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**THE IMPACT OF FOREIGN EXCHANGE CONTROLS ON
THE ECONOMIC PERFORMANCE OF EMERGING
ECONOMIES AND SOUTH AFRICA IN PARTICULAR**

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ABSTRACT

This study sets out to investigate the impact of foreign exchange controls on economic performance of emerging economies and South Africa in particular. Amidst South Africa's newly established stable political environment and its reintroduction to the global economy, a fierce debate exists on whether some measure of exchange controls are necessary or whether they should be abolished altogether. The debate also extends to the nature of the economic liberalisation process in the removal of exchange controls, either in an instantaneous "big bang" approach or in a gradual manner.

The research describes arguments for both the support of exchange controls and their abolition. This includes a description of the path South Africa has adopted and an assessment of the merits of exchange controls. Experience from other emerging economies is investigated and correlated with the South African experience.

Results indicated that a gradual approach in the relaxation of exchange controls is recommended and that domestic monetary and fiscal policy and trade reforms first before liberating the capital account. It was found that the intensive use of exchange controls as a means of capital account restriction appears to hinder good economic performance; instead it is recommended to create and maintain an institutional environment in which the investment process can occur and where policy-makers can stimulate investment activity with a consequential elimination of capital flight.

DECLARATION

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Masters of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination at any other University.

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1. INTRODUCTION TO THE RESEARCH PROBLEM

1.1. INTRODUCTION TO FOREIGN EXCHANGE CONTROLS

This research attempts to investigate the impact of foreign exchange controls on the economic performance of emerging economies and South Africa in particular. Foreign exchange controls refers to the implementation of restrictive measures by the central government or central bank of a country (known as the “exchange authority”) in relation to foreign exchange income and expenditure, buying and selling, pricing, settlement and market through legislation or promulgation of relevant regulation, stipulation or decree in order to conduct the required foreign exchange control, coordination, organisation or restriction (Hong, 2004). Miller and Wood (1979) indicated that foreign exchange controls exists where private individuals, traders, companies or other organisations have to seek permission from the government or one of its agencies to buy, sell or hold foreign currencies or gold. The key objectives of the implementation of exchange controls have been the protection of the economy from disruptions that have an impact on capital flows, exchange rate stability and exchange reserves.

Typical examples of foreign exchange controls include banning the use of foreign currency within the country, banning locals from possessing foreign currency, restricting currency exchange to government-approved exchangers, implementing fixed exchange rates and restricting the amount of currency that

may be imported or exported. These controls allow countries a greater degree of economic stability by limiting the amount of exchange rate volatility due to capital flows.

Particular countries with foreign exchange controls are those with transitional economies or emerging economies, including Argentina, Chile, Brazil, China, Cuba, Malaysia, Venezuela and South Africa. Emerging economies refer to economies having low to middle per capita income and comprising approximately 80% of the global population yet representing about 20% of the world's economies (Heakal, 2003). These economies are termed "emerging" because of the developments and reforms of their markets and their emergence in the participation in the global economy. Emerging economies are viewed as transitional because of their progress from a closed to an open market economy.

1.2. RESEARCH OBJECTIVES

Emerging markets operate in circumstances far from ideal or free relative to developed markets. A debate exists whether some measure of exchange control is often required, but it is uncertain how much is appropriate. Some argue that no capital or currency controls would be ideal, but this may not always be practical due to the lack of reserves, liquidity and an accumulated demand for foreign exchange. The easing of exchange control cultivates opportunities for investment but the process is critical and, if not well managed,

it can be disastrous because speculators can exploit the expectations of further easing of exchange controls, thereby creating a constant negative bias towards the currency (Visser, 2002). A good example of this damaging approach is the rapid deterioration of the Rand in the early 21st century to the extent where it was severely undervalued.

Supporters of the implementation of exchange control rules argue that exchange controls, when required, should be steady, certain, fair, enforceable and sustainable. Monetary and exchange rate policies can have a positive effect on economic performance, especially in the short term, but when it is poorly handled it can impede economic growth and hurt the poor.

The primary objective of this research is to investigate what impact exchange controls have on the performance of emerging economies. One of primary reasons for exchange controls is to protect against capital flight in an emerging economy. However, it is also a hindrance to manage and provides a challenge for growth for any business with legitimate offshore interests. This research examines the debate on exchange controls and investigates the implementation of exchange controls versus the abolishment of exchange controls in the context of emerging economies.

There is a fierce debate on the benefits and impediments that exchange controls provide against capital flows. A key objective is to investigate what effects surges in capital flows have on the performance of emerging economies and what influence exchange controls have on these effects. As many

countries explore the abolishment of exchange controls in an effort to be more participative in a free and globalised market, a debate exists on the economic liberalisation process and the merits on the two types of approach to this, namely a “big bang” approach of instantaneous abolishment of exchange controls or a gradual, more relaxed approach of exchange control removal. The objective is to review these two types of approach based on experience in other emerging economies.

The research focuses on South Africa as it has been a country where exchange controls have been in place since 1933. This provides an example of a long and sustained implementation of foreign exchange controls. Exchange controls are a burden for the South African central bank to enforce and are costly to enforce and comply with (Van Zyl, Botha and Skerritt, 2003). Furthermore, businesses with legitimate offshore interests also find compliance with exchange controls a challenge. Therefore, in this context, South Africa offers a rich environment for studying the impact of exchange controls and the efficacy of the implications of relaxation.

1.3. WHAT EVIDENCE IS THERE TO VERIFY THE EXISTENCE OF THE PROBLEM?

Globalisation has made emerging markets more vulnerable as the larger economies have attempted to dominate the commercial world. The opening of markets has exposed emerging markets to international volatility and contagion.

Consequently, globalisation has raised the level of competitiveness to new and higher levels. A high cost of capital for emerging markets has contributed towards making it even more difficult for emerging markets to compete in an environment where manufacturing quality controls demand a high level of capital intensive technological input.

In addition, subsidies and tariffs have moved against emerging markets, where emerging markets were required to lower tariffs while economic power blocks such as the European Union continued with agricultural subsidies (Jha, 2003). A result of globalisation is that emerging economies cannot set their economic policies independently. They need to align their monetary and fiscal policies to the global environment as global conditions have dictated interest and tax rates (Visser, 2002). As a result of these changes and a loss of policy options, emerging markets have faced huge constraints in developing their policies.

Exchange controls have been a mechanism for emerging markets to protect against shocks to the economic stability of the country amidst the global competition. There exists a contrast between the leading economies and the emerging economies which still use direct instruments of monetary control, such credit ceilings and interest rate controls. These instruments can be highly distortionary. Fardmanesh and Douglas (2003) have found that these instruments have been largely abandoned by industrial countries in recent decades in favour of indirect monetary instruments such as reserve requirements, central bank lending facilities and open market operations.

In most developed countries, there are very few, if any, controls over the inflows and outflows of capital. However, capital flight can occur through illegal activities such as money laundering from illegal activities such as drug running, weapons sales, tax evasion, fraud and accounting scandals (Epstein, 2002a). In the instance of emerging economies, this problem exists in addition to capital flight. Investors can avoid controls, speculate on currencies and accumulate wealth abroad in the instance of political instability or when an unfavourable government comes to power (Epstein, 2002a).

In South Africa, stringent exchange controls have prevented profits being emigrated from the country, thereby limiting its attractiveness for foreign investment (Schutte & Loots, 2002). Furthermore, work done by Loots (2002) indicates that the South African economy is benefiting from the gradual relaxation of exchange controls.

Malaysia is another emerging economy which has implemented exchange controls to protect its economy. Abbas & Espinoza (2006) have evaluated the success of Malaysia's exchange controls on economic performance. The work presented by Abbas & Espinoza (2006) surveys the Malaysian economic crisis and the effects of the consequent imposition of capital controls by their authorities in September 1998 and their subsequent relaxation in February and September 1999. The authors reported that the Malaysian recovery, which commenced in late 1998, was as a result of the implementation of important channels of influence from exchange controls to interest rates (which were lowered) and the stock market recovered dramatically.

The impact of exchange controls is also evident in other emerging economies, namely Turkey, Venezuela, Argentina, Chile and India. The removal of foreign exchange controls and deregulation of financial markets in Turkey have substantially changed the environment in which monetary policy operates (Civcir, 2003). Venezuela has had numerous exchange rate regimes and foreign exchange controls over the past several decades. Zalduendo (2006) investigated the role of foreign exchange controls in supporting the official exchange rate in Venezuela, which indicated that government were able to maintain sharp deviations between the official and equilibrium rate as a result of the effectiveness of exchange controls.

1.4. RELEVANCE OF THE RESEARCH TO SOUTH AFRICA

Recent years have seen a gradual relaxation of exchange control regulations in South Africa, commencing from the abolishment of the Financial Rand in 1995. Exchange controls in South Africa have had an effect on foreign investors. Examples of this effect include loans by a non-resident to a South African resident requiring prior exchange control approval and loans by a South African resident to a non-resident requiring the prior approval of the South African Reserve Bank (Dasoo, 2007). In addition, when a subsidiary of a foreign concern has to manufacture under foreign licence, approval from the Department of Trade and Industry (DTI) is required. The DTI makes recommendations to the Exchange Control Department, which in turn authorises the provision of foreign exchange through the bankers of the applicant company (Dasoo, 2007). Limitations also exist in the application of

foreign exchange commitments to cover currency risks in imports and exports, such as currency requirements to cover permissible, firm and ascertained foreign exchange commitments (Visser, 2002). Furthermore, Dasoo (2007) also noted that royalty and technology agreements, where no local manufacturing is involved, require prior approval of the Exchange Control Department.

Whilst foreign exchange controls have afforded some protection against capital flight and risk to the economy, it has also meant that it has posed a burden on the South African central bank to enforce the regulations and it is costly to enforce and comply with. It has also posed a hindrance to foreign direct investment, businesses with legitimate offshore interests, inward listings on the Johannesburg Stock Exchange (a secondary listing of a foreign company in South Africa) and also a hindrance in the growth of Black Economic Empowerment (BEE) entities from owning shares in foreign-listed companies with local assets.

However, gradual changes have been made to eliminate exchange controls as can be seen from the 2007/2008 budget proposals from the Finance Ministry. For example, South African companies involved in international trade will now be allowed to operate a single Customer Foreign Currency (CFC) account for both trade and services and use it for a wider range of permissible transactions. This will help reduce the transaction costs associated with multi-CFC accounts and their restricted use. Furthermore, the Johannesburg Stock Exchange has been given permission to establish a Rand currency futures market to deepen

South Africa's financial markets and increase liquidity in the local foreign exchange market. This will enable South African investors to participate directly in the currency market through a transparent and regulated domestic channel. This is indicative of the demise of foreign exchange controls in South Africa, which has led to a more liberalised economy.

1.5. SCOPE OF THE RESEARCH

The scope of the research is to interrogate the impact exchange controls have had in emerging economies. The work done investigates why emerging economies have resorted to the practice of exchange controls and what the theoretical arguments are for and against the practice of exchange controls in emerging economies. There is a focus on South Africa due to its long history of implementation of exchange controls and the analysis is rich in the light of the effect of politics during this period. This entails an examination of the history of exchange controls in South Africa and the reasons behind their implementation. This research strives to assess the merits of exchange controls and this is supported by the evidence from experience in other emerging economies, as well as experience in South Africa. Policy implications for South Africa are discussed and include an analysis of the path towards abolishment of exchange controls, in either a “big-bang” instantaneous approach or a gradual approach.

2. LITERATURE REVIEW

2.1. INTRODUCTION

The global economy has experienced both economic liberalisation and globalisation over the past few decades. This has resulted in the economies of many countries becoming more interdependent and conducive to trading openly with each other. Inter-country fund and capital movements have become more frequent, requiring a free payment system. However, foreign exchange control restrictions still exist in many emerging economies hampering economic liberalisation and globalisation of these countries. Many emerging economies have retained some measure of exchange control restrictions as a measure to control the capital flows in and out of their economies, thereby protecting their economies from instability.

In this environment of partial or relatively complete capital controls, it must be recognised that every country is responsible for the legislation and administration of its own currency policies and foreign exchange control regulations. Due to the complicated and wide-ranging nature of foreign exchange control, great difficulties are experienced in international trade and investments. It is therefore crucial for investors and traders involved in the facilitation and participation in fund and capital movements to possess knowledge of exchange control measures and rules.

2.2. THEORY OF FOREIGN EXCHANGE CONTROLS

2.2.1. BACKGROUND TO FOREIGN EXCHANGE CONTROL

Foreign exchange controls are intended to act as an important macroeconomic policy instrument to maintain the balance of payments and to ensure a smooth, continuous and harmonious development of a country's economy by reducing the extent and occurrence of foreign sector shocks or disruptions.¹

Exchange control exists wherever private individuals, traders, companies or other organisations have to seek permission from government or one of its agencies to buy, sell or hold foreign currencies. Exchange controls are an essential instrument of a planned economy, although they also occur in market-based systems, with their history dating back over a considerable period.

Prior to the First World War, the leading countries adopted the gold standard monetary system where currencies were exchanged for gold freely according to a rate stipulated by a particular country's law. Once the First World War commenced, there was a scramble for gold and free international circulation of gold was suspended.

