

CAPITAL FLIGHT AND FOREIGN DEBT: NOTES  
ON THE JAMAICAN EXPERIENCE

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by

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"Everybody's talking about crime, crime,  
but tell me, who are the criminals?"  
Equal Rights - Peter Tosh (1977)

INTRODUCTION

In recent years there has been increasing interest in the phenomena of capital flight from developing countries. This is evidenced by the number of theoretical and empirical studies<sup>1</sup>. An aspect of capital flight which is the subject of recent work is its relationship with developing countries' foreign debt<sup>2</sup>. As the debt crisis facing developing countries worsens, issues related to capital flight become critical from the standpoint of both the lending institutions and the borrowing countries. Lenders have been expressing their concern that new loans to developing countries could be used almost totally to fund capital flight; Morgan Guaranty Trust Company,<sup>3</sup> has pointed out:

"When their own residents are unwilling to repatriate capital to invest at home, the debtor countries cannot expect greater willingness from their foreign creditors."

This appears to be the dominant view among commercial banks which have made significant loans to developing countries. Borrowing countries on the other hand, with limited foreign exchange, are expected to be concerned about the productive investment of borrowed funds. One of the most important aspects of economic transformation of developing countries relates to their capacity to mobilize finance capital (both from local and foreign sources) and channel these funds into productive investment. If real possibilities for capital outflows as "capital flight" exist, then these countries' capacity to improve macro-economic performance is severely affected.

It is arguable that in practice neither the lending institutions nor the governments of developing countries are genuinely concerned about capital flight. It has been suggested<sup>4</sup>, that with reduced costs of international transactions, capital flight has become much cheaper and many US international banks have provided IPB (International Private Banking) channels to facilitate capital flight from developing countries.<sup>5</sup> The reported corrupt practices of many political leaders and their criminal class allies from poor countries who have accumulated millions in foreign banks attest to the levels of state organised and supported capital flight.

In a global context, capital flight has become an integral part of the circuit of international capital. It begins with the commercial banks in the developed countries which provide loans to developing countries; very soon after (or sometimes even before) the loans are actually received by the borrowers, a substantial proportion finds its way back to the lending institutions via capital flight, providing deposits which the banks onlend with the process repeating itself over and over again. The lending institutions are virtually guaranteed that some proportion of their loans will be received almost immediately as new deposits which allows for additional income generation via new loans, while those involved in capital flight from developing countries are ensured that their criminally gained wealth is increased.

Published work on capital flight from the Caribbean, as far as the author is aware, is curiously non-existent. There may be a number of reasons for this. Readily available foreign grants, loans and equity funds over the years may be possible reasons which explain why analysts have not seen it necessary to consider the phenomenon seriously. Another reason may be

the perceived data inadequacy, since, by nature, capital flight is difficult to quantify. However, attention to this issue was raised by some of the participants in the recent Conference of Caribbean Economists (July, 1987) in discussions on the region's economic problems and possible solutions; one participant suggested an examination of private capital held by residents overseas and the extent to which these funds represent capital flight. These capital funds, if repatriated, could finance significant domestic investment and in providing a source of foreign exchange, facilitate foreign payments including debt servicing.

This paper has two modest objectives. Firstly, it attempts to provide some estimates of capital flight from Jamaica; secondly, it looks at the data in comparison with the country's debt statistics without attempting any inquiry into causality.<sup>6</sup>

#### DEFINITIONAL AND METHODOLOGICAL ISSUES

There are various definitions of capital flight which are basically dependent on the theoretical and methodological perspectives of the different analysts. At one extreme, capital flight may be defined to encompass not only movement of finance capital but also the emigration of skilled labour (so-called "human capital flight") from developing countries; this represents the broadest possible definition. The narrowest definition is the "hot money" one used by Cuddington<sup>7</sup> which refers to "short term speculative capital outflows by the private non-bank sector."

A number of philosophical and conceptual issues arise in any attempt to define capital flight. In their normal, legal activities, domestic residents of any country who engage in international transactions hold financial

claims against non-resident economic units. These foreign assets may be both financial and real, owned by the banking and non-banking sectors, held by the private and public sector and either reported or not. A fundamental question now becomes: which of these transfer transactions should be defined as capital flight? Clearly, all capital outflows cannot be identified as capital flight. There is need for a technique to distinguish between various capital outflows; here, a certain level of arbitrariness may arise in classifying the motive of the outflow.

