

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

Opportunities and Constraints

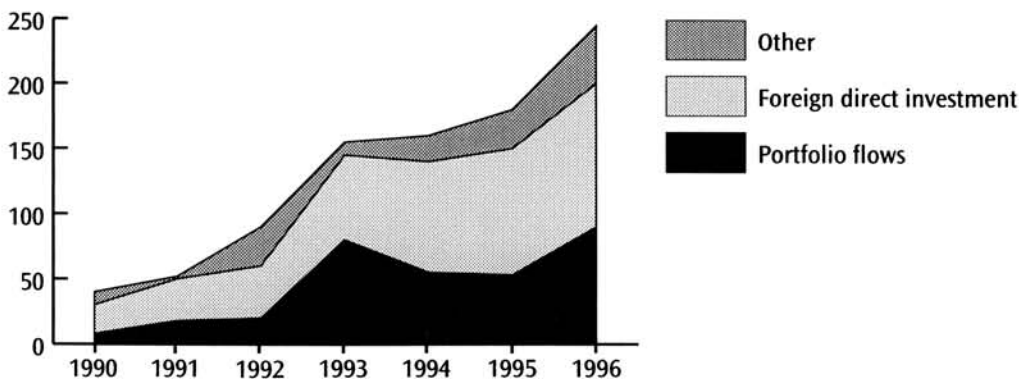
1 Overview

The pattern of private capital flows

- 8 International capital flows have increased markedly since the early 1970s and have, arguably, become as important as trade flows in promoting global economic integration. For the advanced economies, annual average gross foreign direct investment flows increased more than six fold between 1973-78 and 1989-94, while portfolio investment outflows increased 26 fold over the same period.
- 9 The increase in private capital flows to developing countries, both in terms of foreign direct and portfolio investment, has been even more marked. This trend has continued in recent years, not withstanding a brief pause in the first half of 1995 when debt and equity flows to some countries all but dried up following the Mexican peso crisis. Private capital flows to developing countries as a whole no more than flattened out in 1995 and have since increased by a further 50 per cent.
- 10 Developing countries are now an important destination for global private capital. Their share of foreign direct investment flows has risen from a low point of around 15 per cent in 1990 to 40 per cent in 1996. The rise in their share of global portfolio equity flows, over the same period, has been even more spectacular, from 2 per cent in 1990 to 30 per cent.
- 11 There have also been some important changes in the nature and composition of capital flows:
- ❖ the increase in private capital flows has coincided with a decline in official flows, which have fallen by around one half since the mid-1980s. Five years ago, official flows to developing countries were larger than private flows. But private capital flows are now five times the size of official flows.
 - ❖ the fastest growth has been in portfolio investment – both in debt instruments and in equity. Foreign direct investment has also grown very rapidly.

Graph 1 **Private capital flows**

Net flows to developing countries \$bn



❖ the relative importance of commercial bank lending, which used to account for more than 65 per cent of all private flows to developing countries, has fallen dramatically. And, finally, there has been a shift in the destination of flows towards private borrowers. Public sector borrowing now accounts for less than one fifth of total private flows.

