

Enhancing and Sustaining Private Capital Flows

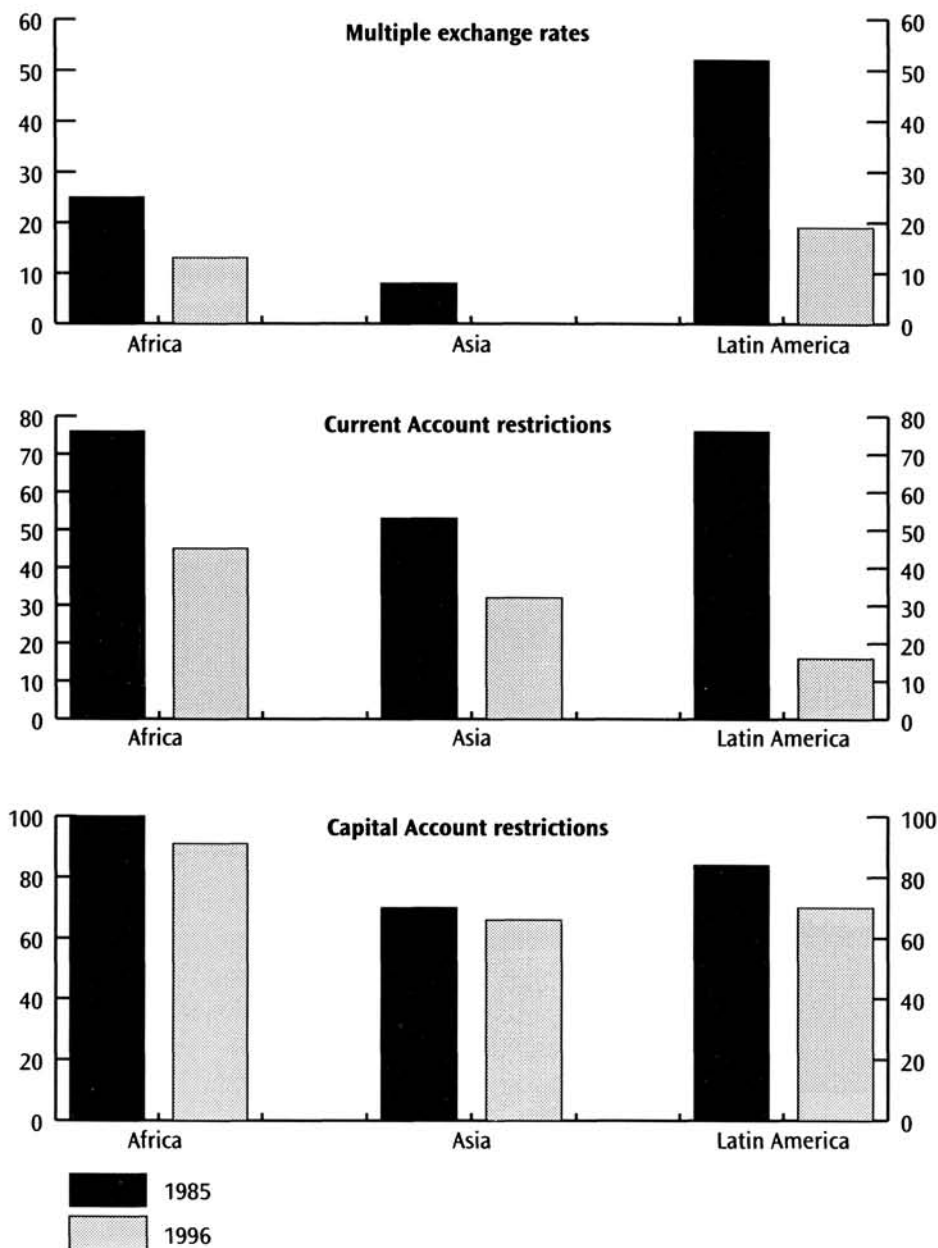
- 29 In this chapter, we discuss the role of national policies in attracting and sustaining private capital flows, and in ensuring that those flows are put to best use within the host economy. While these policies may vary according to individual country circumstances, they will include sound macroeconomic fundamentals and the implementation of good microeconomic policies both on the human and on the institutional side. In this respect, foreign investors will look for many of the same factors that influence domestic private investors.
- 1 Commitment, credibility and sustainability of economic reforms**
- 30 Sound macroeconomic policies along with a stable institutional and legal framework are essential for attracting and sustaining private capital flows. By reducing uncertainty, macroeconomic stability in combination with stable political and institutional framework allows investment and savings decisions to be made in a manner consistent with underlying economic fundamentals, thereby promoting the efficient allocation of resources. Conversely, countries without a stable policy and institutional framework present risks of instability and, importantly for foreign investors, balance of payments restrictions.
- 31 The experience of some economies suggests that, where there is the right institutional and political environment, markets can recognise and reward improvements in macroeconomic policies and hence credit-worthiness. Strong economic growth following the implementation of economic reforms has led to a steady increase in capital inflows, for example, in China since mid 1980s and in India since the early 1990s.
- 32 Other countries, however, have found accessing the international capital markets to be a more drawn out process. Uganda and Ghana, for example, have relatively long track records of pursuing sound economic policies and structural reforms. Fiscal consolidation in the 1990s helped to promote macroeconomic stability and improve economic growth. But Uganda and Ghana have only recently attracted increasing flows of private capital. At the same time, other countries, especially some small states, have found it harder to establish credibility in world financial markets even after a long track record of relatively good policy performance.
- 2 Open markets**
- 33 Within a stable macroeconomic environment, outward oriented trade policies provide the best environment for foreign investors particularly in the context of FDI. While import-substitution (and resource extraction) provided the main impetus to foreign direct investment in the early days of developing country industrial development in the 1970s and early 1980s, the most sustained growth of such investments in recent years has been into economies that are export-orientated.
- 34 Trade liberalisation tends to raise the rate of return on investment in countries which then become more attractive places in which to invest. There may be adjustment problems in the short run, but over time a move to

