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Capital Flight as a By-product of Bad Governance and Early Warning Indicator of Political Risk

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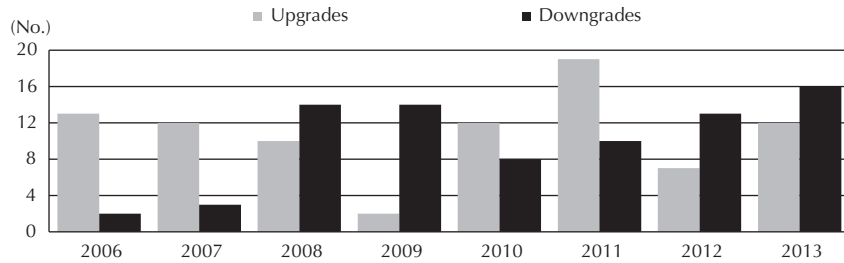
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Country risk is no longer what it used to be. It stems increasingly from all the adverse business consequences of the uncertainty surrounding a country's economic, financial and socio-political situation, not from excessive sovereign debts. As the International Monetary Fund (IMF) summarised it in the midst of the global financial crisis: "Sovereign risks have been transformed in a number of important ways as a direct consequence of the crisis and major fault lines in the financial sector. As the public sector intervened to support financial institutions, distinctions between sovereign and non-sovereign and private liabilities have been blurred, and public exposure to private risks has increased."¹

THE END OF INNOCENCE

The traditional divide between developed/emerging countries is obsolete at best, and a source of errors in country risk assessment at worst. This divide adds a conceptual myopia to the complexity of economic, financial and socio-political risk assessment. Emerging market countries with large external debt and little export diversification have been the traditional focus of country risk assessments. However, liquidity and solvency challenges have shifted northwest, towards developed countries. On average, the solvency ratios (ie, public debt to GDP) are near or above 100% for the majority of

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Figure 9.1 Fitch ratings of developed versus emerging market countries (2006–13)

Source: Fitch

Organization of Economic Cooperation and Development (OECD) countries, while many emerging market countries have boasted substantial current account surplus since the late 1990s. Latterly, such concerns have led rating agencies to shift the risk focus from emerging to developed markets, with a much larger number of downgrades concerning developed countries (see Figure 9.1).

With this shift has come a rising concern for political risk in what were historically seen as the world's most politically stable regions. Drastic adjustment measures in advanced economies have contributed to socio-political turmoil, notably in the EU. The downgrading of developed countries' credit ratings since the inception of the global crisis has in many cases been rooted in political risk. When S&P lowered the US long-term sovereign rating to AA+ from AAA in August 2011, the agency put the spotlight on political uncertainty: "The downgrade reflects our view that the effectiveness, stability and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges".²

Political risk poses a special challenge to the country risk manager. The reason is that while exchange rate variation, trade and investment flows, and GDP determinants can be modelled with econometric correlations, socio-political risk cannot be boiled down to equations – at least not at present, and not reliably. While liquidity and solvency ratios can be measured and predicted with relative ease, political stability requires an in-depth analysis of the country's socio-cultural drivers, including history, religion, ideology and, more broadly, values.

In light of these challenges, new techniques for risk assessment are

needed. This chapter therefore proposes a novel approach. When attempting to understand the complexities of country and political risk, it is perhaps most useful to turn to those who are embedded in a country's matrix of social, political and economic forces, and hence understand these forces best – that is, a country's residents. In assessing residents' behaviour, we can arrive at a new and often very different understanding of risk levels in countries. In this chapter, the tool used to assess resident's behaviour is data on capital flight. There are costs and risks associated with transferring one's money abroad. When citizens do so consistently over time and *en masse*, it is meaningful.

This chapter first presents an overview of the results of our own cross-country research regarding the determinants of capital flight. The econometric analysis suggests that ongoing capital flight is a symptom of underlying bad governance, and a "flashing light" to indicate underlying country and political risk levels that are higher than is commonly realised.

We then apply this research to several country risk cases, including southeast Asia (both historically and in the present day), the Arab Spring countries and Greece. Ongoing capital flight in these cases is an indicator of underlying risk conditions that tend to be overlooked by external analysts, and in some instances produced major politically driven crises.

THE DETERMINANTS OF CAPITAL FLIGHT

The challenge of political risk analysts is to forecast turmoil and destabilisation before discovering the impact of political crisis on the front page of newspapers. Political risk analysts will never match the volume and quality of country residents' information and economic intelligence. The former scrutinise second-hand reports, while the latter are embedded in a variety of socio-political, cultural and economic risk parameters. The former are one or a few people; the latter are numerous and thus represent the so-called "wisdom of crowds".

Ideally, country risk analysts and fund managers should identify a risk yardstick similar to that used by country residents to assess and anticipate turmoil. One such yardstick stems from country residents' portfolio choice, between domestic spending and private savings expatriation. From a private economic agent's standpoint, indeed,

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expatriated capital can be a symptom of distrust in the country's macroeconomic and socio-political stability.

Internationalisation of one's capital generally entails significant costs and risks. Capital flight (or its reverse) can be viewed as being driven by a tug of war between "centrifugal" and "centripetal" forces. The internal "centrifugal forces" of capital pushed out of national boundaries are numerous. Capital flight reacts to bad economic policies, including mismanagement of interest and exchange rates, excessive tax burden, inflation, budget deficit and an excessive public sector debt. In the political arena, capital flight responds to nationalisation threats, bad governance and corruption. One can also observe external "centripetal forces" that pull capital outside the home country, due to dynamic foreign financial systems, offshore tax havens, booming stock markets in foreign countries and positive real interest rates.

Econometric analysis has shown that private capital leakages stem from a combination of various adverse policy and political factors conducive to private savings expatriation.³ First, money laundering flees a country because of fear of being caught by the tax and judiciary authorities. Second, private expatriated savings react to price misalignment between the domestic economy and the rest of the world, such as overvalued exchange rate and negative real interest rates. Third, private capital flees a country because corruption and institutional weakness do not provide a stable and conducive socio-political environment for safe savings and profitable investment.

