

Foreword

The Commonwealth Secretariat has been giving a great deal of emphasis in its activities to assisting developing countries of the Commonwealth in attracting private flows. It has set up an intergovernmental working group, consisting of the representatives of 15 Commonwealth countries, to develop recommendations for national and international policies for attracting private flows for investment. The Group will be presenting its conclusions to the next meeting of Commonwealth Finance Ministers in September 1997. This paper, prepared by Richard Portes and David Vines, was commissioned by the Economic Affairs Division as a contribution to the deliberations of the Group.

Private capital flows to developing countries have increased dramatically in the 1990s. These flows are important because of their role in supplementing savings and financing investment and growth. In addition, the benefits of foreign direct investment are now widely recognised including their value in facilitating transfer of technology, greater access to foreign markets for domestic goods and enhanced competition within national markets particularly for services. There are however major concerns about the sustainability and volatility of these flows. On sustainability, there is a view that the recent increase in flows can be explained as a once-for-all stock adjustment on the part of the world's investment community to the newly liberalised financial markets and profitable opportunities in developing countries, and that once such adjustment has been completed, these flows would stabilise to more normal levels. Another view is that the capital flows to developing countries are an ongoing response on the part of globally-oriented investors to changing incentive structures so that the recent increases in capital flows could be easily be reversed.

The increasing integration of developing countries into the global capital markets has also meant that these countries are becoming more vulnerable to external developments such as cyclical swings in industrial countries or disturbances in major markets. The Mexican crisis and its contagion effect on other countries in early 1995, led to a sharp cut back in portfolio flows to emerging markets, but once the initial reaction subsided, the attitude of investors became discriminatory. Broadly speaking, countries with low savings, large current account deficits, weak banking systems and significant values of short-term debt, experienced greater pressure than countries with sound fundamentals. Sudden inward capital surges can give rise to serious problems of real exchange rate appreciation, falling profitability in the production of tradeable goods, rising current account deficits, accumulation of foreign currency debt and eventually the sudden shock of reversal of flows. Portes and Vines argue for the need *inter alia* to: use a wide range of diverse policy instruments; control budget deficits before opening up the capital account; have an institutional framework that will firmly underpin monetary policy; preserve freedom for the timing of liberalisation of the capital account. They discuss the risks of using sterilised intervention while conceding that this may be useful only if inflows are temporary; and briefly consider the role of cross-border transaction taxes arguing that the costs of using such taxes would far outweigh any short-term benefits.

In respect of global systemic reform, the authors recommend that the IMF should continue to improve data standards of members as a source of information to the markets, but argue against their use as an early warning system. They do not believe that there is a precise connection between out-

comes on a large number of indicators and the possible emergence of crisis which inevitably would depend on a number of difficult-to-measure factors not on the IMF's list. They conclude that the IMF should not aim to become a rating agency but instead continue to provide confidential advice to countries and to work with them, confidentially, to solve their problems. In addition Ports and Vines make a major contribution by coming out with an innovative proposal for orderly debt workouts. Their ideas have been accepted by the G10 but there is still a great deal of reluctance on the part of the G7 and the IMF to support the proposals. The Fund has a particular difficulty in agreeing to lend into arrears in dealing with financial crises involving securitised debt. We believe that orderly debt workouts is an idea whose time has come and one which the Commonwealth needs to consider supporting.

A handwritten signature in black ink, appearing to read 'E Anyaoku', written in a cursive style.

Emeka Anyaoku, *Secretary-General*