SOUTHERN AFRICA GLOBAL COMPETITIVENESS HUB

Report Title:
The Rationalization of Foreign Exchange Controls in Angola

By:
Keith Jefferis – Consultant

Submitted by:
The Services Group

Submitted to:
USAID / Southern Africa

Gaborone, Botswana

June 2008

USAID Contract No. 690-M-00-04-00309-0

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ACRONYM LIST

AML/CFT	Anti-money Laundering/Countering the Financing of Terrorism
BNA	Banco Nacional de Angola (National Bank of Angola)
BoP	Balance of Payments
BVDA	Bolsa de Valores e Derivativos de Angola (Angola Stock Exchange)
CMC	Capital Markets Commission
EU	European Union
FCA	Foreign Currency Account
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Programme
IMF	International Monetary Fund
KYC	Know Your Customer
MCP	Multiple Currency Practice
NBFI	Non-Bank Financial Institutions
OECD	Organization for Economic Co-operation and Development
RISDP	Regional Indicative Strategic Development Plan
SADC	Southern African Development Community
TBC	Titulos de Banco Central (central bank bills)
URR	Unremunerated Reserve Requirements
USSR	Union of Soviet Socialist Republic
WHT	Withholding Tax

1. Introduction

One of the items considered in the Policy Matrix on Expanding Credit Access in Angola, prepared early in 2007, was the issue of foreign exchange controls. The matrix noted that Angola had in place an elaborate foreign exchange control and licensing system administered by the National Bank of Angola (BNA). It also questioned whether such a system might not be doing more harm than good, for instance by increasing transaction delays and costs while actually undermining confidence in the currency and inhibiting capital inflows. The Policy Matrix therefore proposed that consideration be given to rationalizing the existing system of exchange controls, as part of a broader process of financial sector reform and liberalization, and extending the scope of market-based economic policies in Angola. At the same time it was acknowledged that such a program of exchange control reform would have to be handled carefully. It was noted that exchange control liberalization may lead to short term capital flows that could destabilize the economy, and also that alternative measures might be needed, for instance to complement exchange rate policy. Hence it was felt that a cautious program of reform would be appropriate.

This paper examines the potential for exchange control rationalization in Angola in more depth, and is divided into two parts. The first half of the paper considers general issues around exchange controls and the experience of other countries that have been through the process of exchange control reform, focusing on the elements of other countries' experiences that are relevant for Angola. The second part of the paper briefly reviews the existing system of exchange controls in Angola, and then lays out the issues involved in exchange control liberalization in more detail. In particular, it considers the potential impact on other policies (monetary, exchange rate and financial sector policies), and identifies other measures that would be necessary to complement an exchange control reform program. It also considers the specific implications of moving to International Monetary Fund (IMF) Article VIII status. Finally it suggests a sequencing of the various policy reform measures.

2. The Economic Impact of Exchange Controls and their Liberalization

2.1 A Typology of Exchange Controls

Exchange controls can be usefully classified in a number of ways. The most important distinction is between those on current account transactions (of the balance of payments) and those on capital (and financial) account transactions.

Restrictions on current account transactions can apply to various different components – visible (merchandise) trade, invisible (services) trade, income payments and current transfers. Current account transactions have been extensively liberalized in most countries. Of those that remain, the most heavily used exchange restrictions continue to relate to payments and transfers for current invisible transactions, while those related to payments for imports of goods remain rare. More specifically, the most commonly applied exchange restrictions are binding limits on foreign exchange allowances for remittances and travel. Only a few countries still maintain exchange restrictions related to imports, such as prior import payment requirements. Some restrictions that apply to current account transactions – such as documentation requirements or repatriation of export remittances - are in fact required to administer other exchange control restrictions, such as or those on capital transactions.

It is difficult to justify restrictions on current account transactions from an economic perspective, at least not in a market-based economic environment. Where they exist they are generally hangovers from regimes with extensive systems of direct controls over economic activity that have been in place for many years; they would typically have been justified in terms attempts to conserve scarce foreign exchange in countries with serious balance of payments problems, often resulting from seriously overvalued fixed exchange rates.

Arguments for the liberalization of current account transactions are widely accepted, and few countries now maintain such restrictions; the number of IMF members subscribing to Article VIII membership – which involves a commitment not to restrict current account transactions - has risen from 150 in 2001 to 166 in 2006. At the end of 2006, only 19 countries (including Angola) continued to subscribe to Article XIV, which does not involve such a commitment (see Box 1)[1].

The situation regarding restrictions on capital account transactions is more complex. Whereas current account restrictions are almost always aimed at restricting foreign currency payments or outflows, capital account restrictions may be aimed at restricting inflows or outflows. Furthermore, restrictions may be aimed at restricting short-term or long-term capital movements. The different types of capital account restrictions can be classified as in Table 1 below.

Table 1 – Types of capital account transactions and examples of flows in each category

Maturity of Flows / **Direction of Flows**	**Short-term**	**Long-term**
Inward	*Portfolio inflows (e.g. non-resident investment in stock market, T-Bills)*	*Foreign Direct Investment (FDI)*
Outward	*Portfolio outflows (e.g. pension fund investment offshore)*	*Direct investment offshore Purchase of foreign property*

It is also helpful to classify capital account transactions in terms of the types of institutions undertaking them or the instruments involved, as this will later be seen to be important when it comes to the sequencing of liberalization.

The main classifications are as follows:

- Capital and money market instruments (stock exchange, bond markets).
- Credit operations (cross-border lending and borrowing).
- Real estate (transactions by non-residents).
- Personal capital transactions (by individuals).
- Transactions by banks and other credit institutions.
- Transactions by institutional investors (such as pension funds).
- Non-resident accounts.

[1] The other Article XIV countries are: Afghanistan, Albania, Bhutan, Bosnia & Herzegovina; Burundi, Eritrea, Ethiopia, Iraq, Laos, Liberia, Maldives, Mozambique, Myanmar, Nigeria, São Tomé & Principe, Somalia, Syria and Turkmenistan.

Box 1 – Exchange Controls and the IMF

The Articles of Association of the IMF provide for all members to accept obligations for exchange controls under one of two articles: Article VIII or Article XIV. Under Article VIII, the member commits that it will not:

- "without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions" (Section 2);
- "engage in any discriminatory currency arrangements or multiple currency practices" (Section 3).

In other words the member commits to permit free exchange of their national currency for the purposes of current account transactions (visible and invisible trade, income and transfers). The member also commits not to introduce or reintroduce current account restrictions without the agreement of the IMF, or to engage in multiple currency practices (such as dual exchange rates or different exchange rates for different types of transactions).

However, if on joining the IMF a country does not or did not feel able to adhere to the Article VIII commitments, it had the option of notifying the IMF that it intended to make use of transitional arrangements under Article XIV. The permits members to:

- "maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on the date on which it became a member" (Section 2).

Article XIV therefore permits restrictions on current payments as a transitional arrangement. However it does add that:

- "members shall withdraw restrictions maintained under this Section as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments" which makes it clear that this is intended as a temporary arrangement that should be terminated as soon as is feasible. Article VIX also requires that:
- "any member retaining any restrictions inconsistent with Article VIII, Sections 2, 3, or 4 shall consult the Fund annually as to their further retention"

The IMF, for its part, may "make representations to any member that conditions are favourable for the withdrawal of any particular restriction, or for the general abandonment of restrictions, inconsistent with the provisions of any other articles of this Agreement".

Over the years, there has been a steady movement of countries from Article XIV to Article VIII. By 2006, only 19 of the IMF's 185 members still subscribed to Article XIV, including Angola. One of the immediate issues for Angola to consider, therefore, is whether to accept the commitments of Article VIII membership of the IMF, which entails removing the remaining restrictions on current account transactions.

Articles VIII and XIV apply only to current account transactions, and there are no limitations on the ability of members to impose restrictions on capital account transactions.

2.2 Current Account Liberalization: Arguments for and Against

As noted above the economic arguments in favor of current account liberalization and the elimination of multiple currency practices are widely accepted. Current account restrictions and Multiple Currency Practices (MCPs) introduce economic distortions that can have economic costs, especially if significant levels of transactions are shifted to parallel markets as a result. While there is little current evidence of such movement in the case of Angola, there is nonetheless a significant administrative burden associated with the administration of exchange controls on the current account, given the level of bureaucracy (in the commercial banks, private sector and the BNA) needed to administer the controls and associated documentation. Liberalizing controls enables a more efficient use of scarce skills in the financial sector. Perhaps more importantly, acceptance of IMF Article VIII obligations is often seen as a positive signal that commits members' authorities to refrain from resorting to distortionary restrictions in the future. This in turn, could help to build investor confidence and encourage capital inflows.

While some countries maintain current account restrictions as a means of protecting foreign exchange reserves, it is widely accepted that such controls are ineffective. Other arguments against liberalization include a fear that a liberalized current account will make it easier for unauthorized capital exports to take place, and concerns that collection of data on balance of payments transactions will become more difficult. There are trade-offs here: the more intensive the requirements for vetting of liberalized current account transactions (to guard against disguised capital outflows) and for data collection, the lesser will be the benefits or reduced red-tape and transactions costs. The key issue is to find an appropriate balance, allowing improved administrative efficiency while guarding against large scale abuse.

2.3 Capital Account Liberalization: Arguments for and Against

As with current account liberalization, there has been a general global trend towards capital account liberalization over the past several decades. This trend was particularly strong during the 1980s and the 1990s, although it has wavered somewhat since the Asian crisis of the late 1990s. Arguments regarding capital account liberalization are more complex than those involving the current account, however, and a wide range of practical issues need to be factored into liberalization programs. However it should be noted that complete abolition of capital exchange controls is typically required of developed countries, and is a condition of membership of both the European Union (EU) and the Organization for Economic Cooperation and Development (OECD).

