

## **THE PRICE OF OFFSHORE REVISITED**

### **APPENDIX II**

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### **EXPLAINING CAPITAL FLIGHT**

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When it first became evident in the late 1980s that a vast amount of flight capital was pouring out of the developing world, economists began to propose a variety of explanations for it. Most of these were “micro-economic” in the sense that they emphasized the rational behavior of utility-maximizing individuals, confronted with a given set of alternative investment vehicles offering different rates of return and patterns of risk, as well as given exchange rates, tax rates, and transactions costs.

In our view, as noted in Chapter One, these “explanations,” while helpful, overlook much of what is most interesting and most in need of explanation – namely, the fact that from a standing start, capital flight took off in so many different developing countries at roughly the same period. If we are interested in capital flight from the standpoint of its impact on developing countries as a whole, this suggests that we need to examine more macro-economic factors.

The following provides a brief overview and critique of each of the main microeconomic explanations that have been proposed. They are not mutually exclusive -- the real dispute is over which ones mattered most, and how they might be supplemented by macro-economic explanations.

#### **Portfolio Diversification**

One very popular explanation for capital flight in the finance and economics literature emphasizes the role of “portfolio diversification” -- the notion that rational international investors may be able to reduce the riskiness of their investment portfolios by acquiring foreign assets.<sup>1</sup> A related fact is that to this day, there are still not very many publicly-traded, internationally-diversified Third World multinationals. So if Third World residents want to diversify, they can’t usually do so by investing in local companies.<sup>2</sup>

Of course if diversification were really what Third World investors were after, in hindsight many did a rather poor job of it, since so much of their money disappeared into worthless Texas banks, Miami condos, low-yield CDs, and failed Internet venture funds. But poor ex post investment results, no matter how bad, don’t necessarily refute the possibility that, ex ante, diversification is a key motivation.

Even apart from disappointed expectations, however, the portfolio diversification story alone is a prime example of what C. Wright Mills once called “abstract empiricism.” It has trouble explaining even the most basic historical patterns in flight flows -- for example, why there was relatively little capital flight in the 1960s, a tremendous increase in the 1970s and 1980s, and a continued steady growth of offshore investments since then.

After all, Third World portfolios were at least as undiversified in the 1950s and 1960s, but there was no flight surge then. To explain these patterns according to the diversification theory alone, we’d have to posit a sudden shift in perceived risks or the degree of investor risk-aversion. Diversification theory alone doesn’t help us to explain such shifts.

Another basic problem is that if portfolio diversification alone were the key to flight, we might have expected to see much more investment by Third World flight capitalists *in other Third World countries*. For example, it turns out that, given the pattern of portfolio returns, Venezuelan investors could have achieved much better diversification in the 1980s by investing in Brazilian, Colombian or Mexican securities; Mexicans could have done better by investing in Brazilian assets; and First World investors could actually have done better by investing in Third World securities. (See Figure A1-1.)<sup>3</sup> In other words, Americans should have considered Brazilian or Colombian stocks, while Swiss investors should have considered Colombian, Mexican, and Venezuelan deposits. Indeed, Swiss investors might well have been better off investing in *Philippines* assets -- a prospect that Marcos’ Swiss bankers might find amusing.

In practice, of course, many of these ex post diversification opportunities were either completely unexpected, or they were impractical all along because of legal barriers and “transactions costs” – in layman’s terms, because that Third World markets lacked the First World’s mercenary army of private bankers, scouring the earth for funds and clients.

But that is precisely our point: without such institutional factors, we can’t account for the actual global patterns of capital flight. This is also a hopeful message: if we make it easier to invest in developing countries, more and more flight money should return home, remain there, or at least be replaced by First World investment. Indeed, countries like China, Russia and Mexico are already witnessing the repatriation of much flight wealth.

## **Intermediation**

A slightly-more sophisticated explanation for capital flight, *intermediation*, emphasizes the idea that Third World elites are more comfortable investing in their own countries *by way of* First World banks and other intermediaries.<sup>4</sup> Unlike the diversification story, this one at least acknowledges that debt and flight often flowed right by each other, in and out of the same country.