One approach to classifying outflows suggested by Cumby and Levich<sup>8</sup> is to provide a juridicial distinction between legal and illegal transactions. All "illegal" transactions are unreported and generally unrecorded, and although definable as capital flight, it is difficult to determine their levels. All "freely organized transactions" which are legal cannot be defined as capital flight. Cumby and Levich<sup>9</sup> argue as follows:

"For investors from small countries with poorly developed capital markets, there will be a demand for assets in other countries with more developed capital markets... Whenever markets are highly integrated and transaction costs are low, private individuals will have strong incentives to circumvent what appear to be arbitrary barriers to their own utility maximization."

Here these legal transfers are based on a narrow private welfare maximization on the part of resident economic units. Our rejection of this approach results not only from its exclusion of social welfare variables, but also for its failure to recognize that so-called 'legal, normal capital outflows' may mask illegal outflows via techniques like over- and under- invoicing of foreign trade activities. In addition, inherent in this approach is the possibility that individual self interest may generate significant repatriation

of "flight capital" once the situation in the developing country changes; this, in our view, is open to serious question.

Our support is for an alternative position which focuses on the extent to which capital flight impacts negatively on domestic social welfare, restricts domestic investment, and ultimately limits development possibilities. Once domestic social welfare is reduced, even in the context of increasing the private welfare of those engaged in capital transfers, then these transactions represent 'capital flight'. The negative effects include:

- (i) Introducing instability in financial markets especially exchange rates, and foreign reserves;
- (ii) Lowering tax base because of significant transfers of taxable wealth abroad;
- (iii) Reducing available resources for domestic investment, thus reducing potential domestic capital formation;
- (iv) With falling government revenues, government borrowing both locally and abroad increases;
- (v) Capacity for economic transformation and development is limited.

In a sense, therefore, this approach implies that any capital outflow which impacts negatively on national economic welfare is to be defined as capital flight. Following from this view, an expansive definition of capital flight which includes reported and unreported increases in foreign assets by both private and public banks and non-banks becomes relevant. Interestingly enough, this is the measure used by the World Bank<sup>10</sup>.

An IMF approach to defining capital flight appears to be emerging<sup>11</sup>. The recent studies of capital flight by IMF economists have all basically been

65  
200  
10  
100

using the same measurement. The stock of claims held by residents or non-residents which do not generate investment income which is recorded in the balance of payments is taken as the working measure of capital flight. Capital flight, therefore, is that proportion of a country's total foreign assets not yielding recorded investment income reported in the balance of payments. Khan and Ul Haq<sup>12</sup> indicate that in practical terms, capital flight refers to:

"... the difference between total private capital outflows and the part for which income is identified and reported."

The IMF approach first requires capitalising the flows of recorded investment income and then subtracting this amount from the total stock of foreign assets; the difference is used as an approximate measure of capital flight. The problem with this approach is that once all private outflows and their related investment income flows are reported, then capital flight is zero. Might it not be possible for a local resident to reinvest (and report) investment income, without the country ever benefitting from any foreign exchange flow?

Finally, in this section, we discuss some of the methods used to effect capital flight. This may range from the physical transfer of currency, cheques, and possibly other financial assets abroad, to much more ingenious, sophisticated approaches. A common method involves the smuggling of foreign exchange-earning, locally produced commodities abroad. Other widespread methods include invoicing exports (of both commodities and services) at values lower than received (under-invoicing), and conversely, over-invoicing of imports. Another technique used in those countries with exchange control regulations is for local residents to purchase foreign exchange abroad by making local payments, which usually reflect both service charges and

devalued exchange rates. More ingenious, but generally more corrupt methods include collusive behaviour with lenders to place amounts out of foreign borrowing in overseas banks, and creating "dummy" companies abroad whose sole purpose is facilitating illegal capital outflow.