The underlying argument in favor liberalizing controls on capital movements is that free capital mobility promotes an efficient global allocation of capital, better diversification of risk, improved growth and welfare. For individual countries, especially those with low savings rates and high investment needs, capital account liberalization can improve access to international capital flows and therefore boost investment and growth rates, and integration into the global economy. There is a range of other arguments in favour of capital account liberalization, including:

- capital controls are often thought to be ineffective – especially at guarding against capital outflows – and therefore provide an unnecessary bureaucratic burden that raises transactions costs; removing them can therefore improve economic efficiency;
- even if the current account is liberalised, the implementation of capital controls requires the maintenance of exchange control infrastructure which constitutes a *de facto* restriction on current account transactions (such as documentation and approval requirements), and costly bureaucratic infrastructure needs to be maintained in the commercial banks and the central bank;

- capital account liberalisation is usually accompanied by other desirable reforms (such as financial sector reform and improved banking supervision), which together have the potential to improve economic efficiency;
- a liberalised capital account has implications for macroeconomic policy and may be seen as an "agency of restraint" that will prevent (or constrain) the possible adoption of destabilising or undesirable macroeconomic policies;
- controls on capital outflows reduce the choices available to savers (who are unable to purchase foreign currency assets, or face a restricted range such as foreign currency deposits in domestic banks), and essentially imposes a tax on them; this applies to both individuals and institutional savers such as pension funds;
- the same process (restrictions on savers) can lead to the bottling up of domestic liquidity, requiring liquidity absorption through processes such as the issuance of central bank paper, and hence imposes additional costs on monetary policy;
- controls on capital inflows can restrict the development of domestic financial markets, e.g. stock markets and bond markets, which have lower liquidity and less efficient pricing as a result; allowing foreigners to purchase shares and bonds can reduce the cost of capital, and of government borrowing, by allowing access to a larger pool of capital, and also lead to more efficient capital markets;
- controls on capital inflows may also restrict the supply of credit if offshore borrowing is restricted, especially if the domestic financial sector is inefficient;
- liberalizing the capital account provides an important stimulus for the development of domestic financial (money and capital) markets, which is in turn important for increasing the effectiveness of a market-based monetary policy.

Nevertheless, unlike the arguments for current account liberalization – which are almost unequivocally in favor – arguments for capital account liberalization are more nuanced, and there are a number of theoretical and practical arguments which suggest that, at the very least, capital account liberalization should be implemented cautiously and in a phased manner, and is dependent upon the implementation of supportive complementary policies. On a theoretical level, it has been noted that the benefits of more efficient allocation of capital and diversification of risk may not result when there are market distortions and information asymmetries.

A number of empirical studies have been conducted to evaluate whether capital account liberalization has in practice had a beneficial impact on growth. Such empirical studies are not easy to carry out; capital account liberalization is typically not implemented in isolation, and its impact can be difficult to distinguish from other reforms. Furthermore, controls on capital movements can take many different forms, and as a result are difficult to measure in a quantitative manner that is amenable to econometric analysis. There are also variations in the strictness with which legal restrictions on capital movements are imposed, both over time and between countries, so that formal *de jure* restrictions (which are the source of the data used in empirical analysis) may be quite different to actual *de facto* restrictions. Finally, empirical evaluation of the impact of capital controls on growth suffers from the general weaknesses of the analytical growth literature, in that growth is a complex process and the impact of individual factors that are often difficult to identify and measure, and often work jointly, is very difficult to pin down.

As a result of both theoretical uncertainty and practical empirical issues, empirical results regarding the impact of capital account liberalization are inconclusive; there is no general result concerning the consequences of capital account liberalization, and mixed evidence that liberalization promotes economic growth.

However, the main concerns regarding capital account liberalization – and about financial globalization more generally – arose during and after the Asian financial crisis of the late 1990s. While there were many factors that contributed to the crisis, which took different forms in different countries, there were a number of issues relating to liberalized capital account that were seen as contributing to, or exacerbating the crisis. These included:

- the combination of (largely) fixed exchange rates, relatively high domestic interest rates compared to US dollar interest rates, and open capital accounts provided an incentive for (offshore) dollar borrowing by both domestic banks and corporates;
- when exchange rate pegs (formal or informal) came under pressure, due to unbalanced macroeconomic policies, many countries were unable to defend the pegs, and this situation was exacerbated by “hot money” flows - short-term portfolio investment (such as non-resident purchases of T-Bills and government bonds) which could flow out of a country a moment’s notice, putting further downward pressure on the exchange rate;
- with the exchange rate under pressure, borrowers with foreign currency debt found the domestic currency value of their debts rising sharply; while this was not a major problem for exporting companies (which found the domestic currency value of their revenues rising proportionately), it was a major problem for non-exporting corporates, or for banks which had borrowed in dollars and lent in local currency; this led to corporate bankruptcies and bank failures, and threatened the stability of the financial system;
- open capital accounts facilitated contagion effects as distress quickly spread from one country to another, even where fundamentals were different;
- countries with deep financial and foreign exchange markets may have also experienced speculation against their domestic currency.

Many countries in south-east Asia suffered similar financial crises, with South Korea, Indonesia and the Philippines being amongst the hardest hit. Countries which were largely immune from the crisis included Hong Kong – which had a rigid exchange rate peg but very high foreign exchange reserves with which to defend it - and China and India, which did not have open capital accounts.

These events led to a revision of views regarding capital account liberalization in many quarters, including by the IMF; the institution’s earlier support for fairly rapid liberalization with the ultimate objective of removing all controls was reconsidered, and more recent IMF recommendations have been much more cautious, focusing on the appropriate sequencing of reforms.

The Asian crisis also led to much more attention being paid to the interaction of capital account liberalization with other policy reforms, especially financial sector and macroeconomic policies. Following the crisis, the “received wisdom” regarding capital account liberalization can be summarized as follows:

- Open capital accounts make it more difficult for countries to survive with inconsistent macroeconomic policies and poor financial sector supervision;
- Hence the sequencing of liberalisation measures on the capital account is important, and these reforms have to be considered along with other essential reforms;

- Even if capital account liberalisation is beneficial in the long run, it may be necessary to use temporary controls on capital movements in the short term, especially when flows are volatile;
- Such temporary controls should focus on short-term capital movements (primarily inflows) and not long-term capital flows such as Foreign Direct Investment (FDI).

It should be noted that concerns about “capital flight” and restricting capital outflows are not seen as a particularly convincing reason for maintaining capital controls. This is because capital controls are seen as very leaky, especially when maintained over a long period of time, as they can be circumvented in many ways by private firms and individuals (such as under- and over-invoicing, transfer pricing policies and leads and lags in the timing of trade payments). It is more difficult for financial institutions to circumvent controls on capital outflows, but in the absence of exchange controls these can largely be governed by appropriate prudential regulation.

2.4 Implications for Monetary and Exchange Rate Policies

Capital account liberalization has a potentially major impact on the range of choices regarding monetary and exchange rate policies. The reason for this is that in principle a country cannot have both an active monetary policy (such as inflation targeting or control of monetary aggregates) and an exchange rate target (fixed or pegged) in the context of completely free capital mobility[2]. Trying to implement an active monetary policy and pursue an exchange rate target in an environment of capital mobility will eventually lead to imbalances and be unsustainable. For instance, pursuing a tight monetary policy to bring inflation down while at the same time maintaining a fixed exchange rate would encourage capital inflows (in pursuit of higher interest rates). This would in turn either cause the exchange rate to appreciate, or foreign reserve accumulation to take place, leading to monetary expansion that would offset the initial monetary tightening; if the reserve inflow is sterilized to prevent monetary expansion, this would lead to higher interest costs which would cause potentially unsustainable fiscal losses. It would also push interest rates higher, thereby attracting even more capital inflows, and raising sterilization costs even further. The opposite would happen in the event of a loose monetary policy, in that capital would flow out, causing the exchange rate to depreciate or the foreign exchange reserves to decline. In either case, the original monetary policy action is offset, or the imbalance leads to potentially unsustainable fiscal losses or reserve outflows. Similar problems would occur with attempts to prevent exchange rate appreciation or depreciation if this conflicts with the needs of monetary policy[3].

To a certain extent this is an extreme or theoretical case, which may not be followed in practice; in particular, shallow or undeveloped money and financial markets would make it less likely, as the country would then be less likely to absorb capital inflows. However, the general conclusion is valid that it becomes much more difficult to have a fixed exchange rate in an environment of free capital movements:

(i) In the event of exogenous macroeconomic shocks, a flexible exchange rate provides a convenient mechanism for the economy to respond to those shocks, but if the exchange rate is fixed, then the economy is more reliant upon adjustment in financial markets and the real sector;

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2 In economics this is often known as the “impossible trinity” – a country cannot adopt all three of an active monetary policy, an active exchange rate policy, and capital mobility.

3 IMF Working Paper WP/08/88 provides an interesting discussion of how in Colombia, central bank intervention to manage the exchange rate under an inflation-targeting regime failed when the two were in conflict.

(ii) a fixed exchange rate is also much more likely to be subject to speculative attacks, especially in an economy with well developed domestic financial markets; pegs are easier to defend if (a) money and capital markets are undeveloped, and (b) the country has very high foreign exchange reserves (such as Botswana, Singapore or Hong Kong) whereby the central bank has more ammunition to defend the peg than speculators can muster to attack it[4];

(iii) if the exchange rate is fixed, macroeconomic problems can easily put the peg under pressure, leading to a running down of foreign exchange reserves, even without speculative attacks;

(iv) given changes in the determinants of the equilibrium real exchange rate (such as changes in relative productivity levels and terms of trade), it can be difficult to know the appropriate equilibrium level for the nominal exchange rate at any point in time, and hence policy may place the peg at the "wrong" (non-equilibrium) level.

