SPEED Project Policy Note

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Economic Effects of Regulating the "Surrender" of Export Earnings

Introduction

Under the 2009 Foreign Exchange Act (*Lei n.º 11/2009 de 11 de Março*), Article 9 requires "resident entities" to declare any funds that are generated or held abroad and to remit to Mozambique receipts from exports of goods, services, or foreign investment, subject to terms and conditions to be defined by regulation.[1] In December, 2010, the Council of Ministers approved a set of regulations, including a provision relating to Article 9 of the Act requiring corporations to remit 50 percent of their export earnings to Mozambique and convert the remittance to local currency. This type of regulation is often referred to as an "export surrender" requirement.

The evident purpose of the export surrender requirement is to reduce dollarization in the economy and enhance the effectiveness of monetary policy in controlling inflation and stabilizing the exchange rate. The requirement may also limit capital flight that can arise from the retention of export earnings abroad. Yet the regulation provoked strong objections from the private sector based on concerns about costs and risks that businesses and investors may face as a result of the compulsory surrender of export earnings, particularly in an environment with an unstable exchange rate.

The purpose of this Policy Note is to assess the economic effects of the export surrender requirement, and to suggest approaches that the authorities might pursue to achieve the intended policy objectives while minimizing possible costs to the private sector. The main conclusion is that the benefits of the measure are likely to be fairly small, but also that the costs will be less serious than suggested by the private sector reactions, because of the flexibility afforded by allowing 50 percent of export earnings to be retained in foreign currency accounts. Still, the new regulation is a backward step in the liberalization process, which sends mixed signals to business and investors about the sustainability of reforms.

Liberalization of foreign exchange transactions in Mozambique

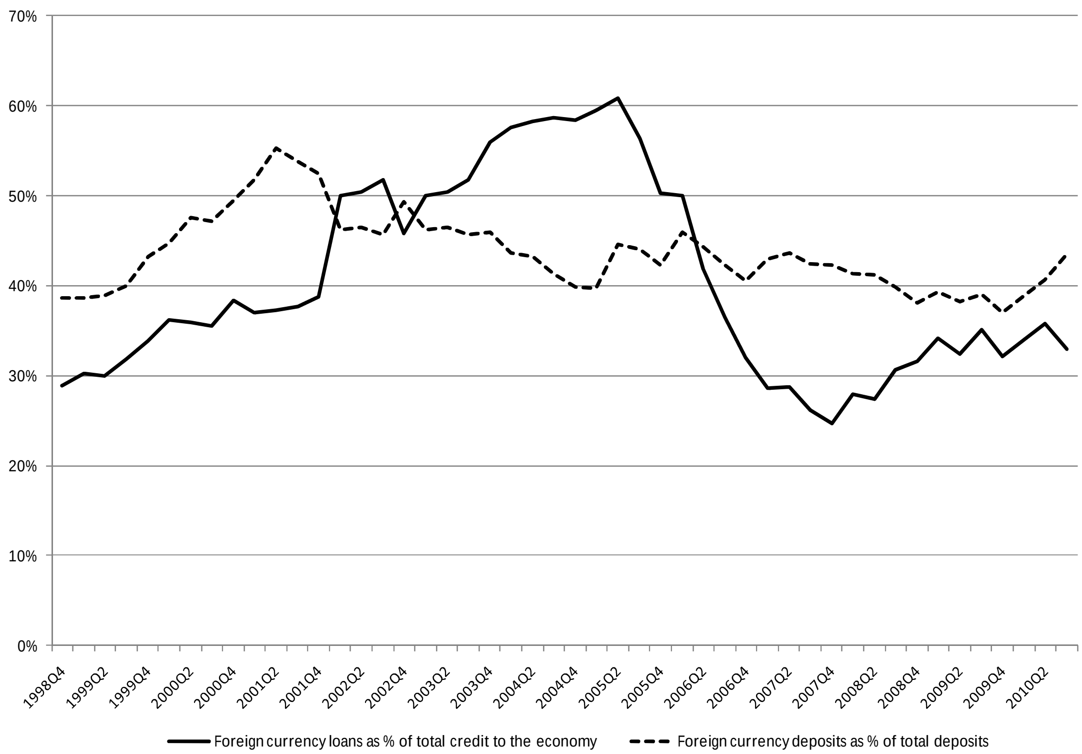
In the 1990s, the government of Mozambique pursued a variety of reforms to establish a competitive market economy. In addition to lifting price controls, privatizing state enterprises, restructuring the banking system, and overhauling the tax code, the government also liberalized foreign exchange controls. The 1996 Foreign Exchange Act (*Lei n.º 3/1996 de 4 de Janeiro*) authorized private *bureaux de change*, allowed bank loans and deposits in foreign currency, and guaranteed foreign investors access to foreign exchange for the repatriation of capital and profits. In addition, the Bank of Mozambique (BoM) ended the compulsory surrender of export earnings, effective January 1997. This measure was adopted