Capital flight will rise depending on both domestic-push and external-pull forces. Push forces include socio-political turbulences that stem from corrupt ruling elites, repressive action implemented by police and military, strikes and bribery. Pull forces are those external influences that encourage domestic residents to shift their assets overseas. Table 9.1 illustrates the political push and pull forces of private savings expatriation.

We have analysed the macroeconomic and institutional causes of private expatriated savings while highlighting the relationship between oil revenues and capital flight for a sample of 43 developing countries over the period 1984–2012.⁴ The econometric research confirms that: (i) capital flight, measured by external private bank deposits, rises in countries with high corruption and weak governance; (ii) private expatriated savings tend to be relatively larger,

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Table 9.1 “Centrifugal” and “centripetal” forces of private capital expatriation

	Internal push forces/domestic factors	External pull forces/foreign factors
Socio-political instability	Political upheaval, nationalisation, strikes, confiscation threats, capital controls, high and rising tax pressure in home country	Socio-political stability, dynamic and sustainable development process in foreign countries
Institutional weaknesses	Banking system weakness, lack of trust in national financial institutions, volatile regulatory and legal framework, deposits withdrawals in home country	Strongly capitalised global banks, dynamic offshore financial systems, tax havens, banking secrecy
Opacity and bad governance	Corruption and bribery, breach of contract, transfer and convertibility restrictions in home country	Stable regulations, conducive legal framework, strong property rights in foreign countries

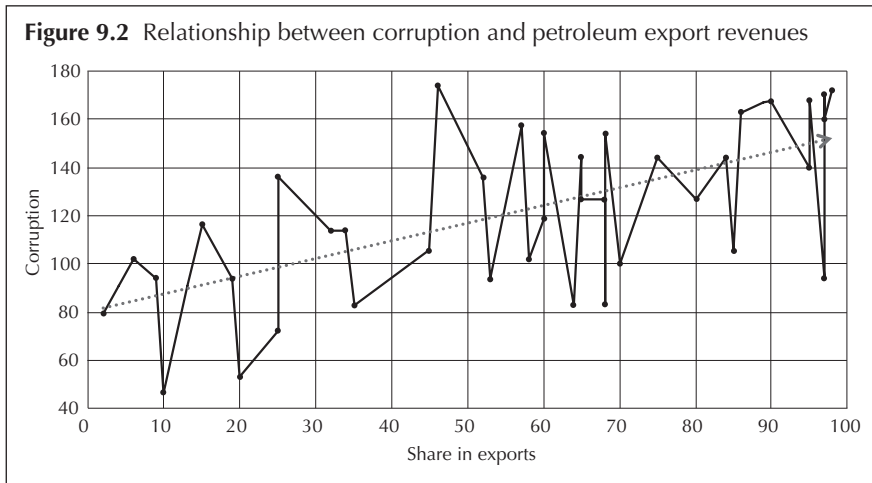
measured by ratios of GDP, in oil exporting countries; and (iii) rising capital flight tends to correlate with economic and socio-political turmoil.

Before proceeding, a further word is required on point (ii) above. With very few exceptions, notably Norway, oil-driven economic growth leads to economic and political power concentration and to weak governance. The combination of corrupt ruling elites and wealth gaps tends to discourage private investment, hence large accumulation of private deposits in international banks. Figure 9.2 casts light on the close relation between high corruption countries on the one side, and hydrocarbon and mining-driven economic growth on the other. Corruption is measured by the corruption perception index of Transparency International while the World Development indicators of the World Bank and IMF data provide the share of hydrocarbon in export revenues. These are the conditions that can drive capital flight, even when economic growth is robust or other risk indicators appear benign.

MONITORING CAPITAL FLIGHT

Risk analysts and risk managers need reliable indicators of socio-political risk levels. The statistical evidence just presented indicates

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that capital flight correlates with the political risk and governance deficiency issues of interest. The key objective then is measuring capital flight across time and across countries at a level of granularity that will enable its utility as a risk indicator.

Calculating and monitoring private capital outflows is, unfortunately, a challenging ambition. The reason for this seems evident: data, by definition, are scarce and of low quality. Investment in offshore financial and real assets boils down to a black box, as risk and return factors, among others, disguise the patterns of interest. Furthermore, measuring capital flight through portfolio and foreign direct investment statistics is clearly of little use. Although cross-country data can be obtained with international financial institutions (IFIs) such as the IMF, the World Bank and regional development banks, capital outflows tend only to measure foreign investors' risk appetite. This is precisely what should not be the focus of country risk analysts. Foreign investors usually wake up too late, once political turmoil, exchange rate volatility and inflation have taken their toll on stock markets. Shortsightedness stems from using second-hand, and sometimes outdated, economic intelligence inputs.

One fruitful source of data, however, stems from the Bank for International Settlements' (BIS) quarterly data on privately held deposits in banks by non-bank citizens outside their countries of origin. The BIS publishes both amounts outstanding as well as exchange rate-adjusted changes in private deposits. This creditor-reporting method adopts a stock approach to private capital

outflows.⁵ The working hypothesis is that a significant increase in the rate of private capital outflows leads to the accumulation of private external assets held in international banks.

Of course, these statistics omit mutual funds, private trusts, custodian accounts and money market funds that hold assets in international banks. Thus, BIS data are conservative and comprise only one form of capital leakages, hence excluding other types of investments such as real estate, art, antiques, bonds, jewels, cash outside the banking system and foreign business ventures, all difficult to trace.

However, they do provide a reliable measure of centrifugal forces that react to socio-political and economic volatility in the home country. A study by the anti-corruption group Global Financial Integrity estimated around 75% of illicit flows are deposited in banks in developed countries.⁶ Overall, the BIS data might not encompass the full scope of capital flight, but they provide a meaningful measure of centrifugal forces.

