4 | 16 | 26.9 | -3.5 | 3.9 | 5.9 |
| FIE | -1.7 | 19.9 | 16.9 | 22 | 93.4 | 36.1 | -8.6 | 7.0 |

*Source:* GSO.

The high growth rate of investment is attributed to the high growth rate in all economic sectors in the economy. Investment of the state sector increased at the average rate of 12.1% while that of non-state sector and foreign direct investment sector were little bit higher at 13.4%. This has contributed to the change in the share of investment in total investment. While investment of the state sector has declined from 49.1% in 1996 to 38.1% in 2010, the domestic private sector have expanded its share from 25% in 1996 to 36.1% in 2010. In the meantime, the share of the FDI is generally not changed from 1996 to 2010, i.e. around 26%, although the share of FDI in total investment has slightly changed from year to years.

The increasing role of FDI in total investment also reflects the fact that the domestic saving and investment gap have widened recently and that Vietnam is more dependent on the foreign savings in order to keep up with the demand for higher investment. The table below presents the pattern of Vietnam’s saving-investment gap (relative to GDP) over the period 2000-2010. The savings ratio jumped from 31.7% in 2000 to over 33.2% in 2001, before decreasing almost continuously to 29.8% in 2010. Meanwhile, the investment ratio increased continuously from 29.6% in 2000 to 35.5% in 2004, and peaked to 43.1% in 2007 before gradually went down to 38.8% in 2010. Consequently, the saving-investment gap exhibited a general downward trend, reversing from +2.1% to more than 9% in 2010. The increasing excess of investment over savings was financed by capital from overseas.

***Table 3.3: Saving – investment gap as percentage of GDP***

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | *2001* | *2002* | *2003* | *2004* | *2005* | *2006* | *2007* | *2008* | *2009* | *2010* |
| Total savings | 32.8 | 31.3 | 30.6 | 32 | 34.5 | 36.5 | 33.3 | 29 | 30.1 | 29.8 |
| Total investment | 31.2 | 33.2 | 35.4 | 35.5 | 35.6 | 36.8 | 43.1 | 40.9 | 38.1 | 38.8 |
| Savings-investment | 1.6 | -1.9 | -4.9 | -3.4 | -1.1 | -0.3 | -9.8 | -11.9 | -8 | -9 |

*Source:* IMF.

* + 1. *Balance of Payment*

Since the onset of the economic reform, Vietnam continuously run current account deficit (Table 4). The current account deficit was however largely contributed by trade deficit. In the meantime, the capital account is always positive. Especially, in 2007 and 2008, the capital account surpluses were large (USD 18.8 billion and USD 11.2 billion respectively) thanks to the massive capital inflows. Accordingly, the overall BOP was kept surplus most of the time, except in 2009 and 2010, when the BOP deficit were approximately 2.2% of GDP in 2009, and 2.9% of GDP in 2010. This deficit was caused by smaller inflow of foreign investment was smaller. Consequently, this resulted in a significantly declining foreign reserve. An important issue should be remarked is that the errors and omissions item in the BOP remained substantial, amounting to over USD 12 billion in 2009 and about USD 4 billion in 2010, reflecting partly unrecorded smuggling and trade activities and largely the shift of people’s asset portfolio towards gold (Vo Tri Thanh, 2011).

***Table 3.4. Vietnam’s Balance of Payment (unit: million USD)***

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | 1990 | 1996 | 1997 | 1998 | 2001 | 2006 | 2007 | 2008 | 2009 | 2010 |
| Trade balance | -41.0 | -2,775.0 | -1,247.0 | -989.0 | 481.0 | -2,775.6 | -10,360.1 | -12,783.0 | -7,607.0 | -5,147.0 |
| Export | 1,731.0 | 7,255.0 | 9,185.0 | 9,361.0 | 15,027.0 | 39,826.0 | 48,561.0 | 62,685.0 | 57,096.0 | 72,192.0 |
| Import (FOB) | 1,772.0 | 10,030.0 | 10,432.0 | 10,350.0 | 14,546.0 | 42,601.6 | 58,921.1 | 75,468.0 | 64,703.0 | 77,339.0 |
| Services | 55.0 | -61.0 | -623.0 | -530.0 | -572.0 | -8.2 | -894.0 | -950.0 | -2,421.0 | -2,461.0 |
| Export | 55.0 | 2,243.0 | 2,530.0 | 2,616.0 | 2,810.0 | 5,100.0 | 6,030.0 | 7,006.0 | 5,766.0 | 7,460.0 |
| Import (FOB) | 0.0 | 2,304.0 | 3,153.0 | 3,146.0 | 3,382.0 | 5,108.2 | 6,924.0 | 7,956.0 | 8,187.0 | 9,921.0 |
| Transfer (net) | 138.0 | 1,200.0 | 885.0 | 1,122.0 | 1,250.0 | 4,049.0 | 6,430.0 | 7,311.0 | 6,448.0 | 7,885.0 |
| Private sector | 0.0 | 1,050.0 | 710.0 | 950.0 | 110.0 | 3,800.0 | 6,180.0 | 6,804.0 | 6,016.0 |  |
| Current Account | -259.0 | -2,020.0 | -1,528.0 | -1,074.0 | 682.0 | -163.7 | -6,992.1 | -10,823.0 | -6,608.0 | -4,287.0 |
| Capital Account | 121.0 | 2,624.0 | 1,944.0 | 1,129.0 | 371.0 | 3,088.0 | 17,769.0 | 12,341.0 | 7,172.2 | 6,201.0 |
| Errors and Omissions |  | -611.3 | -269.2 | -534.9 | -846.7 | 1,400.2 | -565.3 | -1,044.4 | -9,029.0 | -3,678.9 |
| Overall balance |  | 277.7 | 327.8 | 37.2 | 206.3 | 4,324.5 | 10,211.6 | 473.6 | -8,464.8 | -1,764.9 |

*Source:* IMF

* 1. **Capital inflows: An overview**
     1. **Foreign Direct Investment**

The period 1988-2009 witnessed different periods of FDI inflows to Vietnam. From 1988 to 1996, FDI to Vietnam increased continuously and rapidly, with newly-registered capital reaching a peak of nearly USD 8.9 billion in 1996. The number of projects also rose from 37 in 1988 to 415 in 1995, before falling to 372 in 1996. This resulted partly from foreign investors’ expectations of a newly-opened economy, with large consumer market, as well as from attempts to penetrate market in the presence of massive import controls. Implemented capital went up in absolute term, but accounted for a decreasing share of registered capital. As a key reason, this period marked the start of FDI inflows to Vietnam, and foreign investors just wanted to register investment capital, without actual disbursement.