[1] Quote Article 9 sections 2 and 3 in Portuguese.

to promote exports, encourage investment, and reduce the incentives for capital flight to circumvent foreign exchange controls.

The liberalization and stabilization program in the 1990s set the stage for a period of rapid and sustained growth that continues today. One side effect, however, was substantial "dollarization" of the financial system, in the form of loans and deposits denominated in foreign currency (not just U.S. dollars). The BoM viewed this development with concern when foreign currency loans rose to 60 percent of total credit in 1995 (Figure 1). The most serious concern was the systemic risk involved in foreign currency loans to clients lacking income in foreign exchange. In 2005 the BoM took steps to control this risk through a regulation (A*viso 5/2005)* requiring banks to book a 50 percent provision on foreign currency loans to non-exporters. This created a strong incentive for banks to avoid foreign currency loans to unhedged borrowers.[2] Figure 1 shows that the share of foreign currency loans fell to 25 percent of credit to the economy by 2007, before rebounding to 35 percent in 2010. On the deposit side, foreign currency accounts peaked at 55 percent of total deposits in 2001, and have fluctuated around 40 percent of total deposits since 2005.

Figure 1. Share of Loans and Deposits in Foreign Currency



Source: Calculated from Bank of Mozambique statistics

The 2009 Foreign Exchange Act is designed to continue the liberalization agenda by eliminating "any type of restrictions on international payments and transfers for current account transactions."[3] The

[2] For details, see Nathan Associates (2007), *Financial Sector Constraints on Private Sector Development in Mozambique*, Chapter 8 (Foreign Exchange Restrictions), produced for USAID/Maputo. Available at http://www.tipmoz.com/library/resources/tipmoz_media/cat3_link_1182959499.pdf .

[3] The quotation is from the preamble to *Lei n.º 11/2009 de 11 de Março*. Translation by the author.

Government of Mozambique has also agreed to accept the obligations of IMF Article VIII, effective in 2011; this Article commits IMF member states to avoid "restrictions on the making of payments and transfers for current international transactions." A notable technicality is that Article VIII does not preclude export surrender requirements, because these measures constrain the mode for *holding* foreign exchange assets rather than the *access* to foreign exchange for current transactions.[4]

International practices

The IMF's annual report on Exchange Arrangements and Exchange Restrictions for 2009 identifies 55 countries as having some sort of surrender requirements on export proceeds. This is a substantial drop from 2004, when the report identified 70 countries with such requirements. For countries that do regulate the transmission of export earnings, an increasing number have been loosening their measures. The IMF reports 33 changes between 2008 and 2009, of which 22 involved liberalization, such as the elimination or relaxation of repatriation and/or surrender requirements. Malawi, Nigeria, Zimbabwe, and South Africa, for example, loosened repatriation and surrender requirements. According to news reports, Brazil eliminated this requirement in March 2008, and India liberalized their regulation in 2007. The table below summarizes the surrender requirements prevailing in 2009 for selected countries that have relevance for Mozambique.