CASE STUDIES OF THE RELATIONSHIPS BETWEEN CORRUPTION, SOCIO-POLITICAL VOLATILITY AND CAPITAL FLIGHT MEASURED BY EXTERNAL PRIVATE DEPOSITS IN INTERNATIONAL BANKS

The cases of Thailand, Malaysia and South Korea

The three Asian tigers share many similarities, including export-driven economic growth, large inflows of foreign direct investments (FDI) and strong solvency ratios with moderate level of public debt. However, of the three countries, Thailand exhibits much higher-level corruption and much larger political instability, despite the stabilising role of ageing King Bhumibol Adulyadej, who has headed Thailand's constitutional monarchy since 1946. South Korea and Malaysia are ranked 43 and 50, respectively, by the 2014 corruption perception index of Transparency International, while Thailand's ranking is 85, below India and the Philippines. Thailand is also no stranger to political crisis: the southeast Asian country has a history of political instability, with over 20 prime ministers since a new constitution came into being in 1946, while cumulating 19 military coups.

One of the root causes of Thailand's economic and political instability has been encapsulated by the term "crony capitalism".⁷

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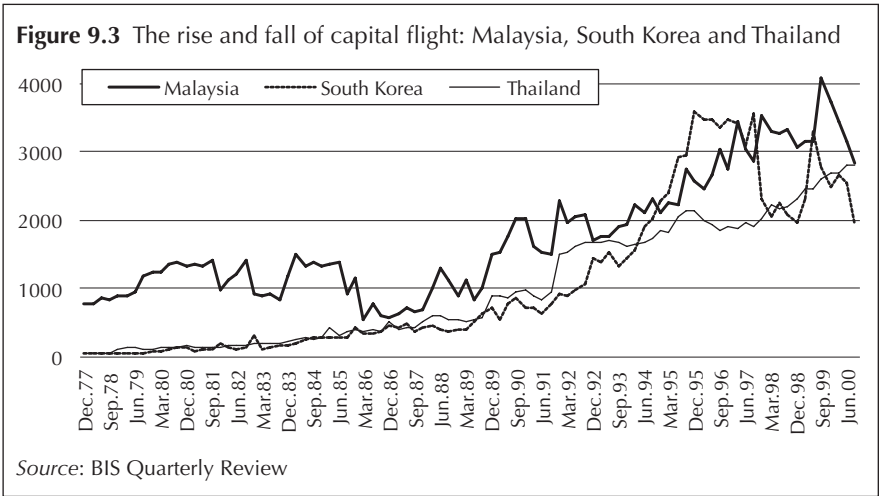
Government intervention leads to overwhelming, corrupt rent-seeking behaviour, hence introducing politically connected privileges, market distortions, moral hazard and savings disincentives. The result is that private capital flees the home country in anticipation of exchange rate crisis and political upheaval. Overall, Thailand's instability has resulted in substantial expatriation of private savings since the regional crisis of the late 1990s.

One can illustrate the outflow of private capital in each of the three countries by looking at two periods, namely 1977–99 and 2000–14. The first period corresponds to economic overheating and weak governance that ended with the so-called Asian crisis. The debt crisis erupted with the 20% baht devaluation in the summer of 1997 and quickly spread throughout Asia, before triggering a spill-over effect that had an impact on the entire asset class in emerging markets countries.

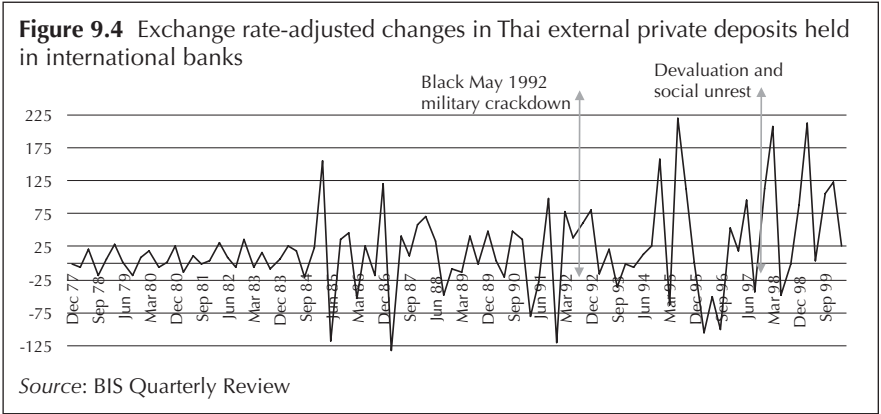
In Thailand, capital flight provides an early warning of a three-fold crisis combining real estate, stock market and banking credit bubbles in an environment of rising current account deficits and deeply rooted corruption. A surge in capital flight from Thailand appeared as early as 1995, and resulted from lower growth, falling world demand and real estate sector contraction. Thus, this capital flight reflected underlying risk conditions, largely unobserved by outside analysts, which eventually contributed to an acute crisis. Capital flight then kept increasing in the wake of the baht devaluation. In particular, the year 1998 epitomised the depth of the economic recession with an 11% drop in GDP. Moreover, manufacturing production shrank by more than 9% in 1998, while domestic interest rates reached 20%, stock market capitalisation fell from 91% of GDP in 1994 to only 25% in 1998, imports declined by 36% and the debt-servicing ratio rose from 11% in 1994–95 to 21% in 1998.⁸

In Malaysia and South Korea, capital flight rose sharply during the period 1995–99, also providing indicators of underlying risks and thus early warning of crisis. However, in contrast to Thailand, capital flight then fell in these two countries due to strong IMF-monitored adjustment programmes and a return of foreign direct investment flows in response to sound macroeconomic policies and improved governance. Figure 9.3 illustrates the different trajectories of capital flight on the eve of the Asian crisis in Thailand, Malaysia and South Korea.

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One can get a still clearer focus on the relationship between expatriated private deposits and socio-political volatility in Thailand by looking at exchange rate-adjusted changes in capital flight. Figure 9.4 demonstrates the sharp increase in private deposits held in banks overseas during the turbulences of 1991–92, including the “bloody May” 1992 military crackdown on social uprising, as well as in the spring and summer of 1997, when the economic and financial crisis combined with large social unrest that continued during 1998. The 1995 surge in capital flight is apparent. The ratio of private bank deposits to bank loans rose to 22% at end-1998 from only 13% at end-1996.



