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Capital Flows To Developing Countries: Does The Emperor Have Clothes?

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This paper begins by examining the pattern of capital flows first to low-income countries, and then to emerging economies. In both cases, we see a dramatic collapse in the last several years. The evolving determinants of these trends in FDI flows (the principal category of private flows to low-income countries) and other capital flows are analysed. The behaviour of flows to emerging economies heavily influences both present and potential future flows to low-income countries. The paper concludes with the policy implications at both source countries and low-income recipient countries.

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I Introduction

Since the Asian crisis, there has been a collapse in private capital flows to low-income developing countries, and emerging economies alike, and sharp changes in the composition of these flows. According to World Bank data, net private flows to low-income countries dropped from $32bn in 1997 to just $2bn in 1999, rising slightly to $4bn in 2000 (see Table 1 below). Net private capital flows to all emerging economies declined since 1997 and were practically zero in 2000 and 2001, according to IMF *World Economic Outlook* data shown in Table 2.

Insufficient emphasis has been placed as yet by analysts and policy-makers on the nature, causes and policy implications of these large changes. A key question is whether these changes are mainly structural or cyclical. Though this is a difficult question to answer, it is very important to attempt to do so, given the different policy implications for all involved, but particularly for low-income developing countries.

Indeed, one scenario is that recent trends continue for a long period. The surge in private capital flows to developing countries in the 1990s might have been, as the IMF November 2001 *Emerging Market Financing Quarterly* puts it, a "one-off portfolio stock adjustment" that has now run its' course. This would imply that the presence of foreign companies, banks and other investors in developing economies would no longer contribute foreign exchange or external savings to these economies; their only contribution would be via transfers of technology, management know-how and other expertise. The latter is clearly important, particularly for certain categories of countries – such as low-income and transition economies. However, much of the value of foreign presence for developing countries is in the *blend* of both capital flows and transfer of expertise. If only transfer of expertise were to remain, the balance of benefits and costs would change quite significantly, as would the amount of policy and other effort that may be justified in trying to attract such flows. The emperor would have no clothes, or - more accurately - would be half-naked.

The alternative scenario is that the sharp decline is mainly driven by general cyclical factors and the memory of recent crises. If this is the case – and if crises stop happening – then the pay-off is far greater for policy-makers (in developed and developing countries, as well as in international organisations), to make efforts to attract private flows to return to developing countries, as well as encouraging more those flows that are more stable.

As already mentioned, for low-income economies, the evolution of private capital flows shows an equally disturbing picture since 1997, when these flows have collapsed, as discussed in detail in section II. The situation there is particularly worrying for two reasons. First, the decline is across the board, affecting all categories of inflows. In addition, the potential negative effect on growth and poverty reduction could be much larger.

The issues to emerge most strongly from this study are those of risk, imperfect information and missing markets. All three of these issues have implications for the developed country investor *demand* for long-term assets and for the *supply* of long-term assets in developing, and especially low-income, countries. As a consequence,

they have profound implications for policy as well. The issues are clearly interrelated, as imperfect information contributes to missing markets – and vice versa – and both contribute to risk. But there are distinct issues that arise in each case that merit separate analysis.

Risk is of fundamental relevance to investors, and has a direct influence on the price investors are willing to pay for an asset. Virtually all of the formal analysis in this area focuses on price risk – that is, the variance of total returns and their covariance with the returns of other assets. The financial crises of the 1990s, however, have demonstrated that liquidity risk is also a crucial factor influencing investors.

More fundamentally, while portfolio theory takes risk as exogenous to the investor, it is now clear that both investor behaviour and developed-country policy decisions influence price risk. Price risk is endogenous to investor behaviour as a result of, among other factors, benchmarking of fund managers and changes in global risk aversion (and its interaction with liquidity risk) – both of which lead to strong herd behaviour among investors. The relevance of these factors has been evident in the large swings in the degree of correlation among emerging market assets in the last half of the 1990s – a pattern that cannot be explained by exogenous changes in "fundamentals". Price risk is also endogenous to policy decisions, which affect the incentives and constraints imposed on investors. An important recent example in this area is the new Basle Capital Accord and the now well-documented implications for the cyclicality, cost and level of financing to developing countries.

This endogeneity of risk to investor behaviour and to policy decisions underscores the importance of a developed-country policy response as part of any initiative to increase the supply of long-term capital to developing countries.

While the endogeneity of developing country asset risk to developed-country policy decisions has only recently begun to attract attention, the endogeneity of such risk to host (developing) country policies has long received intensive scrutiny. As discussed in more detail below, one key issue in this area is that of political and economic stabilisation, and the related issue of policy consistency.

The endogeneity of developing country asset risk to recipient country policy is closely related to the other themes of imperfect information and missing markets. An important component of the "international financial architecture" response to the crises of the 1990s has been an increased emphasis on transparency of country data and policies – as reflected particularly in the area of codes and standards. The crises – notably those in Mexico and Thailand – highlighted how imperfect information can contribute to the misallocation of capital flows, exacerbating booms and impeding necessary policy adjustments. These crises showed that it is not only the comprehensiveness and accuracy of information that matters but also its timeliness and regularity. The initiatives on codes and standards have been important in all these areas. However, as many analysts have noted, improved information is not, in many circumstances, sufficient to improve the efficiency of the allocation of capital flows.

While virtually all of the emphasis in this area has been on developing countries, it is worth remembering the LTCM debacle and the prolonged liquidity crisis that ensued. That crisis demonstrated that a lack of transparency in developed country financial

markets is also a factor that contributes to instability and can have an adverse impact on the demand for developing country assets.

A final theme in our analysis is the importance of missing markets. A distinguishing feature of long-term assets is the need for associated long-term contracts. Such contracts, in turn, require an institutional setting that includes well-defined property rights and effective enforcement mechanisms. It is therefore no surprise that recent research has highlighted the role of governance and property rights as impediments to investment. Another area in which missing markets are important is in the provision of long-term finance from domestic sources. Such finance can facilitate inward investment both directly, by providing an alternative source of funding, and indirectly, by stimulating domestic investment and by providing a domestic yield curve against which assets can more easily be priced.

A related issue is that of the small and segmented nature of most low-income developing country markets. The small scale of most corporates in low-income countries is a factor not stressed in the literature, but one that we have established in interviews is a major constraint for both portfolio investment and bank lending to those countries. Market size and market access have been shown empirically to be key determinants of direct investment (e.g., Devereux and Griffith, 1998). These factors are also regularly cited by firms as a major obstacle to investment in Africa (e.g., the current CREFSA-CSAE survey of direct investors into Africa).

The issues of market size and market access have been interpreted by the "new" trade theory as fundamentally related to trade costs. A now extensive literature has demonstrated the influence of such costs in determining not only the volume and direction of trade, but also the level and location of foreign direct investment. The magnitude of trade costs facing developing countries is determined primarily by three factors. The first of these is the economic trade costs such as those associated with weak transport and telecommunications infrastructure. These costs tend to be highest in the least developed economies. The second is the high costs of trading with partners in the region, as a result of the slow pace of moves towards creating larger regional markets. Africa, in particular, has a long history of regional integration initiatives, but few successes. Progress in reducing the impediments to trade among regional partners in Africa and in South Asia can have a significant impact on inward investment flows. The final, and perhaps most important issue, is that of access to developed markets. The adverse impact on direct investment of small domestic markets can be overcome through access to other markets, particular the largest developed markets in the US and Europe. Yet, access to these markets is uneven, with significant tariff and non-tariff barriers in many of the areas of most relevance to developing countries.

Section II begins by examining the pattern of capital flows first to low-income countries, and then to emerging economies. In both cases, we see a dramatic collapse in the last several years. Section II goes on to analyse the evolving determinants of these trends in capital flows. It provides an assessment of FDI flows (the principal category of private flows to low-income countries) and goes on to assess other capital flows, focusing particularly on flows to emerging economies, which heavily influence both present and potential future flows to low-income countries. Section III examines the policy implications both in source countries and low-income recipient countries.

II New pattern and sharp decline of private flows

As shown by the World Bank data presented in Table 1, total private flows to low-income countries collapsed after 1997. As the collapse in private flows was accompanied by only a small increase in official flows, total long-term net resource flows fell by half over the two years. Recently released figures show little signs of recovery in 2000, and the prospects for 2001-2 remain bleak. As discussed below, the pattern of private capital flows to emerging markets in recent years present an equally disturbing picture.

Table 1: Net long-term resource flows to low-income countries, 1990-2000 (1)

In millions of US dollars	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Total	**33,503**	**36,793**	**38,226**	**37,934**	**48,949**	**47,371**	**53,358**	**50,110**	**38,778**	**26,876**	**25,173**
Official flows	**26,867**	**28,527**	**28,102**	**24,710**	**26,826**	**22,326**	**19,756**	**18,883**	**23,670**	**24,652**	**20,592**
Long-term loans (2)	11,918	12,224	12,594	11,072	9,564	5,758	4,840	5,065	8,878	9,321	5,402
Grants (3)	14,949	16,304	15,509	13,639	17,263	16,567	14,916	13,818	14,792	15,332	15,191
Private flows	**6,636**	**8,266**	**10,124**	**13,224**	**22,122**	**25,045**	**33,603**	**31,227**	**15,108**	**2,223**	**4,581**
Bank lending (4)	3,876	1,986	4,711	952	1,763	1,301	3,335	4,155	-3,765	-7,273	-7,296
Bond financing	142	1,734	-103	435	623	2,304	3,854	5,409	5,315	-2,841	2,787
Portfolio equity flows	416	33	499	4,564	10,727	7,617	8,846	2,671	649	2,616	2,528
Foreign direct investment (net)	2,201	4,514	5,016	7,273	9,008	13,824	17,569	18,993	12,910	9,721	6,562
Memo item											
Short-term debt	7,464	1,962	5,200	-6,035	27	9,286	8,894	2,116	-13,757	-901	-254

Notes:

1. Source: World Bank, Global Development Finance 2002, database.
2. Includes "Net Flow of Long-Term Debt: Public & Publicly Guaranteed: Official Creditors"
3. Excludes technical assistance
4. Includes "Private Creditors (non-Bond)" and "Private Nonguaranteed (non-Bond)"

1. An overview of private capital flows to low-income countries

Private capital flows to low-income countries have fallen across the board, with massive withdrawals of bank lending and even bond finance and, strikingly, a sharp drop in FDI as well. This contrasts with the experience of emerging markets and middle income developing countries more generally, where the collapse has focused on bank lending and FDI has continued to rise, as discussed above. The reversal in long-term bank lending began in 1998 in the aftermath of the Asian Crisis. Following average net new lending of $4bn in 1996 and 1997, there were net repayments of $3.5bn in 1998 more than doubling to $7.7bn in 1999. As shown in Table 3, the total repayments of long-term loans in 1998 and 1999 exceeded the total cumulative net lending over the period 1994 to 1997. This sharp reversal was compounded by a massive withdrawal of short-term loans (see memo item in Table 3). The net withdrawal of short-term lending in 1998 reached $13.7bn – almost fully offsetting the net inflows of long-term capital from all sources that year.

Bond finance to low-income countries also turned negative in 1999, following a string of large inflows in previous years. The downward trend in portfolio equity flows began earlier. Equity inflows dropped from an average of more than $9bn in 1994-96 to less than $2bn in 1997-99.

As briefly sketched out above, and as reflected in Table 2, and Graph 1, capital flows to emerging countries have suffered a major change since the East Asian crisis. According to IMF data from the October 2001 *World Economic Outlook*, net private capital flows to emerging market economies, which had peaked to almost $240 billion in 1996 (having grown consistently throughout the first half of the 1990's), more or less halved to around $120 billion in 1997, fell by around 40% to around $70 billion in 1998, fell a bit further in 1999 and collapsed to practically zero in 2000, and are projected by the IMF to be negative in 2001 (the most recent data for the latter is in the November 2001 IMF *Emerging Market Quarterly*). Emerging market current accounts have as a result also shifted dramatically, from significant deficits to very large surpluses, since 1999.