Judging from cases where details are available, a grace period of 3 to 6 months on the remittance of funds appears to be standard. India grants a whole year, with provision for extensions. Some countries apply the surrender requirement only to surplus foreign exchange, in that they allow exporters to make legitimate external payments before incurring the transactions cost and exchange rate risks involved in the conversion of earnings. Further, some countries, like Ghana, apply the surrender requirements to only a selected number of sectors. Other countries, like Malawi, designate a specific fraction of the foreign exchange for immediate surrender; this provision, however, is far less common.

Country	2009	Specifics of Surrender Requirement of Export Proceeds
Angola	Yes.	Foreign exchange earnings from export of non-oil goods and services must be surrendered to banks domiciled in the country.
Brazil	Yes.	Repatriated export proceeds must be sold to authorized dealers (ADs).
Ghana	Yes.	98% of cocoa export proceeds must be surrendered to BoG. A proportion of gold export proceeds is to be surrendered to BoG in accordance with the Mining and Minerals Act.
India	Yes.	Up to 100% of foreign exchange receipts may be retained in foreign currency accounts (FCAs) with banks in India. ADs may extend the period of collection of export proceeds beyond 12 months from the date of export, up to six months at a time, regardless of the invoice value of exports, subject to conditions.
Lesotho	Yes.	All export proceeds must be surrendered to ADs within 180 days of shipment. Residents may retain export proceeds in FCAs with an AD for six months, after which the proceeds must be sold to an AD.

[4] The quotation is from Article VIII, Section 2 of the IMF Articles of Agreement. The point on surrender requirements is from Saleh Nsouli, et al. (1995), *Resilience and Growth through Structural Adjustment: The Moroccan Experience*, IMF Occasional Paper No. 117, p. 18.

Malawi	Yes.	ADs are now required to convert 40% (previously 20%) of foreign exchange received from exports immediately on receipt at the prevailing buying exchange rate and to credit the kwacha proceeds to the customer's account. The remaining 60% may be credited to the exporter's FCA. There are no restrictions on the length of time such balances may be held.
Nigeria	Yes.	Non-oil exporters may sell their export proceeds to AD banks at interbank rates or use the funds to finance eligible transactions. Inflows for the domestic operations of oil companies are sold directly to banks.
Rwanda	No.	N/A.
Senegal	Yes.	Export proceeds must be surrendered to BCEAO within 30 days of the payment due date, which must not, in principle, be more than 120 days of the shipment date.
South Africa	Yes.	Unless otherwise permitted, all export proceeds must be received within six months of the date of shipment and offered for sale within 30 days of becoming entitled to it, or according to the rules governing customer FCAs. Except for exports made on a cash-on-delivery basis and those for which full proceeds are received in advance, ADs may provide exporters forward cover for their export proceeds.
Swaziland	Yes.	Export proceeds must be surrendered within 90 days of receipt.

Source: IMF Annual Report on Exchange Arrangements and Exchange Restrictions 2010.

Economics of export surrender requirements

The immediate effect of the new surrender requirement is that half of the foreign exchange earnings from exports must now be *repatriated* to Mozambique and *converted* to Meticais (MT). The size of the effect depends on the extent to which companies are already depositing export earnings in Metical accounts, in the course of doing business. The regulation has no effect, for example, on a company that already converts half or more of its export proceeds to Meticais. If any quantitative analysis has been done on this point, it is not public information.

We presume, though, that some exporters have been holding more than 50 percent of their earnings in foreign exchange, either locally or overseas, and that the new regulation will therefore trigger some adjustments in the market for foreign exchange, the deposit base in the banking system, and the composition of money balances held in Mozambique. These adjustments can have both positive and negative consequences for the economy, including effects on capital outflows; the degree of dollarization; exchange rate stability; the effectiveness of monetary policy; systemic risks to the banking system; costs and risks for exporters; and the investment climate.