The years 1997-1999 saw a sharp fall in FDI inflows to Vietnam, mainly as a result of the Asian financial crisis and the less attractiveness investment environment in Vietnam relative to other regional ones. Newly registered capital decreased on average by 34% p.a. Implemented capital went down more slowly, by 3.5% p.a. on average due to the increase in implemented capital in 1997.

Figure 3.2: FDI inflows to Vietnam, 1988-2010



*Source:* GSO.

From 2000 to 2004, FDI inflows to Vietnam were rather small in comparison to her potential. Total registered capital per annum was only about from USD 2.8 billion to USD 3.2 billion. However, the number of new FDI projects increased from 391 to 791. More important, the disbursement of FDI in this period has slightly increased from USD 2.4 billion to USD 2.6 billion per annum.

Since 2005, thanks to improved investment environment and especially thanks to becoming a WTO member, FDI inflows into Vietnam began to increase. The number of new projects rose from 811 in 2004 to 987 in 2006, and over 1,500 in 2007 and 2008. Total registered capital increased even more quickly, from over USD 4.5 billion in 2004 to above USD 12 billion in 2006, before peaking at record-high of USD 71.7 billion in 2008. Similarly, implemented capital jumped to USD 4.1 billion in 2006, and USD 11.5 billion in 2008, from about USD 2.8 billion in 2004. Notably, in 2008, some billion-dollar projects have been granted the investment license.

In 2009, the global financial crisis has caused the slowdown in the FDI inflows to Vietnam. The pace of new FDI registration and the implementation of several FDI projects, particularly large ones, have become significantly slower. In 2009, the number of projects was over 1,200, while registered capital fell more sharply to over USD 23.1 billion. Implemented capital decreased more slowly, to USD 10 billion in 2009 as compared to USD 11.5 billion in 2008. Consequently, the share of FDI in total investment went down to only 25.7%.

During the period 1998-2009, the majority of FDI projects and registered capital came to industry-construction, while those into agriculture, forestry, and fishery were rather limited. The industry-construction sector accounted for 65% of FDI projects, and 57% of registered capital. Meanwhile, agriculture, forestry, and fishery only attracted 6% of FDI projects and 2% of registered capital. The services sector made up shares of 29% in projects, and of 41% in total registered capital.

However, the ratio of implemented FDI over registered FDI tended to fall from 63% in 2004 to 34% in 2006, and 16% in 2008. This was partly because some FDI projects were just registered to “book a place” in Vietnam. In fact, the ratio between chartered capital and registered capital was only 25.6% in 2008 and much lower than that in the previous years (Thanh & Duong 2009). Other reasons for the slower FDI implementation include the “bottlenecks” in Vietnam’s economy concerning inadequacy in institutions, infrastructure and human resources.

Table 3.5: Structure of GDP by ownership (unit: per cent)

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | 1995 | 2000 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
| *Total* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.0* | *100.00* |
| State | 40.2 | 38.5 | 38.4 | 37.4 | 35.9 | 35.5 | 35.1 | 33.96 |
| Non-State | 53.5 | 48.2 | 45.6 | 45.6 | 46.1 | 46.0 | 46.5 | 46.11 |
| FIEs | 6.3 | 13.3 | 16.0 | 17.0 | 18.0 | 18.4 | 18.3 | 19.93 |

*Source:* GSO.

Contributions of private sector and foreign-invested sector

Increase in the contribution of private sector in total investment has resulted in the larger contribution of the private sector and foreign-invested sector in Vietnam’s economy. On the one hand, the structure of GDP exhibited a shift towards larger share of the FIE sector, and smaller share of the State sector (Table 3.6 below). As can be seen, the share of the State sector fell continuously from 40.2% in 1995 to 35.1% in 2009. Conversely, with greater presence and contribution, the FIE sector saw its share being almost tripled from 6.3% in 1995 to 18.3% in 2009. The figure for the non-State sector, meanwhile, fell from 53.5% in 1995 to 45.6% in 2005, before recovering to 46.5% in 2009.

Table 3.6: Structure of GDP by ownership (unit: per cent)

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | 1995 | 2000 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
| *Total* | *100* | *100* | *100* | *100* | *100* | *100* | *100* | *100* |
| State | 40.2 | 38.5 | 38.4 | 37.4 | 35.9 | 35.5 | 35.1 | 33.96 |
| Non-State | 53.5 | 48.2 | 45.6 | 45.6 | 46.1 | 46 | 46.5 | 46.11 |
| FIEs | 6.3 | 13.3 | 16 | 17 | 18 | 18.4 | 18.3 | 19.93 |

*Source:* GSO.

On the other hand, the FIE sector is playing a larger role in Vietnam’s export (). It should be noted that exports of domestic enterprises and FIEs all went up continuously in 1995-2008, from USD 4.0 billion to USD 28.2 billion and from USD 1.5 billion to USD 34.5 billion, respectively. As can be seen, however, export of FIEs increased faster than that of domestic enterprises in 1995-2005. Consequently, the share of FIEs in export rose rapidly from 27.0% to 57.9% in this period. Since then, the trend was slightly reversed, as the FIEs made up a decreasing share in export. The figure actually fell to 53.2% in 2009. More importantly, the presence of FDI also stimulated Vietnam’s exports. As evidenced by Vo and Nguyen (2011), a one per cent increase in FDI led to a long-term increase in export by 0.14%

Table 3.7: Structure of export by ownership

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | 1995 | 2000 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|  | ***Value (billion USD)*** | | | | | | | |
| Total | 5.4 | 14.5 | 32.4 | 39.8 | 48.6 | 62.7 | 57.1 | 71.6 |
| Domestic enterprises | 4.0 | 7.7 | 13.9 | 16.8 | 20.8 | 28.2 | 26.7 | 32.8 |
| FIEs | 1.5 | 6.8 | 18.6 | 23.1 | 27.8 | 34.5 | 30.4 | 38.8 |
|  | ***Share (%)*** | | | | | | | |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Domestic enterprises | 73.0 | 53.0 | 42.8 | 42.1 | 42.8 | 44.9 | 46.8 | 45.8 |
| FIEs | 27.0 | 47.0 | 57.2 | 57.9 | 57.2 | 55.1 | 53.2 | 54.2 |

*Source:* GSO.

