

## The Growing Role of Private Capital Flows to Developing Countries in the 1990s

### The New Flows

- 4 Private capital flows to developing countries, after slumping in the 1980s, increased dramatically, and to unprecedented levels, in the first half of the 1990s. According to the IMF, net private flows in the 1989+95 period were, on average, about ten times those of the 1983+88 period, whereas net official flows had fallen by more than half (see Table 1). According to the World Bank, between 1990 and 1993, private capital flows to developing countries rose nearly fourfold before stabilizing at about \$160+170 billion in 1994+95 as United States interest rates rose and the Mexican crisis hit (World Bank, 1996, pp. 10-11). These private flows remain, however, highly concentrated. Only about 20 developing countries are today considered creditworthy by international capital markets and banks. Foreign direct investment is almost equally concentrated. In recent years, the African continent has received only 4 per cent of total net private flows<sup>1</sup>.
- 5 In the 1990s there was a sharp increase in international portfolio investment, both in debt instruments and in equity, in developing countries. Foreign direct investment also grew very rapidly though at a slower pace. On the other hand, the relative importance of bank lending to developing countries fell drastically. Much higher proportions of external capital were also now directed to private sector borrowers rather than to governments in developing countries. Tables 2 and 3 summarise the overall composition of capital flows to the major developing areas and selected countries in recent years. Private flows have accounted for very substantial percentages of individual recipient countries' GDP in the 1990s (e.g., 6 and 8 per cent in Colombia and Chile, respectively; 11 and 13 per cent in Thailand and Malaysia respectively). Foreign direct investment has been relatively more important in Asia than elsewhere but the relative contribution of portfolio flows has risen nearly everywhere. In some of the sub-Saharan African countries, "private transfers" as a percentage of GDP have reached remarkable levels (e.g., 9 per cent in Tanzania, 5 per cent in Uganda), although knowledge as to what they really are remains sparse.
- 6 These new flows can be partly explained as a once-for-all (permanent) stock adjustment on the part of the world's investment community (notably insurance companies, mutual funds and pension funds) to newly-liberalised international financial markets, both in developing countries and in the industrialised world, and the perception of new profit opportunities in emerging markets, particularly in countries that have achieved sound macroeconomic fundamentals and a receptive environment for foreign capital. Once such stock

1 The issue of broadening capital flows to a wider group of developing countries is discussed further in FMM(96)3.

adjustment has been completed, however, the flows resulting from it can be expected to fall to more “normal” levels (around which they will continue to fluctuate). It would be helpful, in such circumstances, to address the possibilities for smoothing the macroeconomic adjustment in recipient countries to these one-off shifts in global portfolio choices.

- 7 The new private capital inflows to developing countries can also be seen, however, as an ongoing and perfectly normal response on the part of more globally-oriented investors to changing incentive structures – including relative rates of interest, exchange rate expectations, political volatility, etc. Private capital inflows may also be procyclical, increasing in “good” times and falling, even reversing in direction, in “bad” times. If recent international capital flows (into developing countries) are not significantly the product of “one-off” stock adjustment, but reflect normal response to changing incentives, their surge in one direction is likely to be reversible.
- 8 In any case, newly-liberalised international and domestic financial markets certainly create new opportunities for international incentive-responsive private capital flows and short-term volatility in such flows. When large institutional investors alter their overall international portfolio composition only marginally (for them) they can have dramatic consequences for individual national asset markets and exchange rates. Some of the surge towards developing countries’ financial markets in the early 1990s is undoubtedly attributable to the low interest rates in the United States (and other industrialised countries) at that time (Calvo, Leiderman and Reinhart, 1993).
- 9 External circumstances have always been understood to play an important role in

setting the context for national macroeconomic management, particularly in small open economies. Shocks in the external terms of trade have long been recognised as a particular problem for developing countries. Changes in global interest rates, and their effects upon private international capital flows, have now become a further major source of exogenous shocks. “Contagion effects” from financial events elsewhere (e.g., “tequila effects”) are also now an important additional source of exogenous shock. Policy changes – particularly in exchange regimes – in geographically contiguous countries are another potentially significant source of exogenous influence upon domestic macroeconomic management, as shown in some recent African experiences (e.g., Kenya/Uganda, and the CFA franc zone and its neighbours). Realignment of major currency exchange rates can also profoundly affect developing countries’ real effective exchange rates and hence their prospects for external balance, e.g., the nominal appreciation of the yen against the dollar in the 1990s brought about depreciation of many East Asian currencies vis-à-vis the yen.

### Capital Inflows: Development Impacts and Responses

- 10 Capital inflows are important for developing countries because of their role in supplementing savings and financing investment, thereby assisting in long-term development, and/or in shorter-term smoothing of consumption. In addition, foreign direct investment can also be beneficial in a number of other ways including through transfer of technology and expertise, greater access to foreign markets for domestic goods, and enhanced competition within national markets particularly in services. There is now

increasing competition among developing countries to attract foreign direct investment (FDI).

requirements; or via the redeployment of government deposits from the commercial banks to the central bank.