Effect on capital flows

One direct effect of the export surrender regulation is that it will reduce the scope for retention abroad of export earnings, which is an implicit form of capital outflow. Countries like Mozambique that maintain capital controls have a clear interest in restricting this practice, and, as shown above, dozens of countries do impose some form of export surrender requirement for this purpose. The evidence also shows, however, that most countries allow a grace period to provide businesses with the flexibility to cover legitimate external transactions without facing extra transactions costs and foreign exchange risks from back-and-forth international transfers.

This implicit form of capital outflow could be addressed without also requiring the conversion of export earnings to local currency. Indeed, the conversion requirement creates a perverse incentive for economic agents seek other channels to externalize funds and circumvent restrictions on how they may hold their wealth. Over the past forty years, many countries in Latin America and Africa learned from experience that exchange controls actually provoked massive capital flight, and that relaxation of controls helped to reverse it.[5] In short, concerns about capital flight may justify a remittance requirement, but the compulsory conversion to local currency yields no benefit in this respect, and may have adverse effects.

Effect on dollarization

Dollarization—meaning domestic use of foreign currency—is largely a reflection of rational decisions by businesses and individuals who seek to hedge against uncertainties, reduce transactions costs, and diversify their assets. Especially for a small, open economy with underdeveloped financial markets, moderate dollarization can be a sign of financial efficiency. International evidence suggests that a deposit dollarization ratio of 30 percent to 40 percent is not unusual for emerging markets where foreign currency accounts are legal.

But there are potential costs to partial dollarization. The most critical issue is that exposure to foreign currency assets or liabilities can create systemic balance sheet risks to the banking system. In addition, dollarization may weaken the effectiveness of monetary policy and contribute to exchange rate instability. We examine these issues below. Here, the focus is on the relationship between the export surrender requirement and the extent of dollarization.

The remittance and conversion requirement will directly boost the conversion of export earnings to local-currency accounts and reduce the amount held externally or in domestic foreign-currency accounts only to the extent that exporters have been retaining more than 50 percent of their external earnings in foreign currency accounts. In addition, any *gross* inflow will be offset by outflows as exporters pay for imported inputs or repatriation of profits. The *net* inflow will therefore be even smaller.

To get a rough idea of the magnitudes, total export earnings in 2009 (including megaprojects) amounted to $1.85 billion, which is equivalent to nearly 90 percent of local-currency deposits in the banking system at the end of 2009.[6] If the surrender requirement results in a *net* additional conversion equal to one-tenth of the export earnings, the adjustment would boost local-currency deposits by 9 percent over the course of the year, with a corresponding increase in liquidity available for lending in Metical. For comparison, the money supply has grown by about 25 percent per year over the past three years, and growth of credit to the economy has averaged more than 35 percent per year. If the export conversion requirement causes an excess expansion of local-currency liquidity, the BoM will have to adopt sterilization measures to stay on track with its monetary targets and prevent an increase in inflationary pressure. In the end, new regulation might reduce the prevalence of dollarized accounts by a few percentage points, at best.

[5] Alvarez-Plata and Garcia-Herrero (2007, p. 7) report that Peru and Bolivia in the 1980s reversed compulsory conversion policies "due to increasing capital flight." Kokenyne, Ley and Veyrune (2010, p. 6) find that allowing domestic deposits in foreign currency helps to reverse capital flight, especially following episodes of instability.

[6] Calculated from export and deposit data given in IMF Country Report No. 10/174, Mozambique: Sixth Review under the Policy Support Instrument, June 2010, pp. 25 and 30.

In any case, regulatory controls are not an efficient way to achieve a large and lasting decline in dollarization. Several recent studies conclude that success with "de-dollarization" is best achieved through measures to convince economic agents that local currency is worth holding. This requires a steady hand on monetary and fiscal policy to minimize macroeconomic instability and exchange rate uncertainty. Also important are positive real interest rates on local-currency deposits, the development of capital markets to attract savings, expansion of the market for derivatives to hedge foreign exchange risks, and two-way flexibility of the exchange rate to signal the market that holding foreign currency is not a sure bet. Thus, de-dollarization is typically an endogenous outcome of sound policies. Through this approach, Egypt reduced deposit dollarization from 56 percent in 1991 to 22 percent in 1999. Other examples of success include Israel, Chile, Mexico and Poland. In contrast, Pakistan and Argentina de-dollarized through forced currency conversions, but with adverse consequences for efficiency and financial sector development.[7]

Yet some economic costs to dollarization are not internalized by the agents making choices on which currency to hold. This externality provides a justification for intervention to nudge the de-dollarization process along. The nudge can be applied, however, through market-based interventions such as differential reserve requirements or higher deposit insurance premiums on foreign currency accounts. Compulsory surrender of export earnings is a less preferred option.