* + 1. ***ODA***

The Consultative Group Meeting for Vietnam conducted in Paris in November 1993 marked the complete resumption of the development cooperation relationship between Vietnam and international consultative group. By 2010, some 51 donors including 28 bilateral and 23 multilateral are implementing regular ODA program in Vietnam, including the World Bank, IMF, ADB, European countries, USA, Japan…

ODA commitment has been made with annual increasing level. In the period 1993 - 2007, total ODA commitment valued at some USD 42,438 million, most of them coming from many large donors such as Japan, WB, ADB UN agencies, France, Germany. This implies the strong support from the international donor community to the Vietnam’s reform process, socio-economic development and poverty reduction cause.

**Table 3.8: Ratio of ODA in GDP (unit: %)**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| GDP converted to USD (Billion USD) | 45.30 | 53.11 | 60.83 | 70.99 | 89.11 | 86.52 |
| Ratio of ODA in GDP (Percentage) | 3.64 | 3.36 | 2.93 | 3.07 | 2.53 | 4.16 |

Source: MPI

During this period, total ODA conclusions reached some USD 32,109 million, accounting for 75.66% of total ODA commitment; total ODA disbursement is USD 19,865 million or 61.86% of total ODA conclusion. The share of total ODA also increase from 3.64% in 2005 to 4.16% in 2009.

**Table 3.9. ODA commitment, conclusion and disbursement in 1993-2009 (unit: mill. USD)**

|  |  |  |  |
| --- | --- | --- | --- |
| PERIOD | COMMITMENT | SIGNED AGREEMENT | DISBURSEMENT |
| 1993-1995 | 6,131 | 4,858.07 | 1,875 |
| 1996-2000 | 11,546.50 | 9,008.00 | 6,142 |
| 2001-2005 | 14,889.20 | 11,237.76 | 7,887 |
| 2006-2009 | 23,849.80 | 17,282.97 | 10,319 |

Source: MPI

In the period 1993 - 2009, ODA fund has made a significant contribution to development investment, accounting for some 11% of total social investment and some 17% of investment from the State budget.

ODA implementation structure by sector in the period 1993 – 2007 is described in Table 3.10 below. 15% of total ODA are used for the Agriculture and Rural Development sector, in projects relating to upgrading irrigation system, rural power network, schools, health stations, rural transport, domestic water supply, small-scale rural credits, and integrated rural development in combination with poverty reduction. The energy sector received 23% of total ODA funding in order to increase the power source capacity, develop and extend power distribution network including in rural areas. The Transportation, Post and Telecommunication sector received the largest share of ODA funding, accounted for 35.2% of ODA conclusion. The ODA funding for this sector is used for for improving the technical infrastructure and service quality. The remaining 25% of total ODA conclusion has contributed to development of the Education and Training sector, health care, environmental protection

*Table 3.10. ODA implementation structure by sector in 1993 – 2007*

*Unit: million USD*

|  |  |  |
| --- | --- | --- |
| **Sector** | **Concluded ODA Agreement in 1993 - 2007** | |
| **Total** | **Percentage** |
| *1. Agriculture and rural development in combination with poverty reduction* | 5,130.73 | 15.9 |
| *2. Energy and industry* | 7,376.28 | 22.97 |
| *3. Transportation, post and telecommunication, water supply and drainage, and urban development, of which:* | 11,286.64 | 35.15 |
| *- Transportation, post and telecommunication* | *8,222.99* | *25.61* |
| *- Water supply and drainage, urban development* | *3,063.65* | *9.54* |
| *4. Health, education and training, environment, science and technology, and others* | 8,315.60 | 25.9 |
| **Total** | **32,109.25** | **100** |

* + 1. ***Portfolio investment flows***

The development and outlook of Vietnam’s economy and securities market has been appealing to many foreign investors. Foreign portfolio investment inflows, together with the presence of a number of foreign investment funds, became a real new phenomenon in 2006. Foreign portfolio inflows accounted for 2.2% and 10.4% of the GDP in 2006 and 2007, respectively. Foreign portfolio investors have shown a keen interest to invest in Vietnam’s equity market due to their appetite for higher risk-higher return assets and prevailing liquidity in the global economy.

There were 436 foreign investors as of 2005, including 38 institutional investors and 389 individual investors. However, the number of foreign accounts increased by nearly twenty times from 2005 to 8140 in 2007. The trading volume of foreign investors is rather high, accounting for 21% by the end of 2007. In 2007, the trading value increased significantly to around 55% of market trading value.

In 2006, there was around USD 1.3 billion of FPI in Vietnam, of which 70% was invested in stocks, bonds and real estate and 30% was held as deposits in the banking system. In 2007, FPI increased sharply to USD 6.2 billion. After a sharp fall in 2008 and 2009 due to the global financial crisis, the FPI has come back to the country in 2010 with total foreign indirect investment amounted to USD 2.4 billion.

In addition to the increase of the foreign portfolio investment, private remittance increased substantially, from 0% of the GDP in 1990 to 5.1% of the GDP in 2000 and further to 6.2% of the GDP in 2006 and 8.7% of the GDP in 2007. In 2010, the private remittance had increased substantially to more than USD 8 billion and made the country become one of the largest remittance receiving countries.

* 1. ***Managing capital inflows: some Vietnam’s experiences*** 
     1. *Letter Credit crisis in 1996-1997*

Up to 1996, attractive VND-dominated interest rate attracted a substantial increase in banking deposits while credits were hardly expanded due to the high lending rates and the tight regulations on credit ceilings. Many banks had excessive reserves. The situation created incentives for bank to evade Government controls. The letter of credits was an important channel for the evasion of the government controls, since up to that time LCs was excluded from credit ceilings and only importers can obtain loans in foreign currencies. Moreover, together of the implicit government guarantee of exchange rate stability, both banks and firms had incentives to lend and borrow through LCs. As a result, domestic firms, both SOEs and private ones, borrowed a large amount of short-term USD loans (the stock of LC amounted to USD 1.5 billion by early 1997. Net flows on short term debt increased significantly to $311 million in 1995 and $224 million from about $120 million in 1993 and 1994.

