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# FRBSF WEEKLY LETTER

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## Capital Flight and LDC Debt

The very high level of the foreign debts of many developing countries, currently around \$300 billion in aggregate, are a source of great concern for bankers, investors, governments, and the general public. A phenomenon that has attracted much less attention is the exact opposite of the LDC debt problem, namely the "flight of capital" from debtor developing countries. Capital flight is problematic because it represents a drain of a resource that could have had productive domestic uses, and it offsets imported capital. Reversing capital flight could restore a major source of development funding for the countries involved.

### Plight of the boat dollars

"Capital flight" used here refers to the export of savings by citizens of the same developing countries that owe such large amounts to western lenders. It takes various forms, including the investment of funds by these citizens in banks outside their home countries, the holding of other foreign financial assets, and even the holding of foreign currency as cash. In some cases, capital takes flight because businesses in a country require foreign currency reserves in their operations. In many cases, capital flight is illegal, but occurs nevertheless.

By its nature, capital flight is difficult to measure accurately because it is not directly observed in most cases. Nevertheless, a number of studies have been made to estimate its magnitude. These studies generally attempt to infer the capital outflows using balance of payments data from the countries concerned. The estimates vary from study to study, largely due to different definitions and methodologies. Nevertheless, they indicate that capital flight could represent an enormous flow of international lending and investing away from developing countries.

Capital flight, its causes and implications, has become the focus of a growing body of research. For example, between 1974 and 1982, Argentina borrowed \$32.6 billion. Estimates of the level of capital flight from Argentina over the same period range from \$15 billion to over \$27 billion. This would mean that capital flight amounted to between half and four-fifths of the

entire inflow of foreign capital to Argentina. Argentinian residents "exported" this sum to their own foreign bank accounts, overseas holdings, or foreign currency cash holdings.

For Venezuela, the inflow was \$27.0 billion over the same period, with capital flight estimated at between \$12 billion and \$22 billion. The inflow for Mexico was \$79 billion between 1976 and 1984; the outflow has been estimated at between \$26 billion and \$54 billion for the same period. Other debtor countries have also had large capital outflows. And some analysts believe even these figures are too conservative.

### "Country risk" starts at home

Observers have often overlooked a basic fact of life regarding "country risk". Country risk is the set of risks to investment peculiar to a country, and is often discussed in the context of investments abroad. For most people in the world and in most countries of the world, country risk starts at home. The country risk that most concerns these people is the loss of their capital and savings to expropriation, taxation, and inflation, some or all of which they perceive as possible in their own countries.

In unstable political regimes and in some stable ones, wealth is not secure from government seizure, especially when changes in regime occur. Savings may be shifted to overseas institutions to protect them. Hong Kong is a good recent illustration of a country responding to anticipated future changes in regime. Many of its citizens seem to be hedging much of their savings by exporting them. In countries where inflation is high and domestic inflation hedging is difficult or impossible, investors may hedge by shifting their savings to foreign currencies deemed less likely to depreciate. They also may make the shift when domestic interest rates are artificially held down by their governments, or when they expect a devaluation of overvalued currency.

Taxation also may be a major factor inducing capital flight. Savings and wealth may be hidden overseas to avoid taxes on interest and capital gains. A more important motivation might be the

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hiding of income from investments and operations associated with the activities of the "underground economy" in developing countries. Underground sectors actually consist of productive economic activities (but also some criminal activities) where earnings and profits are not reported to local tax authorities. To prevent their detection, funds may be transferred to overseas banks where local tax inspectors presumably are incapable of finding them or of tracing them to their points of origin. In some cases the transfer is performed by couriers carrying out physical cash notes. Banks in countries where disclosure of depositor identification is protected would be the safest havens. Funds held outside the country, without the use of the tax identification numbers used domestically, would be difficult to trace even when overseas banks cooperate fully.

The size of the underground economy in various countries cannot, of course, be directly observed. (If it could be observed, tax collectors would be the first to do so.) It can only be guessed at. "Guesstimates" often put the size of the underground economy in the United States at around 15 percent of recorded GNP, although one study at the Board of Governors of the Federal Reserve System estimated the size at two-thirds of recorded GNP. If this were correct, the underground economy would probably be even bigger in many developing countries.

## **The case of the missing cash**

Capital flight can explain a seemingly unrelated mystery that has puzzled many economists and regulators for years. We know the total stock of U.S. dollars outstanding based on Federal Reserve bookkeeping (currently about \$200 billion). But according to household surveys, Americans report holding only about one-sixth of the currency notes that they *should* be holding based on the quantities of minted notes outstanding. So where's all the cash?

A likely answer is that much of it is being held overseas. As such, it would represent a form of capital flight by foreigners from their own currencies and from the financial institutions in their own countries. In effect capital flight has taken place without the literal fleeing of capital to geographic areas outside the foreigners' home borders.

Capital flight to U.S. dollar bills, like other capital flight, might be motivated by fears of expro-

priation, taxation and inflation. But it has the advantage over distant overseas bank accounts in providing the investor/saver with ready liquidity that can be used to make payments with no advance planning, no paper trail, and no complex financial manipulations.

U.S. dollar bills are used for domestic transactions in many foreign countries, including, ironically, many communist countries. Not only are black market transactions in these countries often conducted in dollars, but in some cases, official foreign currency stores sell hard-to-find commodities to local residents *only* when they pay in foreign currency.

For the United States, foreign holdings of cash dollars represent a zero-interest loan to the federal government. We benefit from the loan as long as the cash is held. In effect, the U.S. obtains real goods and services while giving up only "pieces of paper," at least for as long as that paper is not exchanged for American goods or assets. Even sharp fluctuations in foreign willingness to hold dollars would probably have little impact on U.S. economic stability. Moreover, fluctuations in overseas holdings could be neutralized by U.S. monetary policy.