Effect on the exchange rate

Another possible benefit from export surrender requirement is that it might help to strengthen and stabilize the exchange rate. Over the past two years, the Metical weakened from 25.5 per US dollar at the end of 2008 to 38.3 in September 2010, before strengthening to 32.2 as this note is written (January 5, 2011).

How will the compulsory surrender of export earnings affect these conditions? The new regulation will boost the supply of foreign exchange to the extent that it increases the conversion of export earnings into Meticais. Other things being equal, this will strengthen the Metical, relative to outcomes that would have occurred without the regulation. Once again, the size of this effect depends on the amount of the *net additional* conversion. Moreover, other things may not be equal. If the surrender requirement stimulates back-door capital flight or a loss of confidence in future convertibility of the currency, the net effect on the exchange rate could be small or even negative. Also, over the medium term, the effect of other factors in the currency market (including the inflation rate) will outweigh any effects of the regulation.

The surrender requirement might also affect exchange rate volatility. To the extent that the regulation leads economic agents to hold lower foreign currency balances, there will be less scope for potentially destabilizing currency substitutions in response to transient conditions. For example, expansionary monetary policy may cause a short-term impulse of inflation, which may in turn induce exporters to retain more earnings overseas as speculation on further weakening of the Metical. This speculative response can become a self-fulfilling prophecy.

But there will also be less scope for currency substitutions that *reduce* exchange rate volatility. This can arise when forward-looking economic agents (including exporters) perceive that exchange rate movements are out of line with economic fundamentals. For example, anyone who felt last September that the Metical was unduly weak and likely to appreciate would have had a strong incentive to shift foreign exchange balances *into* Metical, thus reducing the extent of depreciation.

[7] Kokenyne, Ley and Veyrune (2010), pp. 16 and 17; Galindo and Leiderman (2005), pp. 17.

The balance between the favorable and unfavorable effects of currency substitution is an empirical question. On this point, some studies have found that exchange rate volatility is indeed greater in highly dollarized economies.[8] The evidence is less clear, however, for countries with moderate dollarization, as in Mozambique.

Effect on monetary policy effectiveness

Macroeconomic stability is a cornerstone for sustainable growth and poverty reduction. Hence, there is good reason to favor measures that can strengthen the effectiveness of monetary policy. The export surrender requirement might contribute to this objective to the extent that it reduces dollarization. As discussed above, however, this effect is likely to be quite small. But if the impact on dollarization turns out to be substantial, there are several ways in which the regulation may affect monetary management.[9]

First, dollarization can make the demand for domestic money balances less stable by allowing economic agents to easily switch between local and foreign currencies. If so, then dollarization weakens the link between money supply growth and economic activity. Second, dollarization can reduce the effectiveness of some standard tools used by central banks to influence money supply growth. For example, open market operations or lender of last resort operations affect the domestic currency component of the money supply but not the foreign currency component. Third, when exporters or other economic agents hold external accounts, unexpected surges or ebbs in the rate of transfer into local accounts can destabilize liquidity growth.

The international evidence suggests, however, that dollarization does not significantly weaken the effectiveness of monetary policy in developing countries. For example, central banks across Latin America and Africa managed to defeat inflation in the 1990s regardless of whether dollarization was high or low.[10] It is also interesting to see that dollarization is not even mentioned as an issue in a new IMF study on monetary policy effectiveness in sub-Saharan Africa.[11] This study concludes that monetary policy in Africa has been more effective than commonly believed, through central bank management of base money growth and policy interest rates. Key constraints on monetary policy effectiveness are the need to finance fiscal deficits (directly or indirectly), underdevelopment of the financial system, and excess liquidity in the banking system. An export surrender requirement is no substitute for policies that deal with these basic issues.