more open trade policies allows a country to exploit its comparative advantage in production, and promote the importation of lowest-cost products, often with embedded advanced technology. Trade also allows a country to use a larger variety of intermediate goods and

capital equipment that then enhance the productivity of its own domestic resources.

35 The relaxation of foreign exchange controls themselves can also help to attract capital inflows. Private investors will want ready

Graph 3 Proportion of developing counties with ...



Source: IMF

access to foreign currency to import goods, and the freedom to remit dividends and profits and to repatriate capital. Relaxing controls on capital outflows can, therefore, encourage capital inflows (and the return of flight capital) because investors have the assurance that they can disinvest if they want to do so. In practice, the impact of foreign exchange controls (and their removal) on capital movements is difficult to observe directly. Country experience has been mixed. But experience in recent years has been that removing exchange controls has tended to coincide with an increase rather than a decline in net capital inflows.

3 Regional integration

36 Access to large markets remains important in attracting foreign investments that are geared mainly to those local markets. Some of the largest recipients of foreign direct investment have very large market themselves or, as in the case of India, the potential to develop such markets.

37 Greater regional integration is often proposed as a means of, among other things, attracting foreign investment - especially for those countries that do not have large domestic markets themselves. Where domestic markets are small and fragmented by distance and poor infrastructure, regional integration may be the only way to provide the economies of scale necessary to attract domestic market-orientated investments.

38 Sub-Saharan Africa including South Africa, has a sizeable market in terms of purchasing power and population. But this is spread over enormous distances with poor interconnections in terms of transport, communication and other market links. Effective integration could greatly improve the chances of sub-Saharan African countries to attract foreign investment, if this were supported by

improvements in physical infrastructure. There have been a number of efforts at such integration, but without much success. Regional trade remains very limited and the lack of appropriate infrastructure remains a major barrier to the success of any further efforts.

39 Such regional arrangements need also to be open to trade with the rest of the world. The creation of regional blocs with significant external tariffs can have negative consequences for the countries that are excluded from them. This is a risk facing some Caribbean countries as NAFTA threatens to divert foreign investment away from them and towards, principally, Mexico.

4 Stability and transparency

40 As noted in para 29, appropriate macroeconomic policies and an open foreign exchange regime alone may not be sufficient for developing countries to sustain large private capital inflows. Stability and transparency need to be established in a number of key environments in which investors must operate. Private capital flows are more likely to be deterred in the absence of:

- ❖ a stable institutional framework for managing political change
- ❖ good governance: particularly transparency and accountability in public policy making
- ❖ well-defined property rights, which are enforced through sound legal and accounting frameworks (the Group noted the good track record of Commonwealth countries); and
- ❖ clear and transparent tax codes. Relatively low and stable corporate tax rates tend to be more important than a tax regime with many special or discretionary concessions offered to particular investors.

