GDI

GERMAN DEVELOPMENT INSTITUTE

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Private Capital Flows to Developing Countries

Lessons learnt from the Asian crisis

- *With the increasing globalization of the international financial markets, private capital flows to developing countries have risen sharply. At US$ 256bn (1997), they now exceed official development finance sixfold. Despite the Asian crisis, this trend is likely to continue in the long term.*
- *Whether private capital flows stimulate or impede the development process very much depends on how the recipient countries use this capital. Past financial crises have been primarily due to overly rapid liberalization of capital movements, inadequate macroeconomic and exchange rate management and the serious structural weaknesses of national financial systems.*
- *In its present form, the international financial system makes it easy for financial crises to occur. Reform efforts should focus on improving the analysis and limitation of risks. Cooperation among governments, international monetary institutions and the private banks and institutional investors is essential in this context.*
- *The aim of development cooperation should be to increase the number of developing countries with access to the international financial markets. Their capacity to implement sound economic policies should be improved to ensure the efficient allocation of capital flows. Particularly important in this context is a reform of the national financial systems.*
- *For developing countries that have gained access to the international capital markets the importance of official capital transfers is waning. The continuation of financial cooperation is justified if it is conceived primarily as a transfer of know-how, i.e. if it seeks to promote structural changes and to implement model solutions in the recipient countries. In the future loans should be allocated to these countries without a grant element, and the funds this releases should be made available to developing countries that do not have sufficient access to the international capital markets.*

Development in the 1990s

Private long-term net capital flows to the developing countries have increased sharply since the early 1990s. In 1997 they reached the record level of US$ 256bn, compared to a mere US$ 42bn in 1990. With a 47 % share, foreign direct investment (FDI) is the most important form of private capital flows to developing countries, followed some way behind by external loans (21 %) and bank loans (17 %). Bringing up the rear are portfolio investments in shares (13 %), although the part they play has grown significantly in the 1990s.

There is heavy regional concentration of private capital flows: 12 (20) developing countries have accounted for 80 % (95 %) in recent years. China has attracted most foreign capital. Other important recipient countries have been Mexico, Brazil and the East Asian newly industrializing countries. The countries of sub-Saharan Africa have received only 2 % of private capital flows; for them official development finance continues to be the most important external source of funds.

With the outbreak of the Asian crisis in mid-1997 and the ensuing financial turbulence throughout the world, private capital flows to developing countries declined again. While these countries were still able to attract US$ 143bn in the first half of 1997, the figure had fallen to US$ 101bn by the first half of 1998. This development affected all regions, but hit Asia the hardest.

Even if the decline in private capital flows should persist for some time, they are unlikely to drop to the level of the 1980s. The globalization of the financial markets and FDI is still proceeding so dynamically that it will absorb more and more developing countries as time passes. This hypothesis is also corroborated by the marked interest that many developing countries themselves have in gradual integration into the global financial markets.

Causes

Two developments in particular made the sharp increase in private capital flows to developing countries possible:

- the liberalization of international trade in goods and capital movements and
- the development of new communications technologies and financial instruments.

A factor benefiting some developing countries is that they have at times been able to offer more attractive returns than the industrialized countries in the 1990s. This has been due both to their own high rates of economic growth and to falling interest rates in the OECD countries. Other important factors accelerating the export of capital to the developing countries have been the fierce competition among the banks and institutional investors for attractive investments and the struggle among multinational enterprises for additional markets.