The consequences were severe: (i) The current account deficit widened to 9.2% GDP; (ii) A large part of the short-term borrowings was channeled into speculative real estate market, resulting in a market boom (but the market turned into bust later, in early 1997); (iii) Some SOCBs and joint stock banks defaulted on the guaranteed short term debts. Around 40% letter of credit (equivalent to 3% GDP) became bad debts

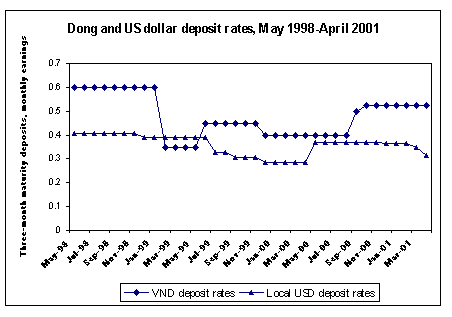
To deal with the situations, the SBV have to use foreign reserve to bail out these banks. It was estimated that the stock of foreign reserves fell by the equivalent to five week of import and Vietnam’s sovereign credit ratings was lowered from BA3 to C.

Moreover, the evasion of banks weakened the effectiveness of the monetary policy because the direct control mechanism was eroded, distorting monetary aggregates. It also triggered an upward pressure on the exchange rate. Due to a sharp increase in demand for foreign exchange by the end fo 1996 and early 1997, the SBV broaden the band between selling and buying rates of foreign exchange from 1 per cent to 5 per cent in Feb 1997. In addition the SBV set strict limits on the amount of deferred LCs and tightened controls over commercial banks’ LC guaranteeing. As a result, during the second half of 1998, the value of late LC payments fell from around USD 350 million to some USD 200 million at the end of 1998.

* + 1. *Dollarization*

Dollarization occurs when residents of a country extensively use the U.S. dollar or another foreign currency alongside or instead of the domestic currency. The amount of foreign currency deposits (FCDs) in Vietnam increased rapidly from 2.1 trillion VND in Dec 1989 to 91.1 trillion VND in Dec 2002 (Tuyet, 2003). It was a result of Vietnam integration into the world economy. At the end of 1990s, the interest rate of VND was very low (negative sign in 2000) led the VND deposits become less attractive than USD. Thus, economic agents and particularly individual converted VND deposits to USD deposit and raised the volume of FCDs significantly. According to IMF’s standard, Vietnam almost reached the threshold of highly dollarized economy.

**Figure 3.3: VND and USD Deposit Rates**



Source: SBV, quoted by Vo, 2010.

The degree of dollarization in Vietnam is always above 20% in comparison with 7-10% in other countries in Southeast Asia such as Thailand, Malaysia and Indonesia due to massive flow of remittance and foreign investment and increased export earnings over the past years. It is expected that dollarization may rise further in the recent context of high inflation and volatility of the VND.

* + 1. ***Policy response to a surge in capital inflow in 2007 and macroeconomic instability in 2008***

The year 2007 was marked a cornerstone in the process of Vietnam’s development by accessing to the WTO. This has heightened the foreign investors’ sentiment about the prospect of Vietnam’s economy. A large number of foreign investors have put their money directly and indirectly into the economy. As the result, net capital inflows in 2007 reach a staggering 24% of GDP, three times higher than the figure in 2006.

Domestic and public sectors were also excited about the development prospect of the country. Significant increases in both public and private consumption reduced the overall saving rate 5% points of GDP in 2007. At the same time, both public and private investment rates increase. The combined effect of declining saving rates and rising investment rates was a decline in the domestic saving-investment balanced of 10 percentage point of GDP (James Riedel, 2009).

Financial inflows in 2007 (24% of GDP) exceeded the financing requirement of the current account deficit (10% of GDP), requiring the central bank, following its policy of pegging the domestic currency to the USD, to buy surplus foreign exchange flowing into the economy through capital account (equivalent to 14% of GDP) and added it to foreign reserves. The foreign exchange reserves have accumulated rapidly to around USD23 billion by the end of 2007 from just USD 3 billion in 2000 and USD 11.5 billion in 2006. However, there are some concerns regarding to the capital inflows during this period:

* Debt-induced financing has constituted a majority of capital inflow, and hence the costs of financing current account deficit may increase;
* FDI inflow has also entailed considerably commercial loans;
* Capital utilization efficacy, especially in the public sector is low and
* Errors and omissions in the BOP are high due to statistical errors which may reflect shortcomings in controlling short-term capital flows.

In addition to the massive accumulation of foreign exchange reserve in 2007 and early 2008, domestic credit expansion, and rising asset prices have caused an acceleration of inflation (by May 2008, the inflation rate peaked at 30%).

Policy responses:

Conduction of the monetary policy faces two problems: (i) increasing macroeconomic policy inconsistencies and (ii) the “impossible trinity” as the capital inflows surges. The SBV have had to consider a trade-off between exchange rate stability and inflation targeting policy. In general, the SBV and the Government are more concerned about the possible negative impact of appreciation on exports and the slowdown of economic growth. In January 2007, the SBV widened the trading band of the VND/USD from ±0.25% to ±0.5% around its daily reference rate. However, the VND/USD appreciated in nominal terms of only 0.2% for the whole year of 2007. At the same time, the SBV kept all official interest rates such as refinancing, discount and basic rate unchanged from early 2006 in order to provide a stable signal to market, although the rates set by commercial banks slightly increased. While stabilizing the nominal exchange rate, the SBV quickly build up its foreign exchange reserves to USD 23 billion by the end of 2007 from USD 11.5 billion in 2006.

As inflation accelerated in the first half of 2007, the SBV engaged in sterilized intervention in the foreign exchange market using the treasury bills and its own central bank bills. In June 2007, it raised the reserved requirement ratio for deposits under 12 months from 5% to 10% for deposits in VND and from 8% to 10% for deposits in USD. However, such measures were apparently ineffective as the money supply (both M2 and domestic credit) expanded sharply in 2007 (by more than 50%), exerting more pressure on inflation (Vo Tri Thanh and Pham Chi Quang, 2010)[[1]](#footnote-2).

To control the money supply, the SBV introduced several policy measures: (i) by the end of December 2007, the SBV widened the trading band of VND/USD to ±0.75%, then further widening to ±1%, ±2% and ±3% in March, June and November 2008, respectively; (ii) to limit potential growth of credit for stock investment, in Jan 2008, lending restrictions for stock investment changed from 3% of total loans outstanding to 20% of chartered capital; (iii) and the reserve requirement ratios raised by one percentage point to 11% from 10% in Feb 2008 and by two more percentage points to 13% in July 2008; (iv) all official interest rates were also raised ; (v) the SBV issued 365-day bills in March 2008 with a coupon rate of 7.8% which was slightly higher than SBV refinancing rate but lower than the rediscount rate, and required commercial banks to purchase such bills.

