

Managing the Economic Impact from Foreign Capital Flows

Discussion paper by Randall Dodd*

International capital investment can play a useful role in development by adding to the savings of low and middle-income developing countries in order to increase their pace of investment. However, foreign investment can also prove unproductive to developing economies by exposing them to disruptions and distortions from abroad, and by subjecting them to surges of capital inflows or massive outflows of capital flight.

The Secretary-General has noted in his first report following the International Conference on Financing for Development that, “capital movements to developing countries have declined markedly from 1997 to 2001, with only a small increase in 2002.” International capital flows can best help economies develop and spread the benefits of prosperity to all their citizens when those flows are steady and do not undermine the stability of the financial systems of the developing economies. Towards this end, the full implementation of the Monterrey Consensus will help channel international capital flows so that they best help economies develop and spread the benefits of prosperity to all their citizens. This is accomplished when the magnitudes of flows are steady and the types of investments are suited to local economic needs and involve an appropriate sharing of market risks.

Description of flows

Foreign capital flows can come from public or private sources. The public or "official" flows come in the form of aid or loans, and they originate from individual country governments as bilateral flows or from the World Bank or IMF as multilateral flows. Over the past twenty years, the volume of private flows has become much greater than public flows. The average annual net official flows were \$26.7 billion from 1980 to 1990, and then declined to an average of \$21.3 billion from 1991 to 2003. Meanwhile, net private flows were \$20 billion and \$118 billion, respectively.¹ These private investments are more important due to the decline in official flows.

Figure 1. Public (official) versus Private flows

(billions of dollars)

	1997	1998	1999	2000	2001	2002e	2003f
Net private flows (debt + equity)	285.1	205.2	194.7	191.8	152.8	143.3	163.0
Net official flows (aid + debt)	39.7	62.3	42.9	23.4	57.5	49.0	32.0

Source: World Bank's Global Development Finance.

The private flows not only become larger but also more volatile. The volatility of foreign capital movements, measured as the standard deviation of the net flows, rose sharply from \$16 billion for the 1980 to 1990 period to \$55 billion for 1991 to 2003.

¹ IMF World Economic Outlook dataset.

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This paper was prepared on the initiative of the Friedrich Ebert Foundation and the Washington-based New Rules for Global Finance Coalition.

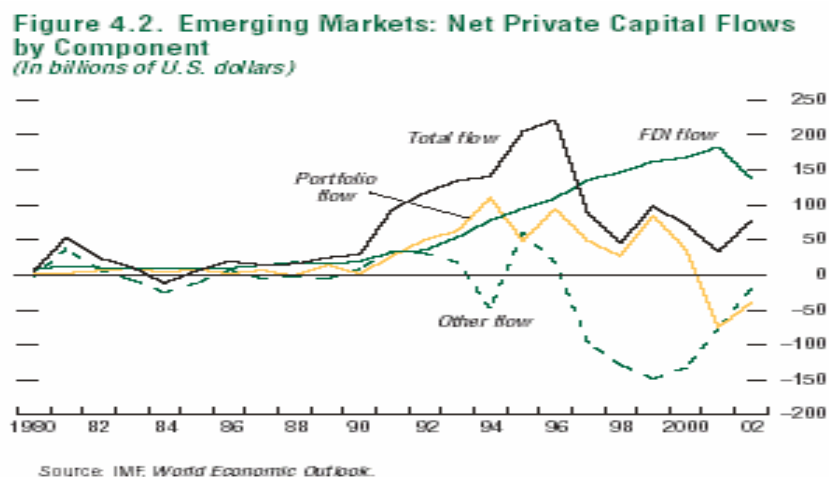
Some types of foreign capital investments were more volatile than others. Foreign direct investment (FDI) grew rapidly over the past decade, and while the pace has declined since 1999 the net inflows remain large. FDI is the purchase of physical plant and equipment, and it is called “Greenfield” when new facilities are constructed and it is called “mergers and acquisition” when existing physical capital is purchased. The privatization of public assets during the 1990s led to greater FDI in pursuit of these existing assets. Examples of FDI include the speculative purchase of real estate in Bangkok, acquiring an existing bank in Mexico or railway in Argentina, or building a new assembly plant in China.

A more volatile source of foreign capital comes as portfolio investment in bonds and stocks issued by developing country governments and corporations.² Net flows of portfolio investment surged starting in 1992, dropped sharply in 1998 and then turned negative in 2000. Measured by the coefficient of variance, portfolio investments have been 4.5 times more volatile than FDI since 1991.³

The result is a broader investor base. Private investment has moved beyond bank lending, and now includes portfolio investment in stocks and bonds that has opened up developing country investments to managed funds, hedge funds and individual investors.

The source of foreign capital that has proven most volatile is that from bank lending. Some bank lending is very short-term whether for trade financing or for speculative purposes. Other times in the 1990s, longer-term bank loans have had attached “put option” provisions that allow the lender to recall the loans prior to maturity. Overall, net capital inflows from bank lending have been even more volatile than flows from portfolio investment. Volatility of these different types of foreign investments is illustrated in the following chart from the IMF's World Economic Outlook (note that bank loans and deposits are listed as “Other flows”).