The USA surrendered the gold standard monetary system at the end of the

¹ The balance of payments is a systematic record of economic and financial flows that occur over a specified period of time between resident and non-residents of a given economy (Miller and Wood, 1979).

Great Depression in 1933 due to the large differences between the gold reserves of the various countries, and this signalled a complete collapse of the gold standard system (Hong, 2004). Resulting from the economic and financial disorder of the Second World War, a group of 44 countries participated in the Bretton Woods conference held in the USA (Hong, 2004). This also culminated in the establishment of the International Monetary Fund (IMF) and the emergence of a new monetary system.

The Bretton Woods system entailed arrangements linking the US Dollar (USD) with gold and linking other currencies with the USD, with the exchange rates of these other currencies being determined according to their gold content or convertibility. However, rapid growth of industrialised nations, such as Germany and Japan, meant that the USA could not provide sufficient gold to maintain the exchange rate of the USD and this culminated in the Bretton Woods system being abandoned in 1971 (Hong, 2004). The Bretton Woods system, when it was operating smoothly, resulted in foreign exchange control measures being concentrated in the management of exchange rates and foreign exchange and gold reserves so as to adjust the balance of payments (Hong, 2004).

2.2.2. TYPES OF FOREIGN EXCHANGE CONTROL

Foreign exchange authorities consider the amount of costs involved upfront for the institutionalisation of the foreign exchange control policy as one of the

primary issues before deciding on the extent to which foreign exchange policy will be implemented. Based on the costs involved, a decision will be made to fully implement or partially implement exchange control regulations.

According to Hong (2004), once the decision has been taken to implement the foreign exchange control policy, the foreign control measure can usually be one of two types:

- Where prior approval is required from the exchange authority for a foreign exchange transaction before it is processed at banks or other institutions; or
- Where prior approval is not required from the exchange authority and the exchange authority may inspect transaction records after the transaction and impose penalties if the transaction is made in violation of foreign exchange control stipulations.

Foreign exchange control measures can be applied either through direct or indirect administration (Van Zyl, Botha and Skerritt, 2003). Direct administration occurs when the exchange authority compulsorily regulates that all foreign exchange earned must be sold to designated banks, sets up a quantitative limitation of foreign exchange supply and that all foreign exchange supply must be approved prior to the relevant transactions occurring. Indirect administration occurs when the exchange authority establishes a foreign exchange equilibrium fund, sets up a quota for import goods and other indirect measures.

2.2.3. OBJECTIVES OF FOREIGN EXCHANGE CONTROL

According to Hong (2004), foreign exchange control policy attempts to meet four core objectives. Firstly, with reference to promoting international trade and maintaining equilibrium of balance of payments, foreign exchange policy is usually accompanied by a foreign trade policy. Emerging economies use foreign exchange control measures to encourage exports and impose limitations on specific goods in order to promote foreign trade and keep the balance of payments in equilibrium.

Secondly, foreign exchange control attempts to encourage stability of the local currency exchange rate. Since the advent of the floating exchange rate system, the primary macroeconomic goal of a country is to maintain exchange rate stability. There are two examples which illustrate the importance of a stable exchange rate. The first example is the case of the European Monetary Union (EMU), which employs an exchange arrangement in order to maintain exchange rate stability. The second example is in the Asian financial crisis, in which the deflation of the Thai baht directly caused the collapse of Thailand's economy. Hence, emerging economies attempt to use exchange control as an instrument to maintain exchange rate stability.

Thirdly, exchange controls strive to assure economic stability. Usually the volume of import and export of an emerging economy depends highly on the fluctuation of the exchange rate and the extent of the impact on the balance of payments. This can place many industries at risk and culminates in an

economic crisis. Therefore, in an attempt to minimise the effect of exchange rate fluctuation on imports and exports, emerging economies use exchange controls to maintain stability on the exchange rates, thereby assuring economic stability.

Lastly, exchange controls play a pivotal role in the strengthening of government's ability to regulate the economy. A government must adopt appropriate foreign exchange control measures to establish a protective screen between local and foreign currencies, for example, a devaluation of the local currency can stimulate export and thereby create employment in a country. A key example of this behaviour is the Malaysian government's reaction in the 1997 Asian financial crisis by adopting a limitation policy of the conversion of the Ringgit to foreign currencies to restrict capital transfer or outflow (Hong, 2004). Therefore, foreign exchange control regulations may be viewed as being one of the most important policy tools an emerging economy may use to refocus the country's economy.

It is clear from the objectives above that foreign exchange controls are implemented where these goals are most keenly sought and this is typical of emerging economies, as identified in the examples of Thailand and Malaysia above.

2.2.4. THE CURRENT ACCOUNT, THE CAPITAL ACCOUNT AND THE FINANCIAL ACCOUNT

Foreign exchange controls may be categorised according to current account transactions and capital and financial account transactions. The current account involves transactions that take place most frequently and consists of four components, namely the export and import of goods, the export and import of services, income and current transfers (Carbaugh, 2000).

The capital account is a systematic record of a country's capital import and export, which shows how the current account transactions are financed (Hong, 2004). The capital account comprises of two components, namely capital transfer and acquisition/disposal of non-produced, non-financial assets (the transfer of funds linked to the acquisition/disposal of fixed assets).

The financial account comprises of four components, namely direct investments, portfolio investments, other investments and reserve assets. Generally, the financial account covers all transactions associated with changes in ownership in foreign financial assets and liabilities of a country or region.

2.2.5. CATEGORIES OF FOREIGN EXCHANGE CONTROL

The categorisation of foreign exchange control according to current account transactions and capital and financial account transactions are illustrated in the table below:

Table 2-1: Categories of foreign exchange control (Miller & Wood, 1979)

CURRENT ACCOUNT TRANSACTIONS	CAPITAL & FINANCIAL ACCOUNT TRANSACTIONS
Payments made by residents to foreigners (Imports)	Payments made by residents to foreigners (Capital outflows)
Payments made by foreigners to residents (Exports)	Payments made by foreigners to residents (Capital inflows)

Source: Miller and Wood (1979, page 16)

Capital outflows are the most common type of transactions that are restricted by exchange control measures. It can be concluded that a large concentration of power exists with the central bank, especially as it has the potential to choose at its discretion the extent to which these measures apply.

2.2.6. EXCHANGE CONTROLS IN AN EXCHANGE MARKET

The impact of exchange control on the foreign exchange market can be depicted as indicated in Figure 2-1 below (May, 1985):

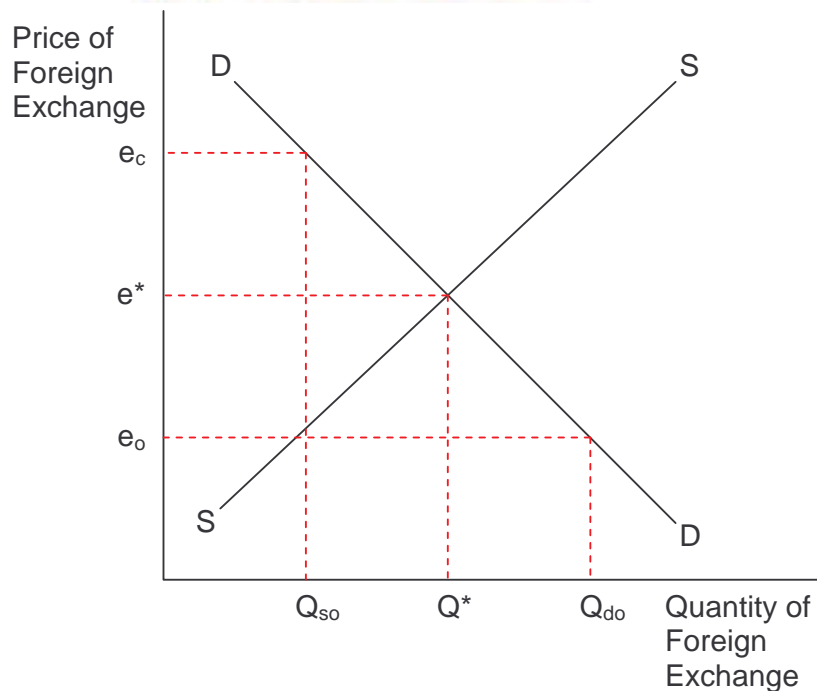


Figure 2-1: The impact of exchange control on the foreign exchange market (May, 1985)

The exchange market acts as a conceptual device which is convenient in summarising the forces determining equilibrium in exchange between countries. Assuming that the exchange rate is overvalued at e_0 therefore, there is an excess of ex-ante payments over receipts (May, 1985). Two automatic adjustment mechanisms exist. If the exchange rate is flexible, the price of foreign exchange will rise and domestic money will depreciate. The gap between autonomous demand and supply of exchange will be closed by movements along the existing schedules to the equilibrium rate, e^* (May, 1985). Alternatively, if the exchange rate is pegged, the deficit will gradually reduce the net foreign liquidity of the country.

The balance of payments affects the money stock over time and as a result the cash balances fall, as does the level of spending, eventually contracting autonomous demand for foreign exchange and expanding the supply (May, 1985). The gap between the two schedules will be closed as both of them shift until they intersect at the prevailing equilibrium point.

Governments can intervene in two ways: They can either reinforce the automatic adjustment process or they can resist it. Government can reinforce the market response by keeping the exchange rate pegged and encourage the necessary price and income changes by means of deflationary monetary and fiscal policies, or depreciate the exchange rate (May, 1985).

If the government decides to resist the market adjustment, it can either impose trade restrictions through tariffs or quotas, and/or give incentives to exports through export subsidies, or they can suspend convertibility and resort to exchange controls, thereby rationing foreign exchange (May, 1985). Trade restrictions serve to bring equilibrium in the foreign exchange market by shifting both curves until they intersect at the given equilibrium (May, 1985). The second alternative simply suppresses excess demand by rationing. From Figure 2-1 above it implies that foreign exchange earned at the overvalued rate Q_{s_0} is rationed (May, 1985). There is an implicit subsidy for international payments of $e_c e^*$ and an implicit tax for $e^* e_0$. Quantitative restrictions are often considered inefficient instruments but these are relatively common amongst emerging economies (May, 1985).

A country's central bank may keep down the price of foreign exchange by using exchange controls to limit its citizens' purchase of foreign currency for imported equipments, materials, consumer goods and travel. The central bank may attempt to avert a balance of payments crisis and domestic currency devaluation by repressing demand (shift in demand curve to the left) through exchange controls and trade restrictions (Nafziger, 1990).

The extent of exchange controls that the central bank can apply may vary. Nafziger (1990) indicated that the central bank may at one extreme seek to gain control over its payments position by directly circumventing market forces through the imposition of direct controls on international transactions. For example, a government that has a virtual monopoly over foreign exchange transactions may require that all foreign exchange earnings be turned over to authorised dealers. The government then allocates foreign exchange among domestic traders and investors at government-set prices (Carbaugh, 2000).

The advantage of this system is that the central bank can influence its payments position by controlling the amount of foreign exchange allocated to imports or capital outflows, thereby limiting the extent of these transactions. Exchange controls also have the potential for the central bank to encourage or discourage certain transactions by offering different rates for foreign currency for different purposes (Carbaugh, 2000). Another theoretical advantage of exchange controls is that it can allow a government to pursue its domestic economic policies without fear of balance of payments repercussions, by controlling the balance of payments through exchange controls (Carbaugh,

2000).

2.3. EMERGING ECONOMIES AND EXCHANGE CONTROLS

There was a perception up to the 1980s that emerging economies were similar to developed economies, with the exception of the levels of wealth (Carbaugh, 2000). However, the oil price shock of the 1970s, which provided both developed and emerging economies with increasing costs for imported oil, showed that developed economies were able to buffer this price shock considerably better than emerging economies. Developed economies produced goods that the Organisation of Petroleum Exporting Countries (OPEC) needed and the prices of these goods could be increased to compensate for the drastic increase in the price of oil (Jha, 2003). In addition, OPEC placed much of its revenues from fuel oil exports in the banks of the developed economies. Developed economies also possessed the skills and technological infrastructure to develop fuel efficient substitutes and processes.

Emerging economies performed poorly by contrast. They were unable to increase prices substantially to compensate for the oil price shocks, suffered drastic deterioration in trade and incurred a high degree of imports from developed economies. There was a sharp decline in the output potential which emerging economies tried to mitigate with an increase in money supply (Jha, 2003). This fuelled inflation and the emerging economies were plunged into a deep crisis. This example illustrates the weakness of emerging economies in dealing with shocks to the economy. In an attempt to exert better control over

their economy against disruptions, the emerging economies imposed strict foreign exchange controls to regulate the flow of capital in and out of the economy.

Emerging economies are exposed to an external economic environment undergoing considerable change. When an emerging economy chooses to apply exchange controls, it will be able to achieve monetary independence and exchange rate stability, but it will have to surrender financial integration, as it would have to impose strict exchange controls to protect its capital markets from responding to external events (Carbaugh, 2000).

A country that does not have full capital mobility can have some leeway in setting its interest rates and having an independent monetary policy at the same time (Jha, 2003). This can be seen from the experience of India and China. The Malaysian experience of implementing exchange controls following the Asian financial crisis in 1998 has indicated that exchange controls are useful in dealing with crises and shielding against speculative bubbles.