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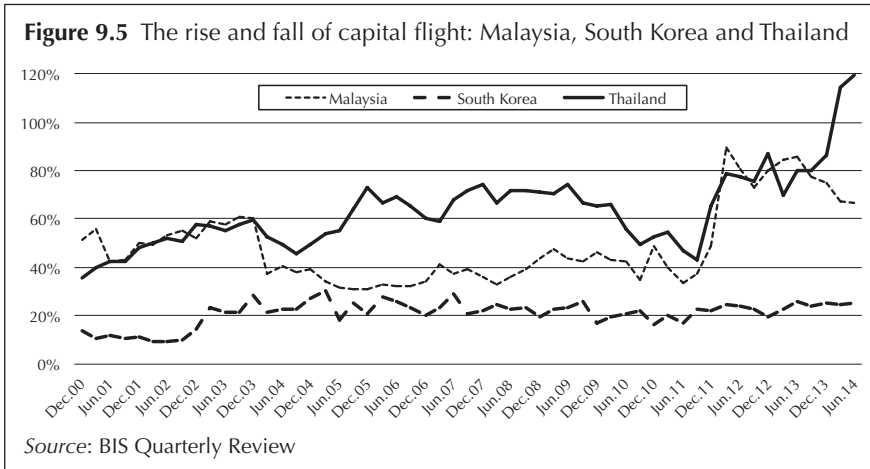
During the later period of 2000–14, one can observe trajectories between Thailand on the one side, and Malaysia and South Korea on the other, which are even more divergent. Thailand's socio-political situation kept deteriorating during the 2000 decade, and has worsened since then. Anti-government protests were recurrent since the 2006 military coup that ousted Thaksin Shinawatra, a tycoon and former prime minister, who left for self-imposed exile after being sentenced to prison for corruption. Since 2011, the combination of devastating floods and ongoing political destabilisation worsened the economic situation, with declining growth, worsening fiscal accounts, sharp decline in export growth rate and depreciating exchange rate. Capital flight started rising sharply from US\$7.5 billion at end-2010 to US\$12.3 billion at end-2012. In the spring of 2014, the Thai army declared martial law, suspended the 2007 constitution and launched a new coup in a bid to end the violent conflict between government supporters and opposition forces with the establishment of a military junta.

Between December 2011 and March 2014, Thai private external deposits in overseas banks rose by 116%, reaching more than US\$22 billion, equivalent to nearly 6% of GDP and twice as much as bank loans to the country. During the same period, the ratio of private bank deposits overseas to private bank loans rose to 114% from 65%, according to BIS data. Between only October 2013 and March 2014, US\$7 billion left the country toward international banking accounts. In conclusion, the January 2014 state of emergency that suspended constitutional and democratic rights led the Thai population to vote by expatriating their private savings.

In contrast, Malaysia and South Korea exemplify much more stable and lower levels of capital flight, equivalent to 4% and 1% of GDP, respectively, in 2014. Figure 9.5 illustrates the divergent levels of capital flight between Thailand on the one hand, and Malaysia and South Korea on the other, during the 2000–14 period. Private deposits in international banks are presented as ratios of bank loans.

The divergent trajectories of Korea, Malaysia and Thailand are striking. During the 2000s, the three countries become more competitive, market-driven and investor-friendly. Much of this growth stemmed from the private sector. Consequently, Korea and Malaysia's economies remained resilient during the period, mainly because of a rapid expansion of domestic demand and of buoyant

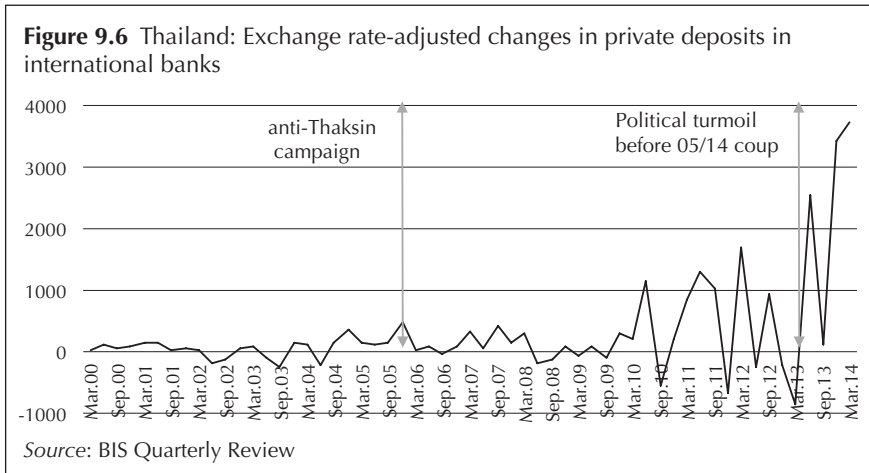
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and diversified exports. However, from the inception of the global financial crisis, Korea was the only country of the trio that managed to stabilise expatriated private deposits at a level of roughly US\$11 billion, or the equivalent of 20% of bank loans, during the 2008–14 period. In Malaysia and Thailand, the combination of shrinking foreign bank exposure and socio-political volatility led to a sharp rise in the ratio of expatriated private deposits to bank loans, which reached 80% for the two countries. Socio-political turbulences in Malaysia exerted push forces on private capital outflows. The government's authoritarian policies lead to social unrest in 2011–12; in July 2011, police forces cracked down on a demonstration (the “Bersih 2.0 rally”) organised by the Coalition for Clean and Fair Elections, in Kuala Lumpur. More than 1,600 people were arrested. The following year, police forces again cracked down on a demonstration (the “Bersih 3.0 rally”), with massive arrests while the government rejected demands for effective electoral reforms. It was only in 2013–14 that socio-political stabilisation returned to Malaysia, with a sharp decline in expatriated private deposits.

Whereas capital flight has remained stable in Korea and decreased in Malaysia since 2011, the expatriation of Thai private savings under the form of external deposits in banks overseas accelerated sharply on the eve of the military coup of spring 2014. Figure 9.6 shows the volatility of Thai private deposits, with abrupt rises during the social unrest of 2005 and during the political turmoil that preceded the military coup of May 2014.