Capital account liberalization has been associated with a "hollowing of the middle" in exchange rate arrangements, i.e. the move towards either freely floating currencies at one extreme, or hard pegs (monetary unions or currency boards) at the other. Fixed (but adjustable) pegs can become more difficult to defend in an environment of capital mobility, for the reasons described above. In general, it is easier to cope with the consequences of an open capital account with a flexible (floating, market determined) exchange rate.

There are many instances of financial crises in liberalized economies that have come about because monetary authorities have (a) through maintaining a fixed peg, created incentives to borrow and lend in different currencies; and (b) have attempted to defend the peg when macroeconomic conditions have changed and the peg may no longer be appropriate, opening the door to speculative attacks; or (c) not implemented appropriate fiscal policies which are supportive of the peg[5].

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4 This is because the primary means of speculation by "shorting" a currency is to borrow local currency funds in the domestic market, and then sell those funds for foreign exchange so to put downward pressure on the exchange rate. Under a fixed exchange rate regime, this requires the authorities to use the foreign exchange reserves (or foreign currency borrowing) to defend the peg. If the downward pressure on the peg is sufficiently large (such as that which forced the pound sterling out of the European Exchange Rate Mechanism in 1991, or that which affected several Asian currencies in 1997), then the value of the currency will fall. Speculators can then buy domestic currency to repay the initial loan, but at a lower exchange rate; the speculator makes a profit determined by the difference between the interest cost on the borrowed funds and the amount of exchange rate depreciation. The ability of speculators to short a currency therefore depends on the availability of funds in the domestic market and the size of the resources available to the monetary authorities to defend the peg, as well as the level of interest rates. In an economy with well developed financial markets relative to the size of the foreign exchange reserves, a peg may be difficult to defend, especially if it is inconsistent with underlying macroeconomic fundamentals. Speculation can also occur in a way that forces a currency to appreciate, and speculators benefit through taking long positions on the currency in the forward market (as happened with Colombia in 2007).

5 The collapse of Argentina's peg to the dollar through a currency board arrangement was an example of this.

3. International experience with capital account liberalization

A number of general lessons can be observed from international experience with exchange control liberalization. The first is that the process generally follows one of two patterns: either gradual liberalization over a lengthy period or "big bang" liberalization where all controls are removed in a short period of time. The latter tends to happen in times of economic crisis, where a dramatic break with past policies is needed, along with a restoration of economic confidence; this was the approach adopted by Zambia in 1994. The "big bang" approach was also adopted by some countries in Eastern Europe following the break-up of the USSR and rapid move to market-based economic policies. In both cases – Zambia and Eastern Europe – the rapid abolition of exchange controls was part of a broad-based economic reform program. The more common approach is progressive liberalization, often from a position of strength.

A second lesson is that while concern about capital outflows and a possible decline in foreign exchange reserves are often major factors justifying the maintenance of exchange controls, countries that liberalize typically find that such fears are overstated. In practice, liberalizers find that there is little capital outflow or decline in foreign exchange reserves. This is because in most cases any capital flight that was going to occur has taken place already, and also because liberalization often takes place at a time of strong or growing foreign exchange reserves.

The third lesson is that the liberalization of capital account controls is dangerous if done prematurely. In particular, countries must be able to manage the risks associated with opening up the capital account. This in turn requires the establishment of an effective regulatory framework for the prudential supervision of the banking system.

3.1 Country - specific experiences

Several periods of concerted exchange control liberalization can be identified over the past two decades. Perhaps the first of these was in Latin America, where the economic reforms of the late 1980s and 1990s led to the adoption of outward-looking, market-oriented economic policies in contrast to the inward looking, import-substitution policies of the past. Exchange control liberalization generally accompanied financial sector reform, the adoption of market-based monetary policies, and a move to more flexible exchange rates. The second wave of exchange control liberalization came in Europe during the 1990s as the Soviet bloc collapsed and the countries of Eastern Europe (including several new countries) adopted market-based economic policies and in many cases set their sights on joining the European Union, for which the removal of capital controls was a prerequisite. A third wave took place in Africa during the 1990s as countries undertook extensive economic reforms, sometimes as part of stabilization and structural adjustment processes, and as in Latin America was typically part of the adoption of market-based economic policies, including financial sector reform, monetary and fiscal policy reform to contain inflation, and the adoption of greater exchange rate flexibility. Finally, the opposite, de-liberalization trend was seen in some Asian countries in the late 1990s, where temporary measures restricting capital flows were adopted following the financial crisis. Selected examples are discussed below.

3.1.1 Europe

In Europe, **Latvia** liberalized exchange controls in 1991 following the break-up of the United Soviet Socialist Republic (USSR) and the achievement of independence, and was one of the first moves undertaken as part of an economic reform process and the adoption of market-based policies. Latvia adopted a liberal foreign investment law to attract foreign direct and portfolio investment. Effectively, capital account liberalization was completed overnight and preceded domestic financial liberalization, the establishment of a central bank, and the introduction of a national currency. When a new national currency was introduced, a fixed exchange rate policy (a peg to the SDR) was adopted. In 1995, Latvia experienced a banking crisis as several banks collapsed leading to a loss in confidence; while this mainly reflected a weak regulatory system, the capital outflows that followed the loss in confidence exacerbated the crisis and put downward pressure on the exchange rate. However, the limited breadth and depth of the financial and foreign exchange markets limited the scope for speculation against the currency, and the peg survived.

The **Czech Republic** adopted a rapid liberalization of capital transactions between the establishment of the new state (following the break-up of Czechoslovakia in 1993) and October 1995. The process initially proceeded through a progressively liberal application of existing controls (first on banks and then on firms). Some restrictions did remain (mostly on the outflow side but some on inflows), including restrictions on the issuance of debt and money market securities abroad by residents and on foreign securities transactions executed through domestic agents. The new Foreign Exchange Act enacted in 1995, while codifying the framework for a liberal foreign exchange regime, included a provision under which the authorities could introduce an unremunerated reserve requirement on non-resident deposits if necessary, to restrict short-term capital inflows (although this was never used).

The remaining restrictions were eliminated within the framework of a plan agreed with the EU. In February 1996, the Czech Republic, in formally applying for EU membership, adopted a tentative five year plan for full capital account liberalization. The authorities lifted the restrictions on foreign security transactions in 1999, those on the issuance of debt securities abroad by residents in 2001, and the ban on purchases of agricultural land by non-residents in 2002. In this manner, the Czech Republic virtually completed the full liberalization of the capital account before joining the EU in May 2004.

Hungary took a more gradual approach to capital account liberalization. It first liberalized FDI in the early 1990s, and then liberalized restrictions on portfolio investment toward the middle of the 1990s in the context of OECD accession. Nevertheless, it continued to maintain controls on short-term capital inflows, notably restrictions on purchases of short-term domestic instruments by non-residents and restrictions on external lending to non-residents by residents in the domestic currency. The authorities clearly stated at that time that the final step to full capital account convertibility should be taken only after the system of regulation and prudential supervision was firmly in place for banking and securities market activities; this was achieved in June 2001. During the 1990s Hungary had maintained a fixed exchange rate, but when exchange controls were fully liberalized it moved to a more flexible exchange rate and widened the exchange rate band substantially (from 2.25 percent to 15 percent).

3.1.2 Asia

Turning to Asia, in **Korea** the objective of accession to the OECD led to the adoption of foreign exchange reform plan in 1994 that aimed to achieve full capital account convertibility in five years, in three stages. The process began with the liberalization of capital outflows, followed by a gradual easing of restrictions on foreign investment in the domestic stock market and short-term trade-related borrowing. Despite this phased and cautious process, Korea had a weak banking system, and during the 1990s vulnerabilities were created by the build-up of short-term external borrowing by weak, poorly regulated financial institutions. As a result, many financial institutions had mismatched balance sheets (foreign currency liabilities and domestic currency assets), and Korea suffered in the Asian financial crisis. **Indonesia**, similarly had partially liberalized its capital account during the 1980s, and had received considerable short-term capital inflows that were vulnerable to a sudden shift in sentiment. Indonesia also had a weak banking sector which was vulnerable due to the country's build-up of external debt.

Thailand responded to the financial crisis in May–June 1997 by introducing temporary selective controls on capital outflows. Specifically they prohibited the lending and sale of baht to non-residents and requiring that any purchase before maturity of baht-denominated securities, or purchase of equities, from non-residents be made in foreign currency. The measures were aimed at limiting the speculation of non-residents against the baht by delinking the onshore and offshore markets. The controls were removed in January 1998.

In **Malaysia,** the authorities introduced temporary capital outflow controls in September 1998, while pegging the exchange rate to the U.S. dollar 3. The measures were designed to restore a degree of monetary independence and included, among others, the introduction of a one-year holding period for the repatriation of portfolio investment. In February 1999, the one-year holding period was replaced by a graduated system of exit levy (in which principal and profits were allowed to be repatriated by paying an exit tax, the amount of which was determined by the duration of the investment). In September 1999, the exit levy was abolished, except for profits from portfolio investment brought in after February 1999. The system was entirely abolished in 2001.

Elsewhere in Asia, **India** has been a relatively slow and cautious liberalizer. A set of reforms in 1991 lifted restrictions on FDI inflows. The authorities subsequently established current account convertibility. Recognizing the link between current and capital transactions, however, the authorities retained certain safeguards in foreign exchange regulations, including (1) surrender requirements for exporters; (2) the need to present documentary evidence for imports and other current account outflows; and (3) indicative limits for representative current account transactions. India then agreed that capital account convertibility was a desirable objective and prepared for a cautious and phased move in this direction. A committee established by the Reserve Bank of India to consider the matter outlined a three-year program to meet a set of certain preconditions covering fiscal discipline, price stability, and banking system soundness. The committee also recognized the importance of sequencing and argued that priority should be given to FDI and equity investment, and that liberalization of restrictions on short-term debt capital and outward investment should be gradual. At the same time, it cautioned against the risks of rapid capital account liberalization in the absence of a strong fiscal position and a more robust financial sector, and stressed the need to sequence capital account liberalization with other structural and macroeconomic policy measures to contain potential risks. It also emphasized the importance of exchange rate flexibility and the need to have market-based instruments for monetary control. However, it was recognized that a more rapid pace of capital account liberalization could be beneficial in encouraging fiscal consolidation and financial reforms.