Overall, the evidence indicates that central banks have adequate tools to deal with any adverse effects of dollarization. For example, monetary authorities commonly pursue sterilization measures to manage liquidity growth from inflows of foreign exchange. Other available tools include differential reserve requirements on foreign currency liabilities, or special provisions against bad debts for foreign currency assets (as established in Aviso 5/2005).[12] Also, if the demand for money is unstable, the authorities can focus on policy interest rates rather than monetary aggregates. The recent IMF study does find, though, that a higher level of offshore bank deposits (as a percentage of domestic deposits) tends to weaken the link between changes in the policy discount rate and bank lending and deposit rates.[13] This evidence lends some support to limiting the retention abroad of export earnings.

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[8] Alvarez-Plata and Garcia-Herrero (2007), p. 18.
[9] Galindo and Leiderman (2005).
[10] Op. cit.
[11] IMF, *Regional Economic Outlook: Sub-Saharan Africa*, Chapter 2, October 2010.
[12] Galindo and Leiderman (2005), p. 15; Kokenyne, Ley and Veyrune (2010), p. 16.
[13] Op. cit., p. 40.

Effect on systemic risks to the banking system

The Asian financial crisis in 1996-1997 demonstrated to the world that dollarization, if mismanaged, can create enormous risks to a financial system. If foreign currency loans go to borrowers who lack foreign currency income or assets, a sharp devaluation can lead overnight to insolvency. Even if the banks adhere fully to regulations limiting an imbalance between foreign currency assets and liabilities, they are still highly vulnerable if their clients have unhedged exposure to foreign exchange risks. Although this risk is extremely important, it is not relevant to the analysis of export surrender requirement s, because the BoM has more effective regulatory tools to deal with the problem.[14]

Effect on exporters and investors

Both Technoserve and the Confederação das Associações Economócas de Moçambique (CTA) produced documents assessing the effects of the surrender requirement on export businesses. [15] Their analyses were based on a draft of the regulation, which indicated that mandated the automatic conversion of export receipts to local currency, "once received from off-shore." The Technoserve analysis used data for a representative cashew processor to show how the regulation would affect the financial viability of an important agribusiness. The calculations showed that the export surrender requirement would have "a devastating effect" that would "likely result in the demise of the renascent Cashew Industry," along with thousands of jobs. This adverse result is derived from the following assumptions:

- The enterprise operates initially with a net margin of 5.13 percent and a return on investment of 15 percent.
- Banks apply a 2% margin to the buying and selling rates for foreign currency, and the company faces foreign currency expenses amounting to 37 percent of gross revenues.
- Earnings that are converted to Metical and then back to dollars incur an exchange rate loss of 1 percent over the holding period.
- Automatic conversion to Metical precludes local borrowing in foreign currency, thus quadrupling the interest cost of borrowed funds (which amount to one-fourth of variable costs in this example).

Technoserve concludes that the regulation should either be dropped or modified to provide a 90-day grace period allowing exporters to cover foreign exchange expenses without incurring the extra costs and risks of a back-and-forth currency conversion.

The CTA position lacks numerical details, but similarly concludes that the regulation can cause large losses for exporters who need to use foreign exchange revenues to cover payments for inputs, transportation, and other external costs. The CTA points out that sugar production in Mozambique has a large foreign exchange component, including debt service costs. The document also notes that South Africa allows 90 days for exporters to use their proceeds for external payments, and adds that Mozambique has to compete for investment with neighboring countries that impose no conversion requirement. The document recommends that the regulation should be suppressed, or if that is not possible, that the implementation should be examined closely to mitigate the negative effects.

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[14] IMF, *Republic of Mozambique: Financial Sector Assessment Program*, Country Report No. 10/12, January 2010, p. 24.