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The case of Vietnam

Vietnam is a case study of economic overheating. The country is the archetype of a dynamic emerging country that has faced inflation, overvalued exchange rate, weak banking system and twin deficits – ie, both fiscal and balance of payments. Vietnam, a country whose GDP per capita has reached US\$5,000 with a widening wealth gap, has been in overheating mode since the early 1990s, with GDP growth rates averaging 8% until the global crisis, and 5% since then. The acceleration in Vietnam’s inflation, particularly since 2005, led to a real effective appreciation of the dong that the central bank did not tackle until 2011 – ie, too late to enhance the competitiveness of the country and stem capital leakages. In addition, the stock market crisis starting in the second half of 2007 stimulated “push forces”.

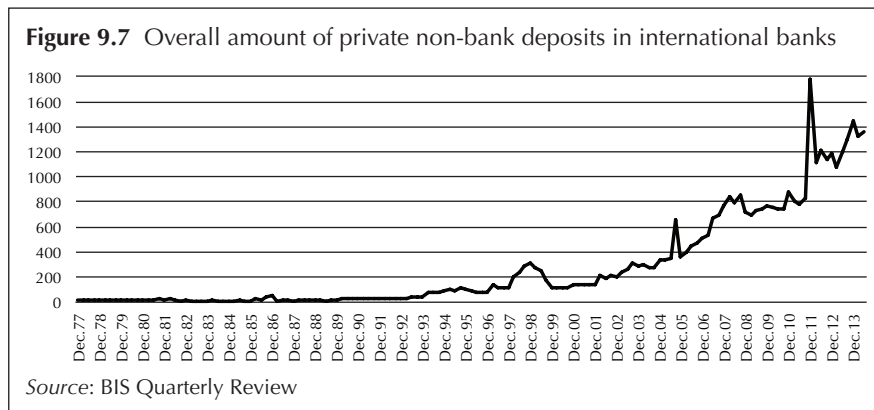
Corruption is also a deeply rooted problem in Vietnam, with no sign of improvement. The corruption perception index of Transparency International gives Vietnam a consistently low ranking since the inception of the ranking, and of 119 in 2014, similar to that of Sierra Leone and Mozambique, among a total of 180 countries. As the non-governmental organisation (NGO) highlighted: “The global financial crisis and political transformation in many Asian countries exposed fundamental weaknesses in both the financial and political systems and demonstrated the failures in policy, regulations, oversight, and enforcement mechanisms”.⁹ The World Bank’s governance indicators show no sign of progress of Vietnam in the two key domains of “voice and accountability” and “control of

corruption".¹⁰ Regarding the "doing business" rating of the World Bank, Vietnam's rank was only 99 in 2014, around the same as Zambia and Kosovo. Regarding COFACE's Business Climate rating of only C, similar to Uganda and Albania, the rating agency considers that "governance remains Vietnam's Achilles heel and is a risk in terms of its appeal to foreign investors. The main shortcomings concern respect for the law and corruption, which, despite the reforms undertaken, remains widespread".¹¹ The WEF's global competitiveness index ranked Vietnam only 68 out of 144 countries, well below the Philippines, Indonesia and Thailand.¹²

In such a weak governance environment, the combination of unabated inflation, negative real interest rates and overvalued exchange rates has led to growing expatriated savings, shown by a 50% rise in 2011. The ratio of external private deposits to bank loans shot up to 19%. A decline in capital flight did not occur before end-2012, when tighter monetary policy and a more competitive exchange rate induced private agents to repatriate their savings at home. The ratio of private deposits/bank loans declined to roughly 10% in 2012–13, and to only 8.5% in Q2 2014.

Figure 9.7 presents the evolution of Vietnam's private deposits in international banks over the period 1992–2014. One can observe expatriated private savings climbing to US\$1,800 million at end-2011 from US\$500 million at end-2006. Overall, despite a later dip, the dramatic rising trend is suggestive of an unobserved country risk element that may, over time, become more clear.

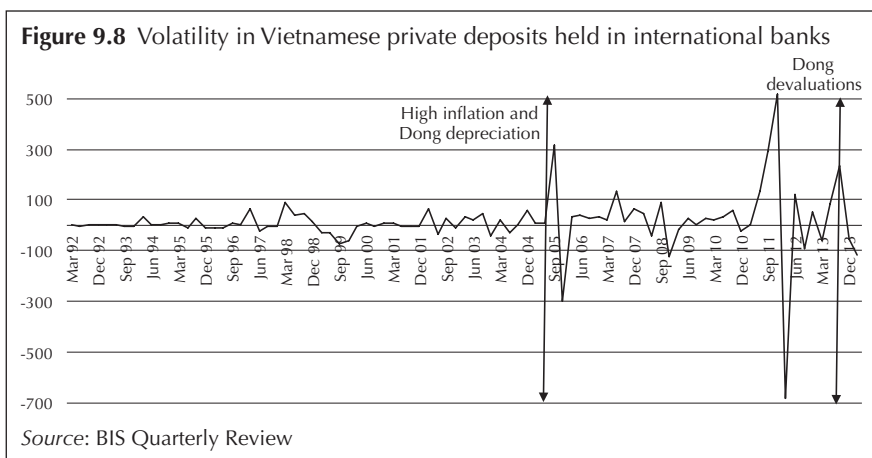
While the overall trend towards greater capital flight is obvious,



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there have been particular surges that need to be examined. These appear to correspond to devaluations of the Vietnamese currency. A traditional analysis of the country's macroeconomic parameters in the mid-2000s would have concluded that the country faced tighter but sustainable liquidity situation. Indeed, growing balance of payment deficits were being financed by large FDIs and international bank lending. The looming risk of twin real estate and stock market bubbles did not cut Vietnam off from global capital markets.