3.1.3 Latin America

In Latin America, **Chile** is a frequently-cited example of a successful economic reformer in many respects. With regard to exchange controls, Chile's experiencing in responding to excessive capital inflows is often quoted. After liberalizing exchange controls during the 1980s, Chile experienced a surge in capital inflows. In response, the Chilean authorities introduced a 20 percent unremunerated reserve requirement (URR) on all foreign loans, except for trade credits. The URR was a non-interest-bearing deposit in foreign currency to be lodged with the central bank for a specified period of time (one year from May 1992), in an amount proportional to the value of the capital inflow. The URR effectively acted as a tax on short-term capital inflows (it did not apply to FDI). The URR was relaxed over time, and was eventually removed in 2001. Evaluations of the impact of the URR have generally concluded that it was successful in lengthening the maturity of capital flowing into the country, in increasing the share of non-debt-creating inflows, and thereby in reducing the volatility of capital flows. However, it has also been noted that the effectiveness of the URR diminished over time, as people progressively found their way around it. **Colombia** has made use of a similar URR to respond to moderate inflows of short-term capital.

3.1.4 Africa

In Africa, the continent has been transformed from one with relatively restrictive exchange control regimes to one of the most liberalized over a relatively short period of time. Many countries experienced severe economic problems during the 1980s and adopted stabilization and structural adjustment measures in the early 1990s as part of a process of economic and political reforms. In several countries the implementation of reforms was carried out during a period of crisis characterized by low (or negative growth), high (or hyper-) inflation and overwhelming debt problems. As an example of this, **Zambia** abolished exchange controls in 2004, moving from a relatively tightly regulated and controlled system to a completely deregulated system overnight. This was part of a stabilization program to arrest a severe economic crisis that also involved moving from a fixed to a market-determined exchange rate, fiscal reform and financial sector reform. There have been no controls on current or capital account transactions since that time.

Zambia's program of market-based reforms is generally considered to have been successful, although it took a long time for macroeconomic stability to take effect. Given that exchange control liberalization was part of a much broader package of reforms, it is not possible to separately identify the impact of exchange control liberalization as distinct from other reforms.

The only real concern relates to the impact of inflows of short-term foreign capital (portfolio flows), when foreigners purchase treasury bills and government bonds. At times these have offered attractive rates of interest (reflecting tight monetary policy to control inflation), and international investors have purchased these instruments, considering the interest rate premium (over US treasuries) to outweigh any default, country or exchange rate risk. This has been a particular problem when the kwacha has been appreciating (as it has done in recent years in response to debt relief and increased mineral export earnings), which has improved the returns for foreign investors. This has required extensive sterilization to minimize the impact on the money supply and inflation, which at times has been expensive for the Bank of Zambia and the Government of Zambia. Notwithstanding the removal of exchange controls, Zambia's foreign exchange reserves have continued to grow.

Another African country which has completely abolished exchange controls is **Botswana**. All remaining capital account controls were abolished in February 1999, after a long period of progressive liberalization, which had involved the abolition of remaining current account controls in 1996 (when the country accepted IMF Article VIII). Progressive capital account liberalization had allowed residents to open foreign currency accounts (from 1993), non-residents to purchase shares on the Botswana Stock Exchange, and domestic institutions such as pension funds to invest up to 70 percent of their assets offshore. Inflows of FDI had never been restricted.

Unlike Zambia, Botswana abolished exchange controls from a position of strength, and had foreign exchange reserves equivalent to 30 months of imports and five times money supply (M2). Prior to the abolition of exchange controls there were concerns that there might be a capital outflow that would reduce the foreign exchange reserves, but in the event this was not an issue, and the reserves have continued to grow.

Exchange control abolition was accompanied by the strengthening of prudential regulation applying to banks and non-bank financial institutions (NBFIs); the offshore exposures of banks are regulated under the banking supervision legislation and the offshore investment by institutions such as pension funds through relevant legislation. The banks and NBFIs have taken advantage of the flexibility given to them under the prudential regulations, and have increased their holdings of foreign financial assets, within applicable limits; pension funds, for instance, are permitted to invest up to 70% of their assets offshore. Residents are now permitted hold offshore accounts, but seem to prefer to hold FCAs in domestic banks, which account for around 30% of total deposits. One important “quasi” exchange control is that non-residents are not permitted to hold central bank paper, the main tool for liquidity absorption, which acts as a constraint on capital inflows.

Botswana has a somewhat unusual policy framework, which combines an active monetary policy and a fixed/managed exchange rate, an environment of capital mobility. Although this may not be a sustainable policy combination in the long term, policies have nonetheless been continued in the nine years since exchange controls were abolished. This has involved a stable exchange rate (through a basket peg) with high domestic real interest rates, reflecting tight monetary policy to control inflation. There have been issues of excess liquidity, but this is mostly domestically generated; there is no evidence of significant short-term capital inflows despite attractive real yields. This is in turn limited by shallow money and capital markets, although this is unusual, and partly reflects the rather lack of a government bond market as the government runs budget surpluses and does not need to borrow.

South Africa, the largest and most developed economy in sub-Saharan Africa, has undertaken a lengthy program of progressive exchange control liberalization. During the apartheid era, exchange control regulations were very restrictive, and for many years a dual currency system was in place, with different exchange rates for current and capital account transactions. Following the ending of this system, restrictions on current account transactions were removed and the country moved to IMF Article VIII. Capital account restrictions on residents have been progressively eased, although significant restrictions remain, especially on outward portfolio investment. However, restrictions on outward portfolio investment by institutions (pension funds, life insurance companies etc.) have recently been transferred from exchange control regulations to prudential supervision regulations. In the 2008 Budget, the method of compliance with most remaining capital account regulations was changed from requiring pre-approval of transactions to a post-transaction reporting obligation. South Africa’s publicly stated eventual objective is the complete abolition of exchange controls.

Africa does of course boast a number of currency unions which have no exchange controls internally; these include the Common Monetary Area (South Africa, Lesotho, Swaziland and Namibia) and the two CFA zone monetary unions (UMOA and CEMAC). There are also ambitious plans to strengthen monetary integration within the continent. Both Botswana and Zambia are members of SADC, as is Angola. SADC has a program of exchange control liberalization between member states, and is also planning, through the Regional Indicative Strategic Development Plan (RISDP), to adopt a single common currency within ten years, which would require the complete abolition of exchange controls on current and capital account within the grouping.

4. Exchange Controls in Angola

Angola has traditionally had in place a relatively strict system of controls on foreign exchange transactions. In part this reflects the historical reliance on direct controls across a wide range of economic activities. In addition, however, it more specifically reflects a desire to prevent capital outflows in order to retain domestic savings within the country to finance investment, and support exchange rate policy. As discussed earlier, Angola is one of only 19 countries that continue to subscribe to the IMF under the more restrictive provisions (with regard to exchange controls) of Article XIV, compared to the more liberalized Article VIII.

The main features of Angola's system of exchange controls are outlined in Table 2.

Table 2 – Main Features of Angola's Exchange Controls

Current account	
Imports of goods	
	No restrictions – only documentation requirements, including pre-shipment inspection for most imports
	Approvals delegated to commercial banks
Exports	
	In general, export receipts must be repatriated. Oil companies treated separately – can retain export proceeds offshore (net of tax obligations).
Dividends, interest payments, royalties, management fees	
	Only for investments over a certain size (dividend payments are not permitted below US$ 100 000)
	Permitted if inward FDI has received prior approval
	Requires proof of tax compliance, issued by Ministry of Finance
	No delegation to banks – all handled by BNA
Invisibles and Current Transfers	
	Private individuals: Travel: Residents permitted up to US$15 000 per month for foreign travel for business, training, educational, scientific, cultural, health or other personal reasons, up to an annual limit of US$60 000, against suitable documentation.
	Non-residents can bring up to $15 000 into the country in foreign exchange without declaration; higher amounts must be declared on arrival. Foreign currency can be exported up to $15 0000 or amount previously declared. Export of kwanza currency is prohibited
	Outward transfers to Angolans resident abroad are permitted up to US$60 000 per annum.
	Payments for membership of professional associations are permitted and payable against suitable documentation
	Credit cards: use of domestic credit cards abroad is limited to US$10 000 per annum
	Higher amounts may be authorized by the BNA in exceptional

	circumstances
	Businesses: All transactions and contracts over US$500 000 subject to prior approval by the BNA. BNA must issue authorization (BAPIC) prior to payment being made by commercial bank.
	Payments are permitted against suitable documentation for transport, insurance and other services procured outside of Angola.
Capital Account	
General	All capital transactions are subject to prior approval by BNA - no delegation to banks.
Capital inflows (FDI)	Capital import license needed, under Private Investment Law; inward investments above $5m must be approved by the Council of Ministers Outward FDI requires capital export license
Short-term	Non-residents can open bank accounts for purchase of T-Bills
Other	
Residents' foreign currency accounts (FCAs)	Domestic FCAs permitted for individuals and companies Offshore FCAs permitted for individuals without prior approval. Exporting companies can open offshore FCAs with BNA approval.
Non-resident accounts	Non-residents can open FCAs, and domestic currency accounts but with restrictions.
Stamp duty	Certain foreign exchange operations are subject to a stamp duty of 0.15%. Transactions between banking institutions or involving banknotes and travelers checks are exempt from stamp duty.
Dual currency	The IMF has identified a multiple currency practice (resulting from the application of stamp duties and the functioning of the foreign exchange auction system)
Banks	Banks are permitted to lend locally in foreign exchange Reserve requirements on foreign currency accounts must be paid in local currency Liquid asset requirement is 50% of foreign exchange portfolio

***Source**: IMF Annual Report on Exchange Arrangements and Exchange Restrictions, 2007 and IMF Article IV Report on Angola, 2007*

4.1 The Potential for Exchange Control Liberalization

In considering the potential for exchange control liberalization, a number of issues have been raised for consideration by the BNA. These include:

- How can Angola move to IMF Article VIII status?
- Would exchange control liberalisation lead to capital flight?
- What is the impact of exchange controls, or their liberalisation, on access to credit?
- What are the implications for the collection of information (on trade, capital flows etc.) by the BNA?
- Would exchange control liberalisation lead to money laundering?
- What are the implications for monetary and exchange rate policy?
- How should any liberalisation be sequenced?