[15] TechnoServe, "The Future of Agribusiness for Export under the new proposed Regulations to the Exchange Law (Law 11/2009 of 11 March)," PowerPoint slides dated 1 November, 2010; and CTA, "Matriz'Posição da CTA sobre Projecto de Regulamento da Lei Cambial," 2010.

Although the final regulation has not yet been published, available information indicates that the conversion requirement applies to 50 percent of export receipts, not 100 percent. This makes a big difference to the cost analysis. In particular, with 50 percent retention of export earnings in foreign exchange accounts, the representative cashew producer cited by Technoserve can avoid all of the extra costs enumerated in the case cited above.

Extra costs may still be incurred, however, by exporters whose foreign exchange expenses exceed 50 percent of their export earnings. This might apply, for example, to labor-intensive assembly operations that depend heavily on imported intermediate goods. In addition, exporters with borrowing requirements that exceed 50 percent of revenues may now be unable to obtain access to loans in foreign currency due to the conversion requirement. If this issue is not addressed effectively, exporters in this position will face far higher borrowing costs, as highlighted by TechnoServe and the CTA. Ironically, these companies will also face added exchange rate risks from the regulation-driven mismatch between their foreign exchange earnings and Metical debt service costs.

These considerations show that the impact on exports will vary case by case, and discriminate against exports that involve either a high import component or a high borrowing requirement.

Conclusion: Balancing the benefits and costs

Judging from the qualitative analysis and the international evidence, it appears that the benefits of the regulation will be relatively small in terms of its effect on capital flight, dollarization, the exchange rate, and the effectiveness of monetary policy. Moreover, the discussion shows that for each of the potential benefits, alternative policies could be far more effective than an export surrender requirement. For example, the key consideration for monetary policy effectiveness is control of the budget deficit to reduce the government's borrowing requirement.[16] In a similar vein, sound macroeconomic policies and the development of attractive local-currency instruments for saving are far more important than any form of exchange control for stemming capital flight and reducing dollarization.

On the other side of the ledger, the 50 percent retention provision greatly reduces the cost of the export surrender requirement to the private sector, compared to the dire results suggested by TechnoServe and the CTA. Nonetheless, there will be a negative effect on exports and jobs, because the measure will reduce profitability for some companies and benefit none. In addition, as suggested in the CTA assessment, reintroduction of the conversion requirement sends a mixed signal to investors about whether market-oriented reforms will be sustained. Given the international trend towards eliminating or loosening such regulations, and the fundamental importance of a *credible* commitment to private sector development, the effect of this mixed signal on investment could ultimately be the most important cost of the new regulation.

On balance, a policy establishing a 90-day or 180-day grace period instead of (or in addition to) the 50% conversion provision would have been a preferable option, because it would have given exporters more flexibility in meeting legitimate external payments and covering foreign currency borrowing requirements, without incurring extra costs for currency transfers and extra risks from exchange rate movements.

With the regulation as adopted, the main implication of this analysis is that the authorities need to manage the implementation in a manner that will minimize the cost to the export sector. For example, the BoM should ensure that all exporters retain access to loans in foreign currency, by clarifying (if necessary) the relationship between the automatic conversion requirement and provisions of Aviso

[16] This may be a suitable topic for a subsequent SPEED Policy Note.

5/2005. The BoM should also examine international experience in cultivating a forward market in foreign exchange to provide businesses with an efficient instrument for hedging against exchange risk. In addition, the government might consider exempting companies that export from a Special Economic Zone to ensure that the regulation does not discourage investments involving import-intensive assembly operations.

The most important step, however, is for the authorities to maintain a regular dialogue with the private sector to monitor their experience with the new regulation, and discuss their concerns and suggestions.

Finally, the government and the BoM need to focus on maintaining sound policies that create incentives for de-dollarization, while strengthening monetary management and exchange rate stability. These include sustained efforts to control fiscal deficits, maintain low inflation, establish positive real interest rates on local-currency deposits, stimulate the development of capital markets, and diversify exports.