5 Attitude to foreign ownership

- 41 Foreign ownership remains a sensitive issue for many countries. (see box on foreign direct versus portfolio investment). Most governments, for example, place restrictions on foreign ownership where there are strategic concerns or involve public monopolies. Some have also sought to protect infant industries through such restrictions. But even proponents of this kind of interventionist industrial policy agree that promotion of infant industries should be targeted to those activities which would not, because of the costs and risks involved, receive sufficient investment under free market conditions; and that protective barriers should be small, selective, and limited in duration.
- 42 Restrictions are also motivated by concerns that foreign investment is more volatile than domestic investment. Some have argued that volatility has increased as markets have opened up in recent years (as in cases of major crises such as Mexico in 1994/95 and episodes of surges in Argentina and Thailand). Others believe that the increasing importance of institutional investors in international capital markets has contributed in reducing volatility. Evidence on either side is however, mixed. In any case, domestic investors can also be volatile and outflows of domestic capital have been among the major factors behind a number of recent episodes.
- 43 There are also practical difficulties in placing restrictions on foreign ownership. Foreign investors are often able to circumvent restrictions by channelling their investments

through domestic companies, just as domestic investors can invest through, say, foreign mutual funds.

- 44 There is a general trend to reduce restrictions on foreign ownership, linked in part to the shift of enterprises of the public sector. This trend is becoming more common as countries come to recognise and reap the benefits of foreign investment in terms of jobs, technology and other spillover effects.

6 Privatisation

- 45 Privatisation can and does generate significant interest, both among foreign direct and portfolio investors and among financial institutions as sources of advice on the privatisation process itself.
- 46 Between 1988 and 1992, foreign sources provided about 30 per cent of total privatisation financing for developing countries. Privatisation has been particularly important for some countries in Latin America and the Caribbean and, more recently, in eastern Europe where the public sector has traditionally played a greater role in the economy. In Jamaica, for example, the privatisation programme accounted for about 40 per cent of foreign direct investment flows between 1987 and 1990. While foreign investment in privatised infrastructure will not have as direct an impact on export earnings as investment in exporting activities, the improvement in infrastructure may nevertheless be crucial for success in exporting.

Box 1**Composition of foreign investment: FDI versus portfolio flows**

Most countries have, to varying degrees, sought to influence the composition of capital inflows, typically favouring foreign direct over portfolio investment. Ownership restrictions may also vary by sector, with lower limits frequently imposed in banking and financial sectors. This is motivated by a number of factors:

- ❖ general political economy concerns about foreign investors owning domestic companies which can in turn be magnified by a lack of transparency in the mergers and acquisitions process;
- ❖ fears that portfolio investors lead to volatility in asset markets insofar as they cause prices to move more sharply than would be justified by 'fundamental' factors. Portfolio investors, the argument goes, are interested in short run capital gains and dividends rather than in contributing to the long run health of domestic companies (and hence the domestic economy as a whole). Foreign direct investors, by contrast, are presumed to base their decisions on longer term economic and political fundamentals, and are therefore less volatile in their short term behaviour;
- ❖ fears that, because of their wealth, foreign investors will be able to buy large shares in domestic firms and capture the majority of capital gains and dividends that flow from rapid economic growth.

The effects of foreign equity investment on domestic corporate performance are debatable. On the one hand, some investors tend to follow an index-based approach and have little interest in underlying performance of the companies in which they invest. Others may simply be unable to play an effective role in domestic corporate governance because they do not have enough information to do so. Ownership restrictions, however, by confining foreign investors to small equity stakes, can reinforce such ineffectiveness.

On the other hand, foreign equity investment can lead to improvements in company performance, through demonstration effects as domestic companies seek to attract foreign investment, and also foreign practices are adopted by domestic shareholders. In India, for example, foreign portfolio investment in domestic financial institutions has led to better corporate governance, both directly in the institutions involved, and indirectly on a wider scale by setting a new benchmarks in standards.

A preferable way to provide a counter-balance to foreign involvement in domestic equity markets would be to build up domestic institutional funds (pensions and mutuals). A stronger domestic institutional base would provide additional depth and liquidity to domestic capital markets. Domestic institutional investors could help to stabilise those markets by stepping in if, for example, many foreign investors were selling at the same time for reasons not related to domestic factors or to the domestic capital markets. This may in turn require further reforms of the domestic legal and regulatory framework for investment, particularly in the area of investor protection.

7 Infrastructure

47 The importance of good physical infrastructure in attracting foreign investment is also largely self evident. For example, Hong Kong and Singapore, have remained attractive to foreign investors because of good infrastructure, despite being high wage economies.