These issues are addressed below.

How can Angola move to IMF Article VIII status

As noted in Box 1 above, moving to Article VIII status would involve abolishing the remaining restrictions on current account transactions and any multiple currency practices (MCPs).

The main changes that this would involve are:

- the ending of the prohibition of dividend payments under $100 000;
- removing limits on external payments for services (such as travel and education) and for remittances;
- ending the discriminatory application of stamp duty to certain foreign exchange transactions;
- ending the MCP identified from the operation of the foreign exchange auction system
- a commitment not to introduce any new current account restrictions without the consent of the IMF.

Ending the restriction on dividend payments under $100 000 would require changes to regulations relating to Foreign Direct Investment;
The removal of limits on certain invisible transactions would mean that, in principle, any amount could be paid for invisible imports, and the limits specified in the relevant legal instruments (e.g. Instrutivo 01/06) would be abolished. However, it would still be possible for the BNA to maintain indicative limits on such transactions, above which applicants would have to provide appropriate documentation to prove that the transactions were justified and <u>not</u> capital transfers. This would not involve a major change from the current situation, which already allows the BNA to examine applications on a case-by-case basis and "exceptionally, allow the transfer of funds above the limits" (Instrutivo 01/06, para. 8.5).

Other requirements, such as the necessity for tax clearance prior to the payment of dividends, and necessary documentation (such as audited accounts) would be permitted. It is also permitted to maintain import licensing requirements.

The contravention of IMF Article VIII, Section 2(a) relating to the discriminatory application of stamp duties to specific foreign exchange transactions could be most easily dealt with by abolishing stamp duty (which would have other benefits for the financial system more generally[6]). This would also contribute to removing the MCP identified by the IMF, which contravenes Article VIII, Section 3. Full removal of the MCP would also require moving from a variable price auction in the foreign exchange market to a uniform-price auction.

It is important to note that a member of the IMF can elect to accept Article VIII at any time and does not require the prior approval of the IMF to do so. Some countries have notified the IMF of their acceptance of Article VIII obligations while maintaining exchange restrictions, or introducing new ones. Should a country adopt Article VIII while current account restrictions and MCPs remain in place, or adopt new ones without the approval of the IMF, it will be in breach of its obligations under the Articles and subject to the imposition of sanctions by the Fund under Article XXVI. These sanctions comprise a declaration of ineligibility to use the Fund's general resources, the suspension of voting and certain related rights, and compulsory withdrawal. However, these sanctions have not been applied to members for a breach of Article VIII, Section 2(a) or 3.

While a country can adopt Article VIII at any time, the IMF advises that a member should invite the Fund to conduct a comprehensive review of exchange restrictions prior to doing so. Importantly, the jurisdictional finding on whether the exchange system is in compliance with Article VIII obligations must be made by the Fund.

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[6] See the report on Developing the Supply of Financial Services and Improving the Efficiency of the Banking Sector in Angola, USAID January 2008, Chapter 4. ,

Finally, many IMF members that have accepted Article VIII have introduced exchange restrictions in the context of recent international initiatives to combat the financing of terrorism and money laundering. Some of these restrictions, introduced for security reasons, have to be notified to the Fund prior to their introduction[7].

4.3 Would Exchange Control Liberalization Lead to Capital Flight?

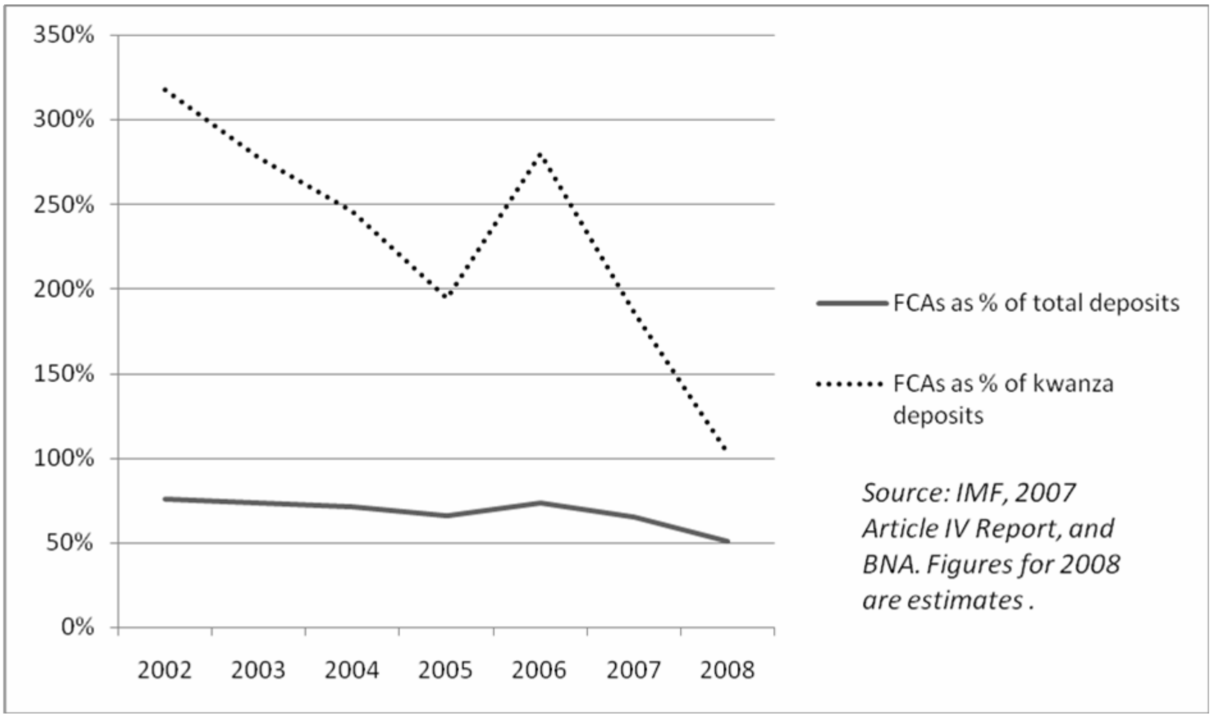
Most liberalizing countries have not experienced capital outflows as a result of liberalization per se; to the extent that capital outflows are a problem, this occurs after short-term flows have been liberalized and results from rapid outflows of money that has previously flowed in; i.e. it is non-resident capital that tends to flow out of the country not residents' capital.

There are a number of reasons to believe that capital outflows would not be a problem for Angola in the event of liberalization of the capital account:

- Residents already have a choice between holding domestic currency deposits (or other financial assets) or US dollar deposits at local banks. In the past, high levels of inflation and lack of confidence in the local currency meant that there was a strong preference for US dollar assets. Over the past five years, however, this has changed considerably; whereas in 2002, foreign currency deposits accounted for 76% of all deposits on the banking system, by 2007 this had fallen to an estimated 55%; similarly, in 2002, FCA deposits were more than three times the level of local currency deposits, but by the end of 2007 FCA deposits were only around 20% higher than local currency deposits. In other words, residents had demonstrated increasing confidence in the local currency as inflation has fallen; these trends suggest that there would be little reason for residents to move significant funds offshore in the event of exchange control liberalisation;
- The second reason to believe that potential capital outflows would not be a concern is that the foreign exchange reserves have risen sharply in recent years. Preliminary estimates are that the official reserves totalled US$ 11.2 billion at the end of 2007, compared to US$375 million five years earlier. Over the same period, import cover rose from an estimated 0.5 months to over 4 months (see Figure 2).
- The sharp rise in foreign exchange reserves reflects a transformation of the balance of payments in recent years, driven by rising oil production and high energy prices. Exports have increased from US$8.3 billion in 2002 to an estimated $39 billion in 2007. While imports have also increased over the same period – import of goods have increased from $3.8 bn to an estimated $15 bn, and the net services balance has risen from a deficit of $3.1 bn to $8.6 bn – the overall balance has improved sharply, and now is in substantial surplus. Back in 2002, the current account was in deficit, there was a substantial debt service burden (26% of goods and services), and the foreign exchange reserves were almost non-existent. Five years later, the current account was in substantial surplus, debt service burden was down to 4.5% of exports, and foreign exchange reserve cover had reached comfortable levels.