### MEASURING CAPITAL FLIGHT

As already stated, measuring the size of capital flight is difficult, if not impossible. Difficulties are compounded by the wide range of possible conduits of such capital outflows from developing countries. In spite of those limitations, we attempt to apply a few of the measurement methods in the Jamaican context. We now make a summary presentation of the methods used.

Firstly, we examine the World Bank method. This is the most expansive method and is defined as:

"...the sum of gross capital inflows and the current account deficit, less increases in official foreign reserves".<sup>13</sup>

'Gross capital inflows' is defined as gross foreign debt (public and private) plus net foreign direct investment. The World Bank measure may be presented as follows:

$$CF_t = (\Delta FD_t + NFDI_t + CAD_t) - \Delta FR_t$$

where CF = Capital Flight  
FD = Gross Foreign debt  
NFDI = Net Foreign Direct Investment  
CAD = Current Account Deficit  
FR = Foreign Reserves  
t = time period

In our above measure, where  $CF_t > 0$ , then we assume that capital flight is taking place; conversely, where  $CF_t < 0$ , then we assume capital repatriation.

The attractiveness of the World Bank approach lies in its attempt to capture more than illegal outflows, hence its more expansive nature.

The second measure is developed by Morgan Guaranty Trust Company; it is similar to the World Bank's with one modification. Morgan Guaranty subtracts any increases in the short term foreign assets of the commercial banks from total capital inflows. The clear implication is that Morgan Guaranty does not consider commercial banks' acquisition of foreign assets as capital flight, while simultaneously indicating that foreign asset holdings by other economic and financial units may be part of capital flight. Felix and Sanchez make an interesting remark about Morgan Guaranty's modification of the World Bank approach; they point out that:

"(S)ince Morgan Guaranty is reputedly one of the largest holders of IPB deposits, its modifications seems little more than gratuitious slighting of the capability of Latin American banks for comparable chicanery." (emphasis ours)

Finally, we examine Cuddington's<sup>15</sup> measurement methods. Cuddington's definition of capital flight as referring to "short term speculative capital outflows" or "hot money" leads him to focus on short term foreign asset holdings of the private non-bank sector. He argues that, by its very nature, capital flight has to be concealed; he suggests that these outflows can only show up in the 'errors and omissions' entry in the balance of payments accounts. In applying his measurement of capital flight to various countries, he adds selected short term capital items chosen for each individual country being analysed to the 'errors and omissions' figures. The other capital items included are usually:

- (a) "other short term capital, other sector" (which includes the official sectors and banks);
- (b) "bonds and corporate equities" (assets).

Cuddington may be criticised firstly, for his short term focus rather than attempting to measure both short and long term capital movements. Secondly, there are items which occur in the 'errors and omissions' category which may not be unreported short term capital movements; since this category is a residual item which is the result of inconsistencies in estimates and omissions in entries, it becomes a "catch all" item. Thirdly, there does exist a certain arbitrariness in the selection of his additional short term capital items listed above, which he never justifies. For application in the Jamaican context, we have preferred the more expansive Cuddington measure which adds the two items listed to the 'errors and omissions' category.

#### EMPIRICAL RESULTS

In this section we present the various estimates of capital flight from Jamaica using the measurements identified in the previous section<sup>16</sup>.

The methods used are:

- (i) World Bank (WB) approach
- (ii) Morgan Guaranty Trust Company (MG) measure
- (iii) Cuddington's (CU) more expansive definition

Some caveats are worth stating immediately.

The data is based on annual flows (from IMF, BOP Statistics) and as such, our estimates may exclude important short term capital movements occurring within our data base period. Additionally, our approach assumes data foreign trade and BOP/reliability; we recognize that under-invoicing and over-invoicing of foreign trade may be important conduits of capital flight, and note here that using our measures allow for this form of capital flight to remain undetected. Where significant criminal enterprises may be involved in cross-border trade, our methods become even less reliable since there are hardly any means of generating data on these activities. Therefore, we

concede that estimates of capital flight obtained from the measures used may be understating the magnitude of the flows.