8 Human capital

48 While cost of labour does remain a factor, upgrading of skills is increasingly important in attracting inward investment. A host country with a larger supply of trained and trainable labour is likely to attract more foreign investment than others. This investment is also more likely to be of higher quality and in linkage intensive-activities such as engineering, that require a strong local supplier base with a diverse range of technical skills, but also allow the host economy to capture the beneficial spillover effects of foreign investment more readily. So national policies to improve levels of human capital are of great importance.

9 Investment promotion, targeting and special incentives

49 Promotion and targeting strategies can also be successful in attracting inward investment. Success is dependent on the development of clear long term strategies. The most successful investment promotion agencies tend to have, for example, a comparatively narrow focus – concentrating on identifying specific opportunities and targeting them very closely both in terms of sectors and specific markets that they regard as being particularly effective for them. Uganda, for example, is looking towards Malaysia as a more likely source of investment than Singapore. Other agencies are also starting to target individual companies.

50 Perceptions among potential investors can be particularly important. African countries, for example, suffer from a blanket image insofar as they tend to be regarded as a single entity – and one that is failing. South East Asia by contrast now has an exceptionally powerful image as a stable and strong economic base. Investors, therefore, accept lower rates of return in Asia than they do in Africa. Perceptions can, however, change rapidly as the recent currency crises in a number of South East Asian economies have demonstrated.

51 Follow up and use of networks to support existing investors are also of fundamental importance, in two ways:

- ❖ by generating reinvestment which is a common feature among the biggest recipients of foreign investment
- ❖ by maximising the value of the investment to the domestic economy and helping to embed those investments into the economy. Companies which are tied into the local economy, use local suppliers, have local markets, and are involved in local joint ventures, are less likely to move than simple assembly or ‘screw-driver’ operations that import most of their inputs and export most of their outputs. This in turn places a premium on investment in education and human capital to raise the skill levels of local labour forces.

10 The role of financial markets

52 The strength of domestic financial markets and the banking sector in particular is a key factor in enabling a country both to avoid the pitfalls and exploit the benefits of integration with the international capital markets.

53 Private capital flows carry dangers for vulnerable financial systems, as discussed below. But they can also enhance the role of domestic capital markets in increasing domestic invest-

ment and better allocating capital among potential investments. They provide access to larger supplies of investment resources for domestic capital markets generally, and to larger amounts of loanable funds for the banking system. They also allow more efficient diversification of risk through the availability of new financial instruments. And they generate increased financial market competition.

54 Increases in private capital flows have been a key factor behind improving the depth and liquidity of domestic capital markets in many countries. Trading activity has expanded in parallel with the growth in market size. But within this global trend toward larger capital markets, the largest increases in market size have been in developing countries. Equity market capitalisation in the major emerging markets, for example, has risen from 7.2 per cent of GDP in 1985 to 42.9 per cent in 1994 (Table 1). The African experience is illustrated in Box 2.

Table 1 Stock market growth (market capitalisation, per cent GDP)

	1985	1994
Emerging markets	7.2	42.9
o/w India	6.9	44.0
Malaysia	52.0	281.6
Pakistan	4.4	21.6
Sri Lanka	6.2	24.6
Major markets	54.6	68.2
o/w UK	70.8	118.2
memo: South Africa	n/a	185.2

Sources: IFC Emerging Markets Fact Book, and Emerging Markets Investor Fact Book

55 But most emerging markets still have some way to go to match the depth and liquidity of capital markets in most advanced economies. And a great many more markets are still at the pre-emerging stage. In Malaysia, which is arguably one of the world's more advanced emerging financial market, one fifth of all securities trades do not settle on the contractual settlement date. This is four times more than in the US. Bid/ask spreads (and therefore the cost of equity capital) in emerging markets tend to be significantly higher than in advanced economies.

56 In order to compete for new issues and investors, not only with advanced markets but also with a growing number of emerging markets, developing countries will need to develop their capital markets. Better capital market infrastructure, protection of property rights, and a well conceived and properly enforced regulatory framework can all facilitate market development by promoting investor interest and liquidity, and reducing systemic risks and volatility. The experience of some East Asian countries, such as Singapore and Malaysia, suggests that this development can take place in a very short space of time.

57 However, open capital markets also increase the risks of potential financial instability which can then undermine the benefits of private capital flows and magnify the impact of macroeconomic and financial problems. International financial flows have exposed the underlying vulnerability of weak financial systems in several emerging market countries. The early establishment of a robust financial system is therefore an essential element in avoiding or coping with such problems. The viability of domestic financial systems has important implications for handling volatility in capital flows and for the liberalisation process itself. These are discussed further in section 4.