Table 2. Emerging Market Economies: Net Capital Flows
(billions of US dollars)

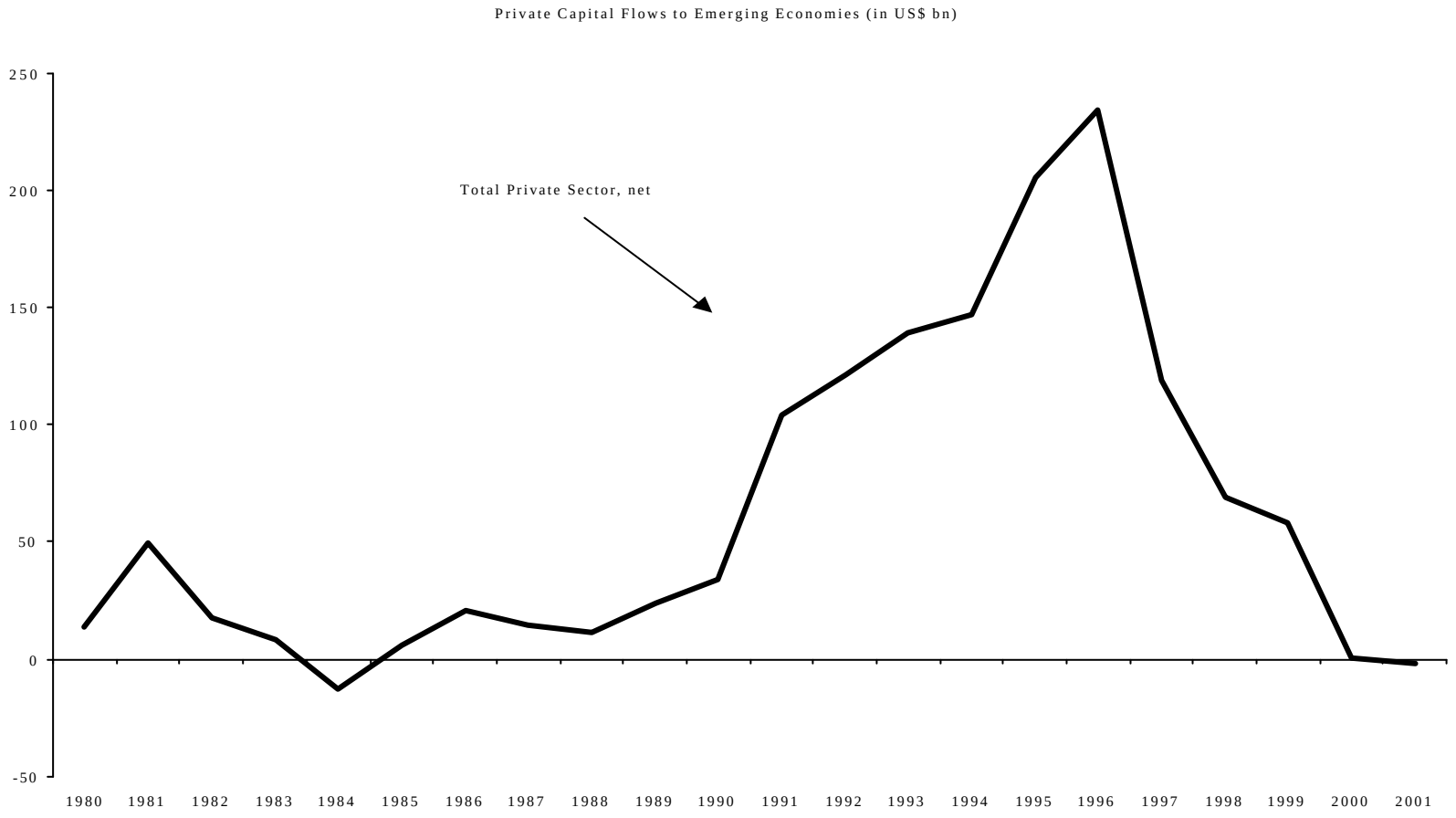
	1993	1994	1995	1996	1997	1998	1999	2000	2001[(1)]	2002[(2)]
Total										
Private capital flows, net	139.1	147.5	205.5	234.4	119.1	69.1	58.6	0.5	-1.4	71.0
Private direct investment, net	57.6	81.4	97.5	120.0	145.8	155.9	153.1	147.3	162.7	158.2
Private portfolio investment, net	87.6	112.8	43.8	87.8	48.1	-2.0	31.7	1.5	-0.2	24.0
Other private capital flows, net [(3)]	-6.1	-46.8	64.2	26.7	-74.8	-84.9	-126.2	-148.3	-163.9	-111.2
Official flows, net	50.3	5.5	24.1	0.1	62.2	55.4	9.5	1.4	19.6	-3.5
Change in reserves	- 64.3	-69.8	-117.7	-109.1	-61.9	-44.4	-87.6	-112.7	-81.5	-83.8
Memo item										
Current account	-117.3	-72.7	-91.6	-95.7	-70.0	-52.6	39.1	128.1	69.6	14.5

(1) Estimated
(2) Forecast
(3) Mainly net bank lending. Net bank lending is net lending minus variations of deposits in international banks and estimates; p projection

Source: IMF World Economic Outlook, October 2001

Source: IMF - Emerging Market Financing Quarterly. 14th November 2001

Graph 1


Private Capital Flows to Emerging Economies (in US$ bn)
Total Private Sector, net
250
200
150
100
50
0
-50
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001

As we will discuss in more detail below, there has also been an important change in the structure of private flows to emerging markets. These flows are now dominated by FDI (see again Table 2), which are the only significant source of supply of private capital to the total of emerging markets. According to data in the IMF 2001 *International Capital Markets Report*, this is particularly true for the Western Hemisphere and somewhat less the case for Asia, as in the latter net portfolio flows play a relatively large role (though smaller than FDI).

Compared to the experience of emerging market countries, the most striking and disturbing feature of the recent trends in private capital flows to low-income countries has been the sharp fall in foreign direct investment inflows. After climbing every year in the 1990s to reach a peak of almost $20bn in 1997, FDI inflows fell by almost half to less than $10bn in 1999. These changes are examined in more detail in the section that follows on FDI flows.

China has attracted around one-fifth of all private capital flows to developing countries in the 1990s. As shown in Table 4a, private flows to China increased strongly in the first half of the 1990s, peaking at $60bn in 1997, before falling back sharply to $42bn in 1998. The fall was due, in part, to a reversal in long-term bank lending, as net borrowing turned sharply negative in 1998 and 1999 (this was accompanied by a massive withdrawal of short-term bank lending, as shown in the memo item of Table 4). In addition, there was a collapse in bond finance and a sharp fall in equity investment. The impact of these declines was, however, limited by the dominance of FDI in total inflows. Indeed, FDI accounted for three-quarters of total net private inflows in the peak year 1998 and almost one-hundred percent in 1998 and 1999.

Table 3a: Net long-term resource flows to China, 1990-1999 (1)

In millions of US dollars	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Total	**10,082**	**9,797**	**23,982**	**44,437**	**47,849**	**51,900**	**54,751**	**65,381**	**45,230**	**42,670**
Official flows	**1,975**	**2,286**	**2,683**	**4,887**	**3,457**	**8,231**	**4,652**	**4,552**	**2,554**	**2,038**
Long-term loans (2)	1,727	2,044	2,356	4,615	3,119	7,902	4,409	4,315	2,288	1,706
Grants (3)	249	242	327	272	337	329	243	237	267	333
Private flows	**8,107**	**7,512**	**21,299**	**39,550**	**44,393**	**43,669**	**50,099**	**60,828**	**42,675**	**40,632**
Bank lending (4)	4,668	2,469	8,952	5,979	3,814	4,696	5,264	4,805	-3,936	-2,514
Bond financing	-48	24	-3	2,238	2,876	317	1,190	3,330	1,587	660
Portfolio equity flows	0	653	1,194	3,818	3,915	2,807	3,466	8,457	1,273	3,732
Foreign direct investment (net)	3,487	4,366	11,156	27,515	33,787	35,849	40,180	44,237	43,751	38,753
Memo item										
Short-term debt flows (net)	2,410	1,463	2,985	1,531	2,187	4,843	3,082	6,057	-3,532	-10,251

Notes:

1. Source: World Bank, *Global Development Finance 2001*, database.
2. Includes "Net Flow of Long-Term Debt: Public & Publicly Guaranteed: Official Creditors"
3. Excludes technical assistance
4. Includes "Private Creditors (non-Bond)" and "Private Nonguaranteed (non-Bond)"

Table 3b: Net long-term resource flows to India, 1990-1999

In millions of US dollars	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total	**4719**	**5001**	**5242**	**7345**	**8755**	**4430**	**7486**	**6927**	**7629**	**3351**
Official flows	**2846**	**3460**	**3161**	**2321**	**1614**	**-490**	**809**	**146**	**1477**	**1538**
Long-term loans (2)	2334	2895	2581	1836	1002	-1048	220	-397	1001	1069
Grants (3)	512	565	581	485	612	558	589	543	476	469
Private flows	**1873**	**1541**	**2081**	**5024**	**7141**	**4920**	**6677**	**6781**	**6152**	**1813**
Bank lending (4)	1459	87	1769	2178	1475	973	35	-781	-946	-532
Bond financing	147	1380	-206	456	-37	286	-182	1869	4121	-1125
Portfolio equity flows	105	0	241	1840	4729	1517	4398	2116	342	1302
Foreign direct investment (net)	162	74	277	550	973	2144	2426	3577	2635	2169
Memo item										
Short-term debt flows (net)	1043	-1474	-730	-2714	638	785	1677	-1680	-717	-286

Notes:

1. Source: World Bank, *Global Development Finance 2001*, database.
2. Includes "Net Flow of Long-Term Debt: Public & Publicly Guaranteed: Official Creditors"
3. Excludes technical assistance
4. Includes "Private Creditors (non-Bond)" and "Private Nonguaranteed (non-Bond)"

Private inflows to India were, by contrast, stable in 1998, but then fell very sharply in 1999. As shown in Table 3b, FDI flows fell back somewhat in 1998-99 from their peak in 1997. While private flows to India proved resistant to the immediate fall out of the Asian crisis, the sharp contraction of the flow of international bond finance to developing countries that occurred in 1999 did have an effect, as India experienced a sharp reversal of bond financing leading to a drop in private inflows overall.

2. Foreign direct investment

Foreign direct investment is the dominant form of private capital flow to developing countries, accounting for about 70 percent of private flows to developing countries as a whole and a significantly higher percentage of private flows to low-income countries. It is therefore particularly important to understand how these flows have evolved in recent years. The data analysed in the first part of this section were provided by UNCTAD, from the *UNCTAD Handbook of Statistics 2001*.

It is important to emphasise, as discussed above, that these data do not fully capture the flows of direct investment experienced by developing countries. As discussed in Annex 1, Bhinda, Griffith-Jones, Leape and Martin (1999) show that direct investment flows are exceedingly difficult to monitor due to the problems of measuring and identifying flows through institutions such as bureaux de change and even banks. Although it is impossible to identify the scale of the under- or mis-recording with any degree of precision, case studies suggest that the underreporting of direct investment flows can easily amount to several percentage points of GDP. Thus, while the UNCTAD data on FDI remain the most reliable source of data for international comparisons and analysis, they, like the World Bank data, must be used with caution.