Detailed annual data on estimated capital flight from Jamaica, using our three measures, is given in Table 1. Firstly, predictably WB and MG estimates are much larger than CU's. Secondly, the estimates are fairly large in absolute terms and reflect a serious loss of foreign exchange, which constrains the development process. Thirdly, both WB and MG estimates show in excess of US\$840 million over the period 1970-84; CU estimates for the same period is US\$4.5 million.

TABLE I  
ESTIMATES OF CAPITAL FLIGHT FROM JAMAICA  
(in millions of U.S. dollars)

<u>YEAR/METHOD</u>	<u>WB<sup>1</sup></u>	<u>MG<sup>2</sup></u>	<u>CU<sup>3</sup></u>
1970	53.6	40.0	-4.6
1971	-0.7	-4.0	-20.2
1972	-112.1	-129.6	-2.7
1973	129.8	108.8	-4.8
1974	89.3	96.7	40.5
1975	3.8	9.6	11.3
1976	100.7	102.6	-2.7
1977	31.6	27.8	52.0
1978	90.6	98.5	-13.4
1979	126.1	130.1	-1.6
1980	136.5	127.1	29.3
1981	210.7	202.7	4.3
1982	148.3	133.3	-63.7
1983	39.3	17.7	61.4
1984	-142.1	-116.5	-80.6

<sup>1</sup>WB = World Bank

<sup>2</sup>MG = Morgan Guaranty Trust Company

<sup>3</sup>CU = Cuddington

In Table 2, aggregated annual flow data over three selected sub-periods is presented; the sub-periods are:

(a) 1970-75 during which the government changed (1972) and attempts (post 1972) were initiated to address some of the country's social and economic problems, while trying to minimize negative local consequences of rising oil import prices and devaluation (1973).

(b) 1976-80 which saw domestic economic policy being largely fashioned by 'perceived' and actual IMF conditionality, and domestic economic conditions deteriorating.

(c) 1981-84 during which period there was a change in economic policy (following a change of Government in 1980) towards increasing promotion of private foreign and local capital, under a predominantly IMF regime.

Apart from CU estimates for 1981-84 which show capital repatriation of US\$78.7 million, all other estimates show capital flight. Capital flight appears to have peaked during the 1976-80 period, during which time the Jamaican economy experienced serious decline.

In Table 3, the relationship between estimated cumulative capital flight and debt increments is shown. WB and CU estimates indicate that for 1970-84 capital flight equalled nearly forty per cent of debt increments; 1976-80 is remarkable and places Jamaica during that period virtually on par with major debtor countries like Argentina and Mexico (based on roughly comparable estimated indices). The 1981-84 data indicates a significant reduction from the previous period. What is noticeable here is that since 1976, Jamaica has been almost under annual IMF regime; IMF policies apparently failed to stop the 1976-80 outflows, while having success in stemming capital flight since 1981.

TABLE 2

ESTIMATES OF CUMULATED CAPITAL FLIGHT FROM JAMAICA  
(in millions of U.S. dollars)

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<u>YEARS/METHOD</u>	<u>(WB)</u>	<u>(MG)</u>	<u>(CU)</u>
1970-1975	153.7	121.4	19.6
1976-1980	485.7	486.1	63.6
1981-1984	256.1	237.2	-78.7

TABLE 3

ESTIMATES OF CUMULATED CAPITAL FLIGHT FROM JAMAICA AS  
PERCENTAGE OF INCREMENTS TO EXTERNAL DEBT

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<u>YEARS/METHOD</u>	<u>(WB)</u>	<u>(MG)</u>	<u>(CU)</u>
1970-1975	26	20	3
1976-1980	65	65	9
1981-1984	23	21	-7

We compare accumulated estimated capital flight since 1970 with external debt for three years (1975, 1980, 1984) in Table 4. The results are fairly similar to those of the previous ratio; they indicate that over 20 per cent of debt may be lost via capital flight.

The results we have presented cannot establish any relation between debt and capital flight. In the recent literature,<sup>17</sup> a strong debt-capital flow relationship has been identified. What is not finally agreed upon is causation. Is capital flight generating increases in foreign debt or is increased foreign borrowing motivating more capital outflows? In the first instance this suggests that as a result of increased capital flight, government is forced to borrow abroad; this may represent the classic case of "throwing good money after bad" with government borrowing to offset shortages of foreign exchange which was worsened by increasing capital outflows. Increased foreign borrowing motivating more capital flight may indicate that with foreign debt expanding, local residents predict economic deterioration and seek to move out of local money balances into foreign assets. On the other hand, the implication may also relate to corrupt practices on the part of various criminal enterprises which are allowed greater possibilities of siphoning foreign exchange abroad.