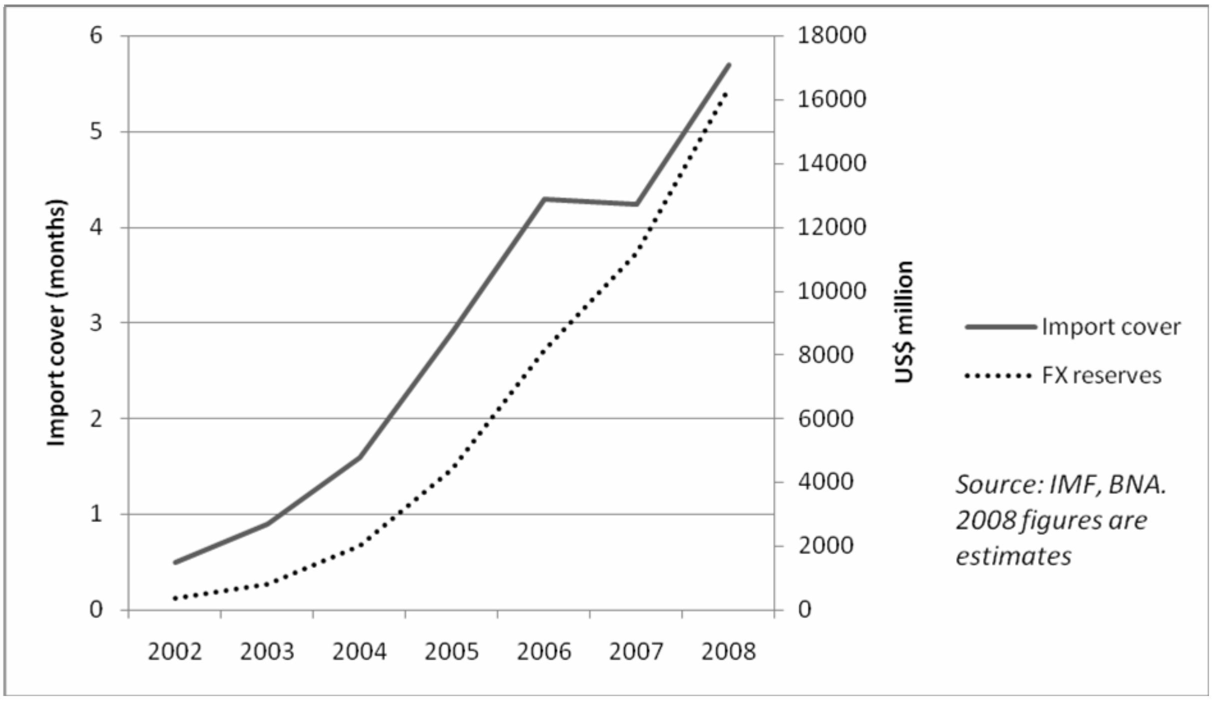
[7] Further details relating to these issues can be found "Article VIII Acceptance by IMF Members: Recent Trends and Implications for the Fund", IMF, May 2006.

Figure 1 – Foreign Currency Accounts (FCAs) and Kwanza Deposits in the Banking System



- Forecasts from the IMF indicate that this favourable balance of payments position is expected to continue, with a further substantial increase in exports in 2008, a doubling of foreign exchange reserves to $23 billion by 2010, by which time reserve import cover will be over 6 months. These forecasts accommodate further large increases in imports, particularly driven by the needs of reconstruction and infrastructure development.

Figure 2 – Foreign Exchange Reserves

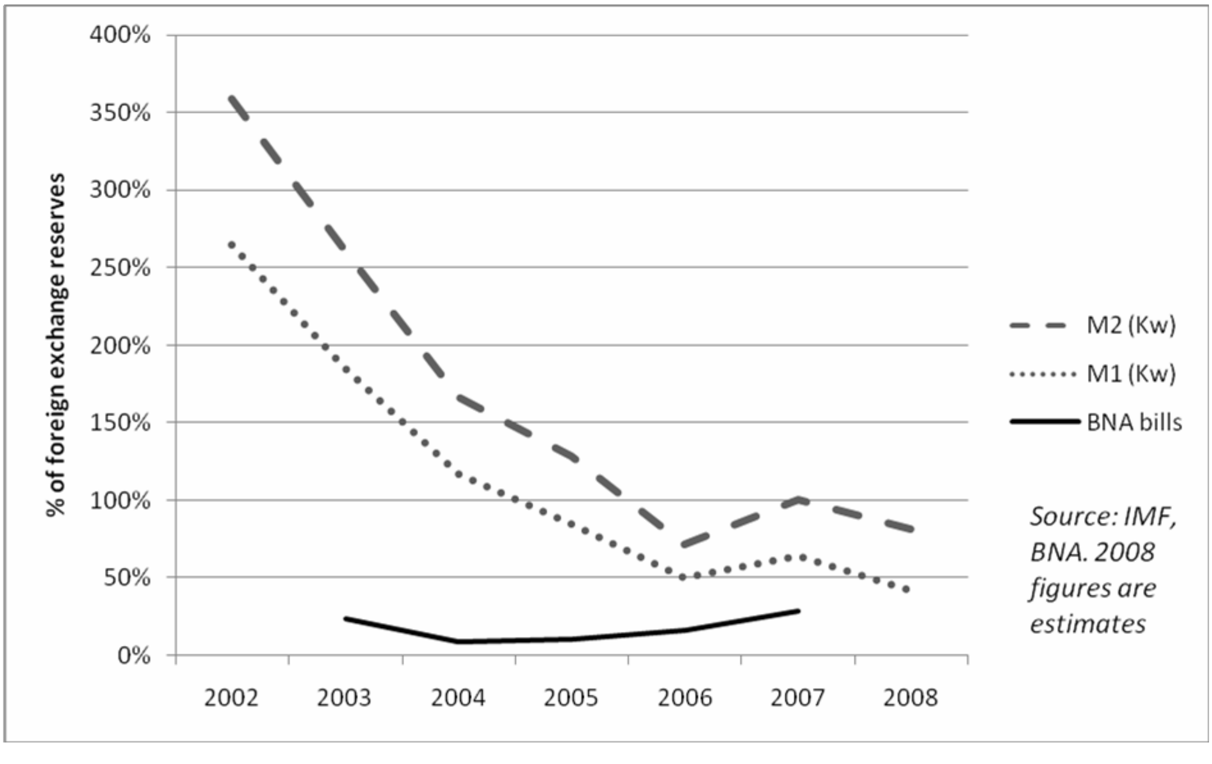


- These developments suggest that the foreign exchange reserves are now large enough to withstand any capital outflow that might result from exchange control liberalisation.

This conclusion is reinforced by the assessment of the potential magnitude of any outflows. Such outflows would have to be ultimately sourced from existing holdings of domestic currency, and therefore an upper limit to the size of potential outflows is provided by the size of the money supply. Over the past five years, the reserves have grown much faster than the (kwanza) money supply; whereas in 2002, M2 was 3.5 times the foreign exchange reserves, by 2007 the reserves were larger than M2. Similarly, M1 had declined from 2.5 times the reserves in 2002, to only half the size of the reserves in 2007. Given that not all of the money supply can be converted to foreign currency and exported, it is clear that any potential outflow is small relative to the size of the reserves. Very few countries have foreign exchange reserves as large as the monetary base, let alone as large as a broader measure of the money supply, thereby illustrating Angola's relatively strong reserve position.

The magnitude of maximum potential outflows is indicated by the quantum of BNA bills Titulos de Banco Central (TBCs) issued for liquidity absorption purposes. While the ratio of TBCs to foreign exchange reserves has been rising, at the end of 2007 the total value of TBCs in issue amounted to only 28% of the value of the reserves, again indicating that the maximum potential outflows is small relative to the size of the reserves. In conclusion, Angola is now well placed, from a foreign reserve perspective, to liberalize exchange controls, without any significant adverse impact on the reserves being likely.

Figure 3 – Money supply in relation to foreign exchange reserves



Data collection issues

The liberalization of foreign exchange controls may have implications for the collection of balance of payments (BoP) data. The forms associated with obtaining approval for foreign exchange transactions (e.g., approval of foreign exchange purchases for imports of goods and services, documentation of export repatriation proceeds, permissions for capital inflows and payments of dividends etc.) provide one of the main sources of information for the collection of balance of payments statistics.

Despite this potentially important information source, it appears that the quality of balance of payments information is poor. The IMF reports that with regard to external sector data, “there are still weaknesses in data sources . . . an STA mission in June 2005 identified continuing problems in collecting data on the operations of the oil companies, the overseas accounts of large enterprises, and foreign direct investment. Furthermore, data on imports are minimal and detail on services and income components are missing. Essential details in the financial account are not reported due to problems with proper recording of public external debt transactions, particularly debt restructuring and forgiveness. Data for net international reserves are incomplete, particularly concerning information on official foreign exchange balances in overseas escrow accounts…While the authorities have continued to improve the management of external debt data and compilation has improved, data quality remains a cause for concern.”[8]

It appears that balance of payments data need to be improved regardless of exchange controls. While a detailed review of the procedures for reporting of balance of payments data is beyond the scope of this assignment, some suggestions can be made as to how reporting can be maintained and improved:

- even without exchange controls, banks should be required to report to the BNA on all debit and credit transactions over a certain size (e.g. US$ 5000), with information requirements as per BoP needs; as long as this requirement is adhered to and enforced, this would collect the same BoP information that is currently collected by exchange control procedures administered through the commercial banks;
- information on government transactions conducted through the BNA, or on transactions carried out directly by Ministry of Finance, the can also be fed into the BoP compilation process;

The coverage of information collected through these mechanisms should not be much different to current coverage, if efficiently done. The main gaps in coverage would be:

- Credit card transactions, including the purchases of goods & services over the internet;
- Transactions settled between offshore accounts (e.g. oil companies paying for imported inputs from accounts holding the proceeds of oil sales); however, this would not be covered under the existing exchange control regime either, so there is no change);
- Export products paid for outside of the country, such as tourism receipts paid to foreign travel agents (this is unlikely to be significant in the short to medium term given the low level of tourism in Angola at present);
- Other foreign currency receipts paid to offshore accounts.