Figure 2. Comparing Volatility of Foreign Investment Types



² A portfolio equity investment of more than 10% of a corporation's shares is classified as FDI.

³ The standard deviation divided by the mean, the figures for portfolio and FDI are 1.97 and 0.44, respectively.

Concentration of capital flows in a few countries

In addition to problems related to the volatility of international capital flows, there is the additional problem that the flows tend to concentrate in a few countries. According to data from the World Bank for 2002, 61% of FDI in developing economies went to four countries (76% went to 9 countries), and 96% of portfolio equity investment went to just six countries. All of Sub-Saharan Africa received just 4.9% of FDI. The data for debt is more complicated because the latest figures show a net outflow of debt for 2001. Of this, Argentina, Brazil, Thailand and Turkey figured prominently as shares of the outflow, and the only countries with substantial net inflows were China and Russia. The last year Sub-Saharan Africa had positive net debt inflows was 1997.

Coming and going – risks to developing countries

Capital flows are most helpful when the magnitude of those flows is steady and stable, and when the types of investments are suitable to meet the development needs of the economy. Although the useful purpose of foreign capital is to augment domestic savings in order to raise investment, the volatility of those flows sometimes results in the opposite. Savings averaged 23.4% of GDP for developing countries between 1981 and 1996, while investment averaged 25.7% -- thus foreign investment contributed 1.3% of GDP towards investment on average each year. However, since 1998 the savings rate has exceeded that of investment because of the net outflow of capital from developing countries. Trend is predicted to continue through the near future.

There are many motivations for international capital investment, and generally it is the pursuit of a higher rate of return. Some particular motivations that raise grave concerns are the outflanking of labor standards and environmental protections in the home country. In addition, FDI seeks out special natural resources and opportunities to acquire newly privatized assets. Foreign lending, through bank loans or bonds, helps developing countries adjust gradually to external shock such as an oil price hike or natural disaster, and provides the lenders some geographical diversification of their assets.

While these motivations can be identified and accounted for, the actual behavior of financial markets sometimes appears less rational or dependable than these economic factors would indicate. The consequences of this include unstable or undependable international capital flows.

A surge of capital inflows into a developing country can be triggered by the lifting of restrictions on the capital account, known as capital account liberalization, and by a policy to privatize what were formerly publicly owned assets such as the telephone or railway system. Foreign capital can also be “pushed” from abroad when the rates of return on capital decline in the advanced capital market economies.

When investment managers of large funds such as pension funds, mutual funds, hedge funds, trusts and insurance companies engage in “herding” or trend investing, this can lead to a surge of capital into a country.

The consequences of this rush or excessive capital inflow can be devastating. It puts upward pressure on the developing country's exchange rate and if it is not sterilized through central bank intervention then it appreciates the currency and reduces the competitiveness of the country's traded goods. The capital inflow can also lead to speculative booms in the price of local assets such as real estate and equity shares. Thailand experienced a boom and bubble in its real estate and stock markets before they burst during the financial crisis in 1997.

The rapid movement of capital, like a speeding bullet, can do more damage through the exit wound it creates. Capital flight is generally the cause of the collapse of fixed exchange rate systems as was the case for Mexico in 1994, the five crisis countries of East Asia in 1997, and Russia in 1998. The massive outflows depress the prices of real estate, equity shares and other domestic assets, and they cause a loss of bank deposits that leads to lending constraints and tight credit conditions. The result is a rise in unemployment and poverty, and the weight of these social dislocations has proven to fall disproportionately on women and the poor. Women are often the targets for lay-offs during an economic contraction, and families respond to falling incomes by increasingly sending wives and daughters into the labor force.⁴

Making matters even worse is the tendency for international capital markets to spread the effects of a financial crisis in one country to others in a process known as contagion. In this way, financial market disruptions in one country inflict severe costs on other countries that played no role in the cause of the original crisis.

Exposure to market risk and credit risk

In addition to, and interrelated to, the impact of international capital surges, panics and droughts, developing countries face the risk of changes in exchange rates, interest rates and debt default. The risks associated with changes in interest rates and exchange rates are known as market risk because it refers to the uncertainty of the market price of credit or foreign currency.

Capital flows to developing countries that are invested as bank loans or bonds have been almost entirely denominated in US dollars or other major currencies such as the euro or yen. When the dollar appreciates, say in response to tighter monetary policy by the Federal Reserve, then borrowers in developing countries will face higher debt payments when measured in either the own local currency or other major currencies.

Similarly, foreign debt is also subject to changes in interest rates when it is rolled-over at maturity or according to a regular schedule if it is variable rate debt. Hence an increase in interest rates in the US will lead to higher debt repayments costs, and if the higher interest rates also lead to a higher valued US dollar then the debt costs will rise that much more.

This situation puts a great deal of pressure on fixed exchange rate systems in the developing world. Investors and speculators alike know the consequences of a general US dollar appreciation on the ability of a smaller, poorer country to maintain its peg to the rising dollar.