But the intermediation story has other problems. First, at least a third of all flight went into assets like real estate, securities, and cash that could not easily be in-

termediated. And while major US and Swiss banks did lend and borrow to the same country at the same time, others (such as Japanese and smaller U.S. banks) collected very little flight capital. Intermediation alone can't explain why a handful of the major global banks ended up with such a large share of flight, or why the flight boom occurred when it did, unless we assume that investors suddenly all discovered this intermediation gambit at the same time. Finally, of course, even investments that are channeled through First World banks are not risk-free -- especially those in global banks that had heavy Third World portfolios.

## Speculation

A third explanation, financial *speculation*, focuses on investor expectations about exchange rates and relative returns on investment. The notion is that flight surges when investors expect increased (real after-tax) returns on foreign investments relative to domestic investments, because of expected-but-not-yet-fully-priced devaluations or "uncovered" changes in interest rates and tax rates.<sup>5</sup>

More broadly, this explanation explains capital flight in terms of country policy errors -- for example, overvalued exchange rates. First World bankers and economists are especially drawn to it, because it emphasizes misbehavior by government officials rather than their own. And, indeed, policy errors like overvaluation -- plus the opportunities they created for trading on inside information -- have indeed often been associated with increased capital flight.<sup>6</sup>

However, the speculation theory also has many shortcomings. It can't explain why the very same policy errors were committed again and again all over the developing world. It has no explanation for debt-flight counter-flows: if investors in developing countries really expect foreign yields to exceed domestic yields, it is hard to explain so much foreign borrowing by their own countries. But if they expected *lower* foreign yields it is hard to explain foreign investment. To account for simultaneous borrowing and investment, we need at least two different sectors, or classes of investors, that are behaving differently, with most of the borrowing being done by deficit-ridden governments and the flight handled by nervous private elites, under the spell of professionally-pessimistic private bankers.

Like the pure diversification and intermediation stories, the speculation story also fails to take account of differential taxation of offshore capital -- the outright of evasion of income taxes, and the huge subsidies that are often available to foreign investors. If we bring in the notion of "inside information" on critical events like devaluations, the speculation theory can be improved, because there is evidence that huge windfall profits have been reaped by Third World insiders on such events. (See Figure A1-2) That might also help to explain the long-standing preference for fixed exchange rates in small countries. Overall, however, the speculation story works best for the (relatively-small) share of flight that is "hot money," constantly on the move across borders.<sup>7</sup>

## The Need for a Broader Theory

As noted, all of these focused on the behavior of individual investors. The problem is not that these explanations are “wrong,” but that they are incomplete. They don’t account for the aggregate flight patterns described earlier. They also imply that capital flight was “efficient,” and fail to address the social costs of capital flight.

From a microeconomic perspective, of course, flight capital is always “efficient” in an almost tautological sense -- it leaves those who engage in it better off, at least on an expected returns bases, without necessarily hurting anyone else. Some neoliberal economists have even argued that financial and “human capital” flight are also efficient at the macro level, because they reallocate capital to more profitable offshore uses, protecting it for future repatriation and securing higher incomes and growth for source countries in the long run.

It is interesting to compare this Panglossian view of capital flight with the traditional development economics’ “scarce savings” story about the benefits of foreign investment. It was supposed to supply not only raw capital to “capital-short” countries, but also technology and managerial skills.<sup>8</sup> Neoclassical economists may be trying to have it both ways, with the benefits of supplying capital and skills to the developing world depending on who the owners are.

In our view, both of these conflicting perspectives on the social benefits of capital flight ignore crucial real-world influences like crises, tax evasion, regulatory corruption, and economies of scale. These factors drive a substantial wedge between private and social profitability. They make it impossible for developing countries to simply defer to investment decisions by private investors, whether their own citizens, foreign and domestic migrants, or foreign investors. There may indeed be an “optimum” level of capital flight and emigration, but it is unlikely to be anywhere near as high as the levels described in this Chapter.

To explain the global historical record, then, we need a much broader theory, one that explains why capital flight became so prevalent across multiple countries at once, why it affected some developing countries much more than others, and why specific offshore havens and global banks received such a disproportionate share of the outflows. The microeconomic theories of investment have a role to play, but the real stage was set at the macro level.