However, exchange controls can come at a cost. The efficacy of restricting inflows is likely to be greater than that of restricting outflows. A sustained application of exchange controls may shrink the flow of much needed development finance capital to an emerging economy (Jha, 2003). While exchange controls may provide relief during an economic crisis, it is less useful for an emerging economy to consider using exchange controls as a long-term solution. A more appropriate course of action would be to undertake banking

and financial sector reforms that would ensure a smooth integration of the emerging economy into the world economy (Carbaugh, 2000).

2.4. THE DEBATE FOR AND AGAINST EXCHANGE CONTROLS

One of the earliest supporters of exchange control was John Keynes, who published his views in a White Paper, *Proposals for an International Clearing Union* in 1943 (Miller and Wood, 1979). Keynes' view was that flows of speculative funds from debtor to creditor countries should be stopped by exchange control in all countries. The control should cover all transactions due to the difficulty of distinguishing between genuine trade payments and capital flight without the presence of a formal system. Keynes based his thinking on the assumption that such capital flows were the cause of exchange rate instability (Miller and Wood, 1979). He advised that stability of exchange rates must be created and maintained by controls on short-term capital movements (Miller and Wood, 1979).

Furthermore, arising from the Bretton Woods Agreement, countries were encouraged to use exchange control in order to ensure that the IMF's resources were not used to support large or substantial capital outflows. It was decided that member countries which failed to prevent the misuse of the IMF's resources could be declared ineligible to borrow from the Fund (Miller and Wood, 1979). Hence, this set a precedent for the implementation of exchange control measures as a policy instrument for maintaining exchange rate stability and minimising the risk of economic instability resulting from large and

unwarranted capital flows. Furthermore, it was viewed that without exchange controls to regulate capital flows, it would not be possible to regulate inflows of funds and withdrawal of funds by foreign speculators.

Another reason for employing exchange controls is to protect the precious reserves of a country. Countries have used exchange controls as a measure to protect their reserves from large capital outflows as well as a defence mechanism against speculative activity from investors.

Several governments have used exchange control as a method of controlling interest rates at home by discouraging investment overseas. This has been employed as part of the strategy of a planned economy employed by many emerging economies with limited success. Exchange control is intended to work in parallel with other measures of control such as tariffs, export promotion incentives and differential exchange rates in order to alter the allocation of resources.

Another intention of exchange control is to prevent the movement of assets overseas in order to escape taxation. Exchange control when applied is able to assist the inland revenue departments to prevent instances of tax avoidance and tax evasion.

The maintenance of balance of payments is also a favoured theme in the implementation of exchange controls. One of the requirements of the IMF is that all transactions under the current account, capital account or any account

which is between a resident and non-resident must be reflected in the statement of balance of payments (Hong, 2004). Therefore, all members of the IMF seek to adopt various means of balance of payments administration systems to compile a relevant set of balance of payments. Exchange controls are used as a regulatory measure to attempt to balance the balance of payments statement.

In sharp contrast to the above, a different set of views holds that exchange controls are an impediment to economic growth and free trade. The presence of any controls provides an incentive for people to evade them. This is no different for exchange controls, which attempt to control the large scale capital flows, however, it results in a large flow of capital being exchanged illegally. Thus, while exchange controls attempt to regulate capital flows, it can be viewed as encouraging illegal flow of capital and therefore transparency on all flow of capital is lost (Wood and Moll, 1994). This can be particularly painful in the longer run where, for example, servicing and repaying foreign debt quickly is made more difficult when private capital is being sent out of the country illegally (Wood and Moll, 1994). It is therefore indicated that the presence of exchange controls can promote an undesirable behaviour which in turn does the economy more harm than the well-intended efforts of economic protection that exchange controls strive to provide.

Another key disadvantage of exchange control is the limitations on economic growth arising from foreign investment and international trade. Countries that employ exchange controls attempt to use these controls as a means of discouraging free participation and investment in foreign markets where

residents do not have a majority shareholding. This forces companies in these countries to bear an enormous risk of exposure in the foreign market. In many instances, this risk is something companies neither want to take on nor can afford.

Sometimes, the companies are constrained by their shareholders and boards who do not allow this risk to be challenged due to their internal risk management policies. The net result is that companies are restricted in their efforts to invest abroad and grow, thereby limiting the economic growth potential of the country. In instances where there is approval from company authorities, final approval must be forthcoming from the central bank of the country. This process can be long and complicated. Consequently, the opportunity for the investment is lost due to these obstacles from participation in the foreign market. This can discourage investment and participation of foreign markets in the local economy and the country becomes less attractive as an investment opportunity and therefore further isolated from healthy trade. An abolition of all exchange controls can assist in economic growth since capital outflows would be stimulated, thereby favouring a participation of the emerging economy in the global economy.

Exchange control postpones the adjustment of the exchange rate to the underlying market realities. Holding the rate below the market level by administrative means leads to more exports and fewer imports and vice versa than in a free market. In the first instance, a massive amount of resources is spent to buy a unit of goods from abroad and in the second instance, too little

local resources are used. It therefore makes it difficult to support policies which not only inhibit the transfer of resources between industries in this way, but also distort the flow of funds for investment between alternative uses.

Exchange controls paradoxically make the country's exchange rates even more difficult to control. Due to the fact that exchange control regulations ensure that local residents are excluded from buying foreign currency in the foreign exchange market when they want to make capital payments overseas, the market is effectively narrowed and thus becomes more volatile. Foreigners can sell emerging market currency for other currencies as and when they please, however, local residents are constrained by exchange control measures. Foreigners may be subject to unfounded pessimism or panic on the emerging economy's future value of their currency, whereas local residents would be prepared to buy it on a more realistic assessment of the prospects of their currency based on first-hand knowledge of their economy. The pure existence of exchange control regulations in an economy is a clear signal to investors that the government of the country does not have adequate confidence in its ability to protect and grow the value of its currency.

The removal of restrictions on foreign investment abroad would assist in encouraging the accumulation of both assets and income abroad, which would strengthen the international balance sheet of a country. Furthermore, there would be a creation of a substantial economy from the re-absorption of unnecessary and unproductive resources that are involved in administering exchange controls. In addition, the role of the state in dictating the individual's

choice of investments is questionable. The power of a state to prevent individuals in making their own decisions about what to do with their own money is fundamentally flawed in principle. This action leaves the state open to apply its power in an oppressive and illegal manner. Whilst this may have been necessary in wartime to protect the country, it loses its relevance in other circumstances.

An outcome arising from the abolition of exchange controls is that it could serve to provide the benefit of a revival in confidence in the government's management of the economy. This act by government to demonstrate it does not require an artificial aid of exchange control will provide an emerging economy a powerful platform to encourage confidence and investment in its economy in a global arena of floating currencies.

Following the Asian financial crisis of 1997, Malaysia implemented several measures to maintain economic stability. It had been successful in curbing inflation, improving its external balance, maintaining a low external debt exposure and external reserves remained intact. However, despite these measures to stabilise the economy, Malaysia continued to remain vulnerable to external developments. During this period, it became evident that there was an increase in the rate of internalisation of the Ringgit and this trend reflected as an increase in outflow of the currency (Aziz, 1998). There was a demand for offshore Ringgit at high costs and this increased the vulnerability of the currency. It was viewed by the Malaysian authorities that this trend could cause fundamental damage to the real economy (Aziz, 1998). Therefore, it was

decided to introduce exchange control measures on 1 September 1998 as a means of protecting the Malaysian economy from further disruptions during this unstable external environment.

The above discussion illustrates some of the examples whereby a vulnerability to disruptions exists amongst emerging economies. These countries have used exchange controls as an instrument to exert control over the flow of capital in order to overcome potential threats or disruptions to the economy.

South Africa provides a typical example where there has been a long and sustained implementation of exchange controls. While there has been a gradual relaxation in exchange controls since 1994, there remains a strongly contested debate on whether some measure of exchange controls are necessary, or whether they should be scrapped altogether. The debate also extends to the nature of the economic liberalisation process in exchange control removal. Two schools of thought are prominent, namely a “big bang” approach of instantaneous removal of exchange controls, or a process of gradual liberalisation of exchange controls. South Africa has employed a process of gradual liberalisation of exchange controls despite calls for all exchange controls to be scrapped immediately.

Therefore, in this context, South Africa offers a fertile environment for consideration of the impact of exchange controls and the efficacy of the implications of relaxation. Against this setting, the following section provides a brief history of exchange controls in South Africa.

2.5. FOREIGN EXCHANGE CONTROL IN SOUTH AFRICA

2.5.1. THE HISTORY OF FOREIGN EXCHANGE CONTROL IN SOUTH AFRICA

South African policy makers have traditionally been in favour of using monetary policy in a combination with other economic measures to promote internal and external stability of the economy. The history of exchange control in South Africa can be traced back to the demise of the gold standard at the end of 1932. However, the government of the time was part of a group that favoured the retention of the gold standard. They based their thinking on the belief that gold convertibility was an unmistakable symbol of stability, discipline and financial integrity. Gold was regarded as a non-negotiable part of the monetary infrastructure. The government was confident its policies were adequate to meet the challenges of an economic depression, however, it was forced to revise its stance on the gold standard due to a rising speculative onslaught on the economy.

Arising from the departure from the gold standard, it was unclear how the external value of the currency would be determined and who would bear the exchange risks. The government was advised that it was its duty to regulate the currency and proposals in this regard culminated in the Currency and Exchanges Act (1933). This Act included direct control measures such as exchange control. A likely explanation for the involvement of government in exchange trading, rather than allowing forces of supply and demand to

determine their own equilibrium level, is that when South Africa abandoned the gold standard, it did not terminate the agreement it shared with the Chamber of Mines to buy the gold output (Franzsen, 1983). The central bank continued to buy all the gold output and in continuing to monetise the gold output, the central bank (and indirectly the government), played a pivotal role in foreign exchange transactions (Franzsen, 1983). As the central bank had become the principal operator on the supply side of foreign exchange transactions, it also assumed the responsibility of exchange risk attached to foreign exchange transactions.

South Africa, due to its strong colonial links to Britain, was a member of the Sterling Area.¹ As a member of the Sterling Area, South Africa had to dovetail its exchange control with other members of the Sterling Area. This implied that intra-area transactions could be done freely, but those transactions outside the Sterling Area attracted exchange control (Franzsen, 1983).

The end of the Second World War saw a revival in monetary policy due to a quadrupling of money supply in South Africa. The South African Reserve Bank then acted with controls to curb the phenomenal increase in money supply (Franzsen, 1983). Furthermore, due to uncertainty caused by the nationalisation policy of the British Labour Government in 1948 and the fear of sterling devaluation, British investors were encouraged to shift their funds outside the Britain in the interests of safety. South Africa was one of the places chosen due to its political security, booming economic conditions, attractive investment opportunities and the close relationship between Britain and South

¹ The Sterling Area refers to a group of countries which linked their currencies to sterling after Britain departed from the gold standard in 1931.

Africa. However, by the end of 1948, the South African Reserve Bank had acted to implement control measures as a means of curbing current account items.

The sustained outflow of private capital which South Africa experienced in the 1950s reflected nervousness on the part of international investors in setting of local political disturbances and a steady decline in the foreign exchange reserves and the weakening of the currency. Following the Sharpeville incident in March 1960, there was acceleration in private capital outflow. The Sharpeville incident was a political uprising against the government of the time, whereby the government retaliated against protestors in a violent manner with several deaths to civilians. It then became clear to the authorities that it was not possible to compensate for these outflows with official loans and that more stringent control measures were required (Van Zyl, Botha, and Skerritt, 2003). The Sharpeville incident provided an example to investors of political instability and as such a threat to the stability of the economy. This provided investors with the motivation to invest their capital in other markets. In this instance, a political event triggered a surge in capital outflows, which the South African authorities sought to control by implementing foreign exchange controls.

In 1961 an IMF delegation visited South Africa in an attempt to assist in resolving this financial crisis. The IMF delegation approach was to encourage South Africa to control the flow of capital and this included IMF approval for the application of stringent exchange control measures. Franzsen (1983) indicated that the authorities followed by imposing a comprehensive control of securities

on 16 June 1961, where previously unrestricted capital repatriation facilities were suspended.

2.5.2. REASONS FOR EXCHANGE CONTROLS IN SOUTH AFRICA

It is evident from above discussion that the primary reason for exchange control regulations in South Africa has been to protect the balance of payments and the foreign exchange reserves. The perception of capital flight as an abnormal risk has been mostly due to a function of political instability, both within South Africa and in the context of South Africa's near neighbours (Van Zyl, Botha and Skerritt, 2003). The South African Reserve Bank monitors and enforces the exchange control regulations, but the decision to impose or remove them is the responsibility of the Treasury and the Minister of Finance. The administration of the exchange control regulations is done by the South African Reserve Bank's Exchange Control Department, which aims to ensure that what remains of the exchange control system operates effectively.

2.5.3. EXCHANGE CONTROLS ON NON-RESIDENTS

Since the Sharpeville incident in March 1960, there has been significant tightening of exchange controls on residents and thereafter on non-residents. The Johannesburg Stock Exchange was the main channel for capital flight, however, this avenue was blocked by preventing the transfer of proceeds from local shares by non-residents. The proceeds of such sales became known as blocked Rands and were not transferable between non-resident accounts (Van

Zyl, Botha and Skerritt, 2003). This was changed in 1976 to allow transfers of the renamed Securities Rand between such accounts. The system was formalised in 1979 and became known as the Financial Rand.