Although fiscal tightening can be a good response to capital inflows, however, by the early 2008, Vietnam, in general, had no serious intention of using fiscal policy as a policy complement to monetary and exchange rate policies in response to capital inflows. This is partly due to the fact that scope for reducing budget deficit seems to be limited (Vo Tri Thanh and Pham Chi Quang, 2010). But on April 17, 2008, the Government released Resolution No.10/2008/NQ-CP detailing measures to restrain inflation, stabilize macro economy and ensure social security and sustainable growth. The government carried out a tight fiscal policy with different measures such as (i) cutting down public expenditure to further reduce budget deficit; (ii) reducing public investment, especially investments of state-owned groups and enterprises; and (iii) giving priority to investment in economic sectors. Inefficient public investment projects have been cancelled while new projects were postponed.

Furthermore, in December 2008, the government released Resolution 30/2008/NQ-CP on urgent measures to deal with the economic recession, maintain economic growth and ensure social security. On fiscal policy, the government announced several measures to support SMEs in Vietnam. For example, SMEs may benefit from (i) 30% Corporate Income Tax (CIT) payable deduction; (ii) an extension of up to 9 months for the deadline of submission of the tax payables of 2009; and (iii) a temporary refund of 90% input Value Added Tax (VAT) for exported goods without justifiable payment documents. And the government has announced a fiscal stimulus package to compensate for the effects of the global economic recession.

*Impact of policy responses*

Despite efforts made by the SBV and the Government, inflation continued to increase until the mid of 2008 (The figure peaked at 28.3% in August 2008). Between September 2008 and September 2009, month-on-month inflation went down significantly and by the end of 2008, the year-on-year inflation rate have reduced to 19.9%. This decline continued until March 2009, when year-on-year inflation reached 11.3% while month-on-month inflation was low. The underlying reasons were of both “good luck” (falling international prices of rice and fuels) and “better policy implementation” (the impact of stabilization policies) (Vo Tri Thanh, 2011). For 2009 as a whole, the CPI-based inflation rate was reportedly below 6.9%.

1. **Capital Flow of Mozambique**

***4.1. Overview of Mozambican Macroeconomic Situation***

The Real Gross domestic Product (GDP) in Mozambique has grown in average at 8% per year. The growth of the sector of Agriculture (8%), Manufacturing Industry (9%), Transportation and Communication (9%) and Trade (10%) has been determining the growth of GDP contributing in average with 23%, 14%, 10%, 11%, respectively, in the overall share of GDP.

The inflation rate has grown in averaged 10.6% per year and the prices of food have been its main determinants of during this period.

***Table 4. 1: Macroeconomic Indicators in Mozambique***



The Mozambican population was estimated at 22 million in 2010, of which 69% live in rural areas and 31% in urban areas (INE, 2010). According to IOF08, 70% of households are located in rural areas and virtually all of them (96%) are engaged and depend in agriculture in some way, however this sector still faces low productivity problems.

According to the household survey, IOF 2008/2009, nearly 12 million people, of 21.5 million, lived below the poverty line in 2008/9 and during survey period the national headcount ratio was 54.7%, 0.6 percentage point increase compared with the last household survey 2002/2003. The 2008 household surveys shows that during the period 2002/03 to 2008/09 there was a moderate increase in rural poverty, from 55.3% to 56.9%, and a moderate reduction in urban poverty, from 51.5% to 49.6%. According to the World Bank (2007), the headcount ratio decreased in 15% from 1997 and 2003 and during this period the poverty decreased more in rural areas (from 71% to 55%) than in urban areas (from 62% to 52%) and Mozambique was the second country after Vietnam that succeeded these results.

The Exports has grown in average by 16.7% in the last ten years and imports for the same period by 9% but the imports are still higher than exports corresponding to 45% of GDP relatively of 31% of Export to GDP. This has resulted in the deficit of trade balance as percentage of GDP in average of 14%. The Current Account deficit as percentage of GDP has been in average at 13% which was partially offset by a surplus of capital account the averaged 4% as a percentage of GDP.

**4.2. Capital flows to Mozambique and Current Account Financing**

*4.2.1. Capital flows to Mozambique: Trends and composition*

4.2.1.1. Trends

Capital Inflows are important source of economic growth for much low income developing countries investment because is the main source of investment finance. At the same time, the composition and variability of capital inflows are important to investment decisions and economic policy.

The main objective of this section is to describe the volume of international capital flows to Mozambique form 1987 to 2010, particularly since 2002.

***Figure 4.1: Net Capital Flows to Mozambique (1999-2010)***

*Sources*: Bank of Mozambique and National Statistical Institute

The trends of net capital inflows to Mozambique during 1999-2010, are presented in Figure 4.1. Before 1987 the capital inflows to Mozambique were very low and it was in form of Official Development Assistance (ODA). From 1987, under the liberalized foreign transactions regimes Mozambique began to receive, although low, private capital inflows in the form of Foreign Direct Investment (FDI). From 1998/1999 Mozambique witnessed a surge of capital inflows; this is in part due to FDI inflow from MOZAL . Mozambique has received growing net capital flows, mainly since 2002, when the net capital inflows was around USD 1441.2 million (34.3% of GDP) and achieving the highest level (USD 1995.1 million) in 2009. The growing of net capital inflows reflects the increase of capital inflow that has offset the capital outflows. Despite, the financial crisis 2008/9 the net capital inflow to Mozambique continued growing but the composition as changed during this crisis period.

4.2.1.2. Composition

Before 1987 the capital inflows to Mozambique was very low and it was in form of Official Development Assistance (ODA) and in 1987 Mozambique began to receive private capital inflows in the form of Foreign Direct Investment (FDI) and ODA continued the main source of capital inflow to Mozambique. But from the years 1990 the composition of capital inflows has changed significantly over years and dependence over ODA has vanished and FDI, Capital transfers (CT), foreign portfolio investment (FPI) and others have had a considerable weight in the capital Inflows composition.