However, the global financial crisis of late 2008 further exacerbated imbalances in the Vietnamese economy. The ongoing macroeconomic problems of trade deficit and inflation put Vietnam in a critical position. In order to reduce the deficit and keep inflation under control, Vietnam resorted to devaluation of the dong. The State Bank of Vietnam (SBV) undertook a series of devaluations between 2008 and 2014. However, stubborn inflationary expectations and concerns about further devaluation intensified dollarisation pressures, leading to a self-fulfilling dong depreciation spiral, and to capital flight. Six devaluations took place between 2009 and 2011 in a vicious circle of imported inflation, hoarding of gold and dollar assets, and capital flight. Figure 9.8 illustrates the volatility of private deposits in international banks, ahead of rising domestic prices and continued depreciation of the domestic currency.

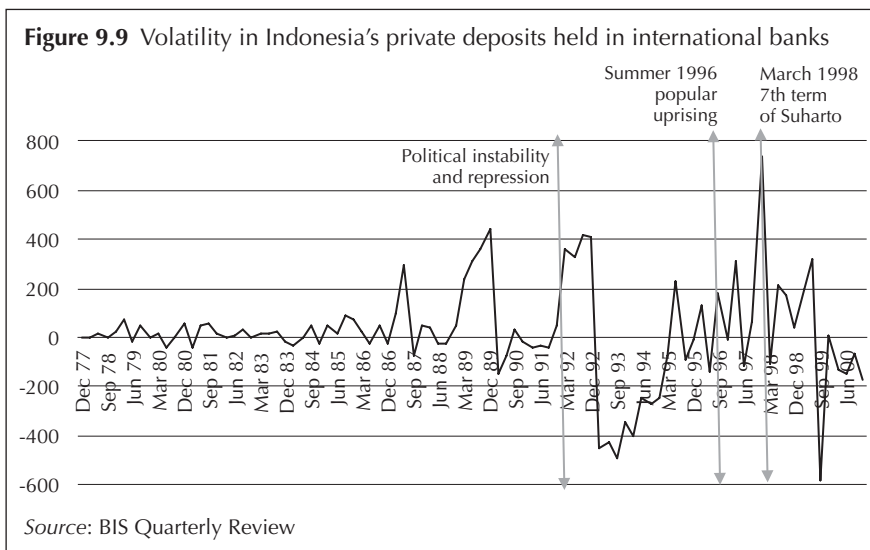


The case of Indonesia

In Indonesia, the 1977–2000 period was characterised by the strong rule of General Suharto, who has been in continuous political command of Indonesia for more than 30 years until 1998 – ie, the longest period of one-man rule in modern southeast Asian history. Nepotism and corruption were two faces of the military regime that crushed anti-government unrest and separatist struggles across the archipelago. Social and regional inequalities, coupled with the spill-over effect of the Asian crisis, resulted in mounting social unrest and repression in the late 1990s. Suharto abruptly resigned in May 1998, just two months after he had been re-elected for a seventh term by the country's rubber-stamp parliament.

Capital flight reflects these mounting push factors, as well as anticipating severe political and economic crises. Capital flight hit a record high of US\$750 million in the quarter preceding the dictators' re-election. Figure 9.9 casts light on the volatility of expatriated private savings in tune with Indonesia's cycles of economic expansion and political repression until the aftermath of the Asian regional crisis.

Latterly, compared to most Asian countries, Indonesia's oil-driven growth has not been greatly affected by the global crisis of 2008. The country managed to maintain GDP growth rates at around 5%



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between 2008 and 2014, thanks to large foreign direct investment inflows. Its solvency has remained strong, with an external debt to GDP ratio of 33%. The country's corruption index is similar to that of Vietnam and Thailand, although with a worse business conditions index – ranking 120 out of 189 countries due to a weak regulatory framework for enforcing contracts and resolving insolvency.¹³

The political situation has also stabilised since the riots of late 1990s, in the framework of a presidential representative democratic republic with a multi-party system. Pluralistic and competitive parliamentary and local elections in 1999, 2004 and 2012 underscored the gradual normalisation in Indonesia after decades of authoritarian rule. Political reforms such as the decentralisation of political power to regional and provincial leaders have fostered even greater political and popular participation in the country's growth.

The result has been relatively stable external private bank deposits, reaching a total of roughly US\$5 billion between 2007 and 2014. However, deteriorating business conditions, persistent corruption and the terrorist bombing in Bali and the capital Jakarta created large volatility between 2002 and 2009 in outflows of private savings to international banking accounts. These levels of capital expatriation suggest an ongoing significant element of risk (see Figure 9.10).

The cases of Tunisia, Morocco, Algeria and Egypt

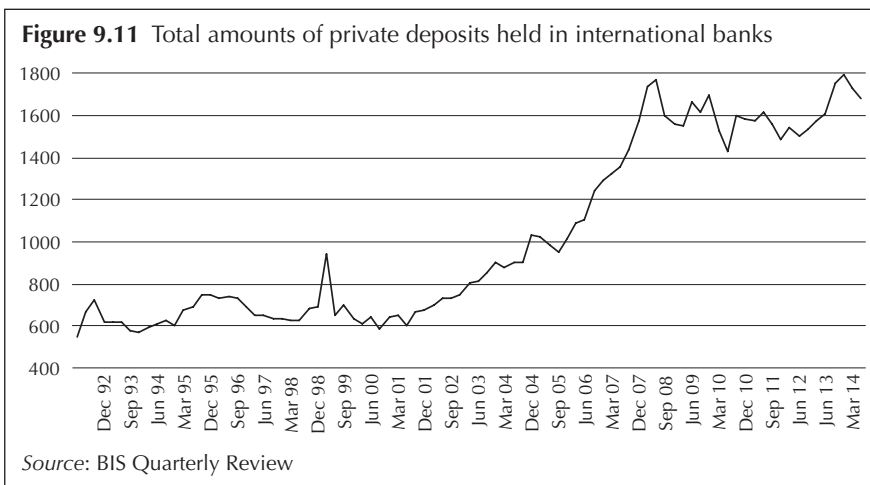
The Arab Spring revolution was a typical example of abrupt political upheaval. The challenge, however, is how to anticipate such a major political shock. All these four countries share large corruption, poor

competitiveness and low economic freedom, although business conditions are better in Tunisia given trade and investment openness that both Presidents Bourguiba and Ben Ali have maintained since the 1960s.