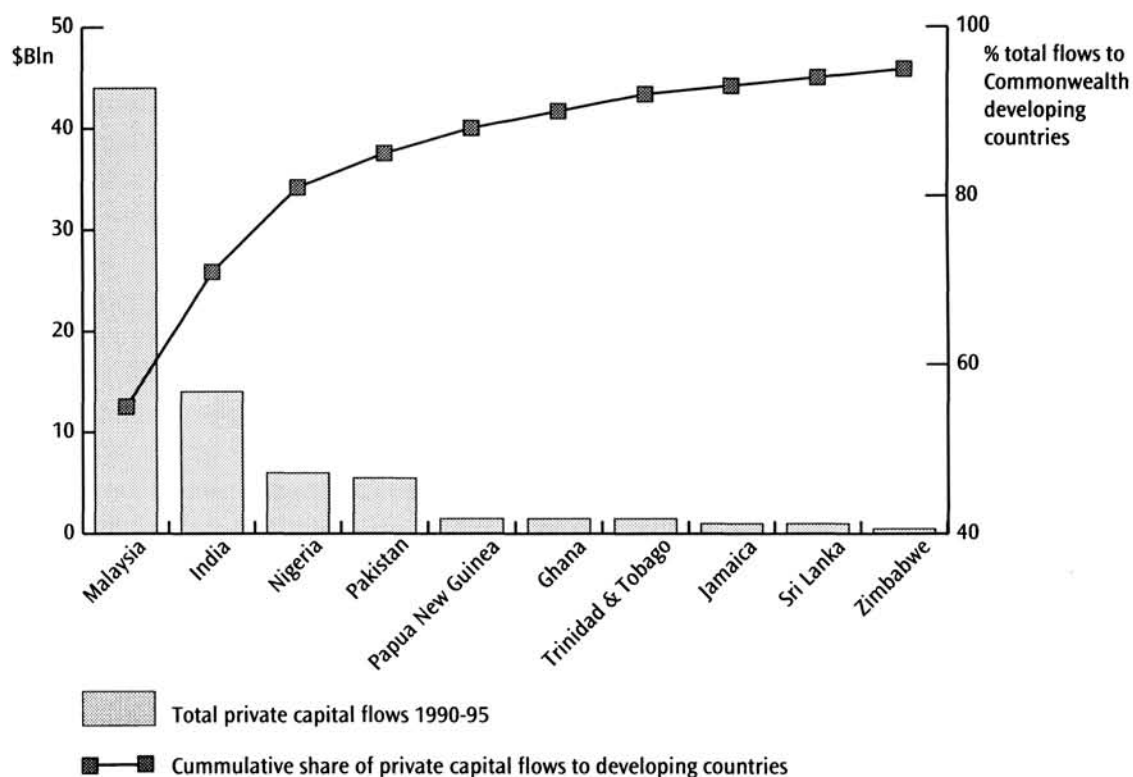
2 Marginalisation

12 New competition for capital has also emerged as economic and political conditions in Eastern Europe and Russia as well as in other parts of the world have improved. Since the mid-1980s, the number of developing countries that have been able to access the international capital markets has been increasing steadily. Around 30 countries are today considered credit-worthy by the international

capital markets and banks. And, increasingly, these countries are able to attract private capital through a combination of different channels rather than relying entirely on banking flows or foreign direct investment for example. In most cases they still have to offer higher returns than industrial countries, reflecting the higher perceived risks.

13 Yet despite these developments, private capital flows to developing countries remain highly concentrated among a few economies. A dozen countries account for 80 per cent of net private capital flows to developing countries, while around 140 countries account for less than 5 per cent of flows. Much the same pattern applies to Commonwealth developing countries – six of which accounted for over 90 per cent of all private capital flows between 1990 and 1995 (see Graph 2). These difference are much less stark, however, when

Graph 2 **Concentration of private capital flows**



capital flows are scaled according to the size of the recipient economy, particularly among Commonwealth countries - many of which are small. Moreover there may be under-recording of flows in some cases, particularly in Africa. (In general, the Group notes that following liberalisation of exchange controls, countries need to establish new ways to capture data on inflows and outflows.)

- 14 Some developing country members such as Malaysia and Singapore are now foreign investors themselves. South Africa is also becoming a source of investment for the Southern and East African region. Intra-regional private capital flows between developing countries have been a new feature of the 1990s. This feature is most marked in terms of foreign direct investments in Asia, where intra-regional flows have accounted for around three-quarters of total direct investments in recent years.

3 Benefits of private capital flows

- 15 The potential benefits of international capital flows are substantial as demonstrated by the experience of the East Asian and Latin American countries. It has contributed to the shift in the thinking about the need for capital account liberalisation.
- 16 In some senses, the benefits are similar to the gains from international trade – both for individual countries and for the world economy as a whole. When combined with a more open trading system, capital liberalisation allows capital to flow to where it produces the greatest return, sharpening the incentives to save and invest, and helping to maximise economic growth. Access to international capital markets also allows companies and individuals new and better ways to manage their risks. For all these reasons industrial countries have, in recent years, removed restrictions on private capital outflows.

Where it is prudent to do so, they should also consider relaxing any remaining restrictions, for example, in the share of institutional portfolios that can be held in foreign markets.

- 17 Foreign investment also encourages the transfer of technology, management skills and know how, with substantial benefits for host economies. Pressure on domestic companies, either to compete with foreign investors, or to compete among themselves in order to attract foreign investment, may also help to boost domestic productivity. Foreign investment could improve export performance if it takes place in export oriented activities. In addition, foreign investment can also aid the process of privatisation and in channelling investments into infrastructure development.
- 18 Foreign investment and the associated spillovers can have particularly beneficial effects on national financial markets by enhancing the depth and efficiency of those markets. The improved ability of the financial sector to allocate scarce resources can have strong positive knock-on effects for growth and investment.
- 19 Some have questioned whether private capital flows can redistribute world-wide savings on any major scale – noting, for example, that there is a tight link between national savings and investment rates. Government policies, the argument goes, would be better targeted at boosting domestic savings from which the bulk of investment will have to be financed. There is, however, a strong presumption that these policies to encourage domestic savings will also attract foreign savings. In most cases, they are likely to be complementary since domestic investors often influence foreign perceptions. Private capital has therefore tended to flow to those countries which already enjoy high domestic investment levels – that is where the relative rates of returns are higher.