***Table 4.2: External Financing and Net Capital Inflows Composition in Mozambique***



During 1998-2010, the ODA and FDI has been the main sources for the capital inflows to Mozambique contributing in average with 73%, 28% in the total of the net capital inflows.

The figure 4.2 shows the tendency of ODA during 1998 to 2010. It shows the ODA has been growing over time. The high inflows of ODA to Mozambique began in 1886/7 with the launching of the Economic Rehabilitation Program (PRE) in 1986/7 supported by the International Monetary Fund (IMF) and as a result large amount of foreign aid from Western Bilateral and Multilateral donors. Before the PRE (Economic rehabilitation Program) the most share of aid inflow came from the Soviet Union and its allies.

***Figure 4.2: Evolution of Official Development Assistance to Mozambique (1998-2010)***



*Source:* Based on the Bank of Mozambique

The FDI has been increasing over time, although the growth has been instable. The instability is due, principally, to the concentration of investments in few mega projects which don’t invest the same amount annually. The peaks of 1998/1999 and 2002/2003 reflect the construction phase of Mozal I and then Mozal II and Sasol . And from 2006 to 2010 the growing trend reflects the investments from Vale and Riversdale in Coal Mining.

***Figure 4. 3: Evolution of FDI in Mozambique (1986-2010)***



Source: Based on the Bank of Mozambique

Reserves

In a number of developing countries, notably the emerging markets, there has been a tendency in recent years to accumulate reserves as a safeguard against discontinuation or reversal of capital flows and speculative attacks on the currency. While reserves have followed a boom-bust cycle in line with the rapid surge and exit of private capital, on average, they have absorbed an increasing proportion of net capital inflows, over and above what is typically needed to finance the flow of imports (UNTACD, 2000).

A high portion of Net Capital Inflows has been used to accumulate foreign reserves in Mozambique. The Figure 4.4 shows the evolution of foreign reserves in Mozambique. In average those reserves has covered six months of goods imports during 1998-2010.

This trend of Net Foreign Reserves are justified because of high dependence from imports in Mozambique and also to guarantee the existence of enough foreign exchange reserves for monetary policy purposes such as management of inflation using exchange rate policies which needs huge reserves amounts.

***Figure 4.4: Evolution of Net Foreign Reserves in Mozambique (1998-2010)***



Source: Based on the Bank of Mozambique

Current Account Financing

The necessity of accumulating reserves and to make payments abroad has absorbed together the huge amounts of net capital inflows in Mozambique. The Mozambican Current account has presented in average a deficit over USD 800 millions which correspond in average to 70% of net capital inflows.

Although the Net Capital Inflows have increasing over time there is a big challenge in mobilizing domestic savings and foreign exchange reserves because Mozambique still depends a lot in foreign savings and this as contributed a lot for current account deficit.

***4.3. Determinants of Capital Flows to Mozambique***

The capital inflows to Mozambique, like other developing countries such as Tanzania, Uganda and Zambia, is explained by significant progress in economic policy reforms over the last decade, which have contributed to price stability, fiscal discipline, improvement of the economic infrastructure, and creation of better environment for private investment (Ndikumana, 2003).

The World Bank (2003) identifies the socio-economic and political stability as the main driver of capital inflows to Mozambique since 1992, has experienced advance in governance system and peace and democracy has been maintained, principally after 1994 multiparty elections.

According to Castel-Branco (2002), Noronha (2009) the main reasons for FDI inflows to Mozambique are: the endowment of Natural Resources, economic stability, strategic location.

However Noronha (2009) argues that the weak development of infrastructure and of Human Resources has affected negatively the inflow of FDI

Bolnick (2004), Emphasized that tax breaks are fundamental in the cases which the FDI projects are viable in other regions where the fiscal determinants are not the same, as well, for the projects which the financial and economic feasibility depends on the tax breaks. Noronha (2009) finds a positive but insignificant relationship between tax breaks and FDI flow. This confirms the thesis of Bolnick (2004).

***4.4. Capital Flow to Mozambique: Impacts and Management***

*4.4.1. Capital Flows and GDP Growth*

FDI inflows to Mozambique, like in many African countries, have been concentrated in extractive industries, which contribute to large dependence from primary sector. Because of extractive activities is predominantly capital intensive, capital flows in this area have little contribution to employment creation.

For Batley and Cumbi (2006), it is difficult to measure the effects of ODA in the Mozambican development but ODA has been contributing for Economic Growth and Poverty reduction in Mozambique. The reason for this statement is that the over 50% of the budget has been financed by ODA and the finance to the investment budget has been bringing many positive returns in the productive sector and in the job creation. The other arguments is that ODA has been the main source for financing the Plan for Poverty Reduction and according to the same authors Mozambican began to receive significant ODA in 1990 and if we compare the periods before and after 1990 the conclusion is that there has been fast improve in the access of social services such as education, water supply and health.

The ODA has minimized the budget deficit along the time and without donations the budget deficit is high in Mozambique, like in many developing countries. In Average the budget deficit is about 12% of GDP between 1997-1999, 16% in 2000-2004 and 13.4% from 2005-2010. The percentage of current expenditure has percentage of GDP was very high after the civil war but it has then decreased in the years 1990, but since 2000 due to high inflow of ODA it has increased more rapidly than the increase in the national income (Batley and Cumbi, 2006).

Since 1996 this pattern, i.e. relationship between aid and inflation, has been broken, with inflation going down in spite of increasing in aid. But this effectively means that there is no relationship between aid and inflation because as IMF find (1999), the decrease of inflation in 1996 may be related with the tightening of the monetary policy by the bank of Mozambique which resulted in the decrease of broad money from 38% in 1995 to 20.3% in 1996.

A research from Afonso and Ribeiro (1999) about the impact of ODA in Mozambique and Cape Verde shows a positive relationship between the ODA flow and GDP growth. It suggests that an increase of 1% on ODA increases GDP in 0.17% in Mozambique.

*4.4.2. Capital Flows and Exchange Rate Appreciation*

Other effects from the capital inflow result in exchange rate appreciation. Looking at the graph 3 above we may find a close and positive relationship between ODA inflow and exchange rate movements, i.e. increases in ODA lead to exchange rate appreciation and ODA reduction result in depreciation of exchange rate.

