BOOK REVIEWS

Private Capital Flows to Developing Countries

- *The Road to Financial Integration,* World Bank, Oxford University Press, New York, 1997, pages xvii + 406.

Capital flows to developing countries has become a serious topic for debate and discussion, particularly after the Mexican crisis in 1995 and the East Asian crisis in 1997. Various publications on different aspects of capital flows have originated from several quarters. Mention may be made of IMF Occasional Paper No. 108 (1993) on "Recent Experiences with Surging in Capital Inflows", IMF Occasional Paper No. 122 (1995) on Capital Flows in APEC Region, World Bank Discussion paper No. 228 (1993) on "Portfolio Investment in Developing Countries" and the World Bank Publication on "Managing Capital Flows in East Asia" (1996). The Per Jacobson Lecture on "The Recent Surge in Private Capital Flows to Developing Countries" is also worth citing. However, the book under review is unique in nature. It is a well documented report of the World Bank on private capital flows to the developing countries based on extensive research and empirical findings. The Report not only discusses in detail the nature, pattern and causes of the private capital flows to developing countries but also analyses the impact that this surge would have on economic activity, the banking system and the stock market.

The main findings of the Report indicate the fact of manifold increase in private capital flows to the developing countries in the recent years reflecting the progressive financial integration of the developing countries into world financial markets. This can be inferred from the following statistical facts cited in the report.

- Net private capital flows to developing countries exceeded US$ 240 billion in 1996, nearly six times greater than they were in 1990.

- Private capital flows to developing countries in 1996 were five times the size of official flows. In contrast official flows in 1990 were larger than private flows.

- The share of the developing countries in global foreign direct investment (FDI) flows has gone up from 12 per cent (US$ 25 billion) in 1990 to 38 per cent (US$ 95 billion) in 1995. Their share of global portfolio equity flows has gone up sharply to 30 per cent in 1996 from 2 per cent in 1990.

- The importance of private flows has also increased markedly in the economies of developing countries, from about 4 per cent of domestic investment in 1990 to almost 20 per cent in 1996.

- The composition of private capital flows has undergone significant changes - more towards FDI and portfolio flows to bank lending.

For the purpose of measuring the extent of financial integration, an index has been constructed based on several measures. According to the report, the developing countries as a

group have become more integrated since the mid-1980s. The number of countries that are classified as highly integrated increased from 2 in 1985-87 to 13 in 1992-94 whereas the number of countries classified as moderately integrated increased from 24 to 26. India's level of financial integration has been revised from "medium" to "medium +".

The Report extensively deals with the structural forces leading to integration of world financial markets into a single global market place. The driving forces of capital flows have been put forth in terms of push and pull factors. The trend now evident in private capital flows to developing countries is being driven by two primary forces, i.e., higher long term expected return in developing countries and the opportunity for risk diversification. Competition and rising costs in domestic markets of industrial countries encouraged firms to look for opportunities in developing countries leading to progressive globalisation of production. Underpinning the improvements in economic performance of developing countries has been the systematic adoption of macro-economic stabilisation programmes and structural reform by a growing number of developing countries in terms of sustained fiscal adjustments, trade liberalisation, investment deregulation, financial sector liberalisation and privatisation. The Report argues that although the risk of investing in emerging markets remain relatively high, the policy reforms are resulting in a progressive decline in these risks and in improvement in expected rates of return. Investors of the developed markets have thus begun to respond to the relatively higher expected rates of retun in developing countries. The second force behind the trend in private capital flows is investors' desire for portfolio risk diversification. Investors can benefit from holding emerging market equities because returns in emerging markets tend to exhibit low correlation with industrial country returns. The opportunity for portfolio diversification offered by emerging markets is a relatively recent phenomenon as the capital markets in these countries have deepened and broadened during the 1990s.

The strong response of private capital flows to the two primary forces described above has in large part, stemmed from changes in enabling environment in both industrial and developing countries. The Report discusses changes in two broad areas experienced by the industrial countries. First, in the real sector, increasing competition and rising costs at home, combined with falling transport and communications costs, have heightened firms' responsiveness to opportunities to increase efficiency and reduce costs by locating investments abroad. Secondly, a self-reinforcing process of competition, deregulation and technological advancement has substantially enhanced the responsiveness of investors to international investment opportunities. Particularly, financial innovations during the 1980s and 1990s have played a key role in the internationalisation of financial markets. These innovations have made it more attractive for borrowers to raise capital in foreign markets and for investors to make cross-border investments.