Box 2 The Emergence of Stock Markets: Africa

The evolution of capital markets in Africa in recent years has been rather dramatic. To date, Africa has 16 stock exchanges. Most are less than 10 years old. A statistical comparison of some African Stock Exchanges is attempted in the table below.

In recent years, activity in African capital markets has been boosted by a number of positive developments. Political changes have enabled political pluralism to emerge in many countries. Greater accountability and transparency of government actions is another development. Economic reforms have given rise to liberalisation and led to freeing up of exchange controls and exchange rates. At the same time privatisation of state-owned enterprises, lifting of price controls and reducing the monopoly of marketing and distribution of products; and deregulation of trade flows has created an environment for the private sector to function. Consequently, African markets have made significant progress. Activity in a number of capital markets that have been dormant for years picked-up significantly and a number of new markets have emerged in the last decade. Furthermore, countries such as Uganda and Tanzania are taking steps to launch their own stock exchanges. In a number of established stock exchanges, activity has been boosted by increased listings of companies, partly made possible by privatisation of state-owned enterprises.

African markets are however, relatively small, illiquid, indeed at a rudimentary stage of development. The total number of listings is less than 2,000 (Egypt, Nigeria and South Africa account for almost 75 per cent of all listings). This compares to a country such as India which has around 6,000 listed companies.

The continuing success of stock exchange development in Africa is likely to depend on the speed and effectiveness of creating the right environment. The evolution of viable and efficient financial markets with diversified banking and non-bank financial sectors and an appropriate legal and regulatory and supervisory system. Financial market development tends to be sensitive not only to the legal, regulatory and tax frameworks existing in a country, but also to country, country, country, the nature of macroeconomic and sector policies being pursued.

Country	GDPcurrent prices (\$US Millions)1995	Population (Million) 1995	Year established	Number of Listed Companies mid 1995	Market capitalisation (US\$ Millions) mid 1995	Average dividend yield of companies quoted (%) mid 1995
Botswana	4,318	1.5	1989	11	340	6.5
Namibia	3,033	1.5	1992	8	200	2.6
Zimbabwe	6,522	11.0	1974	60	2,050	5.4
Zambia	4,073	9.0	1994	7	790	0.9
Kenya	9,095	26.7	1960s	52	1,690	4.8
Nigeria	40,477	111.3	1960s	147	775	5.7
Ghana	6,315	17.1	1990	17	1,750	1.6
Ivory Coast	10,069	14.0	1976	27	525	6.9
Morocco	32,412	26.6	1950s	51	6,090	2.7
Mauritius	3,919	1.1	1989	24	1,580	n.a.

Source: IFC, Euromoney/World Bank

11 Conclusions

58 This sections brings together the Group's conclusions on the role of national policies in attracting and sustaining private capital flows, and in ensuring that those flows are put to best use within the host economy.

- i sustained implementation of sound macro-economic and structural policies is as important for attracting and sustaining private capital flows as it is for promoting healthy domestic economic development
- ii investors are attracted by stability in the political process, and by reliable and transparent legal, accounting, regulatory and tax systems
- iii early establishment of robust and well regulated financial and banking systems is important, and essential to safeguard against financial stress in the event of a reversal of capital inflows
- iv open trade and investment policies, particularly in well-integrated and rapidly growing regional markets, provide the best environment for foreign investors to operate in. The relaxation of foreign exchange restrictions can in itself help to attract private capital flows
- v regional integration can be helpful in attracting private capital flows. This may in turn require improvements in transport, communication and other market links within the region. It would, however, be counter productive for countries to pursue regional integration at the expense of wider multilateral trade and investment liberalisation

vi 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 foreign markets

vii governments should be careful about imposing restrictions on foreign ownership and consider whether existing restrictions are necessary or useful

viii countries should take advantage of privatisation programmes, and private involvement in domestic infrastructure projects as a way of attracting foreign investors, and improving the quality of infrastructure

ix investment in a well functioning physical infrastructure, can also in itself help to attract private capital flows.

x a skilled and trainable work force is another key factor in attracting investment. National programmes to invest in human capital are critically important to enhance competitiveness and attract investments in high value added activities.

59 The Group recognised that even after the implementation of many of these measures, it can take a number of years to establish credibility among the international investment community - especially for those countries which are new to international capital markets. Good marketing in the form of investment promotion and targeting strategies can help to overcome barriers and establish credibility.