2.5.4. EXCHANGE CONTROL ON RESIDENTS

Whilst exchange controls on residents have been gradually relaxed, they remain restrictive relative to most other developing and developed countries. These regulations are divided amongst individuals and companies. The exchange control regulations have included measures to prevent residents from holding an offshore bank account or to hold foreign currency in their name (Visser, 2002). Any foreign currency accruing to a resident must be converted into Rands and brought onshore. A range of restrictions apply to residents such as those who want foreign exchange to travel abroad, pay for education overseas or foreign alimony and maintenance payments (Van Zyl, Botha and Skerritt, 2003). Any exceptions to these rulings must be approved by the central bank and to the satisfaction of the South African Revenue Service that the resident's tax affairs are in order. While these measures attempt to control the flow of capital, it is unclear what the opportunity cost is to residents or the economy in the administration of these controls because they are relatively difficult to quantify accurately.

2.5.5. THE FINANCIAL RAND

The Financial Rand mechanism served as a two-tier foreign exchange market and dual exchange rate system. Effectively, all non-resident transactions in South African financial assets took place in a separate market for Financial Rands, while all current account transactions were settled in Commercial Rands. The difference between the two exchange rates in the two markets acted as a barometer of foreign investor sentiment and expectations, with the Financial Rand trading at a large discount to the Commercial Rand (Van Zyl, Botha and Skerritt, 2003).

The Financial Rand was seen as a temporary measure and was withdrawn in 1983 but re-instated in 1985 as a result of massive withdrawals of foreign capital, triggered by political events and instability in the country at the time. Although the country had a market determined floating exchange rate and was running a current account surplus in 1985, it was illiquid in the sense that short-term foreign currency denominated liabilities were high relative to the available foreign exchange reserves (Farrel and Todani, 2006).

The Financial Rand was eventually abolished in 1995 and this has remained in place since then. Whilst it offered the authorities a mechanism for dealing with speculative capital flows and capital flight under unstable political and economic circumstances, the Financial Rand interfered with the efficiency of a free market in foreign exchange (Van Zyl, Botha and Skerritt, 2003). The mechanism required constant monitoring and enforcement by authorities. This

administrative burden was further exacerbated by the practice of corruption between the two markets (Van Zyl, Botha and Skerritt, 2003).

Following the 1994 elections, the South African Chamber of Business (SACOB) published a discussion document prepared by the former Deputy Governor of the Reserve Bank (Farrel and Todani, 2006). This option involved immediate removal of all exchange controls for residents and non-residents. Supporters of this approach argued that exchange control deterred foreign investment. However, the authorities decided on gradual removal of exchange controls based largely on the Reserve Bank Governor Chris Stals's view that after years of exchange control, there was a huge pent-up demand for moving capital out of the country and that the country's foreign exchange reserves were depleted, resulting in an unduly painful short-term adjustment following immediate removal of exchange controls (Farrel and Todani, 2006).

In 2003, the Minister of Finance introduced an exchange control and tax amnesty for residents, which served to allow capital to be repatriated back into the country, which had previously been transferred abroad mainly on an illegal basis against exchange control regulations (Gidlow, 2006). This action indicates a tendency from government to further relax exchange controls in South Africa.

2.6. CONCLUSION TO THE LITERATURE REVIEW

Changes in exchange control can provide huge opportunities for investors. Emerging markets operate in circumstances far from ideal or free. Some sources indicate that some measure of exchange control is needed, preferably as little as possible to minimise the impact of distortion. The ideal situation would be to have no capital or currency controls; however, this is not always practical for all emerging markets due to the lack of reserves, liquidity and a pent-up demand for foreign exchange.

South Africa has experienced seventy-five years of exchange controls and therefore provides an interesting study of the practice of exchange controls in an emerging economy. An unstable local political climate through the previous century largely contributed to implementation of exchange controls arising from disruptions to the economy resulting in a surge in capital outflows, instability and deterioration in the exchange rate and a dwindling of the central bank's reserves. The political instability of the previous century culminated in democratic reforms in the early 1990s. This was accompanied by the establishment of a stable constitution from 1994. Amidst South Africa's newly established stable political environment and its reintroduction into the global economy, a fierce debate has existed for and against the abolishment of exchange controls. The abolishment debate has largely centred on the issue of the process of liberalisation, either in an instantaneous "big-bang" approach or in a gradual manner. The experience from other emerging economies is

investigated and correlated with the South African experience in the analysis that follows.

Easing of exchange control is advisable, but the process of liberalisation can be critical and dangerous. Relaxation of exchange controls can be risky as speculators exploit further easing, creating a constant negative bias towards the currency. The rapid deterioration in the Rand to the point where it is fundamentally undervalued is a good example of this damaging approach. Exchange control rules, where required, should be steady, certain, fair, enforceable and sustainable.

Companies are constrained by their shareholders and boards who do not allow this risk to be challenged due to their internal risk management policies. The net result is that companies are restricted in their efforts to invest abroad and grow, thereby limiting the economic growth potential of the country. In instances where there is approval from company authorities, final approval must be forthcoming from the central bank of the country. This process can be long and complicated; consequently, the opportunity for the investment is lost due to these obstacles from participation in the foreign market. This can discourage investment and participation of foreign markets in the local economy and the country becomes less attractive as an investment opportunity and therefore further isolated from healthy trade. An abolition of all exchange controls can assist in economic growth since capital outflows would be stimulated, thereby favouring a participation of the emerging economy in the global economy.

3. RESEARCH QUESTIONS

The following research questions collectively aim to describe the nature and extent of the impact of exchange controls in emerging economies. The questions below to be investigated are based on findings from the literature review:

1. What is the effect of surges in capital flows on emerging economies?
2. What are the key issues in the debate on the application of exchange controls in an emerging economy?
3. What is the effect of foreign exchange controls on the economic structure and economic liberalisation process?
4. What evidence is there of impacts that gradual relaxation of foreign exchange controls have had on the South African economy?

The first research question attempts to investigate the effects of fluctuations of capital flows on emerging economies. Research has indicated that many emerging economies resort to exchange control to manage the surges in capital flows and this forms the basis of the first research question. The second question of this research attempts to investigate what the key issues are in the existence of exchange controls in emerging economies. The third research question attempts to address the approach of how countries attempt to restructure their economy towards freer markets and this includes the gradual removal of exchange controls. Finally, the South African economy has endured gradual relaxation of exchange controls since 1994. There is a debate on how

this has contributed to economic liberalisation of the South African market and whether exchange controls should be removed completely.

4. RESEARCH METHODOLOGY

4.1. DESCRIPTION OF RESEARCH METHOD

The objectives of this research were determined using a quantitative descriptive research method. Descriptive research refers to a research methodology that is designed to describe the characteristics of a population or phenomenon (Zikmund, 2003). It helps to segment and target markets and is based on some previous understanding of the nature of a research problem.

According to the research questions defined in the previous section, the objective of this research was to describe the impact of foreign exchange controls on economic performance. This involved discussing some of the key issues facing emerging economies and how different emerging economies have performed comparatively under exchange controls.

Secondary information was researched from economic research databases, institutions and publications and were analysed quantitatively in a description of the findings of the research. Based on the scope of this research and a need to describe information of exchange controls from a variety of emerging economies, secondary information was deemed useful and more readily available.

4.2. POPULATION

Zikmund (2003) defines a population as a complete group of entities sharing some common set of characteristics. The title of this research states the impact of foreign exchange controls in emerging economies. Therefore, the population was defined as all emerging economies with foreign exchange controls. Emerging economies comprise 80% of the world's population and represent 20% of the world's economy. There is considerable focus on emerging economies as they are viewed as being emergent as key participants in the global economy. They are viewed as transitional from closed to more open in economic structure.

4.3. SAMPLING

Sampling involves the process of using a small number of items or parts of a larger population to make conclusions about the whole population. The method of sampling used was non-probability convenience sampling as the most convenient samples were selected for analysis. The advantage of this method is that there is no need for a list of population, it entails a very low cost and is extensively used (Zikmund, 2003). However, disadvantages of this method are that variability and bias of estimates cannot be measured or controlled and projecting data beyond the sample is not appropriate (Zikmund, 2003).

The emerging economies of the world can be clustered by geographical locations, namely, Eastern Europe, Latin America, Asia and Africa. Countries were selected within each cluster based on the availability of data and information pertaining to foreign exchange controls for each country. It was important to select certain prominent emerging economies, such as Chile, Argentina, Malaysia and South Africa, which offered useful and unique experiences of exchange controls under different conditions.

4.4. SAMPLE

Sampling aims to enable researchers to estimate some unknown characteristic of the population. According to Zikmund (2003), a sample should be a subset or part of a larger population.

Emerging economies that have been most prominent in the use of exchange controls are listed in Table 4.4-1 below. These represent parts of each of the emerging economy clusters across the world. These countries featured prominently in the analysis below.

Table 4.4-1: Sample of emerging economies with exchange controls

No.	EMERGING ECONOMY
1	South Africa
2	Argentina
3	Brazil
4	Chile
5	China
6	Columbia
7	The Caribbean Countries – Barbados, Guyana, Jamaica and Trinidad and Tobago
8	Ghana
9	India
10	Iran
11	Ireland
12	Kenya
13	Malaysia
14	Mexico
15	Russia
16	Tanzania
17	Thailand
18	Turkey
19	Uganda
20	Venezuela

The nature and experience of these emerging economies in dealing with exchange controls were used in the analysis in composing responses to the research questions identified earlier. The results of this were used in the analysis of the South African experience with exchange controls and in recommending a way forward.

4.5. DATA

All data collected constituted secondary data from various sources to develop an analysis of foreign exchange control practices across the sampled population.

This data was collected in the analysis of the following key issues aimed at fulfilling the research questions based on the findings from the literature review. These issues are discussed below.

4.5.1. EFFECT OF CAPITAL FLOWS ON EXCHANGE RATE

This key issue involved an analysis into the argument that capital flight is viewed as the general cause of the collapse of fixed exchange rate systems such as in Mexico, Asia and Russia. Several emerging economies use this reason to justify the application of exchange controls to restrict the capital account fluctuations and to cultivate a stable economic environment.

4.5.2. SUPPORT OF EXPORTS BY FOREIGN EXCHANGE CONTROLS

According to Hong (2004), one of the objectives of foreign exchange controls is to promote international trade and to maintain the balance of payments. Emerging economies attempt to use foreign exchange control measures to

encourage exports and impose limitations on specific goods in order to promote foreign trade and to maintain equilibrium in the balance of payments.

4.5.3. MAINTENANCE OF BALANCE OF PAYMENTS

Franzsen (1983) states another objective of exchange controls is to maintain the balance of payments. Maintenance of balance of payments is crucial for ensuring a smooth, continuous and harmonious development of a country's economy. Several emerging economies use exchange controls as a means of maintaining equilibrium in the balance of payments.

4.5.4. STABILITY OF LOCAL CURRENCY

According to Hong (2004), since the advent of the floating exchange rate system, the primary macroeconomic goal of a country is to maintain exchange rate stability. Exchange controls are one of the mechanisms by which emerging economies attempt to achieve this.

4.5.5. RESTRICTION ON PROFITS BEING TAKEN OUT OF THE COUNTRY

South Africa attempted to use exchange controls to restrict the amount of capital taken out of the country as a means of maintaining economic stability. However, in many instances these meant ceilings were imposed on the

expansion and growth of many successful South African companies, who were forced to invest their profits within the country rather than to grow globally.

4.6. DATA PERIOD

The data period was limited to the extent of data and information available on the emerging economies.

4.7. DATA SOURCES

The primary source of data was international literature describing the effect of exchange controls on a particular emerging economy. In addition, commentaries from various authors were obtained from the National Bureau of Economic Research (NBER). Other sources of information included the World Bank, the International Monetary Fund, Organisation for Economic Co-operation and Development and the South African Reserve Bank.

4.8. DATA ANALYSIS

Data analysis entailed an interrogation of the facts presented in the international literature and commenting on the implementation, use and relative success of exchange controls. In addition, comparative studies were undertaken between views in support of exchange controls and those against. Furthermore, an

analysis was taken regarding the process of economic liberalisation as either gradual or immediate removal of exchange controls.

4.9. RESEARCH LIMITATIONS

The following limitations were noted in undertaking this research:

- The extent of the analysis was dependent on the available data and information. This was limited to the emerging economies covered in the sample.
- Due to the limited availability of data for analysis, the sampling method employed was non-probability convenience sampling. A limitation of this method is that conclusions cannot be made outside the conveniently selected sample.

However, despite the limitations noted above, this research study provides an important and meaningful contribution to understanding the impact of foreign exchange controls on emerging economies and sets a path for further research in this domain.

5. RESULTS

5.1. RESEARCH QUESTION ONE

What is the effect of surges in capital flows on emerging economies?

5.1.1. FLUCTUATIONS IN CAPITAL FLOWS

The benefit of international capital investment to an emerging economy is the contribution to the savings of low and middle income developing countries. However, it can also be an impediment to developing countries by exposing them to disruptions and distortions from abroad and by exposing the country to surges of capital inflows and outflows.