The surge in foreign direct investment – and in private capital flows generally – in the 1990s is well-documented, as is the even greater surge in direct investment into developing countries. While the analysis below focuses on normalised levels of these flows as percentages of gross fixed capital formation (GFCF) and of GDP, it is useful first to examine the changes over time in the levels of direct investment flows and how these have been distributed across countries. Since both GFCF and GDP are relatively stable over time, it is by direct examination of the changing levels of FDI in low-income countries that we obtain the clearest picture of the trends and patterns in these flows.

As shown in Table 4, annual inflows of direct investment into developing countries in the 1990s averaged $108bn (compared to $16bn in the 1980s). Indeed, the level of direct investment to developing countries increased every year in the 1990s, reaching $194bn in 1999.

An examination of the *share* of worldwide direct investment flows going to developing countries reveals a somewhat different picture, especially in the most recent period. UNCTAD data show that developing countries' share of world direct investment flows averaged 27 percent in the 1990s (compared to 17 percent in the 1980s), peaking at 37 percent in 1997. This rise reflected, in part, the gathering pace of privatisation programmes in developing countries.

Since 1997, however, the share has dropped by more than half, reaching 14 percent in 2000. The declining developing country share is, in part, the result of the global mergers and acquisitions boom in 1998-2000, in which developing countries played only a very minor role. But the effects of the Asian crisis and of the LTCM-Russian crisis, and their aftermath, are also evident: apart from a short-lived increase in 1999, FDI flows to developing countries have not increased since 1997 while flows to developed countries have almost quadrupled.

Much of the increase in direct investment flows to developing countries in the 1990s was the result of a sharp rise in the investments flowing to a handful of the largest economies. The major emerging market countries together accounted for about two-thirds of the $93bn rise in average flows to developing countries between the 1980s and 1990s, with China alone accounting for $27bn of the rise. China's share of total FDI flows to developing countries peaked at 38 percent in 1993, before falling to less than a quarter in recent years.

Direct investment flows to the major emerging markets have also proved robust to the downturn in flows to other developing countries since the Asian crisis as discussed below. Flows have risen strongly over the period, from $86bn in 1996 to $126bn in 2000. Much of the increase has gone to the major Latin American economies, together with Taiwan and, especially, Korea, with flows to China and India remaining flat over the past five years.

Table 4: Inflows of foreign direct investment, 1990 – 2000

In millions of US dollars	Annual Average Inflows 1980 - 89	Annual Average Inflows 1990-99	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
World	93836	396624	202297	155583	168501	221855	256518	331068	384910	477918	692544	1075049	1270764
Developing countries	15749	108252	26491	36546	52587	72335	91682	110228	133404	174367	174862	193606	175593
as % of world	17%	27%	13%	23%	31%	33%	36%	33%	35%	36%	25%	18%	14%
Major emerging markets	8333	69414	15398	21230	34000	47971	61740	71896	85622	112461	106335	132547	126166
as % of dev'g countries	53%	64%	58%	58%	65%	66%	67%	65%	64%	64%	61%	68%	72%
China	1508	28465	3487	4366	11156	27515	33787	35849	40180	44237	43751	40319	40772
Sub-Saharan Africa	1288	4514	1285	2413	2104	2287	3714	4724	5221	8704	6341	8310	6846
as % of dev'g countries	8.2%	4.2%	4.9%	6.6%	4.0%	3.2%	4.1%	4.3%	3.9%	5.0%	3.6%	4.3%	3.9%
Angola	134	574	-335	665	288	302	170	472	181	412	1114	2471	1800
Nigeria	434	1177	588	712	897	1345	1959	1079	1593	1539	1051	1005	1000
South Africa	21	850	-78	248	4	10	380	1241	818	3817	561	1502	877
South Asia	260	2259	545	408	758	1118	1586	2945	3686	4935	3541	3063	3036
as % of dev'g countries	1.7%	2.1%	2.1%	1.1%	1.4%	1.5%	1.7%	2.7%	2.8%	2.8%	2.0%	1.6%	1.7%
India	105	1523	236	74	277	550	973	2144	2591	3613	2614	2154	2315

Source: Data supplied by UNCTAD, from forthcoming *Handbook of Statistics, 2001.*

The robustness of direct investment flows to the major emerging markets since the Asian crisis has not, however, been shared by the low-income developing countries. As shown in Table 1, FDI flows to low-income countries in 2000 were only a third of the 1997 levels.

An analysis of flows to Sub-Saharan Africa and to South Asia confirms this downward trend among low-income countries. As shown in Table 5, FDI flows to Sub-Saharan Africa as a whole have been volatile in the late 1990s. Virtually all of this volatility has, however, been due to just two countries: South Africa and Angola. Excluding those countries and Nigeria, FDI inflows to the region have declined since 1998, although less sharply than for low-income countries as a whole (see Leape, 2002, for a more detailed analysis of capital flows to Africa).

FDI flows to South Asia have dropped more sharply since 1997, with falls in all countries (see Table 4). After increasing almost 1500 percent between 1990 and 1997, direct investment flows to India have fallen back 40 percent in the last three years. Flows to the rest of the region have decreased by 30 percent over the same period.

If, however, we examine the magnitude of FDI flows in terms of recipient country GDP and gross fixed capital formation (GFCF), a different picture emerges. Annual FDI inflows to Sub-Saharan Africa, according to the UNCTAD data shown in Table 5, averaged just over three percent of GDP in the 1990s – on a par with flows to developing countries as a whole and substantially higher than the figures for the major emerging markets (two percent of GDP) or for developed countries (1.2 percent). As a share of gross fixed capital formation, FDI flows to Sub-Saharan Africa averaged 11 percent in the 1990s, more than double the percentage for developed countries (excluding the high M&A-driven figures at the end of the 1990s). These figures appear inconsistent with the high levels of risk in low-income countries, especially in Africa – a theme that is explored in more depth in section III.

The apparent inconsistency is, in part, a reflection of the low levels of fixed investment in Sub-Saharan Africa. More important, however, is the different composition of direct investment in Africa compared to other regions. Leape (2002) shows that almost exactly half of the stock of US direct investment in Sub-Saharan Africa in 2000 was petroleum-related. Moreover, this percentage has increased from only a third in 1990, indicating that a substantial fraction of new direct investment into Sub-Saharan Africa in the 1990s was in the petroleum sector. This contrasts with the diversification of FDI flows to poor countries generally during the 1990s, where the share of the mineral- and oil-exporting countries in total FDI to the poor countries dropped from almost half in 1991 to 20 percent in 1997 (GDF 2002).

Table 5: FDI inflows as a percentage of GDP and of Gross Fixed Capital Formation

	FDI as % of GDP		FDI as % of GFCF	
	Average 1980-89	Average 1990-99	Average 1980-89	Average 1990-99
World	0.7	1.4	3.2	6.6
Developing countries	1.3	3.2	6.0	12.8
Major emerging markets	0.7	2.0	2.9	7.5
China	0.5	4.1	1.5	11.2
Sub-Saharan Africa	1.3	3.1	7.3	10.9
Angola	2.2	10.1	19.3	55.6
Nigeria	1.4	3.9	14.1	26.1
South Africa	0.0	0.7	0.0	3.7
South Asia	0.4	1.0	1.1	3.8
India	0.0	0.4	0.2	0.4

Source: Data supplied by UNCTAD, from forthcoming *Handbook of Statistics, 2001*.

The countries of South Asia have experienced lower levels of foreign direct investment than other developing countries, whether we look at FDI inflows as a fraction of GDP or of GFCF. FDI inflows averaged just one percent of GDP in the 1990s – less than one-third the level in developing countries as a whole (see Table 5). A similar picture emerges from a comparison of FDI inflows to gross fixed capital formation, where the share averaged less than four percent. Indeed, over the 1990s, FDI inflows into developing countries (and to Sub-Saharan Africa) more than doubled as a percentage of GDP – but rose by less than 25 percent in South Asia. The same picture emerges in even starker form as regards FDI flows into India. Measured as a fraction of GDP, FDI flows to India in the 1990s averaged only 0.4 percent – one-eighth the average for developing countries generally. As a fraction of GFCF, FDI was even less important, at less than a twentieth the average developing country level.

FDI flows to China present a very different picture. From insignificant levels in the 1980s, direct investment into China surged in the first half of the 1990s. As shown in Table 6, FDI to China as a share of GDP was twice the average for the major emerging markets, and well above the average for developing countries. Foreign direct investment into China accounted for more than a tenth of average gross fixed capital formation in the 1990s, again exceeding the average for emerging markets by a significant margin.

Policy reforms and direct investment flows

The potential for sharply increasing FDI flows to low-income countries through policy reforms has been illustrated by the experience of Bangladesh in the 1990s. Bangladesh removed several restrictions on foreign investors – including prior approval requirements and restrictions on profit repatriation and on equity stakes – in

the early 1990s.[1] FDI inflows then increased more than tenfold in 1997 (from $13mn in 1996 to $141mn in 1997) and continued at the new higher levels in 1998 and 1999. Although the energy sector has been the major recipient of these flows, manufacturing and service industries have received almost one-third of the new inflows. It is, however, important to note that FDI flows to Bangladesh remain very small relative to the size of the economy, at less than one-half of one percent of GDP at their peak in 1998.

While liberalisation of restrictions on investors is clearly essential to attracting investment, they are far from sufficient. Numerous studies have identified unstable political and economic environments as a key impediment to long-term investment (see, for example, Hess, 2000, for a discussion of the issue in Southern Africa). Such instability creates problems of imperfect information, as investors face greater uncertainty in their expectations of future prices and future policies. Instability also leads to missing markets, as the resulting range of possible contingencies inhibits firms from entering into long-term contracts.

Many sources of economic and political instability are, however, amenable to action by governments and societies. Resolution of long-standing political conflicts can yield dramatic benefits. So, too, can macroeconomic stabilisation and greater policy consistency. The transformation in Mozambique, for example, has been associated with a six-fold rise in inward direct investment, compared to a rise of less than threefold for developing countries generally. The political and economic stabilisation in Uganda led to a similar rise in direct investment inflows over the same period, while that in Tanzania has been associated with a tenfold increase. Equally dramatic was the impact of the democratic transition in South Africa, which was associated with an even larger proportionate increase in direct investment inflows over the period, albeit from a particularly low base in the early 1990s.

Table 6a,b,c provides further evidence of the importance of sound policy in attracting foreign direct investment. Table 6a show the net long-term resource flows to severely-indebted low-income countries, excluding the "original" and "enhanced" HIPC countries. Here the trends identified above for low-income countries as a whole (Table 2) come out even more strongly. Not only did private flows to these severely-indebted low-income countries collapse in 1998 (falling to a negligible £590mn from $16bn the previous year and $20bn in 1996), but they then turned strongly negative in 1999, with a net outflow of $4.4bn in private capital.

An examination of the composition of inflows shows a staggering withdrawal of long-term banking lending, with outflows in 1998-99 equal to some four-fifths of total cumulative inflows in the previous eight years. This outflow of long-term bank lending was accompanied by an equally dramatic outflow of short-term bank lending, an outflow of bond finance and a collapse in portfolio equity. Most surprisingly – and in contrast with the experience of emerging markets, as noted above - the data show a collapse in FDI inflows, with a drop of almost 80 percent between 1996 and 1999. Indeed, the reversal of private capital flows to these countries has been so dramatic

[1] *Global Development Finance 2001*, p. 39.

that more than half of all official assistance to these countries in 1999 was absorbed by repayments to private banks and bondholders.