***Figure 4.5: Evolution of ODA Inflow (%) and Exchange Rate (%)***

*Source:* Based on the Bank of Mozambique

There is a strong belief that more capital inflow may easy inflation pressure as it leads to exchange rate appreciation, i.e. an increase in ODA is accompanied by reduction on inflation and vice-versa and this is the result of the impacts of exchange rate movements (appreciation and depreciation) on inflation.

To minimize the inflations pressure the Bank of Mozambique intervenes in the foreign market exchange causing sterilization costs or increasing the monetary directory taxes which have impact in system credit to the economy.

According to IMF (1998), an expansionary monetary policy in combination with inflationary effects of large devaluations of metical and the deregulation of prices largely explains the high inflation in Mozambique during the first half of 1990. However it’s possible that foreign aid contributed to this development, because during 1990-1996 the increases (decreases) in aid went together with increases (decreases) in inflation, which supports the hypothesis of Dutch Disease theory that the spending effect of aid affects prices. In particularly, it’s noteworthy that inflation peaks in 1992 and 1994, i.e. the years of the large aid inflows due to peace treaty and democratic elections respectively (Falck, 2000).

*4.4.3. Capital Flows and Reserves Accumulation*

As stated before, Mozambique has been accumulating huge amounts of foreign reserves. In 2010, the accumulated foreign reserves were USD 1700 millions, 228% above of its value in 1998 and these reserves has corresponded in average to 6 months of goods imports. However, according to international conventional rules they are above of what is advised to face adverse external shocks.

According to IMF (2009), in 2008, Mozambique was negatively affected by the increase in the international prices, particularly in countries with which maintain trade relations. However, because of the significant inflows of capital, this negative impacted was offset and the overall result was an increase in the gross external reserves of about USD 140 million. Nonetheless, inflows of capital might face fluctuations; particularly in periods of crisis where there might be some delay from the donors in fulfill all commitments with countries which depend on foreign aid. As a consequence, the current balance and in the case of Mozambique, the state budget might run out of enough capital to meet all public expenditure and it may destabilize the economy.

In the next years the main challenges for monetary policy in Mozambique will be related with the management of capital inflows as the country is likely going to receive more capital as a result of natural resources exploration (e.g. coal and gas). Currently the Central Bank to minimize the impacts of the flows has been intervening in foreign exchange markets buying or selling foreign exchange.

The Central Bank of Mozambique in managing capital inflows has used a market-based approach which involves financial transactions between the Central Bank and the Market, mainly with the commercial banks. In this approach the traditional instruments used by the Central Bank of Mozambique has been the treasure bills and repo and reverse repos auctions under the day-to-day liquidity adjustment facility.

The Central Bank of Mozambique uses those instruments in order to adjust the foreign exchange without changing the money supply. So in case of excess of foreign reserves the Bank of Mozambique intervenes in the foreign exchange market buying this excess leading to increase of money supply, by increasing monetary base, which may contributes to more credit to the economy and inflation pressure. Therefore to mop the excess of money supply the Bank of Mozambique sells the treasure bills mopping the excess of liquidity.

However, these operations bring immediate costs to the Central Bank related with the interest that it has to pay for the sale of treasure bills but it can brings revenue to the Central Bank if it increase the return over foreign exchange assets. So the costs of these operations will be the differential between the yields on the treasure bills and return on foreign exchange assets.

Generally the domestic interest rate of Treasure Bills is above the international interest rate making the returns of the Bank of Mozambique very low. Beyond that, a huge quantity of foreign exchange accumulated by the central bank are denominated in USD what actually constitutes disadvantage to Mozambique, as at international level, the interest rate for USD applications has been too low, and close to zero (Amarcy, 2009).

Amarcy (2009), arguments that foreign exchange accumulation has been used for precautionary purposes, but they could be used to boost the investments, aggregate demand which could also contributes for enlargement of fiscal base.

1. **Conclusion**
   1. ***Some lesson learnt***

*Lesson 1: Capital inflows can have both benefits and risks*

Capital inflows provide invaluable benefits in pursuing economic development and growth by enabling the finance for investment, smooth consumption, diversifying risks and expanding economic opportunities. Capital inflows will also help to make the resource allocation become more efficient and increase social welfare.

However, capital inflows if not managed property can make a country expose various types of risks. According to Kawai and Takagi (2010), at least there are three types of risks a country may be exposed when large capital inflows. These risks include: macroeconomic risk, financial risks and capital flow reversal.

* Macroeconomic risk: capital inflows could accelerate the growth of credit (or even create loss of monetary control), cause the real exchange rate to appreciate, cause inflation and affect other macroeconomic variables in a way inconsistent or incompatible with immediate domestic policy objectives such as price stability, exchange rate stability and export promotion. Greenville (2010) argues that the macroeconomic consequences of recent capital inflows, including on monetary control and inflation, have not been so large, although the impact on real exchange rates may have been large.
* Financial stability risk: Capital inflows could push up equity and other asset prices, reduce the quality of assets and adversely affect the maturity and currency composition of balance sheets of the private sector (particularly banks and corporations), thereby contributing to greater financial fragility. Recent experience suggests that the impact of capital inflows on asset prices has been particularly significant.
* Risk of capital flow reversal. Capital inflows could reverse themselves suddenly with a potential for the depletion of reserve of sharp currency depreciation. According to Schadler (2010) about 15% of the capital inflow episodes over the past 20 years ended in crisis. It is mainly against this crisis risk that many countries in Asia have accumulated large foreign exchange reserves as a form of self-insurance.

*Lesson 2: Ensuring the macroeconomic consistency is essential for avoiding financial speculation and crisis*

Macroeconomic policy inconsistency may lead to

* Ineffectiveness of monetary policy and mismanagement of cross-border capital movements
* Encouragement of speculative financial activities
* Serious double mismatch in balance sheets of banks and firms. This in turn can possibly cause a crisis in the context of a surge in capital inflows.

*Lesson 3: Policy response to a surge in capital inflows are always constrained by the impossible trinity but in favor of exchange rate flexibility, financial supervision strengthening and policy coordination*

In an economy open to capital inflows, the policy consistency over time requires the authorities to have either a very strong commitment to a pegged exchange rate or pursue a fully flexible exchange rate. However, this is constrained by the well-known “impossible trinity” which states the impossible coexistence of exchange rate stability, free movement of capital and monetary policy.

According to Kawai and Takagi (2010), in general, three broad categories of macroeconomic measures are available to countries facing surges in capital inflows, if they are not willing to allow the nominal exchange rate to appreciate. These policies include (i) sterilized intervention; (ii) greater exchange rate flexibility and (iii) fiscal tightening.