Capital flows can be differentiated into two sources, namely public and private sources. Public sources entail flows that come in the form of aid and loans. Dodd (2004) indicated that over the past twenty years, private flows have become both larger and more volatile. It is further evident that the more volatile source of foreign capital flows arises from portfolio investments in bonds and stocks issued by developing country governments and corporations (Dodd, 2004).

A sudden rise of capital flows to a developing country can be initiated by the lifting of restrictions on the capital account (capital account liberalisation) and by a policy to privatise previously publicly owned assets such as the telephone or

railway system (Kadochnikov, 2005). Furthermore, when investment managers of large funds engage in trend investments, it can also contribute to a surge of capital into a country. Herd behaviour can also contribute to the surges in capital flows in this manner. The consequences of the surge in capital inflows can be devastating due to the upward pressure on the developing country's exchange rate (Dodd, 2004). If this is not modulated by the country's central bank, it may cause the currency to appreciate and thereby reduce the country's effectiveness of its traded goods. Dodd (2004) provides an example of this in Thailand's real estate and stock markets boom and bubble which burst in the 1997 financial crisis.

Another example is the appreciation of the currency in Russia, which is expected to encourage speculative flows and is a cause for concern for the Central Bank of Russia (CBR). This is based on the slow yet steady pace of appreciation during 2005-2006 when investors were presented with a predictable exchange rate path, thereby encouraging currency speculators. However, a recommendation arising out of this situation is that a policy of resisting appreciation with exchange controls will only serve to encourage this type of behaviour. Furthermore, Vernikov (2007) indicated that increased intervention associated with this type of policy is expected to accelerate money growth, which may reveal a deeper contrast in the CBR's inflation and exchange rate goals. This may result in a perception in the market that the exchange rate targeting will eventually have to give way in order to control inflation. Acceleration in currency appreciation might discourage speculative inflows, thereby ensuring that market expectations about the future path of the

exchange rate are more balanced.

5.1.2. EFFECT OF CAPITAL FLIGHT ON EXCHANGE RATE

According to Kadochnikov (2005), capital flight is viewed as the general cause of the collapse of fixed exchange rates systems, such as in the case of Mexico (1994), the Asian financial crisis (1997) and Russia (1998). The effect of massive outflows is the depressing of prices of real estate, equity shares and other domestic assets, causing a loss of bank deposits that leads to lending constraints and tight credit conditions (Dodd, 2004). Consequently, there is a rise in unemployment and poverty. It is further evident (Dodd, 2004) that the situation is worsened due to the tendency of international capital markets to spread the effects of financial crisis from one country to another in a process known as contagion.

Developing countries that employ fixed exchange rates systems endure a great deal of pressure resulting from the common consequences of a general USD appreciation. This places pressure on the developing country to maintain its peg to the rising USD.

Research done by Du and Zhu (2001), offers an explanation between exchange rate risk and exports. It is indicated that there exists significantly negative and positive impacts of exchange rate risk on exports. Du and Zhu (2001) found that the impact may be dependent on the existence of a forward market and trade position of a country.

Research by Rogoff (2004) indicates that many developing countries claim to have fixed exchange rates, but this may be only possible by imposing severe capital controls. In these circumstances, pervasive controls can typically lead to either a large parallel market for foreign exchange or to an official dual market. Consequently, there have been several cases where countries have reported their exchange rates as fixed while actually following a monetary and exchange rate policy that can be likened with a floating exchange rate system, for example China. Rogoff (2004) concludes that the intensive use of exchange controls as a means of capital account restriction appears to hinder good economic performance. This provides support to the debate that exchange controls impede economic growth.

5.1.3. TRADE MISINVOICING AS A MEANS OF CAPITAL FLIGHT FROM SOUTH AFRICA

Trade misinvoicing is a means by which capital is deliberately sent out of the country. Export under-invoicing is an example of the practice of trade misinvoicing. Export under-invoicing has been one area which has received considerable interest in South Africa due to its association with capital flight. This type of fraudulent activity can be done through falsification of export and import invoices as a way of evading exchange control. For example, a company in Port Elizabeth may halve the value of a consignment of car parts destined for England on the South African end, but the importers in England might arrange to substitute a different invoice and report the correct value on arrival. Assuming this goes through, perhaps half of the proceeds of the sale

might be repatriated to South Africa, whilst the rest remains abroad.

It is suspected that the bulk of this activity has occurred since 1985, when in the background of an unstable political climate many people were nervous about the long term safety of their assets. This has been estimated to be an average of R5 billion per year between 1985 and 1993 (Van der Walt and De Wets, 1993). However, it is questionable whether exchange controls provide the proper mechanism for preventing capital drain. Assets will inevitably find ways of moving to areas of less risk, whether through legal or illegal channels. The debate exists as to whether exchange controls then serve a purpose in preventing capital flight or whether they are in fact ineffective in preventing capital flight and should therefore be scrapped completely. Work done by Wood and Moll (1994) indicates that there are flaws in the ways of measuring the quantity of capital flight from South Africa and that certain estimates in this regard have been severely exaggerated, thereby placing the performance of exchange control regulatory authorities in a less dubious light.

Due to the effects of capital flow surges on economic performance and exchange rate stability, many developing economies resort to exchange control as a means of shielding the economy from capital flow shocks. However, exchange controls are accompanied by a range of costs and inefficiencies, including fraud and limiting one's individual freedom. Furthermore, regardless of the efficiency of the exchange control mechanisms, exchange controls cannot mitigate poor macroeconomic policies. Whilst there are concerns due to the leaks in exchange control system which allows instances such as export

under-invoicing to occur, it is unlikely that stricter exchange controls would yield improvements in minimising capital flight and may be counter-productive. For example, money can be circulated abroad by people travelling overseas, however, this can only be eliminated by prohibiting foreign travel.

5.2. RESEARCH QUESTION TWO

What are the key issues in the debate on the application of exchange controls in an emerging economy?

5.2.1. ISSUES ARISING FROM ECONOMIC REPRESSION

Economic repression refers to measures taken by the government to control economic activity in the country. These measures usually result in inadequate financial development and include the implementation of controls on ceilings of interest rates, exchange rates, and exchange control among other measures which culminate in constraining economic activity.

Emerging economies can be prone to economic repression and this can take several forms. Foreign trade can be repressed by quantitative restrictions and/or high tariffs. The domestic financial system becomes insulated by exchange controls and obtaining foreign exchange for purposes of foreign trade is very difficult. Besides exchange controls, several other forms of controls may exist on the foreign trade sector and consequently multiple exchange rates exist

(Jha, 2003). The “official” exchange rate typically undervalues the true scarcity of foreign exchange and there is a thriving parallel market for foreign exchange.

Investment is subject to the application of controls and licences have to be obtained for investment in certain sectors. The existence of these licences encourages corruption among the government bureaucracy.

Once inflation begins to grow steadily, governments of emerging economies have a tendency to accentuate its negative effects by imposing further controls. One of the ways this is done is by pegging or slow adjustment of the nominal exchange rate. Many emerging countries have preferred to peg their currencies to a major currency rather than to pursue a floating exchange rate system. This measure will be adequate provided the country is capable of maintaining sufficient international reserves, thereby allowing the country to support its currency. However, a problem emerges when a country depletes its reserves and it has to contend with the demand for foreign currencies. As a result, the country has no choice but to adhere to some form of foreign exchange controls (Bahmani-Oskooee, 1999).

5.2.2. THE EXISTENCE OF PARALLEL MARKETS IN EMERGING ECONOMIES

Parallel markets for foreign currencies have become a common occurrence in developing countries. One of the reasons for the presence of parallel markets in emerging economies is the implementation of exchange controls. According

to work done by Fardmanesh and Douglas (2003), in instances where the central bank does not have sufficient reserves to satisfy the demand for foreign currency, a parallel market develops.

Fardmanesh and Douglas (2003) examined the relationship between the official and parallel exchange rates in three Caribbean countries – Guyana, Jamaica and Trinidad during the 1985-1993 period. Their research found that exchange controls, expansionary fiscal and monetary policy and changes of government mostly have the expected positive effect on the parallel market premium (Fardmanesh and Douglas, 2003).

Fardmanesh & Douglas (2003) reported that foreign exchange controls in Guyana have resulted in current account restrictions, which caused a large negative impact on the exchange rate. Their research indicated that exchange controls have exerted the strongest impact on the emergence and behaviour of parallel markets for foreign exchange. In Venezuela, foreign exchange controls were used to support the official exchange rate (Zalduendo, 2006). This research indicates that the government's exchange control policy enabled sharp and persistent departures from the equilibrium exchange rate. It also shows that the differences between the official and parallel exchange rate existed as a result of government's control over oil export earnings and internal and external trade (Zalduendo, 2006).

Furthermore, research done by Bahmani-Oskooee (1999) illustrates that from evidence provided in Iran, a depreciation of the parallel market exchange rate

has no effect on exports because oil prices are denominated in dollars. However, importers tend to import more when the parallel market exchange rate depreciates as a result of the expectation of devaluation of the official rate. This has an overall impact of deterioration in the trade balance due to the depreciation of the parallel market exchange rate (Bahmani-Oskooee, 1999). It is recommended that the Iranian government avoid resorting to exchange controls but rather focus on long run economic fundamentals such as high inflation, improving productivity, industrial and agricultural policies as a means of resolving exchange rate crises (Bahmani-Oskooee, 1999).

5.2.4. THE EFFECT OF CORRUPTION IN EMERGING ECONOMIES

Besides the challenges endured in striving to be competitive in global markets, emerging economies have to overcome challenges to economic liberalisation in the form of corruption. According to Hartungi (2006), one of the main criticisms of emerging economies is that they have weak economic, legal and political institutions, making them vulnerable to high levels of corruption, insecurity and conflict. This situation is worsened through lack of competitiveness in terms of labour, technology and skills.

This problem has notably been experienced in Africa (Kumssa and Mbeche, 2004) where institutions in Africa have been weaker and ineffective because of poor enforcement of law, corruption, mismanagement, absence of strong civil society and political interference. Uganda endured a coup by Idi Amin in 1971 and succeeded in destroying all the political and economic institutions which

had served it well since independence in 1962. Similarly, Tanzania suffered an economic slump with a GDP of 5.2% (1970) to a GDP of 1.2% (1980) due to President Julius Nyerere's socialist policies (Kumssa and Mbeche, 2004). This hampered the growth of a flourishing market economy. In Kenya, President Moi's policies failed at implementation as they contradicted country rules and regulations (Kumssa and Mbeche, 2004). These policies contributed to an authoritarian state, corruption and abuse of power.

Conversely, evidence of the benefits of a stable economic base for growth can be seen in the performance of the four Asian countries – South Korea, Taiwan, Hong Kong and Singapore, where the necessary institutional and socio-political bases have enabled the implementation of effective and coherent development strategies (Kumssa and Mbeche, 2004). Further discussion of the challenges economies in transition face from corruption is provided by Goorha (2000), where corruption hinders economic activity by raising transaction costs. Wei (2001) offers a discussion on the relation of domestic crony capitalism and international fickle capital where friends and relatives of government officials are placed in positions of power. This contributes towards inefficiencies in the economy. Although exchange controls are employed to control capital flows, corrupt officials can be prone to breaching the exchange controls for their own gain and to maintain their power base.

5.2.5. THE EFFECT OF CAPITAL MOBILITY

According to work done by Gregario, Edwards and Valdes (2000), a number of experts at the World Bank and IMF have recommended restricting capital mobility in emerging markets as a means of preventing currency crises such as those in Asia, Russia and Brazil. Their findings are based primarily on the Chilean experience with the use of unremunerated reserve requirements (Gregario et. al, 2000). However, research done by Nevisky (2000) showed that econometric evidence does not indicate significant long-run effects on interest rate differentials and no effects on the real exchange rate.

Edwards and Rigoban (2005) researched the Chilean experience during the 1990s and investigated whether controls on capital flows reduced Chile's vulnerability to external shocks. Their findings indicate that the tightening of capital controls on inflows depreciates the exchange rate and that the vulnerability of the nominal exchange rate to external factors decreases with a tightening of the capital controls. The authors also found that the tightening of capital controls increases the unconditional volatility of the exchange rate, but this makes this volatility less sensitive to external shocks.

5.2.6. WEAKNESS OF EMERGING ECONOMIES RELATIVE TO DEVELOPED ECONOMIES

There is a significant contrast between emerging and developed economies, whereby emerging economies routinely lose access to international capital

markets. Reinhart (2005) indicates that a substantial portion of the surge in capital flows tends to be channelled into foreign exchange reserves. Furthermore, the public and private sectors in these countries are often required to repay their debts on short notice (Reinhart, 2005). Hence the need for abrupt adjustment in capital flows exists.

The most common policy response to this has been sterilised intervention, whereby central banks have most often opted to sell Treasury bills or central bank paper as a means of offsetting monetary expansion (Reinhart, 2005). It is further argued that the liberalisation of capital outflows has been a popular response to rising capital outflows, whereby permission of domestic residents to hold foreign assets, encourages gross outflows to increase (Reinhart, 2005).

5.2.7. TYPES OF EFFECTIVE CONTROL

It is important to consider the aims of controls when deciding whether or not they are effective. Firstly, controls aim to discourage the volumes of inflows which appear to be effective in some instances of their signalling effect to foreign investors (Hale, 2001b). Secondly, short-term flows increase the probability of a crisis so that restricting flows can make an emerging economy less crisis prone (Hale, 2001b). Thirdly, exchange controls attempt to restrict exchange rate volatility, and lastly, there is the aim of retaining or regaining monetary control and the decoupling domestic interest rates from foreign interest rates. This can be achieved by limiting both inflows and outflows (Hale, 2001b).