- 11 It has long been recognised, however, that where there are significant domestic microeconomic “distortions”, capital inflows can be immiserising. Prior to and during the debt crisis of the 1980s there was a great deal of discussion as to how the proceeds of external bank lending (mainly to governments) had been used, and whether they had contributed to development. There has always been appropriate concern as to whether the government had its economic policy fundamentals “right”. There is obviously a continuing need to understand how capital inflows are ultimately used, and whether recipients’ national policies may contribute to any “misdirection”.
- 12 Concern with the potentially destabilising macroeconomic consequences of private inflows, even when policies in the recipient country are basically sound, is much more recent. Surges of inflowing private capital create macro-economic problems, above all, through their effects on either the exchange rate or the domestic money supply, together with the risk of their abrupt cessation or capital outflow.
- 13 If the central bank attempts to maintain stability in the exchange rate, private capital inflows will expand the monetary base (as the central bank increases its foreign exchange reserves). To prevent consequent overheating of the domestic economy, and a real appreciation of the currency, the central bank may seek to sterilise the domestic monetary consequences, through open market operations – in government securities or in the interbank market (as in Malaysia) or, more usually, through the issue of its own securities; or through increased reserve
- 14 Tightened domestic monetary policy may, however, involve significant quasi-fiscal losses for the central bank as it pays higher interest rates on its domestic liabilities (including those earned by foreigners) than it earns on its foreign exchange reserves. To the extent that interest rates increase in consequence of such sterilisation policies, they may induce a further fillip to external capital inflows. (Interest rates are presumably lowered through private capital inflows in the first place, however, and inflows will, in any case, cease once a new portfolio equilibrium is reached.)
- 15 Increasing bank reserve requirements may also “redirect capital flows to domestic borrowers through channels other than the domestic banking system – such as through domestic markets for equity and real estate. If this disintermediation is effective, the macroeconomic stabilization problem would remain” (Fernandez-Arias and Montiel, 1996, p.73). Domestic agents may also resort increasingly to offshore borrowing. Clearly the structure of the domestic financial system and, in particular, the interest of foreign investors in other domestic assets and their access to them are important to overall macroeconomic outcomes.
- 16 One obvious additional (or alternative) possible response to surging capital inflows is to tighten the fiscal regime, and this is frequently recommended, particularly to countries previously running large fiscal deficits. But recent experience indicates that many countries experiencing monetary and exchange rate pressures from private capital inflows had already achieved fiscal balance or even surpluses (e.g. Chile, Korea and others). In any case, as a recent IMF

paper argues, "In most countries ... it is difficult to use fiscal policy as a short-run response, and it may also exacerbate the problem of unsustainable inflows if confidence in economic policy grows strongly" (IMF, 1995d, p.5). Thus, macroeconomic policy instruments other than fiscal ones might be needed to respond to short-term capital surges.

17 If the central bank instead allows the value of the domestic currency to appreciate in response to capital inflows, this will have undesirable consequences for the overall incentive structure. The current account of the balance of payments is likely to deteriorate in response to currency appreciation, and the economy will become increasingly vulnerable to a sudden reduction or reversal of the capital inflows. The critical question is whether the capital inflows that are associated with such an increasing current account deficit are likely to be sustainable and, if so, at what level. Countries operating a pure floating exchange rate system (in some African countries, they seem to have had few options) are consequently faced with a major set of problems: appreciating and potentially unstable currencies, rising current account deficits and rising external debt.

18 In the many developing countries where there are relatively weak domestic financial markets, there are likely to be further difficulties created by surges of external private capital, either inward or outward. They can easily spark increased volatility in domestic markets for financial assets and real estate. Capital surges have been associated with stock market and property market booms; and outflows with corresponding busts. Where domestic financial markets are thin and/or weakly supervised, even modest inflows of external

private capital can overwhelm both local financial institutions and their regulatory authorities, and create additional macroeconomic management problems. Even in relatively strong financial systems, deposit insurance, whether explicit or implicit, creates a moral hazard that may encourage over-enthusiastic foreign depositing in domestic banks, and over-enthusiastic (and, particularly when there is rapid expansion, inadequately supervised) bank lending to domestic agents.

19 The increased inflow of foreign portfolio capital in the 1990s did not always destabilise national financial markets in the sense of increasing average weekly exchange rate, interest rate, or stock market volatility. But there were frequent episodes of extreme stock market volatility which did appear to be associated with foreign capital flows – e.g. a stock market boom in late 1993 and early January 1994 in Malaysia, followed by rapid decline again in the first half of 1994; and sudden stock market declines in early 1995 in Thailand and Malaysia in response to the Mexican crisis in early 1995, and the Gulf War in the second half of 1990. Similarly, there were at the same time sharp interest rate changes in response to the same external capital surges, and the pressures on policy that they created.

20 Many developing countries maintain various forms of control over external capital account transactions. The ease and speed with which private capital can flow internationally depends partly on the nature of the capital asset or liability, but, no less importantly, on the costs of the flows to private transactors, as influenced by such capital controls – in the form of restrictions, regulations and taxes, both direct and indirect. To an analysis of such policies for the capital account we now turn.