* Of these sterilization is the most commonly used instruments. Broadly defined, sterilization can be any measure that attempts to offset the growth of monetary aggregate coming from reserve inflows. These measures could include raising reserve requirements, borrowing from commercial banks (by the central banks), shifting of government deposits from commercial banks to the central banks. However sterilization works only if two conditions are met: first, domestic and foreign assets must be imperfect substitutes and second, the interest cost of the operation must be manageable.
* In addition to sterilization, greater exchange rate flexibility is another possible response. Greater exchange rate flexibility usually means introduction of a wider bank of fluctuations. The effectiveness of these instruments depends on how much the authorities are willing to allow the exchange rate to move.
* Fiscal tightening is the most assured response to surge in capital inflows because it involves a reduction in the absorption of real resources by the public sector to offset the domestic impact of resources from abroad. However, fiscal tightening has at least three limitations as a response to capital inflows: (i) fiscal policy lacks flexibility; (ii) there is a limit to how much fiscal policy can be tightened; and (iii) fiscal tightening may have the perverse effect of attracting additional capital inflows (by providing a signal that authorities are pursuing a sound, disciplined macroeconomic policy).

Besides, other structural measures to deal with surge in capital inflows should also be carried out. According to Kawai and Takagi (2010), the most common types of measure are (i) financial sector reforms (including improving the system of prudential supervision and developing capital markets); (ii) easing restriction on capital outflows and (iii) further trade liberalization (through tariff reduction and the like).

The following table provides a summary of measures, their outcomes, limitations and effectiveness of measures to cope with the surge in capital inflows.

***Table 5.1. Policy response to capital inflows***

|  |  |  |  |
| --- | --- | --- | --- |
| Policy tool | Intended outcome | Possible limitations | Evidence on effectiveness |
| Macroeconomic policy | | | |
| Sterilized intervention | Prevent nominal and real appreciation while neutralizing the growth of base money | Rising quasi-fiscal cost, higher interest rate that attract additional inflows; unable to prevent real appreciation over the medium term due to eventually inflation | Some evidence of effectiveness in the short term but no in the medium to long term |
| Greater exchange rate flexibility | Direct monetary policy for macroeconomic management; discourage speculative capital inflows by creating two-way risk | Loss of international price competitiveness | Limited evidence on the response of speculative flows |
| Fiscal policy tightening | Contain inflationary pressure; discourage capital inflows by reducing interest rate pressure; prevent real appreciation | Lack of flexibility and timeliness; a natural limit to the degree of tightening; reduction of the provision of some basic services and infrastructure investment; possibility of a positive signaling effect to attract additional inflows | Some evidence of effectiveness in preventing real appreciation and keeping better growth performance following capital flow reversals |
| Structural measure | | | |
| Financial sector reform | Minimize the negative impact of capital flow reversal by promoting risk management | Not achievable in the short run | n.a. |
| Controls on capital inflows | Limit capital inflows | High administrative capacity required | Some evidence of effectiveness in lengthening the maturity of inflows without much impact on the volume; effectiveness tends to weaken overtime |
| Easing restrictions on capital outflows | Reduce net inflows by encouraging outflows; allow residents to diversify risks | Insufficient pent-up demand for foreign assets; possibility of a positive signaling effect to attract additional inflows | Some evidence of promoting additional capital inflows |
| Rebalancing growth | Reduce the current account surplus by refocusing sources of growth from external to domestic demand; contain upward pressure on the real exchange rate | Policy makers’ reluctance to abandon existing policies | n.a. |
| Further trade liberalization | Reduce current account surpluses by encouraging imports; contain upward pressure on the real exchange rate | Failure of net imports to rise when the tradables sector becomes more competitive as a result; possibility of a positive signaling effect to attract additional inflows | n.a. |

*Source:* Kawai and Takagi (2010)

* 1. ***Policy implications for Mozambique***

Mozambique has been receiving considerable amounts of capital inflows particularly in the form of Official Development Assistance and Foreign Direct Investments. Although these inflows have been contributing in the economic growth and minimizing the effects of external shocks they have also contributed to exchange rate appreciation and inflation volatility.

The economic policy reforms socio-economic and political stability, the endowment of Natural Resources, strategic location have been the principal determinants for the capital inflows in Mozambique.

The Central Bank of Mozambique in managing capital inflows has used a market-based approach based on the treasure bills and repo and reverse repos instruments in sterilization operations which brings costs to the Bank of Mozambique. Therefore the Central Bank must not lose in sight these costs particularly when sterilizations operations raise domestic interest rates and result in the trap of even greater capital flows. The fiscal costs of sterilization must be taken in account especially when a large stock of Treasure Bills has to be issued for the purpose.

Foreign exchange accumulation, by the central Bank of Mozambique, has been used for precautionary purposes, but they could be used to boost the investments, aggregate demand which could also contributes for enlargement of fiscal base.

Instead of using the monetary policy to manage the capital inflows, Mozambique could adopt a combination of Monetary, Fiscal and Trade Policy. This combination could reduce the effort of the monetary policy.

Mozambican has been receiving considerable ODA and FDI for extractive industries and these have been increasing over time. So these capital inflows have the potential of overvaluing the currency and the resultant erosion of long-term competitiveness of other traditional and goods sectors - a problem known has Dutch Disease. Given the fact the more population are in goods sector, particularly in agriculture which accounts for great weight in Mozambican traditional exports, Mozambique should redirect capital inflows (from extractive industries) to new growth –promoting, e.g labor intensive areas. This should include policies imposing minimum stay requirement on foreign capital, establishment of differential reserve requirements by type of capital in favor of growth-promoting capital, and providing preferential tax treatments to foreign capital that is direct to new employment-creating and growth-promoting activities.

Mozambique should invest more in financial and human resources to establish mechanisms for systematic monitoring of the inflows and outflows of capital. This could include the creation or strengthening of specialized divisions within Central Banks and National Statistics Institute whose main mission would be to compile and disseminate information on capital movements.

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1. The SBV was recognized by the government to be “perplexed” in conduction monetary policy, which was viewed as one of the major causes of increasing inflation, together with cost-push and demand pull reasons. Moreover, weakening USD in the global economy and increasing international commodities prices, keeping the stability of the nominal VND/USD also meant a significant import of international inflation. [↑](#footnote-ref-2)