Capital flows to developing countries, 1990 - 1997 (US$ bn)[a]								
	1990	1991	1992	1993	1994	1995	1996	1997[b]
Private flows	41.9	53.6	90.1	154.6	160.6	189.1	246.9	256.0
- foreign direct investment	23.7	32.9	45.3	65.6	86.9	101.5	119.0	120.4
- bonds	0.1	7.4	8.3	31.8	27.5	23.8	45.7	53.8
- bank loans	3.8	3.4	13.1	2.8	8.9	29.3	34.2	41.1
- portfolio investments in shares	3.2	7.2	11.0	45.0	32.6	32.5	45.8	32.5
Official flows[c]	56.4	62.7	53.8	53.6	45.5	54.0	34.7	44.2
Total	98.3	116.3	143.9	208.1	206.2	243.1	281.6	300.3

a) long-term net flows; b) provisional; c) including other flows

Source: World Bank, Global Development Finance, 1998

As the regional distribution of the private capital flows reveals, only a few developing countries have, however, succeeded in gaining the confidence of foreign lenders. Foreign capital has gone primarily to countries that feature

- stable political and economic conditions,
- commitment to undertake market-oriented reforms,
- adequate physical and non-physical infrastructure,
- an investment climate that is favourable to foreigners,
- proximity to important markets, and
- attractive foreign portfolio investment opportunities.

Benefits and risks

Private capital inflows enable the recipient countries to raise capital formation above the limit set by internal savings. They may also increase the national output-capital ratio since a transfer of know-how relevant to development is usually associated with the provision of capital. In the case of FDI the transfer of know-how is often likely to be more important than the transfer of capital. Bonds, bank loans and portfolio investments in shares may also help to improve the allocation of resources, to strengthen the domestic financial system and to discipline economic policy (market conditionality).

These benefits are, however, joined by certain risks. With the exception of FDI, international capital is volatile, i.e. characterized by frequent and wild fluctuations of in- and outflows. As globalization and the competition among investors for international investment opportunities have increased, the volatility has grown significantly in the 1990s. It is a threat to the stability of the capital-importing countries primarily when their financial systems are poorly developed and their macro-management is deficient.

Liberalization of capital movements

A question that arises for all developing countries is how much and in what form they intend to accept foreign capital. Countries that have sealed themselves off too tightly from the international capital markets in the past have usually fallen behind other developing countries in their development. Conversely, many developing countries that were very quick to liberalize capital transactions found themselves in serious difficulty after only a few years. In these circumstances, it is generally agreed today that, although most developing countries have no alternative in the long term but to integrate into the international financial system, capital movements should be liberalized gradually.

No single liberalization timetable is valid for every country. What cannot be denied, however, is that, if a country is to remain financially stable, the liberalization process should begin with FDI and financial services and end with portfolio investments in shares and trade in financial derivatives. The general pace of liberalization should accord with the development of the financial system's legal and institutional framework and the training of management in the banking sector.

During this transitional phase the main purpose of capital controls is to prevent the domestic economy from being affected by international turbulence, to control the scale and composition of capital inflows with a view to keeping the risks and volatility within acceptable limits and to ensure that the domestic monetary policy enjoys greater autonomy. The extent to which these aims can be achieved ultimately depends on the effectiveness of the monitoring of capital movements. In general, it is true to say that the more a country is integrated into the international financial markets, the higher the expected speculative gains and the lower the financial system's level of performance, the more difficult it becomes to monitor the import and export of capital.

Tasks of macro policy

Only countries that feature a high degree of economic and financial stability can be sure of a lasting inflow of foreign capital. However, high capital inflows may also pose a threat to this stability. In this area of tension a stability-oriented economic policy has the dual task of laying the foundations for private capital inflows and

ensuring that they are used efficiently without causing any macroeconomic disturbances.

Exchange rate policy has a central role to play in this context. As the Asian crisis has shown, maintaining excessively high real exchange rates for too long leads to growing imbalances on both current and financial account. Confidence in the stability of exchange rates and high domestic interest rates resulted in a sharp increase in capital imports, especially in the form of short-term loans. As these inflows were neither sterilized by the central bank nor neutralized by an anti-cyclical fiscal policy, they were invested speculatively in securities and real estate, there being no efficient bank supervision (asset price inflation).