In the light of our preliminary findings, the capital flight-foreign debt relationship clearly emerges as an area of important research. There is the need for modelling and detailed econometric work. In our view, the development of approximately effective policy instruments by the Central Bank and other relevant agencies should be treated as priority.

TABLE 4

ESTIMATES OF CUMULATED CAPITAL FLIGHT FROM JAMAICA  
AS PERCENTAGE OF EXTERNAL DEBT AT END OF  
1975, 1980, 1984

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YEARS	(WB)	(MG)	(CU)
1975	22	17	3
1980	34	34	4
1984	10	9	-3

POLICY IMPLICATIONS AND CONCLUSIONS

There has been very little discussion and scant recognition of the problem of capital flight from Jamaica in particular, and the Caribbean, in general. Ultimately, the main responsibility for devising policies to stem capital outflows rests with the monetary authorities of these countries.

Firstly, there is need to carefully establish some notion of the amounts involved in capital flight. In the context of Jamaica, our estimates have been fairly large, both in absolute terms, and relative to external debt indices.

Secondly, there is the requirement of establishing the causative factors; a number of these are suggested for developing countries, and include:

- (a) Expectation of domestic currency devaluation
- (b) "Financial repression" (or negative real interest rates) arising from Central Bank controls.
- (c) Domestic price increases
- (d) 'Perceived risk' or the safe-haven motive
- (e) 'Pull factors' in financial and other markets of developed economies.

Thirdly, the monetary authorities should recognise, in fashioning policy, that capital flight always seeks new and additional conduits. One possible inference from Jamaica's capital flight estimates is that foreign exchange controls have been inadequate in restricting such outflows. The authorities, therefore, sought to consider more effective policy instruments; policy instruments, however, tend to be designed and authorised by the

ruling elites who may have more than a passing interest in ensuring their inadequacy.

One possible policy suggestion is increasing monitoring of the activities of commercial banks operating locally. This would necessitate a far more dynamic role for the Central Bank's Bank Inspection personnel to establish whether banks are actively facilitating such outflows.

Assistance from creditor countries and institutions may prove useful in reducing capital flight. This implies that much greater emphasis could be placed by creditors on providing loans for specific projects and purposes. Close monitoring of resources by both creditors and debtors may reduce possible diverting of borrowed funds into capital flight. The joint commissions of both debtor and creditor institutions with monitoring responsibilities have been proposed monitoring and attempting to limit capital flight from developing countries.

On the specific question of external debt policy, the debt equity exchanges warrant closer scrutiny. Jamaica has been engaged in a few debt-equity swaps over the last few months. Generally, for debt-equity swaps to be attractive to foreign capital, they require defacto devaluation by reducing the foreign currency purchase price of the domestic debtor asset. In the largest Latin American debtor countries engaged in debt equity swapping, their recent discount rates have ranged from 25 per cent for Brazil to 78 per cent for Mexico.

With defacto devaluation, foreign capital is attracted by debt-equity swapping. There are, however, real possibilities for "round tripping" where capital flight finances debt-equity swaps which ultimately finance further capital flight.. Although debt-equity swaps may increase, there is no

certainty that net capital inflows of foreign exchange to debtors will increase in similar proportion.

Finally, capital flight is a negative phenomenon which seriously limits the capacity of developing countries' to achieve economic growth and transformation. Effective policies require creative technical approaches and political integrity. Issues related to capital flight warrant more careful study. The potential costs to poor, debtor countries of ignoring this phenomenon are high. Reducing capital flight (and stimulating capital repatriation, if at all possible) represents an important means by which developing countries may extricate themselves from the current economic crisis.