Table 6a: Net long-term resource flows to severely-indebted low-income countries (excluding HIPC countries), 1990-1999

In millions of US dollars	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total	**12707**	**15535**	**15542**	**13727**	**20371**	**21889**	**24762**	**21638**	**7908**	**3663**
Official flows	**8557**	**10254**	**9545**	**8659**	**8689**	**6903**	**4819**	**5617**	**7319**	**8054**
Long-term loans (2)	4600	5470	5161	4380	3943	2570	481	1421	3527	4143
Grants (3)	3957	4784	4384	4279	4746	4333	4337	4196	3791	3911
Private flows	**4150**	**5282**	**5998**	**5068**	**11682**	**14986**	**19943**	**16021**	**590**	**-4391**
Bank lending (4)	2009	1486	2117	-1766	1011	-43	2770	3869	-2889	-6218
Bond financing	26	381	155	8	690	2248	3894	3494	-141	-1533
Portfolio equity flows	312	23	258	2637	5053	5624	3814	552	252	1274
Foreign direct investment (net)	1803	3391	3467	4188	4928	7158	9465	8107	3368	2086
Memo item										
Short-term debt flows (net)	4255	4017	4952	-2548	867	7646	5006	681	-9866	-1609

Table 6b: Net long-term resource flows to original HIPC countries, 1990-1999

In millions of US dollars	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total	**3340**	**3677**	**3246**	**3269**	**4113**	**4487**	**4227**	**3928**	**4578**	**3942**
Official flows	**3254**	**3657**	**3267**	**2948**	**3688**	**3459**	**2923**	**2723**	**2844**	**2186**
Long-term loans (2)	1325	1108	1300	1203	1302	1040	779	649	548	166
Grants (3)	1929	2550	1967	1745	2387	2420	2144	2075	2296	2020
Private flows	**86**	**20**	**-21**	**321**	**425**	**1028**	**1304**	**1205**	**1734**	**1757**
Bank lending (4)	11	-86	-50	-65	-55	59	142	-226	-139	-254
Bond financing	-2	0	0	0	0	0	0	-3	-23	-46
Portfolio equity flows	0	0	0	0	7	3	30	18	6	8
Foreign direct investment (net)	77	106	29	385	473	966	1131	1416	1889	2049
Memo item										
Short-term debt flows (net)	744	155	372	394	-1529	709	2040	1402	-238	8

Table 6c: Net long-term resource flows to enhanced HIPC countries, 1990-1999

In millions of US dollars	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total	**6418**	**5808**	**6277**	**5018**	**5194**	**4708**	**4775**	**5514**	**4941**	**5398**
Official flows	**6189**	**5779**	**6069**	**4780**	**5058**	**4495**	**4151**	**4593**	**4038**	**4185**
Long-term loans (2)	2251	1378	2246	1599	1435	937	915	1909	782	971
Grants (3)	3938	4401	3824	3181	3623	3558	3237	2684	3255	3214
Private flows	**229**	**29**	**208**	**238**	**136**	**213**	**624**	**921**	**904**	**1213**
Bank lending (4)	-12	-129	-75	-58	-130	-221	-2	-60	-20	-9
Bond financing	0	0	0	152	0	-13	-21	-30	-32	0
Portfolio equity flows	0	0	0	0	0	0	0	0	24	0
Foreign direct investment (net)	241	158	283	144	267	448	646	1011	931	1223
Memo item										
Short-term debt	302	-515	-156	-212	-51	213	-28	826	-80	38

Notes:

1. Source: World Bank, *Global Development Finance 2001*, database.
2. Includes "Net Flow of Long-Term Debt: Public & Publicly Guaranteed: Official Creditors"
3. Excludes technical assistance
4. Includes "Private Creditors (non-Bond)" and "Private Nonguaranteed (non-Bond)"

By contrast, Tables 6b and 6c show that the HIPC countries – both those in the "original" group and those in the "enhanced" group – experienced sharp increases in FDI inflows in recent years, which in both cases almost doubled between 1996 and 1999. These increases resulted in a steady rise in private capital inflows over the period, despite the small withdrawals of bank lending that occurred.

The contrasting experiences of the HIPC countries and the non-HIPC severely-indebted low-income countries appears to provide evidence of the success of HIPC in attracting new private capital flows. On closer examination, however, the role of HIPC in stimulating the increasing flows is less clear. In the first instance, private capital flows, especially debt flows, to the original and enhanced HIPC countries in the first half of the 1990s were negligible – in contrast to the significant lending that took place to the non-HIPC severely-indebted low-income countries, with the result that there was simply less private capital to be withdrawn when the Asian crisis struck. Indeed, relative to previous debt inflows, the reversal of debt flows to the original HIPC countries was, if anything, greater in magnitude than the reversal experienced by the non-HIPC countries.

More importantly, the "outperformance" in direct investment flows to the original and enhanced HIPC countries – compared to the non-HIPC severely-indebted low-income countries – dates from 1997, which is *before* the impact of or even eligibility for HIPC (especially in the case of the "enhanced" countries) would have been anticipated by potential investors. It seems likely that HIPC status has conferred additional credibility on the economic reforms undertaken by the participating countries. However, on the basis of these data, one cannot reject they hypothesis that it is the good policy environment – for which HIPC was a reward – that has been more important in attracting increasing private capital inflows.

It is worth noting that the costs of instability can be just as great as the benefits of stabilisation, and tend to be felt more quickly. The current turmoil in Zimbabwe has led to a collapse in investment inflows, from a peak of $444mn in 1998 to $30mn in 2000.

The only significant exception to this pattern is natural resource-driven investment flows, which have proved relatively robust to political and economic instability. Angola, for example, has continued to attract substantial oil-related investments, despite the civil war. It is important to recognise that natural resource-driven investments differ from other investments in important ways. The output is destined for world markets, and wholly independent of the domestic market. The returns are therefore typically in hard currency and often kept offshore in escrow accounts. The investments are carried out in enclaves where it is feasible for the investor to provide any needed infrastructure and protection. And the level of returns is generally high enough to enable the investor to buy the necessary political support from rent-seeking factions and politicians. For all of these reasons, mineral- and oil-related investment is relatively robust to the types of risk that would typically discourage investment in other sectors. This, in turn, helps to explain the relatively high level of FDI to Sub-Saharan Africa, especially relative to GDP and GFCF, in the face of the array of risks discussed more fully in section III below.

By contrast, investments aimed, at least in part, at producing for the domestic market; investments in the manufacturing and service sectors; investments aimed at building linkages with small and medium-sized enterprises – all of these depend critically on economic and political stability. Efforts to increase long-term investment into low-income countries must therefore pay close attention to this issue.

The foregoing examination of FDI inflows has revealed a degree of diversity among low-income countries. While the role of mineral and oil-related investments has been discussed in explaining the relatively high level of FDI in Sub-Saharan Africa, the low level of FDI in the poor countries of South Asia remains noteworthy. Against this background, it is striking that the countries of South Asia have, in recent years, achieved average growth rates twice as high as those in Sub-Saharan Africa. While an examination of the reasons for this divergent growth experience goes far beyond the scope of this paper, it is worth noting that this underscores the crucial importance of the *productivity* of investment.

More importantly, the data presented above demonstrate that private capital flows to low-income countries have collapsed since 1997, as debt outflows have been compounded by steep declines in FDI.

These declines are particularly disturbing in light of the view expressed by market participants that FDI is the most attractive vehicle for investment in low-income countries, especially in Sub-Saharan Africa. Indeed, one senior market participant said: "FDI may be the only likely future flow to low-income countries."[2] An explanation given by another market participant of why investors should prefer to go into low-income countries via FDI rather than via portfolio investment is that the former allows them more control which they see as particularly important, given that according to their perception, there is insufficient rule of law, imperfections in corporate governance and, especially, insufficient protection of minority investors. In this light, if the recent declines in FDI to low-income countries persist, they may herald a sharp reduction in the flow of private capital generally.

The sharp falls in direct investment to low-income countries add a new urgency to the question of how the demand for long-term assets in low-income countries can be increased. Part of the answer appears to lie in addressing a set of issues relating to developed country investors. Another part of the answer seems, as illustrated by the above review of several "success stories" from Africa, to lie in policy reforms – and, in particular, sustained efforts to achieve political and economic stabilisation – in the recipient countries. A detailed consideration of these issues – relating to developed-country investors and to recipient country policies – is presented in Section III below.

Before proceeding to those issues, however, we turn to an examination of the experience of emerging markets during the recent downturn in capital flows. As noted earlier, emerging market experience is highly relevant to that of low-income countries. In the first instance, the more developed and more liquid emerging country markets typically provide the first indications of shocks that will later affect developing countries more generally. More importantly, the emerging markets also

[2] Interview material

provide insights into the issues likely to face low-income countries as their capital markets, and their economies more generally, continue to develop.

In contrast to the pattern identified above in low-income countries, FDI to emerging markets has, in recent years, played a stabilising role, partly offsetting outflows of debt finance. However, FDI flows are increasingly hedged.

Within emerging markets, there has been not just a drastic fall in but also a dramatic change in the structure of flows. FDI to emerging markets, which had tripled since the early 1990's to peak at $155 billion in 1998, remained constant at that high level. It is since 1998 also the only significantly high source of foreign capital inflow for emerging markets. This change in the structure of flows, with far greater importance for FDI, is overall a very positive development.

Important caveats are necessary even for FDI. The first one is that there is a risk that FDI even to emerging markets may not be sustained at its' current high levels. This is both because of changes in the developed economies and because the "easy phase," of FDI purchasing companies that are being privatised or buying large attractive companies already in the private sector, may gradually come to a close. In successful dynamic economies or sectors, this phase may be followed by additional FDI to take account of profitable opportunities of expansion (e.g. as occurred in telecoms in several Latin American countries), or greenfield investment. However, in less dynamic economies or sectors, FDI may just decline in a second phase. (See recent Report on FDI by ECLAC, 2002)

The second caveat has been explored less in the literature, but it has in fact become a major new issue.[3] It relates to the fact that multinational companies, especially those producing for the domestic market, can hedge the foreign exchange risk, either for their profit remittances or even up to the level of their capital. This may reduce the positive net foreign exchange impact of the FDI; this may be done for example, by purchasing US $ or US $ denominated government paper in the country (e.g. Brazil, Mexico), or by hedging off-shore. It is particularly problematic if companies dramatically increase their hedging of exchange rate risk, at a time when a devaluation becomes likely; as there may be no-one willing to "take the other side", this may lead to an outflow of foreign exchange, and thus put pressure on the exchange rate. Though the intention is to hedge and not to speculate, the impact on reserves and the exchange rate may be the same. Reportedly, this trend has been a major one in recent years, especially in Latin America and has contributed to significantly deepen pressures on devaluation. A source of concern is that such hedging takes place both with fixed and floating exchange rate regimes.

The mechanisms through which such hedging by foreign direct investors takes place can be problematic in several ways (see Dodd, 2001). A common instrument for such hedging are foreign exchange forwards and swaps. Such transactions involve both a short and long position. Ideally, a dealer in such transactions faces markets with participants willing to buy and sell in equal amounts. However, often in developing countries (for example, when expectations of devaluation increase), dealers in such foreign exchange derivatives face a one-sided or imbalanced market in which most

[3] Interview material, see also Moguillansky (2001)

participants wish to be short the local currency. This may make it difficult or expensive for dealers to lay-off their long positions by selling short to others in the derivatives markets. As a result, either the forward exchange rate must deteriorate sufficiently to compensate the dealer and other risk takers for holding greater amounts of the long positions or s/he must find other means to manage risk.

One such method used in imbalanced markets is for dealers to create a synthetic short forward or swap contract through the use of the local and foreign credit markets. To do this, the dealer borrows in the local currency credit market, uses the loan to buy foreign currency spot and then lends it abroad, ideally matching the maturity for all three transactions. In the process of creating the synthetic short forward position in order to make a market in foreign exchange derivatives, the dealer has generated a capital outflow by borrowing at home and lending abroad. Thus, in the context of imbalanced markets, with more participants willing to hold short, rather than long positions at certain rates, hedging can generate capital outflows. Thus, should the foreign direct investor hedge the full value of the invested principal, then the hedging process can temporarily neutralise or net-out the capital inflow.