## **Policy issues**

Capital flight from developing countries raises a number of concerns and questions. For investors an unavoidable question must be, "Do those people know something I don't?" After all, residents of debtor countries presumably have a better feel for conditions and governmental intentions there than do outsiders. Sometimes they are concerned about policies that hurt them alone, and not foreign investors. When thinking about these countries' risks, one factor U.S. lenders should bear in mind is the apparent unwillingness of the countries' citizens to invest and lend their savings to their own countries.

Another concern is that it is often foreign investment and aid to developing countries that makes capital flight from those countries possible. Most of the countries involved have controls on purchases of foreign currency and restrictions on the foreign exchange markets. But the foreign exchange used in fleeing capital must come from somewhere. In the absence of capital inflows that evade those controls, virtually no capital outflows could occur. Without capital inflows, LDC savers would find it difficult to

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obtain dollars or other western currencies to stash away. That is, real goods or assets would have to be exported by LDC citizens seeking to "export" their savings. This would necessarily mean an improvement in their own country's balance of payments and debt position, as export earnings would rise.

The inflow of western capital may eliminate such a requirement. As we have seen, a significant share of the capital lent to or invested in many LDC nations never produces any expansion in production in those countries. It merely provides a source of hard western currency that finds its way to savers in those countries, who then hoard the cash or hide the same funds in overseas investments. The LDC then faces the worst of all possible worlds: a skyrocketing level of debt and little real productive economic expansion that could service that debt.

Moreover, by holding overseas financial assets, LDC owners of fleeing capital in a sense magnify the debt exposure of their own governments. Foreign assets held by private citizens would not ameliorate the government's burden of servicing its debt. The fact that domestic citizens maintain foreign bank accounts or hold other assets denominated in foreign exchange does nothing to alter the magnitude of the government's own debts. The government cannot "net out" these assets from its own liabilities.

#### **Gross vs. net debt levels of LDCs**

A developing country's government must bear and service a debt burden based on its "gross" liabilities. Its credit rating and the interest rate that it will be charged by foreign lenders are functions of this gross number. Thus, if capital that has fled were to be repatriated, the debt burdens of LDC debtors could be reduced substantially. Moreover, credit ratings would improve along with loan terms.

In accounting terms, the total "national debt" of a country is the net outstanding level of its debts, that is, its gross debts minus gross holdings of foreign assets by all domestic citizens. However, this measure of debt is irrelevant for most purposes. If capital that had flown were to return home, and government debt were to be reduced in tandem, the accounting measure of net national debt would show no change. But the burden of servicing that debt and the ability to raise new funds abroad would doubtless improve.

Another way of saying this is to note that the same financial institutions from developed countries that lend to LDC debtor nations are not necessarily the same institutions where residents of those LDCs hide their funds. And even if they were, the banks' exposure would not generally improve. The exposure of the banks is based on their gross holdings of LDC debt because the banks cannot "net out" or seize the deposits of those savers in the event of default by the government (or other borrowers) of the LDC. The depositors are different parties.

In sum, a useful source of hard currency funds to finance future debt service and real industrial investments in LDCs may be the foreign exchange savings of their own citizens. There have been some cases where changes in economic policy did induce some reversal of capital flight. Convincing their citizens to make these funds available at home is a major economic challenge facing the governments of developing nations.

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**  
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding	Change from	Change from, 12/10/86	
	12/9/87	12/2/87	Dollar	Percent <sup>7</sup>
Loans, Leases and Investments <sup>1 2</sup>	207,122	- 510	1,178	0.5
Loans and Leases <sup>1, 6</sup>	183,229	- 499	- 2,199	- 1.1
Commercial and Industrial	51,526	318	- 694	- 1.3
Real estate	72,445	- 159	5,469	8.1
Loans to Individuals	36,958	- 172	- 4,443	- 10.7
Leases	5,421	- 2	- 180	- 3.2
U.S. Treasury and Agency Securities <sup>2</sup>	16,548	- 26	3,523	27.0
Other Securities <sup>2</sup>	7,345	14	- 147	- 1.9
Total Deposits	207,114	- 2,228	- 3,518	- 1.6
Demand Deposits	51,866	- 2,033	- 4,827	- 8.5
Demand Deposits Adjusted <sup>3</sup>	36,832	188	- 2,578	- 6.5
Other Transaction Balances <sup>4</sup>	20,467	- 45	1,561	8.2
Total Non-Transaction Balances <sup>6</sup>	134,782	- 149	- 252	- 0.1
Money Market Deposit Accounts—Total	44,145	- 227	- 2,701	- 5.7
Time Deposits in Amounts of \$100,000 or more	31,614	215	- 1,079	- 3.3
Other Liabilities for Borrowed Money <sup>5</sup>	20,612	- 3,993	- 5,953	- 22.4
<b>Two Week Averages of Daily Figures</b>	Period ended 11/30/87	Period ended 11/16/87		
<b>Reserve Position, All Reporting Banks</b>				
Excess Reserves (+)/Deficiency (-)	105	18		
Borrowings	9	6		
Net free reserves (+)/Net borrowed(-)	96	12		

<sup>1</sup> Includes loss reserves, unearned income, excludes interbank loans

<sup>2</sup> Excludes trading account securities

<sup>3</sup> Excludes U.S. government and depository institution deposits and cash items

<sup>4</sup> ATS, NOW, Super NOW and savings accounts with telephone transfers

<sup>5</sup> Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

<sup>6</sup> Includes items not shown separately

<sup>7</sup> Annualized percent change