While it is important to capture these transactions for balance of payments purposes, or at least the larger transactions, it should be noted that transactions of the types described above are not captured by the current exchange control reporting requirement, as they do not require exchange control permissions, so there might not be much change from the

[8] IMF (2007) Angola 2007 Article IV Consultation (Country Report No. 07/354), October, p.50.

present arrangement as a result of exchange control liberalization. The main impact would be that the extent of such transactions might increase, if for instance export firms were more likely to retain earnings offshore and pay for imports directly, rather than repatriate those earnings and pay for imports through domestic banks.

Over time, however, other sources of information will need to be developed to supplement reporting of foreign exchange transactions through the banks. These would typically include:

- Direct reporting by major exporters (oil and diamond companies) to the BNA;
- Data on merchandise exports and imports collected through the Customs department, preferably using an automated documentation system, that can be reported to the national statistics office and the BNA;
- Surveys of invisible transactions, particularly travel and tourism (usually conducted at airports and through hotels and other tourism establishments), transportation and insurance (usually collected directly from companies)
- Regular (annual or quarterly) surveys of major companies regarding inflows and outflows of foreign investment, and payment and receipt of dividends etc., for capital account purposes;
- Information from the stock exchange (BVDA) or the capital markets commission (CMC) on the purchase and sale of financial instruments by non-residents;
- Information on the purchase of government bonds and bills by non-residents should be collected by the banks (as funds are received), which can also report on non-resident deposits.

Improvements in the quality of BoP data are clearly required and this will be a demanding exercise that will take time; however, this is required whether or not exchange controls are liberalized, and it is unlikely that relaxation of exchange controls will make any significant difference to the current situation.

4.5 Impact on Access to Credit

Concerns have been expressed that exchange control liberalization might restrict access to credit, because of the possibility that capital might flow out of the country, and savers might invest offshore rather than locally. While this is a concern in principle, it is unlikely to be a significant concern in practice. First, as discussed above, capital outflows are unlikely to be significant. Second, there is already a buffer of available funds in the banking system, in that the banks hold considerable quantities of TBCs. Should there be an outflow of funds from the banking system, the banks' holdings of TBCs would be reduced before the supply of credit; in other words, it is the excess liquidity in the system that would be affected by any outflow of capital, rather than bank lending. Furthermore, the loan-to-deposit ratio was 66% at the end of 2007, and this provides further evidence of the buffer of funds available in the banking system to maintain or increase credit availability. Therefore, capital account liberalization is unlikely to have an impact on the capacity of the domestic banking system to offer credit, as the availability of funds in the system is not the main factor that determines bank lending.

In addition, the liberalization of capital controls would open up new sources of credit, as companies would be able to borrow offshore. In general, availability of credit has not emerged as an issue in countries liberalizing exchange controls, unless they experience a banking crisis.

4.6 Impact on Tax Revenues

As is common in countries with exchange controls and a relatively underdeveloped tax system, the exchange control system is used to facilitate tax compliance. In particular, companies making external payments of dividends, interest, and management fees etc. have to prove that withholding tax (WHT) has been paid prior to receiving approval for the payment. This requirement could be retained, even if exchange controls on current account were removed, as part of documentation requirements.

However, it would not be practical if exchange controls were liberalized more broadly, as part of the advantage of broad-based liberalization is the reduction in the bureaucratic burden associated with foreign exchange transactions. In this case, the collection of tax revenues becomes far more dependent upon an effective tax administration. For large taxpayers, specific audits can be undertaken to ensure compliance, but this may not be feasible for smaller taxpayers. Until an efficient and effective tax administration is in place, therefore, the liberalization of exchange controls may lead to lower WHT collections.

Full exchange control liberalization would also involve ending the 0.15% stamp duty applied to foreign exchange transactions. While this would represent a revenue loss, the amount would be insignificant in relation to overall fiscal revenues.

4.7 Money laundering

Money laundering is an issue that is of concern to all countries and is taking a steadily higher profile on the international agenda. Anti-money laundering (AML) measures, and related measures aimed at countering the financing of terrorism (CFT) are increasingly seen as an essential component of both legal frameworks and the prudential regulation of financial institutions. The need to have AML/CFT measures in place applies whether or not countries have exchange controls, although exchange restrictions may provide an additional mechanism for enforcing such controls. It is also quite possible that countries with a liberalized exchange control environment (or no exchange controls) will be more vulnerable to being used for money laundering purposes, unless a strong regulatory framework is in place.

A fairly standard set of procedures has been developed to deal with AML/CFT, as follows:

- Ensure adequate legal provision for AML/CFT measures through specialised and dedicated legislation.
- Legally require commercial banks to introduce Know Your Customer (KYC) procedures.
- Legally require commercial banks to have procedures in place to monitor and report on “suspicious transactions”.
- Designate an official body to act as the national financial intelligence centre (typically an anti-corruption agency), which investigates all suspicious transaction reports, initiates legal action where necessary, and also acts as liaison with similar entities in other countries.

This is quite difficult to do effectively, and requires considerable resources, but is needed whether or not exchange controls are in place, and should be seen as part of a more general anti-corruption drive.

4.8 Money and exchange rate policy

The impact of exchange control liberalization on monetary and exchange rate policies is one of the main issues to be considered as recommendations are being drawn up. As discussed earlier, the liberalization of capital account controls and the resulting increase in capital mobility has major implications for what are feasible and sustainable monetary and exchange rate policy combinations.

Angola's present monetary and exchange rate policy framework is focused on bringing inflation down to single digit levels, and on influencing inflation expectations. This is done through the control of monetary aggregates using market-based instruments of monetary policy to influence liquidity conditions and interest rates. Although the exchange rate is *de jure* a floating regime, with the daily exchange rate determined through auctions of foreign exchange by the BNA and in the interbank market, the stability of the actual rate suggests that *de facto* the exchange rate regime is a peg to the US dollar. The IMF has designated Angola's exchange rate regime as a peg to a single currency (the US dollar).

The combination of monetary policy and exchange rate policy has been successful in bringing inflation down to close to single digit levels. However, it has led to real exchange rate appreciation - due to the combination of higher inflation than in the USA and a stable exchange rate (and appreciation during 2007) against the US dollar - and concerns that the real exchange rate is overvalued (although the IMF recently concluded that the exchange rate was "appropriately valued". This may not be consistent with the desire to diversify the economy and develop the non-oil sector, and provide alternative sources of growth once the expansion of the oil sector slows down. Despite these longer-term concerns, the current status of the balance of payments means that short-term market pressures on the exchange rate would be for the kwanza to appreciate rather than depreciate.

There are concerns about the cost of liquidity absorption (through the issuance of BNA paper, TBCs), given the relatively high interest rates necessary to contain inflation and make the general level of interest rates positive in real terms. This could become a more serious problem if there were large capital inflows, especially short-term inflows unrelated to FDI. The persistence of excess liquidity is partly a consequence of the pegged exchange rate.

What would the effect of capital account liberalization be on monetary and exchange rate policy? In the short term, probably not much. The impact would to some extent depend on the balance between incremental capital inflows and outflows, but the most likely outcome is that neither would change much from the pre-liberalization scenario, especially given that non-residents are already permitted to participate in the government bond market, and other financial markets are relatively shallow and underdeveloped. Given that large outflows are also unlikely, the magnitude of additional capital flows is unlikely to impose any constraints on, or require any changes in, the existing monetary and exchange rate policy in the short run.

In the medium to long term, things may change, however. The magnitude of capital flows is likely to increase as the economy grows, as financial markets develop, and as institutional investors such as pension funds and life insurance companies grow in importance. The rate of economic growth is likely to slow down as the oil sector matures. This could make an exchange rate peg more difficult to defend – unless reserves continued to grow steadily and reach very high levels - and would imply that greater exchange rate flexibility would be needed.

In this context it should be noted that many economic and financial crises in liberalized economies have resulted from attempts to defend an unsustainable exchange rate peg, especially if the currency is potentially subject to speculative activity[9].

Exchange control liberalization would, however, have a positive impact on the development of domestic money and capital markets, as the participation of non-residents would help to improve liquidity, efficiency and pricing. This would in turn support the evolution of market-based monetary policy measures and make monetary policy a more effective tool for controlling inflation.

4.9 Exchange control reform and sequencing

Assuming that a "big bang" approach is not appropriate (and it would be difficult to argue for this in Angola's case) then the question becomes what is the appropriate sequencing for exchange control liberalization. This in turn is linked with the implementation of complementary reforms that are required to manage the risks associated with exchange control liberalization.

The first and most straightforward step that can be taken is to remove the remaining current account restrictions and MCPs and accept IMF Article VIII membership, as discussed in Section 4.2 above. The main potential benefits of moving to Article VIII include reducing administrative restrictions on current account transactions and hence savings in transactions costs and the costs of bureaucracy, and the positive signal that would be sent to external parties, including foreign investors.

With regard to the capital account, it is important point to note is that capital account liberalization does not affect the overall balance of payments, although it does affect its content and the sub-categories within which different flows will fall. A country running a current account surplus will necessarily accumulate foreign assets equal to the difference between domestic savings and investment. These foreign assets can either be accumulated as official reserves (of the government or central bank) or as private assets (such as offshore investments by resident individuals, forms or institutions). The extent of exchange controls on capital movements will affect the distribution of these foreign assets between official and privately held assets, but will not affect the total national holdings of foreign assets, for instance as recorded in the international investment position (IIP).

Nevertheless, capital account liberalization should be done cautiously. The sequencing of measures to liberalize the capital account should reflect the different levels of risk involved, and the requirements for accompanying measures.

The lowest risk transactions are those involving inward FDI. As FDI is unlikely to move out of the country quickly, has positive economic effects (on growth, productivity and employment), and introduces little or no systemic risk, it should be encouraged and restrictions removed as quickly as possible.

[9] This is however a long way off in Angola, and indeed throughout most of sub-Saharan Africa; at present only South Africa has domestic financial markets that are broad and deep enough to facilitate speculative activity against the currency.