3. ***Bank lending: water flows upwards***

In sharp contrast to FDI, whose levels has remained high since the East Asian crises, net international bank lending to developing countries has not only collapsed but become highly negative during the 1997- 2001 period (see Table 7) as well as previous Tables. (See also BIS *Quarterly Review*, June 2002, which shows continued decline of lending to emerging markets through 2002).

Table 7: International banks' involvement with developing countries

	June 1998 (US $ BN)	Dec 2000 (US $ BN)	%change (at annual rate)
All developing countries			
Loans outstanding	924	739	- 8.8
Other assets*	110	155	14.7
Loans by subsidiaries in local currency	248	435	25.2

*Includes holding of debt securities, some derivative positions and equities.

Source: Hawkins (2001) and BIS data

The decline was across the board as relates to all developing country regions, but far deeper in crisis-hit East Asian economies. As shown in Table 1 above, low-income countries suffered a particularly dramatic reversal of bank lending. The main reason is banks' greater perception of the risks of lending to developing countries, especially to Asia. The main reason for the increased perception of - and aversion to - risk in international lending for developing countries comes from the frequency and large scale of recent crises. In interviews, bankers argue that currency mismatch is too

dangerous for both lenders and borrowers, given recent experience in crises. A secondary reason is that (once recession or lower growth hit countries), their demand for international loans fell. Another reason for the decline in international bank lending seems to be lower demand for international financing, as sovereigns and companies in emerging markets see domestic financing as safer.

As Kumar and Persaud (2001) argue persuasively for investors, it seems also to be true for bank lenders that at any point in time their appetite for risk is in one of two states: risk loving or risk averse. As emphasised in our introduction, this leads to an endogeneity of risk in low-income and developing countries, stemming from the decisions of developed country investors and lenders. Recent experience, and particularly the losses made in Russia and on developing country corporates[4] (especially in the East Asian crises countries), has contributed to bankers' aversion to developing country risk. This is occurring in a context where banks have become more generally risk sensitive and therefore more reluctant to assume risk. This is related to greater emphasis on shareholder value, which forces banks to reassess the balance of their activities against the criterion of rate of return, and not the volume of business. This pressure on shareholder value is being further encouraged by the growing importance of, and competition from, capital markets. Increasingly banks behave more like portfolio investors, and use similar instruments such as credit risk derivatives. Furthermore, an increasing trend amongst banks to use VAR models not only increase risk sensitivity but also according to some analysts, contribute to herding and pro-cyclicality.

A second, positive major change is that the average maturity of bank loans has increased. Thus, for all developing countries, the ratio of short-term to total debt fell from 54% in 1996 to 46.5% in 2000; the decline was particularly sharp for East Asia and the Pacific, where according to Work Bank data, it fell during the period from 1996 to 2000. One reason for this change is that borrowers have, as a result of the painful experiences of sudden loss of bank credit during recent crises, become reluctant to depend excessively on short term loans. Indeed, reportedly[5] several countries have adopted specific guidelines aimed at restricting short-term borrowing by banks and lengthening debt maturities. Some banks interviewed, argued that they would like to increase their short-term exposure, especially to large banks (which they consider safe), but there is insufficient country demand.

In the case of low-income countries, especially in Sub-Saharan Africa, banks have traditionally concentrated on short term lending, typically related to trade finance, and have - on the whole - avoided medium term international bank lending. Their reluctance to make such medium term loans to poor countries has increased, even if the country itself has improved its fundamental and structural features. However, some banks expressed interest in making small loans to SSA low-income countries, particularly if these are related to the payment business or if there is a package, which involves World Bank/export credit agencies loans or guarantees, and where the private bank lends a fairly small proportion, e.g. 25%. Banks continue to lend to creditworthy low-income countries like India and China.

[4] Interview material
[5] Interview material

A third major recent change (see again Table 2), related to the previous ones, is that international banks have been significantly increasing lending via domestic subsidiaries in local currency. This is made possible by the dramatic increase in foreign ownership by international banks of bank subsidiaries in developing countries, that is, banks "crossing the border."[6] Greater foreign ownership of banks is partly also a result of recent crises; these crises have significantly reduced the entry costs for foreign banks, not only through currency devaluations, but because crises led to an erosion of net worth of banks.[7] From the perspective of international banks, lending through subsidiaries has the advantage of allowing better quality control from lending officers located in specific emerging economies. However, the main advantages for the bank is avoiding a currency mismatch, and thus exchange rate risk.

These loans are funded locally via deposits in domestic currency. Though some bankers argue that local currency lending by foreign subsidiaries could potentially be complementary to international bank lending,[8] recent trends suggest the opposite, that is a substitution effect. Indeed, several bankers argue that there is a large redistribution of banks' overall emerging markets portfolios, in which banks have substituted onshore for offshore lending. From the perspective of developing countries, this may have some advantages, e.g. of stronger and more efficient banks, as well as some smaller vulnerability to crises. For example, in a recent study of private capital flows to Africa, Leape (1999) argues that the presence of foreign-owned banks can facilitate the transfer of skills in risk management and credit analysis and of good regulatory practice, and increase the quality of loans, as increased competition improves credit decisions and reduces margins. All of these factors can reduce vulnerability to crisis and, more generally, increase the resilience of financial systems.[9]

However, "crossing the border" also has costs and other disadvantages. The cost, which can be very significant, is a smaller capital inflow to the developing country (with a one-off purchase via FDI of banks replacing a far larger stream of international bank lending). The potential disadvantages are that domestic lending by international bank subsidiaries may have certain biases not suited for developing countries. For example, in comparison with the domestic banks which they have replaced by purchasing them, they may be more focussed on lending mainly to large companies, and less oriented to lending to SMEs, which generate a high proportion of employment in developing countries. Furthermore, they may attach more priority to consumer lending (e.g. credit cards), especially to middle and high-income persons, and less priority to lending to companies, especially for long term investment. Given the need in development countries for higher and more efficient investment, this may be very problematic.[10] Indeed, Leape (1999) finds that foreign banks in Africa have tended to focus primarily on profitable niche markets in high value consumer and corporate business, thereby undermining the profitability of the indigenous banking sector. In addition, experience in Africa has shown that foreign banks can also increase the vulnerability to crisis – as happened when the collapse of BCCI and of Meridian Banks triggered broader crises of confidence in the financial sectors in

[6] Lubin, 2001
[7] Lubin, *op. cit.*
[8] Interview material
[9] Leape (1999), pp. 145-6
[10] We thank Ricardo Ffrench-Davis for this point

several countries.[11] The effects on development in different categories of developing countries, of these new trends - increased bank foreign ownership, and of bank lending "crossing the border" - needs further careful empirical research.

While "crossing the border" has thus been an important factor in Africa, the same has not been true in China and India, where foreign ownership in the financial sector continues to be subject to stringent controls. In both cases, the incentives to liberalise foreign ownership have been much weaker. In addition to the historical resistance in both countries to foreign ownership, it is likely that the absence of regional integration as a policy objective and the relative lack of vulnerability to financial crisis have also played a role. Looking forward, however, it is likely that the incentives to facilitate foreign ownership in the financial sector will increase over time, and "crossing the border" may well become an important phenomenon in the coming years. A question that will then arise is to what extent the availability of domestic finance from international banks will slow the pace not only of international bank lending but also of foreign direct investment flows into China.[12]

There is another somewhat related change, which is banks' increase in fee-based activities (such as supporting bond issuance), which reflects banks aspirations for high returns, without adding assets to their balance sheet (which require more capital); it also reflects greater unwillingness to taking risks on their own balance sheets.

To conclude, the major reversal of international bank lending in the years following the Asian crisis clearly has a temporary element, largely linked to the memory of recent crises and reinforced more recently by the slowdown in the world economy and its' negative effects on developing countries' prospects. If crises stop occurring, the memory of them fades and the world economy recovers, this temporary element could be reversed.

However, more structural - and therefore more permanent - elements seem to play a significant role in the decline of international bank lending to developing countries. The main one seems to be increased ownership by international banks of subsidiaries in developing countries, which allows them to "cross the border" in their lending, with loans in local currency. Though such local currency lending could be complemented by international lending, there may be a strong incentive for banks not to do so on a significant scale, especially given increasing emphasis on risk sensitivity and the relatively high level of exchange rate risk in international lending to developing countries.

4. Portfolio Flows

a. Equity Flows

Portfolio equity flows to developing countries, which had grown significantly between 1990-1997, fell after the East Asian crisis, though the decline was far less dramatic than that of bank lending; flows then grew briefly especially to Asia, before starting to fall again;[13] furthermore, equity flows have become increasingly

[11] Leape, *op. cit..*, p. 146.
[12] We thank David Lubin for a useful discussion of these issues.
[13] Source: IMF *International Capital Markets*. 2001. IIF *Capital Flows to Emerging Market Economies*. Sept 2001

concentrated in very few developing countries, practically all of which are middle-income. Thus, in 2000, according to the World Bank *Global Development Finance 2001*, just four countries - Brazil, China, Mexico and Turkey - accounted for around 85% of all equity flows to developing countries. Of these four, only one, China, is low-income. Furthermore, the volatility of equity flows remains an issue. As the World Bank, points out, in three of the recent crises - Mexico, East Asia and Russia, mutual funds (which represent some of the most significant equity investors in emerging markets) withdrew large sums of money.[14]

Recent trends in portfolio equity flows to developing countries are in sharp contrast with global cross-border equity portfolio flows which have increased dramatically; indeed, according to Persaud (2001), those have risen fivefold from $268 billion in 1995 to an estimated $1.100 billion in 2000. Thus developing countries have a far lower percentage of global equity flows than in the mid 1990's.

The process of allocation of investors' funds to invest in equity - globally and in developing countries - is quite complex, particularly as it involves different actors. We will very briefly outline it here, as this helps analyse recent changes. Institutional investors - such as pension funds and insurance companies - as well as retail investors (wealthy individuals) and charities, are major actors in investment globally. In the case of pension funds, the ultimate responsibility for allocating funds falls on their trustees. However, particularly in the US and the UK, trustees rely on the advice of consultants, who advise on how - given the structure of their liabilities - they should broadly allocate their assets. Once the broad allocative decisions are taken, one or several fund managers are chosen. These fund managers may have global, regional or country mandates; they may specialise in bonds and/or equities. In the case of investment in developing countries, these may be a small part of a global fund, they may take the form of specialised funds for all emerging markets, they may be regional ones (e.g. for Latin America, for the Far East, Sub-Saharan Africa or Eastern Europe), or there may even be country funds.

One of the more important trends detected,[15] is that since the mid 1990's there has been a sharp reduction of so called dedicated investors: this refers both to emerging market country funds, which have practically disappeared, and a decline in regional emerging market funds. This latter trend seems particularly clear for Sub-Saharan Africa funds. A far higher proportion of equity flows going to emerging markets therefore is via so called "cross-over investors," that is those originating from global funds, where a very small proportion of their portfolios goes to emerging markets. This trend is problematic, because dedicated investors tend to have a more long-term commitment than cross-over investors, and therefore have lower rotation and volatility.[16]

As regards an explanation of the evolution of equity flows to developing countries; the nineties was described by one fund manager[17] as "a history of two halves." In the first half of the nineties, there was great optimism about the prospect for emerging

[14] *Global Development Finance 2001*. See also Griffith-Jones (2001), for a review of the evidence on the role of mutual funds in the East Asian crisis.
[15] Interview material
[16] Interview material and IMF International Capital Markets, op cit.
[17] Interview material

markets, with the expectation that higher returns would compensate for higher risks, and with the perception that emerging markets offered an interesting opportunity for portfolio diversification due to their low correlation with developed economies. As a result equity flows to EMs grew systematically.