The dramatic departure of Ben Ali in December 2010 in the middle of a widespread popular uprising was a surprise for those who had focused on Tunisia's dynamic economic growth rate while ignoring the mounting social discontent due to endemic corruption and wealth concentration, and was hence a typical case of crony capitalism. In Tunisia, a higher index of human development than Morocco, Egypt or Algeria has created an explosive combination of high education rate with very weak governance and strong repression. The resulting "pressure cooker situation" has triggered centrifugal forces leading to brain drain, illegal immigration and capital flight.

On the eve of the revolution, expatriated private savings rose by 12% between June and September 2010, to reach US\$1.6 billion. At that time, the ratio of external private deposits to bank loans reached a peak of 80% (see Figure 9.11). The sharp depreciation of the dinar throughout 2013–14 reinforced the push forces of political volatility that stemmed from the tension between Islamist and reformist political groups in Tunisia ahead of uncertain parliamentary elections in October 2014.

The volatility of expatriated private savings in Tunisia due to



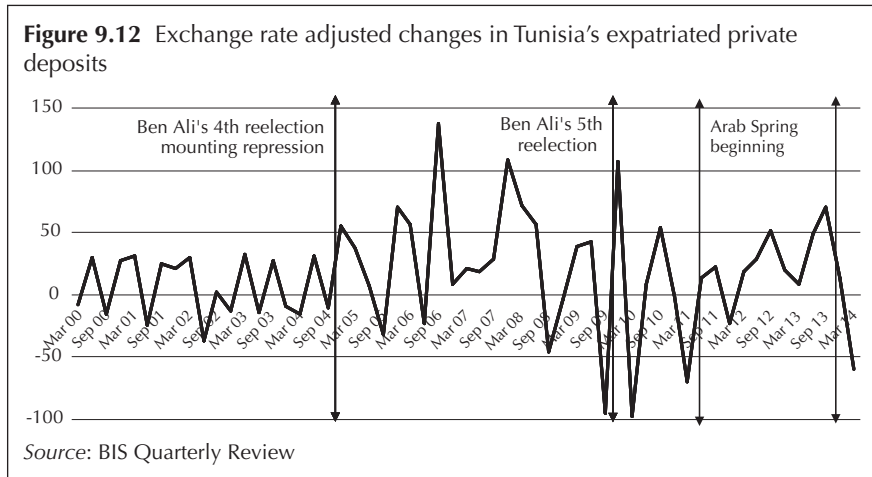
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exchange rate-adjusted changes in private deposits held in international banks is demonstrated in Figure 9.12. Private deposits increased ahead of each of Ben Ali's numerous re-elections until the inception of the Arab Spring revolution, reflecting an underlying level of political risk that should have been noted. The period since 2005 appears to represent the "danger zone" that eventually culminated in a dramatic political upheaval.

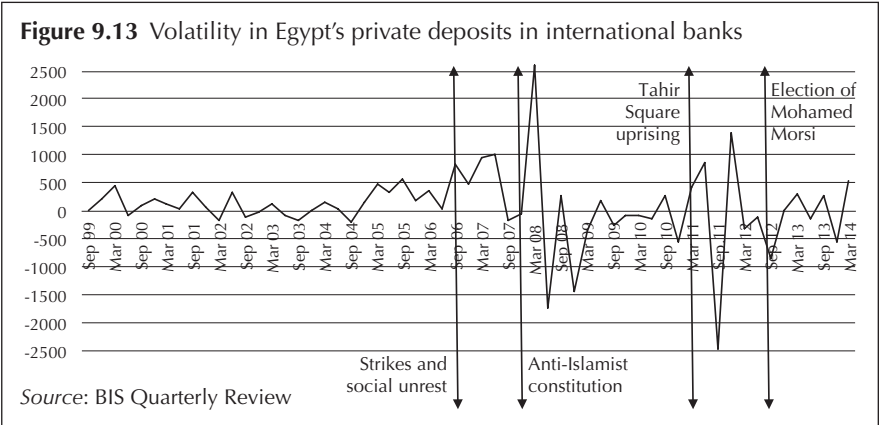
More hopefully, a sharp decrease appeared as economic and political situation normalised when a technocratic prime minister took over the government in early 2014, leading to a sharp decrease in private bank deposits in foreign banks in the first semester of the year.

The situation is even more striking in Egypt, a country with low literacy rate, high gender inequality, large wealth concentration and average life expectancy of less than 60 years, all reflected in an index of human development of 110, worse than that of Mongolia. Egypt's popular uprising, which began on January 25, 2011, led to the overthrow of President Hosni Mubarak and a military coup in July 2013. There was a surge in capital flight just before the uprising.

This protracted revolution also triggered a further explosive capital flight that reached US\$13 billion in December 2011, equivalent to 200% of bank loans and 5.5% of GDP. In the last quarter of 2011, expatriated private deposits rose by 11%, up more than US\$1.4 billion from the previous quarter, to reach US\$13 billion. For those

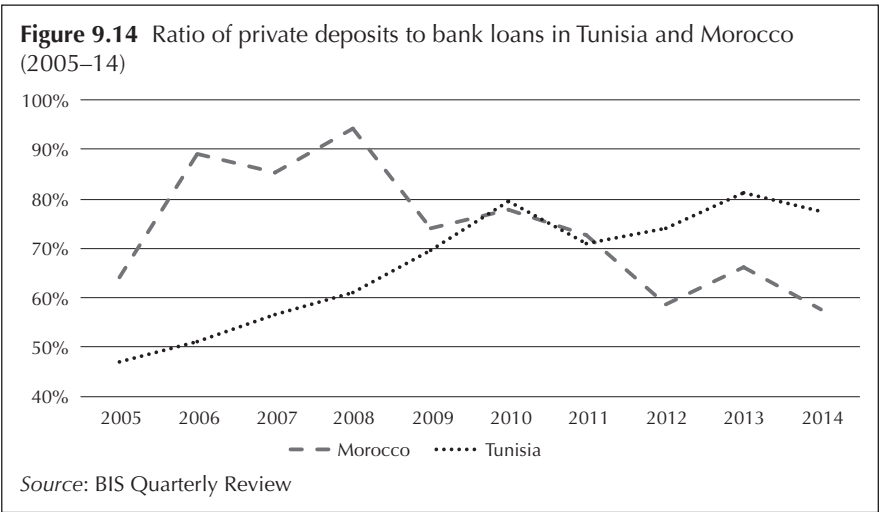


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hopeful regarding Egypt's post-Arab Spring prospects, these data are ominous, and suggest high risks associated with transition. Figure 9.13 sheds light on the volatility in private deposits held in banks at times of social unrest and political repression.