Reform of national financial systems

In a market economy resources are allocated primarily through the financial system. If the financial system is not sufficiently developed, experience has shown misallocations to be inevitable. Sooner or later they lead to a banking crisis, because the growing proportion of "bad" loans can no longer be concealed by loan renewals. Compared to the waste of domestic resources, the misallocation of foreign capital inflows entails specific risks inasmuch as foreign investors may withdraw or stop renewing their loans and so cause the central bank serious difficulties. Under a fixed exchange rate regime the central bank runs the risk of losing its foreign currency reserves and, when the reserves are exhausted, seeing the national currency going into free fall. If, on the other hand, the exchange rate is flexible, the debt burden measured in domestic currency increases for banks and enterprises which have incurred debts in foreign currencies. This in turn leads to a credit crunch and so to economic contraction.

The development of efficient financial systems that ensure the optimum allocation of scarce resources is thus a *sine qua non* for the liberalization of capital movements and the developing countries' integration into the world financial markets. A reform of the financial system goes much further than reorganizing the banking system. It also includes the creation of such legal, economic and institutional conditions as insolvency law and bank supervision and means liberating the financial institutions from political patronage. The banks must be permitted to take it upon themselves to decide for what private or government projects they would like to advance credit.

Of all reform measures, probably the most difficult to accomplish is the depoliticization of the financial system. Restricting the allocation of credit to economically worthwhile projects is likely to force many companies – especially government-owned enterprises – to reduce production and to dismiss workers, thus threatening social stability in the country. A reform of the financial system often involves a reform of the political system, since the elites of many developing countries abuse the banking system to line their own pockets.

Even developing countries with sound market-based financial systems and economic policies are unable to protect themselves fully against the risks inherent in private capital inflows. One risk factor is the small size of their capital and securities markets. Most emerging markets are equivalent in size to the market value of a fairly large enterprise in the industrialized countries. Even minor changes in international capital movements may trigger major exchange rate fluctuations and disturbances of the balance of payments in these markets and so threaten their economic and financial stability. Restrictions of access are therefore likely to be appropriate even in markets that are functioning satisfactorily. A second risk factor is the way the international capital markets operate.

Reform of the international financial system

Viewed with hindsight, financial crises always reveal high-risk behaviour on the part of international investors. Their misguided behaviour may be due to a generally immoderate preference for risk-taking and/or to the incorrect assessment of the risks involved.

International investors vary in their willingness to take risks. The reform of the international financial system urged in connection with the Asian crisis should therefore provide for regulations and mechanisms that limit the activities of particularly speculative investors, hedge funds being an example. This can be achieved, for instance, by forging a closer link between the rules on equity capital ratios and the level of the risks inherent in a financial transaction.

Hedge funds

Hedge funds (HFs) are funds which invest in highly speculative ventures. Since the early 1990s the number of HFs concentrating on emerging markets has increased sharply. In 1997 altogether 57 HFs were operating in these markets, with a portfolio totalling US$ 7.1bn, compared to a mere five funds with a volume of US$ 0.7bn in 1992. HFs operating from tax havens are able to work largely free from rules and regulations and are not subject to normal financial supervision. This enables them to handle considerable volumes of finance with little equity capital. HFs are fed with the deposits of investors who are prepared to take risks; they also receive loans from banks which are not permitted to carry out such transactions themselves. HFs achieve returns that are usually well above the average of other financial investments.

Risks may be misjudged where investors do not examine them carefully enough beforehand. There is much to be said for the argument that the Asian crisis was also due to the banks' and institutional investors' negligence. Preventing these misjudgements by means of more efficient internal monitoring procedures, for example, should be in the various financial institutions' own best interests. They must be joined, however, by far more stringent government supervision that forces the banks to improve their risk management.

Incorrect risk assessment is also due to information problems, especially in developing countries. While the legal framework of the industrialized countries' financial systems largely protects the creditor, this is not yet the case in the developing countries. Consequently, the high cost of obtaining information often prevents a careful analysis of existing risks by international investors.

Besides the better recording, control and monitoring of risks and an improvement in the information base, the debate on the reform of the international financial system that has been triggered by the Asian crisis focuses on the improvement of the existing early warning system, which is meant to prevent financial crises, and the provision of international liquidity to cope with them.