Based on the work on Argentinean attempts at exchange rate stabilisation, Schweickert (1996) indicated that an exchange rate based stabilisation poses a high-risk strategy even in the situation of strong adjustment factors. There are advantages to sustaining the fixed interest rate and adjusting it via a monetary contraction in the case of modest shocks. However, the chances of sustaining large shocks are low. Schweickert (1996) noted that the more inflation converges towards the level of the reference currency, the more likely large shocks require a deflationary process which is hardly sustained.

An empirical analysis of the monetary transmission mechanism in the four largest English-speaking Caribbean countries (Jamaica, Trinidad and Tobago, Barbados and Guyana), has indicated that all four countries pursued a fixed or managed exchange rate accompanied by capital controls (Ramlogan, 2004). A prohibition on the holding of foreign exchange further restricts the extent to which domestic residents may hold foreign assets. This absence of a fully functional capital market indicates an absence of effective open market operations (Ramlogan, 2004).

5.2.8. SUPPORT FOR CAPITAL CONTROLS IN LATIN AMERICA AND MALAYSIA

One argument for the implementation of exchange controls is in cases where there is a lack of success from prudential regulations to discourage drastic capital flows and unnecessary risk taking, or when there is a failure by other means to protect the stability of the financial system from external shocks.

Dodd (2004) indicated that restrictions on capital flows used by Columbia and Chile, which required a portion of inflows to be set aside for a period of time, helped protect these economies from boom-bust cycles. Further support for capital controls is evidenced by Malaysia's use of capital controls to prevent massive capital flight during the financial crises that swept through East Asia in 1997.

Research done by McHale (2001a) indicates that the Malaysian crisis erupted as a result of the combination of euphoria, panic and contagion. He proposes that speculative flows played a major role in the crisis and this was made more destabilising by the large offshore Ringgit market, which gave speculators easy access to domestic currency.

Likewise, analysis of the economies of Argentina, Venezuela and Mexico indicates that harsh controls were imposed, such as suspension of convertibility and forced conversions of foreign exchange. Conversely, Chile and Brazil followed a flexible approach whereby controls are tightened during an inflow cycle and relaxed during an outflow cycle (McHale, 2001b). Chile was able to reduce its non-remunerated dependency requirement to zero to attract inflows but the instrument remains in place for future use.

Over the last few years, many countries have opened their physical and financial markets for foreign investment. During this period, the growth of the market for American Depository Receipts (ADR) has escalated. Work done by Rabinovitch, Silva and Susmel (2000) indicates that Chile imposes several cash

flow restrictions on foreign investments and Argentina has a successful currency board, fixing its currency to the USD, thereby removing all impediments to foreign investments and cash flow movements.

Empirical evidence on the impact of controls on inflows reported by Reinhart (2005) presents the view that controls have little effect on the overall volume of capital flows, but they do alter the composition in favour of longer-term flows. Reinhart (2005) also proposes that efforts to sterilise the effect of inflows on the domestic money supply and interest rates did increase the volume and composition of flows. Such sterilisation efforts were common in Asia leading up to the crisis in an attempt to stop the Asian economies from overheating, keeping rates of return relatively high and encouraging money flows. However, this makes the region vulnerable to a sudden reversal. Controls can generate interest rate differentials; however, they cannot prevent crises, because the opportunities of prospect devaluations create profit expectations.

5.2.9. THE IMPACT OF CAPITAL CONTROLS

Desai, Foley and Hines (2006) have researched the impact of capital controls and their liberalisation on the activities of US multinational firms. These firms attempt to circumvent capital controls by reducing the reported profitability and increasing the frequency of dividend repatriations. Multinational affiliates in countries with capital controls face 5.25% higher interest rates on local borrowing than do affiliates of the same parent borrowing locally in countries without capital controls (Desai, Foley and Hines, 2006). Capital control

liberalisations are associated with significant increases in multinational activity – property, plant and equipment grow at 6.9% faster annual rates following liberalisations (Desai, Foley and Hines, 2006). The combination of the cost of avoidance and higher interest rates discourages investment in countries with capital controls.

5.2.10. CAPITAL CONTROLS AS A GROWTH POLICY INITIATIVE

Kadochnikov (2005), presented a view on the debate of capital flight from Russia. He indicates that a lack of understanding of the economic nature of capital flight and of its institutional context leads to false remedial actions such as stricter exchange controls. The results of the research indicated that capital flight of the kind experienced in Russia does not require policy response such as stricter capital controls. The reasons for this is that such restrictions do not increase the range of good investment opportunities but rather stimulate financing of low quality projects, accumulation of bad debts and credit booms, which will eventually drive the economy into crisis. By improving the institutional environment in which the investment process occurs, policy-makers can stimulate investment activity with a consequential elimination of capital flight (Kadochnikov, 2005).

According to Hale (2001b), emerging economies get treated differently to more established market economies when they have to devalue. Hale (2001b) proposes that in emerging economies, which have a history of weak discipline in fiscal policy-making and do not have central bank independence, it is better

to have stronger monetary and fiscal institutions than capital controls. A similar view is shared by Kaminsky (2004) that capital controls protect inefficient domestic financial institutions and thus may trigger financial vulnerabilities.

Another view is that pegged exchange rates encourage large but volatile capital flows. According to the views expressed by Hale (2001b), rather than trying to control inflows, a more constructive response would be to let the exchange rate float.

5.3. RESEARCH QUESTION THREE

What is the effect of foreign exchange controls on the economic structure and economic liberalisation process?

5.3.1. PROCESS FOR ECONOMIC REFORM

As discussed in Chapter 2, exchange controls were mainly introduced in the 1930s as a wartime measure of protecting economies from shocks resulting from surges in capital flows. However, with the onset of globalisation, there has been a resulting need for freer integration of economies in order to be competitive in the global economy. There has therefore been a gradual move towards economic liberalisation and free markets. The work below reviews the experience of economic liberalisation in the emerging economies of Argentina, Chile, India, Ireland, Turkey, Mexico and Malaysia.

The success of the economic liberalisation process depends primarily on the opening up of the real sector. According to Chakraborty (1999), domestic monetary and fiscal policy and trade reform must be carried out first before opening up the capital account. The capital account liberalisation should be delayed as far as possible because an economy in transition should not be subjected to volatile and often destabilising capital flows (Chakraborty, 1999). Any net capital inflow must be balanced by either an increase in reserve accumulation by the central bank (under a fixed exchange rate regime) or an appreciation of the real exchange rate (under a flexible exchange rate regime). Chakraborty (1999) compares the reform processes in Argentina, Chile and India and concludes that the reform process failed in Argentina because it opened up the real and financial sectors simultaneously and failed to control the fiscal deficit. Chile and India followed the right sequencing of reforms with substantial control over capital flows, though India encountered very high levels of fiscal deficit.

5.3.2. IMPACT OF DIFFERENT EXCHANGE RATE REGIMES ON IRISH MACROECONOMIC PERFORMANCE

Kavanagh (1997) examined the impact of six different exchange rate regimes on Irish macroeconomic performance from 1797-1994. This included research into how the structural features of the economy – openness, trade orientation, labour market linkages and financial market developments have impacted on the exchange rate options open to Ireland. These measures were taken to liberate the economy from the UK economy to which it was closely bound since

the Sterling Area. In 1992, the Irish currency was under pressure because the removal of exchange controls made it easier for non-residents to borrow Irish pounds in order to sell them (Kavanagh, 1997). However, the Irish government attempted to mitigate this with reasonable success through a variety of measures, such as opening the economy to international competition, diversifying its economy from agriculture to manufacturing and a high focus on exports to states other than just the UK. Therefore, it can be concluded that a high degree of openness of the Irish economy assisted in alleviating a crisis without resorting to the wide-spread use of exchange controls.

5.3.3. DEREGULATION OF TURKISH FINANCIAL MARKETS

Turkey liberalised its capital account in August 1989. The removal of foreign exchange controls and the deregulation of financial markets in Turkey have dramatically altered the environment in which monetary policy is exercised. Civcir (2003) investigated the empirical relationship between money, real income, interest rates, inflation, expected exchange rate and the constancy of this relationship in the light of financial reform, deregulation of financial markets and financial crises in Turkey. Turkey has been successful in recovering from an economic slump in 2001 to show an increase in output by a third and the strongest pace of growth amongst OECD countries during the 2002-2006 period (Gurría, 2006). Reforms included the establishment of an independent central bank, improved fiscal consolidation and transparency, restructuring of the banking sector to support the growth of the economy instead of financing the

government deficit, achievement of major privatisations and change in policy to establish a more open and competitive environment for business.

5.3.4. ECONOMIC STRUCTURAL INEFFICIENCIES IN MEXICO

The 1994 Mexican peso devaluation, and ensuing crisis, was based primarily on structural deficiencies and institutional rigidities (Maskooki, 2002). As is typical of many emerging markets, the structural and institutional rigidities have hampered the development of the capital market and modern banking. Despite recent attempts to improve the structure of the economy, Mexico is still hampered by inadequate market regulation, security registration, high transaction costs and poor disclosure practices, resulting in an inefficient, fragmented and illiquid capital market (Maskooki, 2002).

5.3.5. FOREIGN EXCHANGE CONTROLS APPLICATION IN MALAYSIA

Abbas & Espinoza (2006) investigated the restrictive and incentive components of the foreign exchange controls imposed in Malaysia in 1998. They analysed the “level” (first order) effects and the “volatility” (second order) effects of controls on key macroeconomic, banking and financial market variables. Their results indicated that the Malaysian recovery, commencing in late 1998, was at least as quick, strong and lasting as that of other crisis countries and that important channels of influence, from controls to interest rates (which were lowered) and stock markets (which recovered dramatically), were implemented.

Their research model indicated that controls did limit interest rate volatility but worsened stock market volatility (Abbas & Espinoza, 2006). They concluded that this result lends credence to the view that controls shifted the burden of adjustment from quantity to prices (Abbas & Espinoza, 2006).

5.3.6. RELUCTANCE OF EMERGING ECONOMIES TO LIBERATE THEIR FINANCIAL MARKETS

Research by Aizenman (1999) seeks to explain the reluctance of emerging economies to open their capital markets to foreigners. The research focuses on an economy which is characterised initially by a one-sided openness to the capital market – domestic agents can borrow internationally but foreign agents cannot hold domestic equity. One of the conditions identified, whereby emerging market capitalists oppose financial reform, is in the case of a “green field” investment by multinationals which would bid up real wages thereby reducing the rents of domestic capitalists (Aizenman, 1999).

Traditional literature research predominantly considers the effect of premature capital account liberalisation. However, work done by Wei and Zhang (2007) investigates an interesting angle of capital account liberalisation, namely the costs of not removing exchange controls. As a measure of minimising the evasion of exchange controls, countries intensify inspections at the border and increase documentation requirements (Wei and Zhang, 2007). Among other measures this increases the cost of exercising trade. Wei and Zhang (2007)

find that a one standard-deviation increase in the controls on trade payment has the same negative effect on trade as an increase in tariff by about 14%. Furthermore, a one standard-deviations increase in the controls of foreign exchange transactions reduces trade by the same amount as a rise in tariff by 11% (Wei and Zhang, 2007). Hence, considerable collateral damage to trade exists from the management of exchange controls. This poses a severe impediment to free trade transactions.

Nsouli, Rached and Funke (2005) discuss the two approaches to reforms; either a high-speed adjustment or a gradual, phased approach. The debate centres around four core issues; the costs of adjustment, the credibility of the reform programme, the feasibility of the approach and the risks associated with the strategy. Regarding liberalisation of the capital account, Nsouli et. al (2005) discuss that capital account liberalisation can improve welfare as long as financial markets are efficient and foreign funds are used to support the developmental process. Another benefit of foreign capital inflow is that it can help reduce the cost of capital and make capital intermediation more efficient (Nsouli et. al., 2005). One of the steps involved in liberalising the capital account involves removal of restrictions on foreign direct investment. This may provide benefits of transfer of technology and skills, which may help promote more efficient business practices. It is viewed that since foreign direct investment flows are more stable than portfolio flows, they are therefore less prone to sudden shifts in investor sentiment and are in turn less likely to contribute to financial crises (Nsouli et. al., 2003). It is therefore recommended that trade reform precede capital account liberalisation (Nsouli et. al., 2003).

5.4. RESEARCH QUESTION FOUR

What evidence is there of impacts that gradual relaxation of foreign exchange controls have had on the South African economy?

5.4.1. FOREIGN EXCHANGE CONTROL IN SOUTH AFRICA

South Africa has historically applied a wide variety of intrusive exchange control regulations. These regulations have been gradually relaxed since the 1994 democratic elections, however, the remaining exchange control measures are still very restrictive and complex. Although the government has communicated its intention to liberalise exchange controls further and gradually eliminate them altogether, they stubbornly remain as part of the current policy of cautious and gradual relaxation of exchange controls.