Residents should also be permitted to undertake FDI outside of Angola. The amounts involved are likely to be small, and can be accommodated by the current level of foreign exchange reserves. Such investments would add to the country's private net foreign assets, and generate future income inflows.

The sequencing and prerequisites for other types of liberalization are more complex, and will be discussed in terms of the types of markets and institutions laid out in Section 2.1 above.

Capital and money market instruments: allowing inflows from non-residents can contribute to market development, by providing liquidity, increasing the number of market participants, and hence improving market efficiency. This can in turn lead to lower costs of capital for issuers on domestic markets, whether this is firms issuing shares or the government selling bonds.

While there are numerous potential benefits, some caution is in order. First, non-residents should not be permitted to purchase BNA bills issued for liquidity absorption purposes, as capital inflows for this purpose simply adds to liquidity (and hence absorption needs) and imposes a cost on the central bank, without any discernible benefits. Second, non-resident inflows could contribute to asset price bubbles, especially if those inflows are large relative to the size of domestic money and capital markets. Third, non-resident holdings of capital and money market instruments, which are classed as short-term portfolio investment, can provide a source of volatility as the direction of flows can be reversed in the event of a change in sentiment or risk appetite. The magnitude of such short-term portfolio inflows and non-resident asset holdings should be closely monitored, and it may be worthwhile to keep measures in reserve that can be used (sparingly) to discourage such inflows, or lengthen their maturity, should this be considered desirable; such measures could include unremunerated reserve requirements (URRs) or minimum stay requirements.

Credit operations: cross-border lending and borrowing can be considered separately. Allowing the acquisition of liabilities by residents (offshore borrowing) would in principle open up more opportunities for obtaining credit. Although there are balance-sheet risk implications for domestic companies in using offshore borrowing – especially for non-exporting companies – they already have the choice of borrowing in kwanza or dollars from domestic institutions, so the additional choice that would result from having open access to foreign currency borrowing from offshore banks would not be substantially different. However, borrowing from offshore sources would be more difficult to monitor. Although it is not the job of the monetary authorities to stop companies from taking risks, care has to be taken that the economic and financial environment does not encourage companies to take undue risks through the provision of incentives (such as the acquisition of low interest dollar liabilities in an environment of a pegged exchange rate, which may not persist). The need to monitor the exposure of the private corporate sector to such risks strengthens the arguments for effective data collection.

Lending to non-residents should be handled carefully. If such lending is for clearly identified fixed investment then it should be permitted; this will help to boost investment and growth, and will also help to reduce liquidity in the financial sector. However, other lending to non-residents should continue to be restricted, to minimize the potential for speculation against the currency.

Real estate (transactions by non-residents): this issue goes beyond exchange control matters, and inflows may be restricted by other legislation regarding the purchase and ownership of land.

Personal capital transactions (by individuals): outflows should be liberalized so as to permit residents to acquire offshore financial assets; the magnitude of this is likely to be small.

Transactions by banks and other credit institutions: this is a very important category of transactions. The main concern is the foreign exchange risk exposure of banks, in particular the acquisition of foreign currency liabilities (borrowing) vis a vis domestic currency assets (lending) on bank balance sheets. In an environment of a pegged exchange rate, combined with higher interest rates on kwanza instruments than on dollar instruments gives, banks have a strong profit-driven incentive to borrow in dollars and lend in kwanza. This was a widespread practice in Asia prior to the crisis and can lead to major solvency problems for banks – and indeed for the whole financial system - in the event of unanticipated exchange rate changes, especially depreciation. There are incentives for banks to take on these risks in Angola, but if it does happen it would constrain the possibility of a move towards a more flexible exchange rate. Hence this needs to be closely monitored, and the ability of the BNA to supervise and regulate currency risks on bank balance sheets is one of the most important prerequisites for liberalization in this area.

It may also be necessary to keep controls in reserve to limit inflows of foreign funds into the domestic banking system. These could include URRs on foreign currency liabilities of banks; mandatory holding periods (minimum stay requirements); the prohibition of interest payments on non-resident accounts. Such measures have been widely, used even by countries that have liberalized exchange controls; main intent is to limit capital inflows because of the implications for bank balance sheet risks.

Transactions by institutional investors (such as pension funds): institutional investors should be allowed to invest a significant portion (say 50%) of their assets offshore. Domestic markets are unlikely to provide sufficient diversification opportunities because of the limited range of financial assets available (especially shares and bonds); therefore, restricting institutions to domestic assets increases concentration risks for savers. For pension funds, there are no balance sheet currency risks to the extent that they offer "Defined Contribution" pensions. For life insurance companies there may be a balance sheet risk if liabilities are fixed in local currency terms, and companies offering kwanza-denominated annuities will be restricted by actuarial considerations from investing significantly in offshore or foreign currency assets. Hence the main issue is the need for effective prudential regulation of pension funds and life insurance companies.

Non-resident accounts: these should be permitted cautiously, for specific purposes. Non-residents will need to open accounts for transactions purposes, e.g. for participating in the capital and money markets, buying shares and bonds etc., and in general this should be permitted as long as the underlying purpose is legitimate. However, the inflow of non-resident funds into bank deposits purely to take advantage of interest rate differentials is not desirable, as this simply adds to liquidity and increases the absorption burden (and cost) for the BNA. Hence banking supervision needs to monitor the level of non-resident deposits closely, and be prepared to implement restrictive measures (URRs, prohibition of interest, or minimum stay requirements) if necessary.

5. Conclusions

Angola is in a strong position to begin a programme of progressive liberalization of exchange controls; there are potential benefits from both current account and capital account liberalization in terms of reducing transactions costs, improving policy credibility and making markets more efficient. The risk of capital outflow is low. The process should begin with current account liberalization and a commitment to capital account liberalization.

Angola could accept IMF Article VIII at any time; however, it would be advisable to (i) implement measures to remove the remaining current account restrictions (on dividend payments and certain invisible transactions) and multiple currency practices, and (ii) invite the IMF to conduct a comprehensive review of the exchange system.

The sequencing of capital account liberalization and co-ordination with other policies should follow a three-stage plan. The first stage, which is already under way, involves achieving a high degree of macroeconomic stability and developing markets and institutions, fostering good risk management by banks and other economic entities, and remedying the most important shortcomings in prudential regulation, with low-risk capital flows (such as FDI) being allowed to take place first. The second stage entails a consolidation and deepening of the progress made in the first stage, with considerable further capital account liberalization taking place. In the third and final stage, all remaining capital controls are lifted, as macroeconomic and financial sector conditions have improved to the point where risks are effectively managed. The broad sequencing of capital account liberalization should be as shown in Table 3.

Table 3 – Sequencing of capital account reform

Maturity of Flows / Direction of Flows	Short-term	Long-term
Inward	*4*	*1*
Outward	*3*	*2*

The practical steps involved in such a plan could be as follows. Liberalization should begin with easy items such as removing restrictions on inward and outward FDI. At the same time, complementary measures should be developed that will support liberalization of short-term inflows and outflows, specifically:

- Reviewing the adequacy of the bank supervision framework to cope with new risks that banks may be exposed to and develop preventative measures to deal with such risks;
- Reviewing the adequacy of capital market supervision to monitor non-resident investments and offshore investments of domestic institutions;
- Develop statistical processes for more effective compilation of BoP data from banks and other institutions;
- Develop the framework for AML/CFT
- Reviewing the monetary and exchange rate policy framework to accommodate greater exchange rate flexibility in future.

Carrying out a Financial Sector Assessment Program (FSAP) with the assistance of the IMF and World Bank can assist in identifying banking supervision risks and necessary reforms, as well as AML/CFT issues.

More detailed recommendations set out in Table 4.

Table 4 – Summary of Recommendations

Type of transaction	Recommendation/ Comment	Pre-requisites / Complementary Measures	Priority
All		Improve documentation and recording of transactions at banks for statistical purposes Develop AML/CFT procedures (legal / institutional) Request FSAP (IMF/World Bank) Request IMF Review of the exchange system	1
Current account	Remove remaining restrictions on invisible transactions and dividends, and MCPs, and move to IMF Article VIII		1
Foreign direct investment (FDI)	Remove restrictions on inward and outward FDI		1
Capital and money market instruments (stock exchange, bond markets)	Inflows should be permitted due to beneficial impact on market efficiency and costs of capital.	Monitor flows and stocks closely Keep deterrent measures at hand (e.g. minimum stay requirements) should volatility become a problem	2
Credit operations (cross-border lending and borrowing)	Permit lending by domestic banks to non-residents for clearly identified fixed investment Restrict other lending to non-residents (to prevent speculation against the currency).	Effective bank supervision & regulation	2
Real estate (transactions by non-residents)	Inflows may be restricted by other legislation regarding the purchase and ownership of land.		3
Personal capital transactions (by individuals)	Liberalise outflows so as to permit residents to diversify assets; no systemic risk implications.		2
Transactions by banks and other credit	Crucially important area given potential for foreign currency risk on	Effective bank supervision & regulation Development of prudential	1

institutions	bank balance sheets and potential systemic risk; risks must be monitored through effective prudential regulation and supervision; may be necessary to restrict inflows (foreign currency borrowing) to contain risks (URRS, minimum stay etc.)	measures / restrictions for use if necessary	
Transactions by institutional investors.	Allow domestic institutional investors to invest a significant portion of their assets offshore to achieve portfolio diversification.	Ensure adequate prudential regulation of pension funds and life insurance companies through non-bank / capital market regulator	1
Non-resident accounts	Allow for permitted purposes (e.g. non-resident activity in stock and bond markets) but discourage non-resident deposits that simply add to liquidity.	Effective bank supervision & regulation Development of prudential measures / restrictions for use if necessary	2