The optimism even extended to Sub-Saharan Africa, which was called then "the last frontier of emerging markets."[18] However, even then, the lack of liquid secondary markets for African securities remained a major obstacle. Indeed, even South Africa, looked to by many as a potential Pan-African secondary securities market, has suffered from poor liquidity.

However, since the East Asian and other crises, this optimism has declined, and so have the equity flows. The main reasons given are that in the second half of the 1990's, volatility in emerging markets was very high, returns were not only very low, (and on occasions negative), but also lower than in the developed markets, and finally - as these stock markets become more integrated into global financial markets - correlation between emerging and developed markets increased; thus the gains from diversification declined. As a result, the promise that emerging markets would offer a higher economic growth and as a result, high returns and no correlation to compensate for higher risk was not fulfilled; and the risks were certainly seen as high, as one crisis in emerging markets followed another with alarming speed.

There seems to be particularly little interest in investing in low-income countries in Sub-Saharan Africa, as overall disappointment with EMs was reflected in perceptions of low-income countries, even though they themselves did not have currency crises. One reason given for the unwillingness to invest in Sub-Saharan Africa was lack of sufficient and sufficiently regular data. Fund managers and traders argue that to take a risk, they need to understand it, which in their context means to quantify it. It is, however, unclear to what extent improvement in data (though clearly a necessary condition), would be a sufficient one.[19] Amongst the additional pre-conditions highlighted for equity flows to grow to SSA was mainly sustained growth; as second order factors, improved corporate governance and better rule of law was emphasised (see also discussion below in section III).

There emerged also an additional, more structural factor that inhibited equity flows. This relates to the fact that - from the point of view of portfolio investors - there are not "sufficient" large companies left to invest in. Many of the most attractive, large and profitable companies (e.g. telecoms, energy and others) have already been sold to foreign direct investors; this is particularly the case in Latin America. As a result, there is no room for portfolio investors. The remaining companies are seen as relatively too small.

Finally, at the time of writing, there was an important cyclical (and thus hopefully temporary) element in portfolio equity flows. This relates to projected low-growth in developing countries, linked to slow world growth and to the uncertainty following the September 11 events. Several fund managers expressed the view that once growth

[18] For a more detailed discussion, see Bhinda, Griffith-Jones, Leape and Martin, *Private Capital Flows to Africa*, Fondad, The Hague, 1999.
[19] Different views were expressed in interviews.

returned to the world economy and emerging markets, and was sustained for a couple of years, there would be an increase in equity flows.

An important new trend that has emerged in recent years is that a growing proportion of the issuing and trading of developing country stocks takes place in New York and London, via issuance of American and Global Drawing Rights (ADRs and GDRs). As a consequence, a smaller proportion of this activity takes place in the stock markets of developing countries themselves. It could be said that, to some extent, developing countries are exporting their stock markets! There is here a contrast, between international banking - where the analysis and the decision-making of loans by international banks to developing countries is increasingly taking place in the countries (in local currency); and international equity investment in emerging markets, which is increasingly taking place in the major international financial centres.

The trend towards more issuance and trading of developing country stocks in the big financial centres is not unique; indeed similar trends are found in the smaller European countries. This trend is being driven by factors such as deregulation of capital flows, falling information costs and a rising preference for liquidity. The main factor seems to be investors' increased preference for liquidity.

The increased preference for liquidity has had some temporary elements, in the aftermath of the collapse of LTCM and, more recently, linked to the terrorist attacks. However, besides temporary after-effects of recent crises and problems, there are also important structural factors, which suggest that investors will continue to be biased towards more liquid - and therefore larger - markets. A key factor is that the "crowd" of international investors has grown; there is great concentration in huge institutional investors, who argue they are "too large" for the market's liquidity; as a result, if they switch a significant part of their funds, they can have large effects on prices. A second factor is that particularly cross-border investors herd more; according to Persaud (2001), the tendency to herd has increased both due to greater uncertainty on valuation (as the new economy is based on ideas and knowledge, which are more difficult to value than bricks and mortar), and due to the encouragement by regulators of short-term, market-sensitive risk management systems, which encourage investors with different mandates to act in a similar way.

Given that these latter factors are part of more long-term trends this implies that liquid markets will become more liquid while illiquid markets will become less liquid. This has been a growing complaint in developing countries, such as Chile and South Africa, where large local companies either issue ADRs or switch primary listings altogether. This further undermines liquidity in these developing country markets, as overseas investors no longer need to invest there. A particularly problematic aspect, from a development perspective, is that while very large companies will have access to international liquidity, relatively smaller companies will not; they will be restricted to the small stock markets with declining liquidity. Because medium sized companies not only often are more dynamic, but also are an important source of employment, this could have negative development implications. One policy implication that we will discuss more below is that stock markets in developing countries may need to concentrate on increasing their efficiency in raising capital for small companies.

The problem raised above, that relatively small companies are not of interest to foreign portfolio equity investors, is also true for international bond placements and bank loans. In low-income (and small) developing countries, most indigenous firms are relatively small, which seriously restricts their ability to tap directly into international financing of any kind.

b. Bond Flows

Bond markets continued to fund emerging economies in the post Asian crises period, though at a significantly lower level. As the IMF November 2001 *Emerging Market Financing* clearly puts it: "The international bond market, by far the largest provider of net financing to emerging markets since the 1990's, and the mainstay of external financing for sovereigns, has also been the most volatile provider of such flows…. net financing flows on international bond markets to emerging markets has been positive in all but three quarters since 1994. Bond financing plays a very small role in funding low-income countries, therefore we will discuss this category of flows only fairly briefly here. (Also, many of the points discussed in the previous section on equity flows are relevant also for bonds).

For those countries that continued to have access to bond finance, two problems have emerged since the East Asian crises. One has been the very high cost of borrowing due to very high spreads, at levels well above pre-Asian crisis levels as well as the volatility of the cost. The other has been repeated market closures, which seem to be becoming more frequent, when issuance dries up. The IMF 2001 *International Capital Markets* report defines market closures as weeks during which bond issuance falls short of 20% of the prior year's weekly average issuance; with this definition, US dollar emerging bond markets were closed for 16 weeks during 2000-01. One of the main reasons given for the increasing "on-off" nature of market access is the current increased dominance of "cross-over investors" in the investor base of EMs, who can easily reduce or eliminate their EM holdings if their outlook deteriorates, if there are better opportunities elsewhere, or if their risk aversion grows. A third feature that has emerged since the East Asian crisis is the high concentration of bond lending to sovereigns, which is also a reflection of increased risk aversion, and which is problematic for developing country corporates. Reportedly, for corporates to be able to issue bonds internationally, they have not only to be very creditworthy, but also have international partnership or ownership, and have foreign exchange earnings.[20]

Reportedly, on balance, especially recently, there is more preference, particularly by institutional investors for fixed-income instruments, so as to avoid risk; however, in the case of EM bonds, there is also an important fall in appetite for that type of paper due to the increased perception of risk. As a result of recent crises, but especially as an effect of the Russian default, the market in emerging market bonds has become far more prone to panic in individual countries. If panic sets in among investors, this can undermine even countries with relatively good fundamentals. After the Russian default, investors learned that “having the wrong bond, at the wrong time, with the wrong counter-party could lead to complete destruction.” Reportedly, the lesson drawn by many fund managers was that if problems emerge in a country, they should abandon it entirely, and explain to their clients that the country abandoned could be a repeat of Russia.

[20] Interview material

An important further point to stress is that, at least some US investors, mark their performance against benchmarks on a daily basis. Large falls in bond values can therefore impact very quickly the careers of fund managers, so they will be unwilling to stay in bonds that may fall sharply. After the Russian default, reportedly, there is also a tendency amongst analysts towards negative bias, in their country analysis, as there is strong criticism of analysts who wrote positive reviews on Russia.

Besides the Russian default, bond holders - and their associations - tend to deeply resent discussions on orderly debt work-out procedures, which reportedly would further discourage new bond lending to emerging markets. On the other hand, the inclusion of collective action clauses (c.a.c.) is not seen as a major problem, especially after the UK and Canadian Treasuries issued paper with c.a.c.'s; this is true, even in the New York market, where previously there was little tradition of using such clauses, but where investors have become more relaxed about their inclusion; there may still be a slight concern if a country insists on having such a c.a.c, in that it may give a signal that it needs the flexibility, which may show some limitations on its' ability to pay.

As regards guarantees or collateralised deals, several market participants valued them, and appreciated the possibility of their extension, and/or introduction of more innovative mechanisms; other market participants were more sceptical about their potential value, arguing that in bad times such measures are not enough to make the investment attractive; furthermore, one fund manager argued that collateralised markets tend to be less liquid, as their term structure is so different from other instruments, and they are not comparable with each other or with other bonds; secondly, these instruments are less liquid, because investors tend to buy and hold them.

III. Policy implications

A clear conclusion from our analysis is that private capital flows to developing countries have fallen significantly since the East Asian crisis, both for emerging markets and for low-income countries. The decline in private flows is caused not only by cyclical, but also by more permanent structural factors.

An important and high priority task is to design measures that will encourage a return of sufficient private flows to developing countries, especially of more stable flows, and particularly to low-income countries.

Measures in source countries

Even before doing so, it seems important to avoid or reduce existing or future international measures that further discourage private flows to developing countries. A good example is the discussion of the new Basle Capital Accord, where it is important that the resulting final Accord does not excessively further discourage bank lending to developing countries, increase its cost and its pro-cyclicality[21]

[21] See Griffith-Jones and Spratt (2001), Reisen (2001) and Goodhart (2001)

As regards policy measures to encourage flows, we can distinguish those to be taken by: a) recipient countries and b) by developed countries.

Amongst the former, an important area is improving further the level, quality and frequency of information on developing countries, as well as its availability. Though major efforts have been made, and great progress achieved in this area, interviews with market participants showed a further need, especially for low-income countries in Sub-Saharan Africa. This is perhaps an area where the new DFID Fund on Codes and Standards should provide assistance, both to ascertain exactly what information market actors require, and to help countries produce and provide it. Actions in developing countries on this issue are discussed in the section on Transparency and Monitoring below.

As regards information on developing countries, there are particular categories of actors - such as fund managers, and especially pension fund trustees and pension fund consultants - who have especially limited information on developing countries, and who also seem at present, due to many recent crises, to have an exaggerated perception of developing country risk. For this it may be useful to organise meetings/conferences with these market actors, developing country representatives and some experts on developing countries, to improve information and knowledge on these countries.

Other areas highlighted in the interviews with investors and lenders, where improvement would help attract flows are: better legal infrastructures, financial regulation and corporate governance. Emphasis was placed not just on good legal frameworks, but also especially on their implementation (for a more detailed discussion, see below).

As regards bank lending and bond issuance, an important issue to explore is how to better develop and expand public guarantees of loans, especially in periods of increased perception of country risk. Mechanisms such as guarantees only on interest payments could be explored, as these could provide additional leverage. A particularly important area where improved public guarantees could play a big role is in encouraging private investment in infrastructure, especially but not only in low-income countries.

The possibility of using tax incentives also needs to be evaluated carefully, both in source and recipient countries. Could for example, tax relief in developed countries to savers for pensions be somewhat higher, if that pension fund invested a somewhat higher proportion in long-term investments in developing countries, e.g. with a minimum holding period. This would be particularly justified if evidence emerges that on average returns on those countries were higher than on other investments. Or could other mechanisms, such as moral arguments for ethical funds, which are an increasingly important share of pension fund assets also play a role?