### **A. Debt-Based Flight**

The empirical evidence described in Chapter One strongly supports the thesis that one critical contributor to the initial Third World capital flight boom the 1980s was .....the debt itself. In other words, there are many causal linkages between the flight boom and excessive foreign borrowing.<sup>9</sup>

In this view, the mismanagement of Third World lending disrupted the pattern of international portfolio returns during the 1970s and early 1980s. Overborrowing not only lowered expected private returns and increased the expected variability of returns for heavy borrowers and their trading partners. It also exposed developing countries to “contagion” effects, because so many of them because heavily indebted at once. Finally, overborrowing also provided enormous opportunities for private, dollar-denominated enrichment, plus powerful incentives to hide newly privatized wealth abroad before the doors closed.

This was hardly a case, as some economists have suggested, of “productive” inflows of foreign capital merely substituting for domestic outflows, a natural byproduct of portfolio diversification and open capital markets.

Nor was it a matter of foreign banks and other foreign investors merely “standing in” for domestic investors, as suggested by the intermediation theory.

In the case of debt-led flight, a vast amount of lousy lending – privately profitable for the lenders, selected government officials and contractors, but not socially profitable for the countries -- led the way, laying the foundations for a huge private capital exodus.<sup>10</sup>

In a nutshell, the upsurge of irresponsible lending after 1973 destabilized many countries, while greatly expanding corruption. A greatly-expanded global private banking network followed along quickly in the path of this debt boom, enabling Third World elites to move their own money offshore, and also abscond with hundreds of billions in diverted loans, illicit commissions, and corrupt privatizations. Most of the proceeds were parked in First World havens, where they earned tax-free returns for their “non-resident,” frequent-flying owners, creating a disincentive for them to repatriate the funds. All this succeeded in making the entire Third World a much riskier place to invest. And that, in turn, helped to stimulate even more capital flight on an unprecedented scale.

All this is not to deny that factors like portfolio diversification, intermediation, policy errors, and speculation played a role on the ground, for many individual investors, banks, and corporations. But these were surface phenomena -- the critical discontinuity in the global system as a whole was the *overlending*, the increased supply of country loans in the 1970s that, in turn, fed flight through many channels, by:

- Financing *a huge increase in outright corruption* in developing countries -- debt-funded commissions, kickbacks, and overpricing were rampant.<sup>11</sup>
- *Fostering the growth of the new, highly-efficient haven network* for moving money out of the Third World. In this regard it is important to note that all the leading offshore havens started out in life as international lending centers.
- *Increasing the perceived risk of investing in debtor countries*, the perception that countries were overborrowing in the sense that they couldn’t absorb all the loans and still earn positive returns. By the early 1980s this “absorption problem” had already become a global problem.<sup>12</sup>
- *Financing overvaluation*, allowing countries like Argentina, Mexico, and the Philippines to stave off badly-needed currency adjustments, while feeding the private sector’s appetite for dollars. Overvaluation, in turn, encouraged still more borrowing.

- Creating **surplus profits**, much of which accrued to the elite and were stashed abroad. Profit margins were often highest in sectors with poorly-planned projects that generated acute shortages.
- Creating **increased incentives for human capital flight** – higher-skilled labor and professionals – to leave the Third World, taking their financial capital with them.

This *overlending* theory has many advantages. It helps to account for long-term capital flight patterns, debt-flight counter-flows, and the fact that no developing country *not also* a leading borrower had serious flight problems.

It also helps to explain changes in the perceived risks of investing in these countries during the 1980s. And it explains why most of the flight was channeled to just a handful of havens -- those where the leading international "lenders" were hanging their hats.<sup>13</sup>

## **B. Asset-Based Flight – Looting the State**

Another key macro-economic contributor to the flight surge was "asset-based" flight, based on ill-managed privatizations and other state-asset rip-offs, especially in countries with natural resources and other assets to steal. This became especially important in the 1990s, as country credit dried up in the wake of the debt crisis. Third World privatizations and the looting of state resource in general were very important sources of private banking lucre, especially in countries like Russia, Brazil, South Africa, and Nigeria. Many cash-strapped debtors came under enormous pressure to liberalize capital markets privatize state-owned assets – phone companies, energy companies, airports, ports, mines, public utilities, wireless spectrum, and so forth – and over-deplete their natural resources. The result, as described in Chapter 8, was one of the greatest "primitive accumulations" for Third World elites in history, and another huge opportunity for pirate bankers.

