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Barriers and Opportunities For Enhancing Capital Flows In the COMCEC Member Countries

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Trends in capital flows for OIC Member States

Capital inflows to OIC member states, the large majority of which are developing countries, have strengthened since the end of the global financial downturn in 2009, aided significantly by a more favourable global macroeconomic environment. As the US eased its money supply with its quantitative easing (QE) programme, investors in developed countries began an avid search for higher returns on investment. Much of this was to be found in developing countries, where bond issuance has started to become a more common means of raising capital and countries such as Mozambique and Nigeria have, for the first time, raised international bonds that have been oversubscribed and reflect a serious appetite on the part of investors.

Challenges in the COMCEC Member States

The low income group consists of 17 countries with varying degrees of political instability, weak natural resource endowments and shortcomings in terms of governance and rule of law. Eleven of the 17 countries are classified by the OECD as being fragile states. Problems with enforcing regulation, upholding judicial decisions and capital controls are all factors which create an air of uncertainty which affects investor confidence. Foreign direct investment (FDI), often considered the more ‘stable’ and long-term form of capital flow, is already moderate in most cases, and portfolio capital is largely non-existent in most of the countries within this group.

The lower-middle income group contains a number of Middle East and North African (MENA) countries facing challenges related to political transition. The short-term horizons of some of the political regimes in power and the questionable effectiveness of certain policies introduced by some regimes (such as heavy fuel subsidies) create a reticent, ‘wait and see’ approach amongst potential investors that hampers such countries’ attractiveness as an investment location. Some of the larger economies within this group – namely Indonesia and Nigeria – continue to attract considerable capital flows, aided by a vast, young population and hence attractive market. However, the economies’ heavy dependence on natural resources presents an inherent volatility in portfolio inflows and introducing populist policies to protect local jobs and investment by restricting foreign ownership can serve to drive away foreign investors.

The upper-middle income group shares some similar challenges to both the low and lower-middle income groups in terms of winning investor confidence. Uncertainty around the repatriation of profits – in the case of Tunisia – and government intervention in awarding of certain contracts, as is the case in Kazakhstan, weighs on the minds of investors. With the exception of Malaysia, most of the countries in this group also have underdeveloped equity markets and low market capitalisation, which reflects in part businesses having unfavourable perceptions of the stock market as a means of raising capital, instead preferring bank lending as is the case in Lebanon.

The high-income countries within this group are all oil exporting economies, a number of which already have created ‘investor-friendly’ climates for attracting capital flows, such as the creation of free trade zones in the UAE and the establishment of independent bodies tasked with attracting foreign investment by setting up a number of initiatives such as the removal of restrictions on foreign ownership and repatriation of capital, and zero taxation on profits. However, even the high-income countries experience challenges of their own, albeit ‘nicer to have’ ones, such as ownership remaining highly concentrated in the hands of government-affiliated vehicles and large, powerful family-owned conglomerates, and stock markets being limited in size, which consequently limits the choice of listed companies at the disposal of investors.

Opportunities for enhancing capital flows amongst the COMCEC member states

Opportunities for enhancing capital flows in the COMCEC member states tend to vary depending on the specific characteristics of a country. Having said this, there are a number of ways in which countries can improve their perception amongst investors and hence attract more capital flows. For low-income countries, developing large, foreign-owned capital-intensive projects that are export-oriented and attract significant investment can act as a signal to investors that the country is a safe destination for investors and is able to manage investment projects competently. In relation to this, developing countries with large infrastructure projects may find that issuing bonds on international markets could be an effective source of external finance, where there is a clear plan for the government to use the bond receipts to invest in infrastructure. Putting in place investment-related regulations that are properly implemented and provide equal treatment to foreign investors on issues such as expropriation, dispute settlement and profit repatriation also help to build robust credentials for investor protection.

In lower-middle income countries, introducing policies to promote financial stability and transparency can help to attract capital flows. Although the stock market exists in some of these countries, drafting in practical reforms to improve the efficiency and depth of capital markets can boost investor confidence and drive more activity in the equity market. These could include, for example, extending the number of stock market exchange days, updating technology and adopting the NASDAQ trading platform.

Upper-middle income countries tend to have more developed capital markets and far greater financial stability given the emphasis they place on financial sector reforms, as has been the case in Turkey and Malaysia. They also tend to have a more skilled human capital base, higher levels of transparency and more liberal policies towards foreign equity participation, which enhances their competitiveness and acts as a conduit to access new international markets.

Lastly, high-income countries offer a raft of opportunities for attracting capital flows, having put in place well-respected legal systems and having made significant progress in establishing effective financial market regulation and oversight, while keeping a strong grip on market abuse and financial fraud. Countries with comparatively fewer natural resource endowments such as Bahrain have displayed an impressive keenness to adopt innovative policies to support the development of the economy, imposing fewer restrictions on foreign firms wishing to operate within the country such as the lack of restriction on the liquidation of non-resident owned assets or on movement of capital. This further reinforces their attractiveness as a destination for capital flows.

For the details please see ***"Barriers and Opportunities For Enhancing Capital Flows In the COMCEC Member Countries"*** which is also available on the
COMCEC Website: www.comcec.org