The administration of the exchange control regulations is done by the South African Reserve Bank's Exchange Control Department, which aims to ensure that what remains of the exchange control system operates effectively. The South African authorities have chosen to gradually eliminate exchange controls and further phasing out of the exchange controls is materially dependent upon the overall balance of payments position.

Luis (2002) investigated the shift in the government's economic policy from its Reconstruction and Development Programme (RDP) to its Growth, Employment

And Redistribution (GEAR) policy. GEAR was based on the assumption that liberalisation will yield Foreign Direct Investment (FDI). Luis (2002) argues that it is an erroneous view to compare South Africa with other emerging markets and insists that South Africa should fully liberalise because other emerging countries have experienced their initial growth phase and now possess an inherent dynamism. South Africa has yet to accomplish this phase.

5.4.2. REASONS FOR EXCHANGE CONTROLS IN SOUTH AFRICA

The primary reason for exchange control regulations in South Africa is to protect the balance of payments and the foreign exchange reserves. The perception of capital flight as an abnormal risk has mostly been due to a function of political instability, both within South Africa and in the context of South Africa's near neighbours (Van Zyl, Botha and Skerritt, 2003). The South African Reserve Bank monitors and enforces the exchange control regulations, but the decision to impose or remove them is the responsibility of the Treasury and the Minister of Finance.

5.4.3. EFFECTS OF THE REMAINING EXCHANGE CONTROLS

According to Van Zyl, Botha and Skerritt (2003), exchange controls are regarded as ineffective because individuals and companies have been able to circumvent them on a large scale. Exchange control regulations restrict capital outflows from those who obey them, but also strengthen the motives for capital

flight by those willing to risk evading such controls (Van Zyl, Botha and Skerritt, 2003).

Since 1994, the South African government has been slowly liberalising the capital account. This can be seen in the actions of the abolition of the Financial Rand in March 1995 to the gradual relaxation of exchange controls over the last few years. However, in October 2001, the government tightened the enforcement of exchange controls as a response to the rapidly declining Rand. The Reserve Bank remains committed to an orderly and gradual process of relaxation of exchange controls.

The South African government can in tandem consider other additional tools to manage the capital account to insulate the local market from turbulence in international markets. Epstein (2002b) recommends increased taxes on inflows and outflows of funds. This model has been applied in Chile (Epstein 2002b) through the Unremunerated Reserve Requirement (URR). The principle by which it operates is that the URR is equivalent to a tax per unit of time that declines with the permanence or maturity of the affected capital inflows (Epstein 2002b). Foreign investors are alternatively entitled to pay an upfront fee determined by the product of the relevant foreign interest rate and the fraction of capital subject to the restriction (Epstein 2002b). Whilst Chilean controls have been relatively successful in insulating the Chilean economy from financial stability, the merits of replacing exchange controls with another form of control are debatable. It is uncertain whether these new measures would benefit the economy in the long run.

In South Africa, stringent exchange controls have prevented profits being emigrated from the country, thereby limiting its attractiveness for foreign investment (Schutte & Loots, 2002). Furthermore, work done by Loots (2002) indicated that the South African economy is benefiting from the gradual relaxation of exchange controls.

Loots (2002) discussed the most prominent events during 1990-2001. This is summarised in Table 5.4-1 below:

Table 5.4-1: Most prominent events in the relaxation of exchange controls in South Africa

No.	DATE	EVENT
1	March 1995	Abolishment of the Financial Rand
2	July 1995	Allowing of local insurance companies, pension funds and unit trusts to undertake foreign investment through asset swap arrangements
3	March 1997	The abolishment of most controls on current account transactions and the permission to corporates to invest more abroad and raise foreign funds
4	March 1998	Further relaxation of exchange controls on individuals and corporations
5	March 2000	Allowance for companies to use local cash holdings to finance new foreign finance and repay foreign debt, allowance of corporate asset swaps to finance new foreign investments, allowance of certain currency transfers by pension funds, insurers and unit trusts
6	March 2001	Allowance of South African companies to increase their limit on new investments abroad from R50 million to R750 million in Africa and R500 million in the rest of the world

Since 1995 a large number of South African companies have become trans-national. The gradual relaxation of exchange controls have also permitted companies and individuals to invest abroad.

In most developed countries, there are very few, if any, controls over the inflows and outflows of capital. However, capital flight can occur through illegal activities such as money laundering from illegal activities such as drug running, weapons sales, tax evasion, fraud and accounting scandals (Epstein, 2002a). In the instance of emerging economies, this problem exists in addition to capital flight to avoid controls so that investors can avoid controls and speculate on currencies and accumulate wealth abroad in the instance of political instability or an when an unfavourable government comes to power (Epstein, 2002a).

A contrary view to withdrawing exchange control regulations is presented by Epstein (2002b), who proposes that rather than loosening the exchange controls system, the Reserve Bank and Ministry of Finance should enforce the existing controls more strictly, and explore other ways, such as transaction taxes and “speed-bumps” to further insulate the South African macroeconomic policy from global pressures.

In addition, Small Medium Enterprises (SMEs) have encountered exchange controls as an economic obstacle to their growth (Soontiëns, 2002). This view is also shared by Epstein (2002b). This highlights the debate for the elimination of exchange controls with the success of SMEs being a substantial factor in South Africa’s economic growth.

5.4.4. FUTURE MONETARY POLICY OUTLOOK

According to a report by Organisation for Economic Co-operation and Development (OECD) on South Africa (OECD, 2007), despite the volatility of the Rand and South Africa's vulnerability to capital outflows, the authorities remain committed to liberalising capital controls and a gradual lifting the remaining ceilings on outflows. Their objective is to replace quantitative limits on outward investment with prudential regulations for institutional investors. This view is supported by an increasingly comfortable stock of reserves, which has grown from \$18.7 billion in January 2006 to \$21.5 billion in October 2006, implying that reserve coverage of imports on goods and services has been raised from 7.9 weeks in 2003 to 14 weeks in 2006 (OECD, 2007).

While the ratio of reserves to imports is relatively low by emerging markets standards (OECD, 2007), improving liquidity ratios have enabled South Africa to easily withstand the emerging markets turmoil in 2006, thereby encouraging the growth in confidence of international investors. The country's international credit rating has also been elevated in recent months, with improvements in its long-term foreign currency debt rating by Standard and Poor's, Moodys and Fitch (OECD, 2007).

Based on this optimistic macroeconomic policy performance, the sustained application of exchange controls is questionable. A greater potential for economic growth can be realised in the complete elimination of exchange controls thereby fuelling greater investment and trade performances.

6. DISCUSSION OF RESULTS

The following section discusses the results of the findings of the research questions identified in investigating the impact of foreign exchange controls on economic performance of emerging economies, with a particular reference to South Africa. The results provide an insight in relation to evidence found in the literature and in terms of the research question.

6.1. RESEARCH QUESTION ONE

What is the effect of surges in capital flows on emerging economies?

International capital investment provides emerging economies with contributions towards its savings; however, this can leave emerging economies exposed to surges in capital flows because of disruptions and distortions they may cause. Dodd (2004) found that private capital flows from investors, such as portfolio investments in bonds and stocks issued by the developing country governments and corporations, are the more volatile source of foreign capital flows. According to Kadochnikov (2005), another example of a surge in capital flows is the lifting of restrictions on the capital account by a policy to privatise previously public owned assets such as the telephone or railway system.

The surge in capital flow can be devastating to the emerging economy by causing an upward pressure on the developing country's exchange rate. This

requires a central bank intervention to modulate this effect to avoid the appreciation of currency, which can reduce the effectiveness of the country's traded goods. Research done by Vernikov (2007) indicates that applying a policy of resisting currency appreciation with controls only serves to encourage currency speculation behaviour. Hence, in this instance it can be seen that the practice of exchange controls is ultimately self-defeating.

Research by Rogoff (2004) suggests that many emerging economies fix their exchange rates, but this may only be possible by imposing severe capital controls. In this situation, pervasive controls can typically lead to either a large parallel market for foreign exchange or an official dual market. This provides evidence that the intensive use of exchange controls as a means of capital account restriction is a hindrance to good economic performance.

Export under-invoicing is an area which has received considerable interest in South Africa due to its association with capital flight. South Africa has employed exchange control regulations for several decades and, as is inevitable in such circumstances, huge amounts of money have been sent illegally offshore during this time. It is suspected that the bulk of this activity occurred since 1985 when, in the background of an unstable climate, many people were nervous about the long-term safety of their assets. Van der Walt and De Wets (1993) estimate this amount to be an average of R5 billion per year between 1985 and 1993 alone, despite the existence exchange controls in this period. It is therefore questionable whether exchange controls provide the appropriate mechanism for preventing capital flight.

Many emerging economies resort to the practice of implementing exchange controls to shield the economy from surges in capital flows. However, exchange controls are also accompanied by a range of costs and inefficiencies, including fraud and corruption. In addition, regardless of the intensity of exchange controls, they cannot protect an economy from poor macroeconomic policies.

6.2. RESEARCH QUESTION TWO

What are the key issues in the debate on the application of exchange controls in an emerging economy?

The practice of economic repression to shield the economy against shocks is self-defeating. There is a tendency for a scarcity of foreign exchange resulting in a thriving parallel market for foreign exchange. According to the findings of Fardmanesh and Douglas (2003), parallel markets can be found to exist in circumstances where the central bank does not have sufficient reserves to satisfy the demand for foreign exchange. For example, exchange controls have been found to be one of the root causes in current account restrictions in Guyana, resulting in a large negative impact on the exchange rate (Fardmanesh and Douglas, 2003). Another example can be seen in the findings by Bahmani-Oskooee (1999), which reports in Iran that importers tend to import more when the parallel market exchange rate depreciates as a result of the expectation of devaluation in the official rate. This has an overall impact of deterioration in the trade balance due to the depreciation of the parallel market exchange rate

(Bahmani-Oskooee, 1999). An exchange rate crisis can be avoided by focusing on long run economic fundamentals, such as curbing high inflation and, improving productivity and industrial and agricultural policies.

Another key finding from research is that emerging economies are prone to having weak economic, legal and political institutions. This makes them vulnerable to high levels of corruption, insecurity and conflict. Exchange controls are applied as a measure of shielding the economy from shocks, however, it is recommended that a stable base of growth be provided, supported by sound monetary and fiscal policies.

Hale (2001b) offers a counter-argument in support of exchange controls which may be effective depending on the circumstances. Hale (2001b) proposes that the presence of exchange controls can be effective in signalling foreign investors to avoid investing in an emerging economy, thereby shielding the economy from capital inflows. The benefits of this are disputable in the light of the integrated manner of the world economy. An emerging economy can ill-afford not to participate freely in international trade if it wants to grow and be competitive.

Support for exchange controls is provided from experiences in Columbia, Chile and Malaysia. Exchange controls were successfully used to control capital flows, however, it must be noted in all these cases, exchange controls were applied as an emergency measure for a short period of time to protect against speculative capital flows.

Desai, Foley and Hines (2006) found that multinational affiliates in countries with capital controls face 5.25% higher interest rates on local borrowing than affiliates of the same parent borrowing locally in countries without capital controls. Their research further indicates that a combination of cost avoidance and higher interest rates discourages investment in countries with capital controls.

Further evidence against the implementation of exchange controls was found by Kadochnikov (2005) based on views presented on the debate of capital flight from Russia. He noted that the practice of exchange controls is accompanied by a lack of understanding of the economic nature of capital flight and its institutional context leads to false remedial actions such as stricter controls. Exchange controls do not cultivate a climate for good investment opportunities, but rather stimulate the financing of low quality projects, accumulation of bad debts and credit booms which will eventually drive the economy into crisis.

Arising from the analysis of this research question, it is evident that while exchange controls have had some measure of success in a few emerging economies for a short period of time, it must be noted that they were implemented as an emergency measure rather than part of a fundamental economic policy. The underlying theme from the evidence provided is that rather than resort to exchange controls, it is recommended to create and maintain an institutional environment in which the investment process can occur and where policy-makers can stimulate investment activity with a consequential elimination of capital flight.

6.3. RESEARCH QUESTION THREE

What is the effect of foreign exchange controls on the economic structure and economic liberalisation process?

Globalisation has necessitated a need for freer integration of economies in order to be more competitive in the global economy. Consequently, there has been a gradual move towards economic liberalisation and free markets. Research by Chakraborty (1999) indicated that domestic monetary and fiscal policy and trade reform must first be carried out before the capital account is liberated. This is particularly important in an emerging economy to avoid subjecting it to volatile and destabilising capital flows (Chakraborty, 1999). Any net capital flow should be balanced by either an increase in reserve accumulation by the central bank (under fixed exchange rate regime) or an appreciation of the real exchange rate (under flexible exchange rate regime).

Nsouli et. al. (2003) researched the approach to economic reforms and recommended that trade reforms precede capital account liberalisation to minimise the risk to the capital account arising from sudden shifts in investor sentiments. The effects of not taking this approach can be seen in the failed case of Argentina, which implemented instantaneous change in its efforts towards economic liberalisation. According to Chakraborty (1999), the reform process in Argentina failed because it opened up the real and financial sectors simultaneously and failed to control the fiscal deficit. Conversely, India and

Chile followed a process of gradual relaxation of exchange controls, with relative success compared to Argentina.