## **Testing These Theories**

The author has employed several different statistical approaches to test these alternative explanations of capital flight, including the estimation of cross-sectional and time-series statistical regression models. They strongly support the basic notion that a shift in the supply curve of loanable funds to developing countries in the 1970s, and the overborrowing that ensued, contributed fundamentally to the ensuing private flight boom. My favorite test, however, relies on the wisdom of the great Princeton statistician John Tukey's "intraocular stress test" --- "just look at the f..king data!" Chart A1-3, for example, provides a striking portrait of the correlation between Third World debt flows and flight flows in the 1980s. They show that new loans preceded increased flight by just a few months. Before the debt boom, Third World capital flight was limited; when excessive lending slowed down, so did the flight -- except when Third World elites and their pirate bankers were able to find new ways to finance it.<sup>14</sup>




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## APPENDIX II – END NOTES

<sup>1</sup> One MIT finance professor summarized the diversification theory of capital flight as follows: "Recognizing that assets in less-developed countries are very risky in their own right and yet virtually uncorrelated with the bulk of assets in the world economy, one might expect residents to hold as much as 50 to 60 percent of their assets abroad. What may be surprising is not the extent of capital flight, but the extent to which residents of less-developed countries hold local assets." Donald R. Lessard, "Comment," in Lessard and Williamson, op. cit., 98.

<sup>2</sup> First World shareholders, unlike many of their Third World counterparts, can diversify abroad by investing in First World companies like GE or IBM that have widely-disbursed foreign direct investments. Only since the mid-1980s have genuine "Third World publicly-traded multinationals" begun to appear in countries like Chile, Mexico, and Venezuela.

<sup>3</sup> The author's analysis of cross-country correlations of real returns to investors from the major debtor and creditor countries over the last twenty years, and another analysis of covariances among real growth rates for twenty-five countries, shows that developing-country investors might well have profited more from investing in other Third World countries, had the structure of capital market institutions and global private banking not been so skewed toward First World investments.

<sup>4</sup>The "bank intermediation" explanation for flight capital was proposed by Dooley, op. cit., and by Mohsin S. Khan and Nadeem Ul Haque, "Foreign Borrowing and Capital Flight: A Formal Analysis," IMF Staff Papers, V. 32 (4), 12.85, 606-628. Note that there may also be other advantages to round-tripping, as discussed in Chapter IV. It is not unusual for economic agents to borrow and lend at the same time for different maturities, just to manage their cash flows -- that is, after all, what

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balance sheets are all about. But I would argue that many developing countries pursued contradictory policies, by -- for example -- borrowing *and* lending short-term at the same time.

<sup>5</sup>Note that the speculation theory of capital flight assumes either that foreign and domestic investments are not perfect substitutes, or that their markets aren't always in equilibrium. If foreign and domestic investments were perfect substitutes, in equilibrium their yields would differ by a margin that exactly negated expected changes in exchange rates, so that no gains from investing abroad would be possible. In practice, of course, these assets are not perfect substitutes, so both interest rate differentials and exchange rates have to be considered when projecting real returns on foreign investments.

<sup>6</sup> The policy error explanation for flight is favored by Morgan Guaranty, WFM, "LDC Capital flight," March 1986; and Citibank, "Management Comment," Notice of 1988 Annual Meeting of Stockholders and Proxy Statement, 53. One finds few instances where politically - driven flight was not also accompanied by exchange rate or interest rate misalignment. The brief period of Korean capital flight in 1979 after the assassination of Chung Hee Park was one. Argentina's turmoil at the end of the Malvinas War was another, but it was also associated with overvaluation and low domestic returns. The peak years for Mexican capital flight were preceded by a serious overvaluation of the peso.

<sup>7</sup>Testing the speculative theory of flight has many other pitfalls -- for example, what is supposed to matter in the theory are *expected* interest and exchange rates, which are not directly observable. The theory also implies that outflows could be reversed by undoing overvaluation or interest rate movements. Of course in practice the secrecy of the flight process is an important obstacle to instantaneous repatriation.