In the case of taxation of pension funds, how in practice would such a mechanism work? Could tax incentives also be used to encourage other investment/lending to developing countries? Measures could also affect market behaviour through other mechanisms, e.g. through regulatory ones, or through rules established by the industry

itself This could for example be done by encouraging different models to be used by different investors and lenders, according to their specific needs and characteristics.[22] For example, it has been argued that institutional investors do not need such sensitive models as banks, given that they should be prepared to face bigger losses. The use of more appropriate and different models would encourage diversity, and therefore discourage herding. Furthermore, as regards risk management, it is necessary also to introduce non-market sensitive elements, including rules of thumb - such as for example, increased Spanish provisioning during booms - so as to curb excessive volatility.

An innovative suggestion to create countervailing forces to the market's tendency to be volatile and pro-cyclical is to attempt to create market stabilisers, via for example possible greater use of insurance instruments. Similarly, to deal with liquidity holes in emerging markets - either temporary or permanent - there is a need for creating market makers.

Finally, as regards bonds, there is the difficult policy issue on how radical and how formalised should be ex-ante rules for orderly debt work-outs and standstills in times of distress. This issue has been amply debated. It just seems worthwhile to stress here that there are important trade-offs between valuable greater flexibility and speed for debt resolution in times of crises (including the existence of an international mechanisms to reduce debt in cases of insolvency, which may be very helpful for avoiding declines in output or growth) and possibly important negative effects on the ability of raising future new money, or increasing its cost significantly.

As regards portfolio equity flows and equity markets, policy actions seem desirable not only to attract more equity flows, but also to ensure that a higher share is traded in developing countries' stock markets. One important measure to consider is that of creating regional or sub-regional stock markets; important lessons can be here learned from Europe, where the smaller stock markets are uniting to pool liquidity. Another important measure is that, given that large companies may leave, smaller exchanges may need to focus on trying to help raise foreign capital for relatively smaller, but potentially dynamic, companies. As discussed above, a final suggestion that may need to be evaluated is whether, particularly in some emerging countries, there are not tax or other incentives for "exporting" domestic stock-markets and whether it would be feasible and/or worthwhile to modify these.

Recipient country issues

Reducing risk

Reducing the risk of long-term developing country assets is a priority, if increased levels of investment are to be achieved and sustained. The role of political and economic stabilisation, and of policy consistency, in reducing the risk of developing country assets has received much attention. Indeed, the surge in private capital flows in the 1990s has been associated with the increasingly widespread view that the market price of (and the market demand for) a country's assets is the best measure of whether the domestic policy framework is appropriate. This practice is not confined to the private sector. The IMF has, especially since the onset of the Asian crisis in 1997,

[22] I thank Avinash Persaud for valuable suggestions in this area.

adopted the practice of referring regularly to the reaction of financial markets in assessing whether the domestic policy actions have been suitable and successful. It is worth noting, as discussed elsewhere in this study, that this is a simplistic and misleading view of financial markets and market pricing. Crucially, it ignores factors on the demand side – such as herding behaviour and changes in risk aversion – that have a substantial and sometimes decisive influence on asset prices.

It must nevertheless be recognised that the shift toward market sensitivity is evidence that political and economic stability are crucial determinants of the risk of – and hence of the price and demand for – a country's long-term assets. There is now abundant empirical evidence of the link between stability and inflows. As discussed above, successful stabilisation efforts in countries such as Mozambique, Uganda, Tanzania and South Africa has been associated with sharp rises in direct investment inflows, while the recent turbulence in Zimbabwe has led to a collapse in inward investment.

Political and macroeconomic stabilisation are, however, only the first steps that governments must take. The need for a range of measures aimed at risk reduction is recognised in the New Partnership for Africa's Development (NEPAD), formerly known as the New African Initiative, as discussed in the text box below. In many countries, investing firms (domestic as well as foreign) continue to face a host of regulatory and political risks. Political risks include the risk of expropriation, deprivation, currency convertibility and transferability, contract enforcement and political violence. Regulatory risks arise from arbitrary or politically-motivated changes in regulatory rules or their enforcement, and is a critical issue for investment in infrastructure.

The problem is most acute in low-income countries where legislative and regulatory systems tend to be least developed. Investing firms depend critically on these systems, from investment approvals to licensing, from taxation to foreign exchange transfers. Underdeveloped systems, unclear guidelines or criteria, and inconsistent implementation (or enforcement) can all contribute to a high degree of uncertainty in the effective returns on potential investments – thereby needlessly discouraging worthwhile projects.

There is a need, above all, for policy consistency. Investors must have confidence that the "rules of the game" will not change, and that they will be applied in a consistent manner to all investments and all investors. Effective policy consistency requires, in turn, that policies and decisions be transparent and enforcement predictable. Naturally, this should not sacrifice countries' autonomy in changing crucial policies, such as taxation, if the economic circumstances require.

The NEPAD proposal that countries undertake audits of regulation and legislation, followed up by monitored action plans to address any weaknesses, deserves the strongest support. But it must, at the same time, be recognised that existing systems and practices have evolved in response to political and social pressures and cannot simply be changed overnight. Even a sustained effort to tackle these issues is likely to be fully successful only in the medium to long term.

Risk mitigation

A separate but related issue is the scope for measures to mitigate the risks faced by foreign investors in developing country assets. The reduction of those risks through measures such as those discussed above is clearly a priority. However, it must be recognised that even if such measures are successful, developing countries, especially low-income countries, are likely to remain higher risk environments. In part, this stems from the lack of diversification in the production side of most of these economies, which renders them more vulnerable to changes in world prices and in technology. In part, it stems from the restricted set of instruments for risk management in these countries, which makes a broader range of risks undiversifiable. And in part, it stems from their vulnerability to the knock-on effects of policy or behavioural changes in developed countries (e.g., of the Basle II Capital Accord, see, for example, Griffith-Jones and Spratt, 2001, and Reisen, 2001).

For these reasons, policies to reduce risk should be accompanied by initiatives aimed at mitigating risks faced by investors. The demand for such instruments was demonstrated by the rapid expansion of private political risk insurance as private investment into developing country infrastructure projects grew in the 1990s. Political risk insurance and investment guarantees (full and partial) are provided by multilateral development banks, export credit agencies and investment insurers, as well as private insurers.[23]

The NEPAD Private Capital Flows Initiative proposes that consideration be given to supplementing this traditional risk insurance in three ways. The first is the possible establishment of an African currency convertibility fund to address the transfer and convertibility risk of projects that do not produce foreign exchange. The second is the greater use of "B-loans", whereby multilateral banks leverage private funding by syndicating, to private banks, a portion of their loans. The third is the eventual establishment of an African derivative market to enable investors to unbundle the various risks of cross-border investment.[24] Much work is needed before it will be clear whether these initiatives, especially the first and third, are worth pursuing. But the potential benefits in each case are clearly sufficient to justify proceeding with the initial evaluation.

[23] MAP "Capital Flows Initiative", p. 32.

[24] MAP, *op. cit.*, p 34; see also Dodd, 2001, for some of the problems with such derivative instruments

Transparency and monitoring capacity

The role of imperfect information in impeding investment and, especially, in triggering instability has attracted considerable attention in recent years. Indeed, perhaps the only concrete achievement of the extensive discussions of financial stability and international financial architecture – which date from the immediate aftermath of the Tequila crisis in 1994-5, and gained pace with the Asian crisis – has been the development and implementation of international codes and standards. This initiative reflected the view that a lack of transparency regarding country policies and data had played an important role in the crises in Mexico and Thailand, among others. These crises illustrated how imperfect information on a country's macroeconomic and financial position can contribute to the misallocation of investment flows, aggravating booms and delaying necessary policy adjustments (although other factors can play an equally important role).

The spread of international codes and standards, has to a limited extent, been supported by an increase in the demand for information by investors. The growth of emerging market research departments at major international banks in the mid-1990s and the associated proliferation of weekly and monthly publications highlighted the demand not only for comprehensive and accurate information, but for timely, high frequency data as well. It is telling that the downturn in flows to emerging markets in the past two years has been associated with heavy retrenchments in these research departments and their publications.

Developing countries have made considerable progress in this area in recent years, as exemplified by the adoption of SDDS and GDDS data dissemination guidelines promulgated by the IMF. The need for policy coordination and regulatory harmonisation has also been widely endorsed among developing countries. The near universal implementation of the 1988 Basle Capital Accord is one example of this. A more ambitious, if specific, example is the current project within the fourteen Southern African Development Community (SADC) countries to create a standard legal, regulatory and technological framework for national payment systems in Southern Africa.

The data dissemination standards have highlighted the need for improved data capture and analysis of private capital flows. Effective monitoring and analysis is essential not only to data dissemination, but also to informed policy decisions. Indeed, a lack of capacity in this area increases the risk of bad policy while also obscuring potential economic risks. Through a series of projects over the past four years, the Centre for Research into Economics and Finance in Southern Africa (CREFSA), at the London School of Economics, and Development Finance International (DFI) have worked with a range of country teams throughout Africa, and elsewhere, in developing strategies to enhance the monitoring and analysis of private capital flows. These projects have highlighted the scale of the mismeasurement and non-recording of private capital flows in developing countries, and of the human and financial resources needed to address these problems effectively.

Thus, in addition to implementing codes and standards, developing countries need support in their efforts to improve their capacity to monitor and analyse private capital flows. Only if such capacity is strengthened significantly can the benefits of transparency be realised. More importantly, only if such capacity is strengthened will policy-makers be in a position to manage effectively the challenges posed by volatile capital flows.

Property rights and institutional development

A number of papers in recent years have demonstrated the important role of property rights in determining the demand for a country's long-term assets, and hence the availability of external finance.[25] These studies have shown that the more protected is the property right of a particular asset the higher will be the level of foreign demand for the asset. Of fundamental importance, however, are basic property rights including the effective enforcement of contracts. The development and quality of the legal system influences the range of financial instruments available and also the nature of creditor (and equity) rights – both of which feed directly into the demand for a country's assets.

Recent studies have shown how property rights also affect the demand for long-term assets indirectly. Property rights work in a variety of ways to facilitate financial sector development (La Porta *et al,* 1998), which, in turn, seems to affect growth (Levine, 1997; Rajan and Zingales, 1998). Property rights also seem to exert a separate influence on growth.[26] In both cases, the higher levels of growth, resulting from further development of property rights, work to stimulate increased demand for the country's long-term assets. Yet another conduit has been suggested in a recent paper by Claessens *et al* (2001), which presents evidence that property rights are particularly important for the establishment of new firms.

The issue of property rights is closely related to the issues of governance and of institutional development. The establishment of property rights requires the development of effective legal, political and social institutions, but, at the same time, facilitates their further development. While creditor rights must, of course, have a legal basis, they are not effectual in the absence of effective governance. For these reasons, initiatives aimed broadly at institutional development and governance can play a critical role in the development of property rights in general and creditor rights in particular.

The Asian crisis has highlighted the importance of effective financial regulation and supervision in reducing the risk of financial crises and in limiting financial instability when crises do occur. When supervision is weak, surges in capital inflows can lead to a sharp rise in non-performing assets, as cheap funds are made available to less creditworthy borrowers and loans are made on the collateral of inflated asset prices. The rise in non-performing assets increases the fragility of the financial system, making crises more likely and sharply raising the costs of adjustment should a crisis occur. By reducing the likelihood and impact of crises, steps to strengthen regulatory and supervisory capacity can contribute to increases in the demand for a country's long-term assets. As discussed in Bhinda, Griffith-Jones, Leape and Martin (1999),

[25] See, for example, La Porta *et al*, 1997, 1998; North, 1990; Mansfield, 1995
[26] See, for example, Beck *et al,* 2000, North, 1990; Mansfield, 1995.

measures such as introducing capital requirements and limits on the foreign exchange exposure of banks, and supervisory oversight of credit allocation and internal risk management can reduce the vulnerability of the financial sector. Reforms along these lines in Uganda, following the Financial Institutions Act of 1993, seem to have played an important role in strengthening the financial sector and in attracting higher levels of foreign investment, as have similar reforms in Tanzania, Mauritius and elsewhere.