The current early warning system failed again in the Asian crisis. This was due not only to the absence of accurate, up-to-date statistics but also to the IMF's incorrect assessment of the potential hazards emerging in the crisis-hit countries. Nor should critical developments in individual member countries be treated confidentially in the future when it is clear that a government is unwilling to respond quickly and consistently to looming imbalances.

A great deal of criticism has been sparked by the IMF's policy of making generous liquidity quickly available to the Asian countries affected by the crisis. This – so the critics claim – will only serve to endorse the banks' belief that the state or the IMF will always help out in an emergency and fail to induce them to change what has been in some respects a negligent lending policy (moral hazard). Although these objections are partly correct, it seems questionable whether the danger of moral hazard should be made the sole principle guiding IMF policy. Above a certain level of indebtedness it becomes irrelevant whether the debts are public or private. Just as governments cannot stand idly by while a large national bank has payment difficulties, the international community would be ill-advised to allow a whole country or even a whole region to be brought down by repayment problems.

Implications for development cooperation

In the existing national and international environment the assessment of the effect of private capital flows on development cannot be entirely favourable. On the one hand, they have led to strong growth in the recipient countries, especially when they have taken the form of FDI, and greatly reduced the number of people living in poverty; on the other hand, they have plunged these countries into deep financial crises and sometimes set their development back substantially.

From these empirical findings two tasks can be deduced for development cooperation:

- supporting the developing countries in their efforts to lay or improve the legal and institutional foundations for the inflow of foreign capital and
- strengthening their management capacity, especially for the reform of their financial systems, with a view to ensuring the efficient allocation of capital inflows.

Private capital flows to developing countries now exceed official development finance (ODF) sixfold. Not even the Asian crisis, which caused a sharp decline in private capital flows to developing countries in 1998, is likely to interrupt this trend for more than a short time, to judge from the signs of positive reaction to the reform measures taken in the crisis-hit countries. To the extent that developing countries succeed in gaining, or regaining, access to the international capital markets, the importance of official capital transfers will wane. Public and private loans are largely interchangeable. The foreign capital mobilized by means of government bonds, for example, can be used by the government of a developing country in the same way as a financial cooperation credit, i.e. channelled into regions and sectors which a private investor would not consider.

The continuation of financial cooperation with this group of countries can be justified if it is conceived primarily as a transfer of know-how rather than capital. Future financial cooperation should offer model solutions which cannot yet be provided by the governments concerned, foreign investors or the private consultancy sector. Financial cooperation will then need to meet requirements that suggest much closer dovetailing with technical cooperation than has been usual in the past.

As the aim in the case of countries with access to the international capital markets is no longer primarily to provide capital, but to develop and implement projects that serve as models and to promote structural changes, the subsidy element of financial cooperation loans, with few exceptions, also loses its significance. In any case, the grant element is not passed on to projects in full when such loans are allocated (condition-splitting). Financial cooperation loans to developing countries able to obtain funds in the international financial markets should therefore be allocated without grant elements. This would release funds for developing countries that are still dependent on official capital transfers.

Detlef Radke

Further Reading

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Wegener, R. (1998): Private Kapitalzuflüsse in die dynamischen Länder Asiens. Die Bedeutung der internationalen Finanzierungsstrukturen für die Krise, GDI, Berlin

World Bank (1997): Private Capital Flows to Developing Countries. The Road to Financial Integration, Washington

DEUTSCHES INSTITUT FÜR ENTWICKLUNGSPOLITIK©
GERMAN DEVELOPMENT INSTITUTE · INSTITUT ALLEMAND DE DEVELOPPEMENT
HALLERSTRASSE 3 · D-10587 BERLIN · TELEFON (030) 390 73-0 · TELEFAX (030) 390 73-130
DIE-Berlin@die-gdi.de · www.die-gdi.de · ISSN 1434-8934