APPENDIX 1

World Bank (WB)

(a) Capital Flight (CF) = (Gross capital inflows) + (current account deficit) (CAD) - (increases in official foreign reserves) ( $\Delta FR$ )

(b) Gross Capital Flows = Changes in foreign debt (public and private) ( $\Delta FD$ ) + (net foreign direct investment) (NFDI)

$$CF_t = \Delta FD_t + NFDI_t + CAD_t - \Delta FR_t \dots (1)$$

Note that for BOP accounts, increases in foreign reserves are shown with minus sign, so that Eqn. 1 becomes,

$$CF_t = \Delta FD_t + NFDI_t + CAD_t + \Delta FR_t \dots (2)$$

$$CF_{WB} = \Delta FD + NFDI + CAD + \Delta FR \dots (3)$$

Morgan Guaranty (MG)

Similar to World Bank, except that increases in short term assets of the banking system ( $\Delta FA_b$ ) are subtracted; so that

$$CF_{MG} = CF_{WB} - (\Delta FA_b) \dots (4)$$

for BOP sign convention,  $\Delta FA$  represented by minus sign, therefore multiply -  $\Delta FA$  eqn. (4) by - 1, so that

$$CF_{MG} = CF_{WB} + \Delta FA_b \dots (5)$$

Cuddington (CU)

$CF_{CU}$  is the sum of non-bank private short term capital outflows, (NBSTC) bonds/corporate equities (FBE) and 'errors and omissions' (EO). For each of these entries, asset increases are given minus signs in BOP convention:

$$CF_{CU} = -NBSTC - FBE - EO \dots (6)$$

The alternative Cuddington formulation focuses solely on 'errors and omissions'; where sign is negative, these refer to an unexplained build-up of foreign assets which Cuddington argues is a capital flight increase (i.e.  $CF > 0$ ); conversely with a negative sign,  $CF < 0$ , capital repatriation occurring.

## FOOTNOTES

1. See, for example, John T. Cuddington, Capital Flight: Estimates, Issues, and Explanations, Princeton Studies in International Finance No. 58, December, 1986; Morgan Guaranty Trust Co., "LDC Capital Flight", World Financial Markets, March 1986 pp. 13-15; Robert E. Cumby and Richard M. Levich, "On the Definition and Magnitude of Recent Capital Flight" NBER, USA Working Paper 2275, June 1987.
2. See Moshin Khan and Nadeem Ul Haq, "Foreign Borrowing and Capital Flight: A Formal Analysis", IMF Staff Papers, Vol. 32, No. 4, December 1985, pp. 602-28; David Felix and Juana Sanchez, "Capital Flight Aspect of Latin American Debt Crisis", Department of Economics, Washington University, (mimeo) 1987; Peter Kirby, "Latin America: How Capital Flight Affects Debt", IDOC Internazionale 2/87 pp. 19-21.
3. World Financial Markets, 1986
4. Felix and Sanchez, op.cit pp. 1
5. Joe Foweraker, "What's Good for Citicorp..." Challenge Vol. 29, No. 6 (Jan-Feb, 1987) pp. 47-50, has cited a guesstimate indicating that the four largest U.S. banks hold between US\$100 and US\$120 billion IPB deposits, about 70% of which is Latin American.
6. This, hopefully, is the first stage of work to be done by the author on capital flight from the Caribbean.
7. Cuddington, op.cit. pp. 2
8. Cumby and Levich, op.cit. pp. 5
9. Ibid pp. 6
10. World Bank, World Development Report 1985, Washington, D.C., 1985, pp. 64
11. See Michael P. Dooley, "Capital Flight: A Response to Differences in Financial Risks", IMF Staff Studies, 1986, Moshin & S. Khan & Nadeem Ul Haq, "Capital Flight from Developing Countries", Finance and Development Vol.24, Number 1, March 1987, pp. 2-5; and Michael Depplen and Martin Williamson, "Capital Flight Concepts, Measurement and Issues", IMF Staff Studies, 1987.
12. Khan and Ul Haq op.cit. pp.3.
13. World Bank, op.cit. pp. 64
14. Felix and Sanchez, op.cit. p. 4
15. See Cuddington, op.cit. pp. 2-5
16. Details of our approach are presented in Appendix I
17. See, for example, Cuddington, op.cit and Khan and Ul Haq op.cit