The situation appeared different in Morocco, where the monarchy has provided a cultural and identity anchor, helping to stabilise the country with a modest dose of political freedom in the period 2011–14. The monarchy instituted constitutional reforms in the wake of the Arab Spring, deferring more of its power over political, economic and security affairs to a new ruling coalition headed by a moderate



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Islamist party. In addition, the government boosted public spending and subsidies, creating jobs and increasing public sector salaries, hence a ballooning budget deficit of 6.7% of GDP in 2011 and 7.4% in 2012.

Consequently, Moroccans' external private deposits in foreign banks did not rise much during the Arab Spring. Actually, given the ongoing access to capital markets, the ratio of deposits/bank loans declined to 58% in 2014 from 78% in 2010, compared with a rise to 78% from 65% in Tunisia. One can observe the crossing of the two curves between Tunisia and Morocco in the midst of the Arab Spring in 2011.

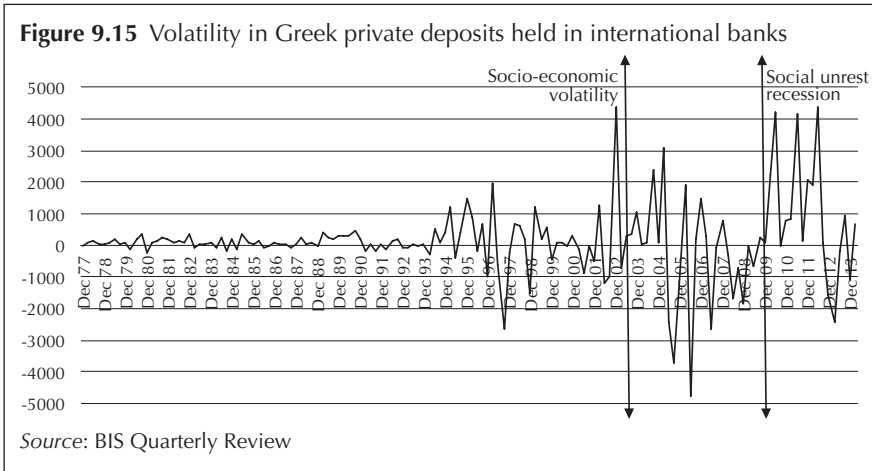
The case of Greece

Capital flight serves as an indicator of underlying risk, not only in emerging markets but also in advanced economies. To illustrate this point, consider the case of Greece. Sociopolitical unrest erupted in the country after the short lag that followed the beginning of the global financial crisis in 2008. The crisis hit Greece particularly hard, as the legacy of large structural deficits and widespread tax evasion, combined with the credit crunch and the resulting recession, to leave the country with a crippling debt burden. In 2010–11, amid fears of imminent insolvency and of the debt contagion spreading to other EU countries, Greece received a large bail-out programme totalling €250 billion under the scrutiny of the so-called troika: the IMF, the European Central Bank (ECB) and the European Commission. Belt-tightening was the condition for the financing rescue operation. Six straight years of recession since 2008 shrunk the economy by about a quarter of its previous size and drove purchasing power cuts and unemployment to record levels.

Push and pull forces of capital flight were at work. On the one hand, wealthy entrepreneurs moved their assets overseas into offshore centres and tax havens. On the other hand, austerity measures and the credit crunch forced households to repatriate private savings at home. Hence, very volatile deposits were held in international banks.

Well before the crisis began, capital flight suggested a worrying situation for Greece. Then, starting in 2012, the combination of rising private deposits in banks overseas coupled with shrinking bank exposure to the private sector increased the deposits-to-loans ratio to

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68% in September 2012, from only 28% a year before. In other words, at the time of the negotiation of massive bilateral and multilateral financing to Greece's government, Greek private agents shifted their assets abroad, to the tune of US\$32 billion.

CONCLUSION

This chapter has discussed the close correlation between corruption and private savings' expatriation. It focused on a reliable and updated yardstick to measure capital flight using the stock and flows of non-bank private deposits held in international banks. This measure of capital flight omits a wide range of non-financial assets, such as real estate. It can also include "legitimate deposits" under the form of working capital balances of private companies. However, data provided by BIS provide a reliable flow of data that can be used for cross-country comparisons across time. The chapter also observed the close correlation between capital flight and bad governance and high corruption, particularly in hydrocarbon-driven economic growth, which is conducive to wealth concentration and repressive ruling elites. The analysis concluded that capital flight can be a useful early warning signal of socio-political turmoil. Mounting capital flight is a symptom of underlying bad governance and a "warning light" for anticipating political risk.

1 IMF, 2011, "Definition and Measurement of Sovereign Risk Need to be Broadened", Roundtable, Press Release No. 11/91, Washington, D.C., March 18.

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- 3 For a review of the literature, see M. H. Bouchet and B. Gros Lambert, 2006, *ESAN Cuadernos de Investigación*, 11(20), June.
- 4 M. H. Bouchet, R. Feki and O. Kharrat, 2014, "The Root Causes of Capital Flight: Governance, Oil Rent and Macroeconomic Variables", SKEMA-ESC Sfax, working paper, summer.
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- 10 See http://info.worldbank.org/governance/wgi/sc_chart.asp.
- 11 See <http://www.coface.com/Economic-Studies-and-Country-Risks/Viet-Nam>.
- 12 WEF annual competitiveness report (available at http://www3.weforum.org/docs/GCR2014-15/GCR_Rankings_2014-2015.pdf).
- 13 See <http://www.doingbusiness.org/rankings>.