Trade costs and market access

A crucial factor influencing the demand for long-term developing country assets is the small and segmented nature of the domestic market in most such countries, and the lack of access to larger markets. The problem is most pronounced in low-income countries, where mass consumer demand is restricted to a narrow range of commodities and the market for other, higher value-added consumer and intermediate goods is limited. Empirical studies of the factors driving direct investment have highlighted market size and market access as decisive determinants of location decisions (see, for example, Markusen, 1995, Devereux and Griffith, 1998). These findings are confirmed by evidence from surveys of investing firms, which show market size and access to be a major obstacle to investment in developing countries, especially low-income countries (see, for example, the findings of a recent CREFSA-CSAE survey of direct investors into Southern Africa summarised in Jenkins and Thomas, forthcoming).

The "new trade theory" has focused on these factors – market size and market access – as issues of trade costs. The new trade theory begins with the recognition that, as shown by Krugman (1980) and others, such costs have a fundamental influence on the level and direction of trade. This implies, in turn, that such costs have a decisive influence on the location of production, and consequently on the level and direction of long-term investment flows. Firms' investment decisions therefore take into account not only the direct costs and benefits of investing in a particular location, but also the trade costs associated with exporting to and from that market.

Trade costs are a prominent feature of the international economic environment, but are particularly pronounced in low-income countries, where weak transport and communications infrastructure are typically compounded by high tariff and non-tariff barriers. As discussed, for example, in Maasdorp (2000), the problem of high transportation and communications costs is common throughout Africa, and is particularly acute for the smaller, landlocked countries. The costs of surface transport have been driven up by decades of underinvestment in national railways in most countries. This, in turn, has forced freight onto the roads, resulting in an increase in a volume and axle loads of road traffic far in excess of the capacity of existing road network. Air transport remains appropriate only for high-value, low volume freight, while sea transport has been impeded by underinvestment in harbour infrastructure. Moreover, direct transport costs are only one component of the total delivered cost, which also includes trans-shipment charges, storage and distribution charges, losses through theft or damage, and delays. For example, at South Africa-Zimbabwe border crossing Beit Bridge, vehicles have long faced delays of several days waiting to clear customs. In war-affected regions, unofficial (and unpredictable) road blocks have sharply raised the costs and risks of transport. (Maasdorp, 2000) Communications

costs, too, tend to be high. The spread of mobile telephony has brought down the costs of voice communication in many parts of Africa. The limited fixed line network, however, continues to impede the roll-out of electronic mail and internet access.

Equally important, however, have been the policy-related trade costs – in the form of taxes, tariffs and non-tariff barriers – that frequently impede intra-regional trade, especially among low-income countries. Africa has a long history of initiatives aimed at regional trade liberalisation. A few have been successful, notably the Southern African Customs Union, which is the oldest customs union in the world. Most, however, have achieved very little. Jenkins, Leape and Thomas (2000) argue that Africa's poor record in designing sustainable regional frameworks is largely due to three factors. The first is poor design: schemes have failed to take into account members' divergent interests, the feasibility of implementation, the incentives to comply and the scope for substituting non-tariff barriers for tariffs. The second is the persistence of domestic policies that conflict with the trade reforms, a problem Jenkins *et al* go on to examine in depth. The third is the insufficient attention given to the problems created by weak national institutions and infrastructure. All of these factors must be addressed if progress is to be made in establishing regional markets in Africa and elsewhere in the developing world.

Recent years have, however, seen some positive developments in this area. The democratic transition in South Africa has led to a new Southern African Development Community (SADC) Free Trade Protocol, the implementation of which has been boosted by strong ministerial commitment and by South African offers of asymmetric tariff reduction. In addition, the New Partnership for Africa's Development (see text box below) has mobilised high level political support for trade integration throughout Africa.

Another development in the 1990s was the Cross Border Initiative (CBI). Launched in August 1993, with the support of the African Development Bank, the European Commission, the International Monetary Fund, and the World Bank, the CBI has had two objectives: to reduce cross-border transaction costs by reducing intra-regional tariffs, liberalising exchange and payments systems, and deregulating investment; and to promote an "open" approach to regionalism, based on across-the-board reductions in effective rates of protection (rather than import substitution and high protection). Although the increases in trade openness achieved by the fourteen African countries participating in the initiative have only slightly exceeded those of non-participating countries in the region, the most successful liberalisers, Uganda and Zambia, have reached the openness levels of Chile and Singapore. Moreover, the technical working groups created under the initiative have contributed to increased institutional capacity, while the concept of "open regionalism" has gained broader support throughout Africa.[27]

A third and crucial component of the trade costs facing investors in low-income countries is the high costs of exporting to the major developed countries. As with regional trade, one of the obstacles is the magnitude of transport and related economic costs. But, policy-related trade costs in the form of tariffs and non-tariff barriers are of crucial importance.

[27] World Bank, *Infobrief (Africa Region)*, no. 58, November 2000.

Although average tariff levels in developed countries have been steadily reduced as a result of global trade negotiations, high tariff peaks and tariff escalation continue to pose a major obstacle to low-income country exports. While the average normal (MFN) tariff rate in industrial countries is due to fall to less than four percent following the Uruguay round, a range of key agricultural exports face average tariff duties of more than 15 percent. Moreover, the preferential access given to African countries is undermined by the massive domestic support to agriculture in the major developed countries, while export subsidies given by these countries distort international trade and drive otherwise competitive African agricultural exports out of the market. At the same time, tariff escalations – rising tariffs from raw materials to intermediate and finished products – work to limit developing country opportunities for moving up the value chain in agro-processing and other manufactured exports, which now account for more than 60 percent of total African export earnings.[28]

The foregoing discussion suggests that, in the area of trade costs and market access, the single most important factor impeding long-term investment into low-income countries is the lack of access to developed country markets. Despite their apparently strong public commitment to trade liberalisation, the major industrial countries continue to have tariff schedules and non-tariff barriers that systematically restrict access for key developing country exports. No factor is likely to have as strong an impact on the price and attractiveness of long-term developing country assets as would concerted action by the major industrial countries to reduce effective rates of protection in these areas.

[28] See NEPAD, 2001, "An Action Plan for Market Access"

Text Box: The New Partnership for Africa's Development

The New Partnership for Africa's Development (NEPAD), formerly known as the New African Initiative, brings together the Millennium Partnership for the African Recovery Programme (MAP) and the Omega Plan. NEPAD is an initiative of African leaders, initiated by President Mbeki of South Africa in partnership with Presidents Obasanjo of Nigeria and Bouteflika of Algeria and now led by a Steering Committee also including Egypt and Senegal. The initiative is aimed at eradicating poverty and achieving sustainable development and growth.

NEPAD includes a range of measures, under the various constituent initiatives, aimed at creating an environment attractive to private capital.

- Measures set out under the Political Environment for Sustainable Development Initiative and the Economic Governance Initiative will reduce political and economic instability – and thus the risks of investing in Africa.

- Measures set out under the Infrastructure Initiative aim to improve the level and quality of infrastructure in transportation, communication, power and water, while proposals of the MAP ICT and Poverty Reduction Initiatives set out programmes to rectify the deficiencies in Africa's human capital.

- Measures set out under the International Trade and Market Access Initiative are aimed at accelerating intra-African trade and increasing access to the markets of industrialised countries. The proposed action plan includes efforts to strengthen capacity in trade policy; to improve preferential trading arrangements (and their benefits for investment); to improve Africa's participation in the WTO; and to deepen regional integration and regional trade liberalisation.

NEPAD also includes a programme aimed solely at stimulating greater inflows of private capital: the MAP Private Capital Flows Initiative. The Private Capital Flows Initiative has three areas of focus:

- The first is measures to reduce and mitigate the political and regulatory risks of investments in Africa. To reduce risks, countries will be expected to undertake audits of regulation and legislation related to investment and to draw up "monitorable action plans" to address any weaknesses. To mitigate risks, the initiative calls for enhanced use of credit guarantee schemes through multilateral institutions to leverage long-term private capital and proposes that consideration be given to creating an African Currency Convertibility Fund to address foreign exchange transfer risk for investments not generating foreign exchange.

- The second is measures to "enhance Africa's capacity to engage directly with private investors through public private partnerships (PPP)". Such partnerships are seen as vital to mobilising private finance for infrastructure projects. It is proposed that the technical expertise to structure particular transactions be concentrated in regional development banks, with complementary capacity developed in individual countries.

- The third is measure to accelerate the harmonisation of financial markets. The initiative recognises that attracting private capital will require reliable and increasingly sophisticated financial and legal systems, which can only be achieved through the harmonisation of Africa's financial markets.

  In addition to the private capital flows initiative, the broader "MAP Capital Flows Initiative" calls for an increase in official flows to Africa through increased and accelerated debt relief and through increases in aid and changes in how aid is delivered.

- The MAP Debt Relief initiative highlights the continuing debt burden and calls for the basis of debt relief to be broadened beyond "debt sustainability" to focus on the need to free domestic resources to finance poverty reduction and development programmes.

- The MAP ODA Reform Initiative calls for an increase in the level of net ODA flows to Africa in line with the agreed International Development Goals for 2015. The initiative also calls for a reform of the aid delivery system to increase the involvement of domestic stakeholders in the definition of development priorities and to enhance Africa's capacity to manage aid effectively towards the goal of poverty reduction.

Source: *The New Partnership for African Development*, October 2001, *An Action Plan for Market Access for Africa's Exports*, and *Capital Flows Initiative* (both undated) from www.africainitiative.org

Annex 1: Data availability and limitations

The data presented in this paper are drawn from a variety of sources, including *International Capital Markets, Emerging Markets Financing Quarterly* and *World Economic Outlook* published by the IMF, the World Bank *Global Development Finance 2001 and 2002* databases, the joint OECD-BIS-World Bank-IMF external debt statistics, the UNCTAD *Handbook of Statistics, 2001* database on foreign direct investment and *Capital Flows to Emerging Market Economies*, published by the Institute for International Finance. While many common trends emerge from the data from these different sources, there are also discrepancies. These discrepancies are symptomatic of underlying methodological problems with some of these data. Amongst the reasons for differences between different sources are: treatment of capital flight, country coverage, and whether net bank lending is measured on its' own, or minus deposits.[29]

There are, for example, difficulties in capturing data on portfolio flows – as evidenced by the attention given to this area at the IMF, with the recent coordinated portfolio survey, and elsewhere. Problems in monitoring portfolio flows include the difficulties of tracking secondary market transactions, which may take place in third countries, and of establishing beneficial ownership in the presence of nominee companies and similar devices.

Even more importantly for low-income countries, Bhinda, Griffith-Jones, Leape and Martin (1999) show that the World Bank and IMF data, and even the official country data, do not fully capture the flows of direct investment to developing countries. In a study of five African countries carried out in association with local central bank teams, Bhinda *et al* show that problems of data capture and analysis of private capital flows are common throughout Africa. Flows through certain institutions, such as bureaux de change, are notoriously difficult to monitor (as even the UK has recently admitted). In other cases, the recording institutions – typically banks – may be unable to distinguish different types of flows (such as direct investment versus private transfers), resulting in misrecording.

While these international data on capital flows are, nevertheless, the most useful available source of information for assessing the overall pattern of capital flows, the above caveats mean that any conclusions drawn must be treated with a degree of caution.

[29] We thank Jens Nystedt from the IMF for a helpful discussion on this.

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