<sup>8</sup> As formulated in the 1950s by the economists W. Arthur Lewis, Ragnar Nurske, W.W. Rostow, and Raul Prebisch, this "scarce savings" theory argued that domestic savings in low-income countries would be inadequate to finance economic takeoffs. See W. Arthur Lewis, "Economic Development With Unlimited Supplies of Labor," May 1954, in A.N. Agarwala and S.P. Singh, The Economics of Underdevelopment. (Oxford U Press: 1958). See also Ragnar Nurske, Problems of Capital Formation in Underdeveloped Countries and Patterns of Trade and Development. (NY: Oxford U Press, 1970); W.W. Rostow, The Stages of Economic Growth. (Cambridge: Cambridge U Press, 2nd ed., 1971); Richard R. Nelson, "A Theory of the Low Level Equilibrium Trap," AER, December 1956; Raul Prebisch, "The False Choice Between Economic Development and Monetary Stability," EBLA, March 1961; Celso Furtado, Economic Development of Latin America. (Cambridge U Press, 1970).

In hind-sight, this "scarce savings" theory glossed over the question of the institutional environment and the question of who would insure that foreign capital was spent productively. From that angle, it overlooked crucial distinctions between foreign debt, foreign aid, and foreign investment. It also assumed that capital markets were left wide open so that dividends and interest on foreign capital could be paid. This ignored the fact that, combined with graft and political instability, unregulated, wide -open capital markets in such countries may provide ideal conditions for a flight panic.



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<sup>9</sup> The author first advocated the overborrowing explanation of the 1980s flight capital outburst in 1986. See Henry (1986), op. cit. Several other analysts also now support it. See also Remolona, op. cit., and Boyce, op. cit.

<sup>10</sup> For the notion that capital flight is only potentially harmful if there are no offsetting inflows, see John Cuddington, "Capital Flight: Estimates, Issues, and Explanation," Princeton Studies in International Finance, No. 58 (1986), Department of Economics, Princeton University; Michael Deppler and Martin Williamson, "Capital Flight: Concepts, Measurement, and Issues," Staff Studies for the World Economic Outlook, (Washington, D.C.: IMF, 1987), 39058; and Michael Dooley and Kenneth Kletzer, "Capital Flight, External Debt, and Domestic Policies," Federal Reserve Bank of San Francisco Economic Review, Vol. 3 (1994), 29-34. Other authors have noted that there is presumption that if markets are working correction, so that private and social returns are equalized, capital should flow toward capital-scarce developing countries, where the social returns are presumably much higher. See Manuel J. Pastor, "Capital Flight From Latin America," World Development, Vol. 18, No. 1 (1990), 1-18. Other economists have tried to explain the simultaneous inflows and outflows of capital in terms of risk asymmetries between residents and non-residents or foreign banks, who may be subject to lower risks of expropriation, taxation, or default than domestic investors. See Mohsin Khan and Nadeem Ul Haque, "Foreign Borrowing and Capital Flight: A Formal Analysis," IMF Staff Papers, Vol. 32, No. 4 (1985), 606-628; Alberto Alesina and Guido Tabellini, "External Debt, Capital Flight, and Political Risk," Journal of International Economics, Vol. 27, No. ¾ (1989), 199-220; and Alain Ize and Guillermo Ortiz, "Fiscal Rigidities, Public Debt, and Capital Flight," IMF Staff Papers, Vol. 34 (June 1987), 311-32.

<sup>11</sup> Misallocation of foreign loans was partly just due to the fact that the normal covenants that would apply to private borrowers -- e.g., companies issuing bonds -- were unenforceable against governments. In the case of bank loans to private companies, for example, legally-enforceable covenants are often written to limit the extent to which management or shareholders can use the proceeds of bonds or loans to the disadvantage of creditors. Thus standard covenants in corporate bonds limit the dividends that can be paid to shareholders, restrict issues of new debt, require insurance, and even limit the ability of managers to invest in risky projects. Secured lending is also another way of controlling private sector behavior that doesn't work well with public agency borrowers, whose assets can't easily be seized. See Clifford Smith and Jerold Warner, "On Financial Contracting: An Analysis of Bond Covenants," Journal of Financial Economics, 7 (1979), 117-61.