4 Problems and risks of private capital flows

- 20 Private capital flows do, however, carry potential risks and costs, including contagion risks. The presence of microeconomic distortions in the economy can, for example, exaggerate and misdirect flows. That is why some countries, such as the UK, have pursued capital account liberalisation after, or as part of, a broader series of structural reforms. Experience indicates that countries that have benefited most from capital inflows, have been those that have successfully liberalised their domestic economies and reduced external barriers.
- 21 Capital flows can also greatly complicate macroeconomic management, particularly where capital flows are volatile. Capital account liberalisation in itself reduces the ability of domestic monetary authorities to set monetary policy independently of international interest rates. The impossibility of simultaneously maintaining free capital flows, monetary autonomy, and fixed exchange rates leaves policy makers with difficult choices to make when faced with surges in capital inflows or their sudden reversal. There are other types of problems as well. Some countries remain concerned to limit foreign ownership, at least in some industries. Fluctuation in capital flows can expose weaknesses in domestic banking system. The possible responses to counteract these difficulties are discussed in sections 3 and 4.
- 22 But the constraints on domestic macroeconomic policies can also have some very positive effects. Exposure to international financial markets imposes a discipline on governments which encourages the adoption of appropriate policies and, ultimately, tends to reward good policies. Equally, of course, it can increase the risks and costs when policy mistakes are made.

5 Sustainability of private capital flows

- 23 Rapid increases in private capital flows in recent years have been driven by a number of forces in both developed and developing countries. Increasing competition and rising costs in domestic markets – initially in industrial countries but also, more recently, in a handful of developing countries – have encouraged firms to look for opportunities to increase efficiency and returns by producing abroad. This has led to an increase in foreign direct investment flows and the increasing globalisation of production. Financial markets have also become more globally integrated following internal and external deregulation, advances in communication and information technology, and the development of increasingly sophisticated financial instruments. For the most part, these processes still have some way to run before global product and financial markets could be said to be fully integrated
- 24 Short term factors can, of course, also have a role in driving capital flows. The initial impetus for some of the surge in capital flows in the early 1990s was probably a search for higher yields following a decline in interest rates and a prolonged recession in the advanced economies. In the last few years, however, private capital flows to developing countries have withstood rising global interest rates in 1994, the Mexican peso crisis of 1994-95, and the availability of substantial returns on US and, to a lesser extent, European equities in the last two years.
- 25 Developing countries for their part have increased the attractiveness and accessibility of their markets by embarking on macroeconomic stabilisation and structural reform programmes, progressive reductions in barriers to trade and investment, measures to liberalise and strengthen their domestic financial

markets and privatisation of public enterprises. As the resulting improvements in economic fundamentals and creditworthiness began to take hold, and as emerging markets became more 'familiar' to investors, long term rates of return and opportunities for portfolio risk diversification have become attractive to some international investors.

26 Institutional investors in advanced economies have played a particularly important role in this respect. Mutual funds, which tend to be less heavily regulated than other institutions, have been at the forefront of increasing international diversification. More than 30 per cent of new investments by US mutual funds went to emerging markets between 1990 and 1994. Pension funds have now started to follow this trend. The share of foreign assets in pension fund portfolios has risen from 7 per cent to 11 per cent between 1989 and 1994 – equivalent to an increase in international investments by pension funds of nearly \$500 billion. In the UK, where the process of international diversification is more advanced than in most countries, the share of international assets in pension fund portfolios has stabilised at around 27 per cent over the last few years.

27 The trend toward international portfolio diversification is, arguably, still at an early stage. Pension funds in most countries are still bound by ceilings on their exposure to foreign investments. But even where there are no such limits, the share of developing country assets in the portfolios of institutional investors is still small and well below their share in world market capitalisation of

around 10 per cent. In the US, for example, mutual and pension funds hold an average of around 2 per cent of their portfolios in emerging market assets. Moreover, ageing populations in most advanced economies are generating demands for higher returns and pressures for pension reforms, which are likely to lead to substantial increases in global pension fund assets over the next 20 years or so. The Group agreed that where it is prudent to do so, institutional investors should be allowed to take advantage of increasing opportunities for portfolio diversification through the relaxation of restrictions on the share of their assets that can be held in emerging markets.

28 On the whole, these developments suggest that recent increases in private capital flows are sustainable. Sustainability, however, is not the same as stability of capital flows. Stability will depend in part on events in the world economy: the potential instability of private capital flows makes it even more important that the major countries should follow stable and predictable economic policies. Even then, there will be unpredictable events affecting global capital markets. In addition, flows to particular countries will fluctuate, reflecting, for example, shifting perceptions of a country's economic and policy fundamentals, or one-off investment opportunities associated with privatisation. For all these reasons it is necessary to have in place national and global arrangements that provide safeguards in the event of sudden or large changes in the volume and direction of flows.