Experience from Ireland indicated that in 1992 the Irish currency was under pressure due to the removal of exchange controls (Kavanagh, 1997). However, the Irish government supported the economic liberalisation process by undertaking a variety of measures such as opening the economy to international competition, diversifying its economy from agriculture to manufacturing and a high focus on exports to states other than just the UK. Ireland achieved reasonable success through this approach by spreading its exposure upon liberalisation. Furthermore, by embracing other measures, Ireland was able to develop new competencies to carry its economy forward successfully. Likewise, the experiences in Turkey and Mexico emphasise the importance of economic liberalisation process, which dramatically improved the state of their economies.

A reluctance to remove exchange controls can prove to be costly. Research done by Wei and Zhang (2007) investigated the costs of not removing exchange controls and found that a one standard-deviation increase in controls on trade payment has the same negative effect on trade as an increase in tariff by about 14%. Furthermore, they reported that a one standard-deviation increase in the controls of foreign exchange transactions reduces trade by the same amount as a rise in tariff by 11%. Therefore, it is evident that considerable collateral damage to trade exists from the management of exchange controls. This poses a severe impediment to free trade transactions.

A prevalent theme arising from the outcome of this research question is that the economic liberalisation process should be structured in a manner that allows domestic monetary and fiscal policy and trade reforms to be conducted before liberating the capital account. This is to ensure the transition to economic liberalisation is smooth. Furthermore, the economic liberalisation process is more likely to be successful if there is support in cultivating a healthy economic climate with measures such as diversifying the economy, exporting products and services to variety of countries and exposing the economy to international competition.

6.4. RESEARCH QUESTION FOUR

What evidence is there of impacts that gradual relaxation of foreign exchange controls have had on the South African economy?

South Africa has experienced a long history of exchange controls, with the primary reason for exchange control regulations being to protect the balance of payments and foreign exchange reserves. The perception of capital flight as an abnormal risk has mostly been due to political instability, such as the Sharpeville incident in 1960.

Research findings provided by Van Zyl, Botha and Skerritt (2003), indicated that exchange controls are regarded as ineffective because individuals and companies have been able to circumvent them on a large scale. They report that exchange controls only work to constrain capital flows for those who seek

to obey the regulations, however, they strengthen the motives for capital flight for those who are willing to risk evading such controls. As part of the economic liberalisation process involving exchange controls, the authorities followed in the footsteps of some other countries by offering an exchange control and tax amnesty in 2003. While this measure may not ensure that the really large amounts of capital outflows are made public, approximately 5000 applications were made in the first few months of the promulgation of the amnesty. This is indicative of the positive reception by investors and others towards economic liberalisation. This helps cultivate a more responsible behaviour under relaxed controls than behaviour which saw billions being spirited away under strict exchange control administration.

Chile has experimented with an alternative method to manage the capital account to insulate the local market against the turbulence of international markets by imposing a “tax-based” controls system, whereby a transaction tax is imposed on all inflows. Epstein (2002b) recommends increased taxes on inflows and outflows of funds. This can function by entitling foreign investors are entitled to pay an upfront fee determined by the product of the relevant foreign interest rate and the fraction of the capital subject to the restriction. Although this measure has enjoyed relative success in Chile, it is questionable whether it is actually worthwhile replacing one form of controls with another.

Research findings by Loots (2002) have indicated that the South African economy has benefited from the gradual relaxation of exchange controls because this approach has allowed companies and individuals to invest abroad.

Epstein (2002b) proposes that instead of relaxing exchange controls further, the South African Reserve Bank and Ministry of Finance should enforce controls more strictly and explore other ways such as transaction taxes to further insulate the South African macroeconomic policy from global pressures. It is doubtful whether this action would be successful. Enforcing stricter controls will only serve to isolate the South African economy further based on the negative effects from the years of isolation of the South African economy during apartheid. South Africa needs to be an active participant in the global economy rather than to be self-restraining, which can arise from the practice of exchange controls and other forms of controls. Furthermore, according to a report by the Organisation for Economic Co-operation and Development (OECD, 2007), despite the volatility of the Rand and South Africa's vulnerability to capital outflows, the authorities remain committed to liberalising controls and gradual lifting the remaining ceilings on outflows. The country's credit rating has also shown a gradual improvement over the last few years.

Based on this optimistic macroeconomic policy performance, the sustained application of exchange controls in South Africa is questionable. There is a greater potential for economic growth to be realised in the complete elimination of exchange controls, thereby contributing to greater investment and trade performances.

6.5. POLICY IMPLICATIONS AND RECOMMENDATIONS

Foreign exchange control policy attempts to meet the following objectives:

- Promoting international trade and maintaining an equilibrium in the balance of payments
- Stability of local exchange rate
- Assuring economic stability
- Strengthening the government's ability to regulate the economy

The results of the analysis above cast doubt on the effectiveness of exchange controls in meeting these objectives. While exchange controls are seen by some to offer a mechanism maintaining equilibrium in the balance of payments, rather than promoting international trade, it serves to act as a barrier to economic growth because it poses strong restrictions on international trade. There are several factors that influence the stability of the local exchange rate, such as social, political and economic variables in the market. Rather than attempting to buffer these factors by introducing another measure of control, it is recommended that the government focus on allowing the market to trade freely by enforcing sound fiscal and monetary policies geared towards sustainable macroeconomic growth.

Foreign exchange controls have existed in South African history since the demise of the gold standard at the end of 1932. As a result of its close colonial relationship with Britain, South Africa followed in Britain's footsteps in applying

exchange controls to regulate capital flows and maintain exchange rate stability in during the Second World War. However, whether the conditions of that period are still relevant today is arguable, particularly given the advent of globalisation, which has seen economies become more integrated and involved in free trade.

Exchange controls necessitate a range of costs in the form of inefficiencies, fraud, lower capital inflows and the restriction of individual freedom of choice for investment. Exchange controls have found some use in instances of emergency in the economy or when there is a threat of political instability in the country, which has a direct bearing on capital flows and exchange rate stability, for example the Sharpeville incident in South Africa in March 1960. However, since 1994, South Africa has shown a gradual growth in the economy, fiscal prudence, favourable credit ratings, an accumulation of reserves and a stable local political climate. Therefore, it is questionable whether the existence of exchange controls currently provides value in promoting economic growth. Furthermore, exchange controls cannot alleviate unsound macroeconomic and particularly fiscal policies.

The South African government has followed a gradual approach of relaxation of exchange controls since 1994. There are merits to this approach as has been discussed in the previous analysis of the experience in India and Chile. Conversely, Argentina had followed an instantaneous abolishment of exchange controls and this approach had a detrimental effect on their economy. A country that has a fully liberalised capital account possesses the advantage of

increasing capital flows. Furthermore, further relaxation of exchange controls and/or the eventual abolishment offers the prospect of promoting international confidence in the South African economy and its macroeconomic policies and long-term sustainable growth.



7. CONCLUSION

This research report sets out to investigate the impact of foreign exchange controls on economic performance of emerging economies with reference to South Africa in particular. This study is intended to contribute to the debate on the merits of exchange controls and to interrogate their relevance to macroeconomic policies, particularly pertaining to South Africa.

7.1. KEY FINDINGS

One of the earliest supporters of exchange controls was John Keynes. He believed that speculative funds from debtor to creditor countries should be stopped by exchange controls in all countries. The control should cover all transactions due to the difficulty without the presence of a formal system to distinguish between genuine trade payments and capital flight. Keynes based his thinking on the assumption that such capital flows were the cause of exchange rate instability. These views were published pre-Second World War and during the war, countries consolidated their foreign trade policies to protect their domestic markets. Keynes' views set a precedent for the implantation of exchange control measures as a policy instrument for maintaining exchange rate stability and minimising the risk of economic stability resulting from large and unwarranted capital flows. Therefore, based on this philosophy, exchange control regulations became widely used in the middle of the last century.

It was felt that exchange controls provided the mechanism to regulate flows of funds and particularly speculation from foreign investors. In addition, exchange controls were employed as a means of protecting the reserves of the country and maintaining the balance of payments.

South Africa has a long history of applying exchange controls. South African policy-makers have traditionally been in favour of using monetary policy with other economic measures to promote internal and external stability of the country. The history of exchange controls can be traced back to the demise of the gold standard at the end of 1932. Following the demise of the gold standard, because of its strong affiliation and colonial history with Britain, South Africa was a member of the Sterling Area. Once Britain embarked on a policy to employ exchange controls leading up to the Second World War, South Africa, dovetailed its exchange control policy in line with other members of the Sterling Area.

Following the end of the Second World War, a sustained outflow of private capital from South Africa contributed to international nervousness, particularly in the background of unsettling political disturbances. This culminated in the Sharpeville political uprising and the government's reaction to this political instability led to an acceleration in private capital outflow and a sharp decline of foreign exchange reserves. In the years that followed, South Africa tightened its foreign exchange policy to stem the outflow of capital and to provide exchange rate stability. This led to the introduction of the Financial Rand in conjunction with the Commercial Rand. The Financial Rand offered authorities a

mechanism for dealing with speculative capital outflows and capital flight under unstable political and economic circumstances. However, it interfered with the efficiency of free market exchange and required constant monitoring and enforcement by authorities.

Experiences from Chile and Argentina offer valuable lessons in foreign exchange policy. Exchange controls were employed in these countries in climates of political instability as a means of maintaining exchange rate stability. Chile followed a liberalisation process of gradual relaxation of exchange controls to its advantage, whereas Argentina employed a liberalisation process of instantaneous abolishment of exchange controls to its detriment. Argentina was particularly susceptible to the 1995 Mexican crisis due to its currency board system, which meant that lower reserve levels caused a liquidity problem resulting in the economy going into recession in the first half of 1995.

Mexico and Turkey experienced problems arising from structural weaknesses in their economies. Large current account deficits, adverse political developments and high inflation were some of the themes that characterised the drain in international confidence in the economy resulting in large capital outflows. Furthermore, monetary policy was hampered in both countries by a fragile and relatively underdeveloped financial sector. The core lesson for emerging economies from these experiences is that the macroeconomic fundamentals need to be functional before economic liberalisation is attempted. South Africa has followed this approach of developing its macroeconomic policy and gradually relaxing exchange controls.

It has been found that exchange controls, whilst attempting to regulate the foreign exchange economy, also cultivates a climate for corruption and the creation of thriving parallel markets. A parallel market arises where the central bank does not have sufficient reserves to satisfy its demand for foreign currency. This was evident in the Caribbean, Ghana, Venezuela and Iran.

One of the main criticisms of emerging economies has been that they have weak economic, legal and political institutions, making them vulnerable to high levels of corruption, insecurity and conflict. Trade misinvoicing on exported goods has been found to be a source of fraud in attempting to send capital outside the country illegally and to subvert foreign exchange regulations in South Africa.

It is evident from the analysis, that while exchange controls have had some measure of success in a few economies for a short period of time, it must be noted that they were implemented as an emergency measure rather than part of a fundamental economic policy. A better practice would be to create and maintain an institutional environment in which the investment process can occur and where policy-makers can stimulate investment activity with a consequential elimination of capital flight.

Despite the volatility of the Rand and South Africa's vulnerability to capital outflows, the authorities remain committed to liberalising capital controls and a gradual lifting of the remaining ceilings on outflows. This has allowed the South

African economy to participate more freely in international trade and create an environment for greater potential for sustainable economic growth.

7.2. RECOMMENDATIONS TO STAKEHOLDERS

Exchange controls are seen by some to offer a mechanism for maintaining equilibrium in the balance of payments, however, rather than promoting international trade, it serves to act as a barrier to economic growth as it poses strong restrictions on international trade. There are several factors that influence the stability of the local exchange rate, namely, social, political and economic variables in the market which have an influence in the local exchange rate. Rather than attempting to buffer these factors by introducing another measure of control, it is recommended that the government focus on allowing the market to trade freely by enforcing sound fiscal and monetary policies geared towards sustainable macroeconomic growth.

South Africa has followed a gradual approach of relaxation of exchange controls since 1994. The merits to this approach have been discussed in the analysis of the previous chapters of the experience in India and Chile. Conversely, Argentina had followed an instantaneous abolishment of exchange controls and this approach had a detrimental effect on their economy. A country that has a fully liberalised capital account possesses the advantage of increasing capital flows. Furthermore, further relaxation of exchange controls and/or the eventual abolishment offers the prospect of promoting international confidence in the South African economy and its macroeconomic policies and long-term

sustainable growth. Hence, based on the economic and political stability South Africa has enjoyed over the past thirteen years and the findings of this research, it is recommended that all exchange controls be scrapped in a gradual manner.

7.3. RECOMMENDATIONS FOR FURTHER RESEARCH

This research study attempts to investigate the impact of foreign exchange controls on emerging economies, with reference to South Africa in particular. The research is intended to contribute to the debate on the merits of exchange controls in the modern economy. A key finding of this research has been the challenge to the existence of exchange controls as part of monetary policy and whether it has merit to cultivate an environment for participation in the global economy.

This study has employed a descriptive method of research to interrogate the debate on the impact of exchange controls in emerging economies. It is recommended that a causal model be investigated to quantify the impact of exchange controls on an emerging economy.

Another scope for further research is a quantitative investigation into the nature of costs involved in the application of exchange controls. This can be segmented into costs arising from administration of exchange controls by the central bank, costs arising from impediments to investments arising from the existence of exchange controls and losses incurred by corruption and the creation of parallel exchange markets.

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