⁴ World Bank (1998). *The East Asian Financial Crisis and the Road to Recovery*. New York: Oxford University Press.

This makes parallel appreciation of the pegged currency reduces the competitiveness of the developing country exports and harms the trade balance. If the central bank finds it necessary to raise interest rates in order to maintain the peg, then it also dampens the developing economy. Alternatively, if the central bank tries to avoid raising interest rates by intervening in the foreign exchange market in order to defend the peg, then investors and speculators alike will watch the level of foreign reserves closely for signs of weakness in the central bank's ability to maintain the peg.

Policy responses

As described above, international capital investment is a paradox of potential good and bad. Former IMF Managing Director Camdessus put like this, “the paradox of the present world economic situation: promise – unprecedented prospects in certain fields – but financial instability and exclusion, the so cruel situation of the poorest and the anxieties of so many in the world.”

Policy makers in developing countries should have the latitude (policy space) to exercise their public authority in order to stabilize the magnitude of capital flows and encourage the most appropriate vehicle for foreign investment. While the first course of action is to pursue macroeconomic policies that promote steady and sustainable growth, this is sometimes not enough. It is a common feature for market economies to experience economic cycles and so an economic downturn at some point in the future, despite the best policy decisions, is all but inevitable. Moreover, international linkages mean that developing economies are also subject to shocks or disturbances from abroad, and even the best of policies cannot prevent outside events from having a contractionary impact on the home economy.

In this context, there are several types of policies that developing countries can pursue in order to best protect their economies from adverse external events and from the volatility of capital markets.

Prudential regulation of financial markets

Capital requirements govern how financial institutions borrow abroad and generally take on risks such as off-balance sheet derivatives. This dampens capital inflows in so far they flow through financial institutions. And when financial institutions hold less market risk they are more stable and less apt to trigger capital flight and contagion to other countries. Collateral requirements, such as those for buying securities on margin, will dampen speculative pressures on asset prices. It also helps prevent systemic failures in markets for derivatives, repurchase agreements and securities lending.

Reporting and registration requirements not only help prevent financial fraud but also make markets more transparent and thereby improve market efficiency in determining prices. It also allows investors and policy makers to detect imbalances in the economy before they build to crisis proportions.

Orderly market rules help maintain liquidity and prevent destabilizing market events. Examples include requiring dealers to maintain bid and ask quotes throughout the trading day,

price limits for securities and derivatives exchanges, fair credit reporting rules, prohibitions against predatory lending and deposit insurance.

Capital controls

When prudential regulations prove insufficient to dampen capital surges and discourage excessive risk taking, or when they fail to adequately protect the stability of financial system from external shocks, then properly designed capital controls can be used effectively to restrict inflows and prevent massive outflows from undermining stability. There are many ways to implement capital controls and their effectiveness requires judicial application. Restrictions on capital inflows used by Colombia and Chile, which required a portion of inflows be set aside for a period of time, helped protect those economies from boom-bust cycles. Malaysia used capital controls to prevent massive capital flight during the financial crises that swept through East Asia in 1997 and these measures have been credited with the rapid recovery of that economy.

Anti-trust laws

Markets work best when they are competitive and not dominated by one or a few major corporations. In order to prevent forces such as mergers and acquisitions from leading to industry concentration, anti-trust laws must be enacted and enforced. When an industry is inherently made up a natural monopoly or oligopoly, then regulatory measures are needed in order to prevent the inefficiencies of price gouging. At other times, industries need to be protected so that one large outfit does not succeed in becoming dominant in the market. Financial markets are often characterized by having a single stock market, single futures exchange, and a few large sophisticated banks. Such a high level of concentration of ownership and control needs oversight so that the inefficiencies and unfairness of non-competitive market do not thwart development.

Performance requirements

In addition to these stabilizing measures, there is also the potential for policy to shape foreign investment so that it is best suited for domestic development. Sometimes FDI amounts to only the sale of cheap labor or natural resources. Policies known as performance requirements are sometimes needed in order to assure that FDI will have collateral benefits such as technology sharing, developing managerial experience and other skills, and gaining exposure into foreign markets. However these policies are controversial and have been sometimes prohibited by trade and investment agreements.

Questions

- How can developing countries protect their economies, and thereby the standards of living and prospects for growth, from the disturbances and disruptions that occur in international financial markets?
- How can developing countries attract fresh capital during droughts in capital flows such as those experienced in the past several years?
- Considering the decline in the importance of lending by official multilateral agencies such as the World Bank, how can the poorest developing countries augment these funds by attracting more private capital?
- How can developing countries encourage more of the type of international capital flows that are best suited for the development needs of the country?
- How do we attract more foreign capital?
- How can we shape the capital inflows to best suit our needs?
- Will the Tobin Tax help?
- What are examples of the most appropriate prudential regulations for developing countries?
- Will derivatives undermine our efforts to regulate markets and manage capital flows?
- What is the best way to dampen surges of capital inflows?
- What is the best way to restrict or discourage capital outflow?
- What about the low-income developing countries that have only simple financial markets?
- How can the low-income developing countries attract more capital?
- Will prudential regulation of financial markets discourage capital inflows?