<sup>12</sup> For evidence of the "absorption problem," Remolona, op. cit., presents evidence that incremental capital-output ratios were declining in many debtor countries by early 1980s. Note that if debt-financed investments aren't expected to earn a positive return over the rate of interest, it doesn't matter how cheap the debt is -- investors would still expect balance of payments problems and devaluations.

<sup>13</sup> The case of Korea shows that increased foreign borrowing was not a *sufficient* condition for flight. But this actually reinforces my argument, since Korea's effective

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developmental state was able to manage its debt well, enforce strict exchange controls, limit foreign private banker activity, and even maintain some controls on official corruption. Until the mid-1980s Brazil's developmental state actually bore some resemblance to Korea's, although it has since proved much less competent. Brazil's case showed that overborrowing can also contribute *indirectly* to flight, by utterly destabilizing the economy.

<sup>14</sup>In Argentina private capital outflows followed very closely on the heels of the debt's rapid expansion from 1976 to 1982. In Mexico, the country borrowed \$20 billion in 1981, more than \$11 billion of which left immediately. After 1983 there was not so much left to take out and foreign banks stopped lending, but another \$17 billion managed to exit by 1987, financed mainly by the country's forced trade surpluses. After 1988, as Mexico's foreign debt was slashed, capital outflows were reversed. In Venezuela the outflows also tracked the inflows -- from 1980 to 1982 nearly \$24 billion of gross private funds fled while \$26 billion of new loans were arriving. In the Philippines the pattern was the same as in Mexico and Argentina. Brazil was more like Korea -- until 1988, as noted earlier, flight consumed only a small fraction of its debt, partly because of Brazil's larger domestic market, more effective exchange controls, and more effective debt management. Changes in Brazilian flight activity are still positively correlated with changes in debt levels, however.

Another approach to testing the alternative explanations for flight is to build a statistical model, predicting flight as a function of variables like exchange rates and interest rates. Several such models have recently been constructed. Most of them focused on the demand for foreign assets and currency in isolation from the debt, as a function of "surface" phenomena like the expected yield on foreign assets, real income, wealth, and expected exchange rates. For examples, see Robert E. Cumby and Maurice Obstfeld, "Capital Mobility and the Scope for Sterilization, in Pedro Aspe Armella, et al., (ed. ), Financial Policies and the World Capital Market: The Problem of Latin American Countries. (Chicago: NBER, 1983), 245 - 276; C.L. Ramirze-Rojas, "Currency Substitution in Argentina, Mexico, and Uruguay," IMF Staff Papers, 12.85, 629-667; John Cuddington, "Macroeconomic Determinants of Capital Flight: An Econometric Investigation," in Lessard and Williamson, op. cit., 85-96; Edward Conesa, The Causes of Capital Flight From Latin America. (Washington, D.C.: IDB, 1987); James Boyce, op. cit.; Herminio Blanco and Peter M. Garber, "Recurrent Devaluation and Speculative Attacks on the Mexican Peso," Journal of Political Economy, February 1986, V. 94 (11), 148-166.

There are many problems with the estimation of such models, including poor data, sample size, and "simultaneity" -- the fact that, for example, exchange rates are not just independent causes of flight outflows; they are themselves affected by the outflows. There is also the problem that many political-economic variables are left in the background. But the models do provide additional evidence that exchange rate overvaluation, interest rates, the level of the home country's real wealth and income, and the supply of new foreign loans were important determinants of flight. The Appendix provides a simple econometric model of Mexican flight. See also the unpublished study by the New York Federal Reserve, which examined 19 flight episodes in 12 debtor countries qualitatively. Remolona, et al., op. cit., 16. It concluded that the most important reasons for flight were excessive foreign borrowing, overvaluation, and political crises. A related study by Boyce included debt in a

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regression analysis of flight for the Philippines, concluding that overborrowing helped to induce flight. Cuddington, op. cit., also included debt in one of his regressions, but did not emphasize it. The Cuddington and the Boyce models are "reduced form" equations that ignore simultaneity. See James Boyce, The Political Economy of Growth and Impoverishment. (Amherst: U. Mass, Unpublished MS, 1988), Chapter 7, Table 7.11

