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A new index for measuring SADC exchange control restrictiveness

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Abstract

This paper addresses the issue of the assessment of foreign exchange and capital controls in the context of the Southern African Development Community's goal of regional integration. It reviews the pros and cons of current and capital account liberalisation and argues that there is a lack of sufficiently refined *de jure* measures of capital account openness. A new index for measuring exchange control restrictiveness is created based on data from the International Monetary Fund's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) for the 15 SADC member states. This index is unique in that it employs ordinal measures of exchange control restrictions rather than the binary measures used in previous measures. The new index illustrates the considerable range of variation of exchange restrictiveness within SADC, as well as illustrating SADC's relative exchange restrictiveness compared with other countries, inside and outside of Africa. The new index also correlates with several measures of financial development, certain balance of payment items, and some measures of institutional development, which makes it a useful measure for SADC integration. The paper highlights the challenges for SADC monetary union in the sphere of exchange control.
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1. Introduction

Financial integration has been intensifying across the world over the past three decades (Binici et al., 2010:666). This can be seen in the lower levels of regulation on foreign exchange transactions, less restricted flows of capital and higher volumes of cross-border asset holdings (Prati et al., 2009:3). While substantial evidence exists suggesting that free trade and low tariffs for goods are favourable for growth and development, there is a lack of consensus on the benefits of free trade in services and capital. Most countries have liberalised merchandise transactions and the focus is now shifting to the debate surrounding capital account liberalisation. Capital account restrictions and exchange controls are still widely used policy tools in monitoring and regulating international financial transactions (IMF, 2012a,b).

The African Union (AU) sees a monetary union (MU) as a symbol of strength and political solidarity, and as a way of perfecting a single market and stimulating economic development. The AU has been working towards this goal by encouraging each of the continent's main regional economic communities to move towards full regional integration before merging into an African MU (Africa Union, 1991). The 1992 Southern African Development Community (SADC) Treaty initiated this process, which was strengthened with the signing of the Regional Indicative Strategic Development Plan (RISDP) in 2003 (SADC Secretariat, 2003), and its Finance and Investment Protocols (SADC Secretariat, 2006). Progress, however, has been much slower than expected.[1]

Evaluating the costs and benefits of exchange controls is important to SADC, as it is a precursor to increased financial integration. While a number of studies have looked at the effect

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[1] The original programme timeline, which has not been realised, foresaw a free trade area by 2008, a customs union by 2010, free movement of factors of production in 2015 and a full monetary union by 2018 (SADC Secretariat, 2003; Tavlas, 2008).

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of exchange controls, the empirical answers have not been robust because of data constraints and the lack of sufficiently refined *de jure* measures of capital account openness (Prati et al., 2009:3).

In order to facilitate examination of the feasibility of SADC regional integration and assess the potential for capital account harmonisation, this paper addresses the data deficit by creating a new index of exchange control restrictiveness for SADC member states. The index is based on data from the International Monetary Fund's (IMF) Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER).[2] It includes scores for 75 sub-categories that reflect the major components affecting the openness of a country's current and capital external account transactions. It is designed to capture the variation in the regulation and effects of capital and exchange controls across the countries, which other existing, aggregated capital control indices fail to account for.

The new index presented in this paper is the first iteration in a series of efforts to create a comprehensive and effective measurement for capturing the subtleties of exchange control restrictiveness. It was initiated as part of a project with SADC, with the methodology being applied to both the IMF (AREAER) and SADC databases.[3]

The motivation for this paper is two-fold: First, the creation of an exchange control restrictiveness index provides a mechanism to revisit the relationship between exchange controls and macroeconomic performance in a more scientific manner. Second, in the context of increasing SADC regional integration, creating consistent controls across member countries of the regional block is important. The exchange control restrictiveness index created here serves as a measurement tool to help assess SADC progress towards regional integration.

Before a common market can be formed with free movement of factors of production, there needs to be capital account liberalisation among SADC countries so that capital can flow freely within the region. While external liberalisation is not a requirement, each member state would need to make sure their policies were harmonised in respect to other member states' policies. This condition would also need to hold for the member states to maintain fixed convertible exchange rates and for monetary policy to be coordinated across the SADC region.

The remainder of this paper is structured as follows. Section 2 reviews the literature on the costs and benefits of exchange control liberalisation. Section 3 presents the new restrictiveness index—its construction, relevance, strengths and limitations, correlation with other existing indices, and some observations. Section 4 briefly considers the relationship of the new index with a number of variables and political economy measures. Section 5 looks at some policy implications and concludes.

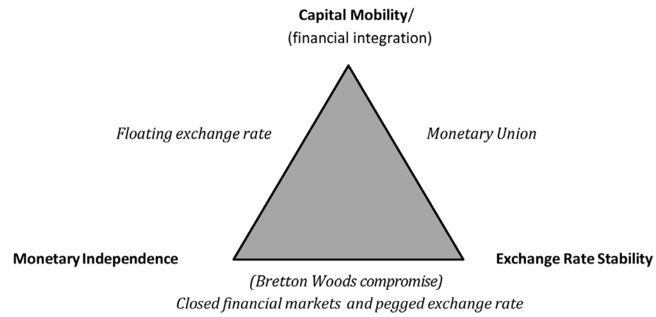

Fig. 1. Impossible trinity hypothesis.
Source: Aizenman et al. (2008).

2. Exchange controls: theory and evidence

For SADC to become a monetary union, exchange controls have to be removed within the union and harmonized across the region. Exchange controls act as non-tariff barriers to cross-border flows, somewhat like quota restrictions. Their impacts on the current account, the capital and financial account, and on monetary policy need to be evaluated.

2.1. Exchange controls and monetary unions

The impact of exchange controls on monetary policy is highlighted by the famous Impossible Trinity Hypothesis (ITH). The ITH is an outcome of the Mundell–Fleming model of open-economy macroeconomics, and suggests that an economy cannot maintain (1) exchange rate stability, (2) free capital movement, and (3) an independent monetary policy simultaneously—although any two are possible (Fig. 1).

Of the three potentially desirable policy goals, the choice is usually understood as being between monetary policy independence or a fixed exchange rate, given the existence of capital mobility (Aizenman et al., 2011). In this situation, the free movement of capital prevents a country from maintaining both a constant exchange rate and controlling its interest rates, as deviation of interest rates from that of its partners causes capital flows that strengthen or weaken the exchange rate.

A SADC monetary union means choosing exchange rate stability among members with intra-SADC capital mobility, while members sacrifice domestic monetary independence—like the Euro zone.[4]

Although there must be unrestricted capital mobility within SADC, there could be a common wall of exchange and capital controls for the region. Thus, the common currency does not

[2] The AREAER is a unique database published by the IMF tracking exchange and trade arrangements for 187 member countries since 1950 (IMF, 2010). Individual country chapters report exchange measures in place, the structure and setting of the exchange rate, arrangements for payments and receipts, procedures for resident and nonresident accounts, mechanisms for import and export payments and receipts, controls on capital transactions, and provisions specific to the financial sector (IMF, 2010). Individual country chapters report exchange measures in place, the structure and setting of the exchange rate, arrangements for payments and receipts, procedures for resident and nonresident accounts, mechanisms for import and export payments and receipts, controls on capital transactions, and provisions specific to the financial sector (IMF, 2010).

[3] A proprietary database based on this methodology was constructed for SADC in 2015.

[4] Africa already has monetary unions in the CFA franc zones: the West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Union (CEMAC). The Common Monetary Area rand zone, which is a hybrid monetary union is noted below.

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