Developing countries on their part have created an enabling environment to improve their creditworthiness. This has generally taken the form of dismantling of barrier to capital movement, trade liberalisation, flexible policies for foreign investment. In addition to the easing of regulations pertaining to the movement of capital, structural changes in developing countries have meant a significant expansion of areas for potential foreign investor involvement. Many developing countries have deregulated their investment regimes and reduced the role of the public sector in directly productive sectors with a view to allowing greater participation of

private investors. Privatisation of State owned enterprises has further boosted foreign investor involvement in developing coutries.

The Report devotes a full chapter to analyse the benefits of financial integration. On the production side, integration permits greater international specialization and facilitates allocation of scarce resources to their most productive uses. On the consumption side, integration allows economic agents to insure themselves against adverse developments in their home economy through international portfolio diversification. Following integration, investment is reallocated towards the most rewarding projects (on a risk adjusted basis), regardless of their location, financed by corresponding capital flows seeking the highest risk adjusted return. For the growing number of developing countries already offering attractive investment opportunities, integration permits an acceleration of investment by augmenting domestic savings with foreign investments. However, permanent gains from integration may emanate from the quality rather than the quantity of investment, i.e., through productivity growth. Further, integration provides more immediate benefits through knowledge spillovers, particularly in financial markets and via FDI. It enhances the depth and efficiency of the domestic financial system, with important feedback effects to investment and growth. The production-side integration has a mirror image on the consumption side as the individuals in the newly integrated economies can stabilize their income and consumption by holding foreign assets and by using international capital markets to buffer consumption against temporary swings in the domestic economy.

However, private capital flows to developing countries are not unmixed blessings. They also impact upon the domestic financial systems and pose challenges for macroeconomic management. Increasing economic dependence has brought with it the problems of greater instability and uncertainty resulting from contagion effects of external shocks, exchange rate misalignments and volatility, episode of inflation and balance of payments disequilibria. Sudden reversal of flows have subjected lost economies to severe contractionary effects. The Report has very candidly discussed these issues and has suggested that suitable checks and balances have to be put in place at the incipient stage in order to avoid any potential damage to the recipient developing economies. One important issue is that volatility of private capital flows can have serious repercussions on the domestic economy. Private capital flows to emerging markets, particularly in terms of portfolio investments are quite sensitive to changes in international interest rates. FDIs are, however, not much affected. A second phenomenon which may cause volatility is that of investor herding which is generally attributed to problems of asymmetric information in the early stages of integration. Another source of volatility is that of cross-country contagion. Conceptually two types of contagion can be distinguished. The first is fundamental contagion, in which a shock in one country can affect investments in other countries because they share similar fundamentals. Secondly, it is possible that the shocks in one country are transmitted through trade or financial channels and thereby affect the economic fundamentals of other countries. This second type of contagion is termed as 'pure' contagion which occurs when shocks in one country affect investments in other countries, even if the economic fundamentals of the latter have not changed. Investors' initial reactions in the wake of the Mexican crisis, which erupted in the last quarter of 1994, were an example of pure contagion. Because investors were not sufficiently discriminating among emerging markets, portfolio flows to almost all emerging markets declined very sharply in the first quarters of 1995.

The financial integration and associated capital flows pose a variety of problems for the policymakers of the developing countries. Empirical evidences cited in the Report indicate that a number of countries experienced macro-economic overheating in terms of acceleration of economic growth, large current account deficits, accelerating inflation and appreciation of the real exchange rate following large capital flows after financial integration. The transmission mostly works through higher money supply due to rise in net foreign exchange assets of the Central Bank authorities leading to lower interest rates, expansion of demand and acceleration in domestic inflation.

The Report has stressed that the developing countries need to effectively manage their economy through various policy tools while confronted with the challenges associated with financial integration. The most direct response to external financial volatility has been imposition of capital controls. The magnitude of gross capital inflows can be reduced by imposing a variety of direct or indirect controls on inflows, liberalization of capital outflows, accelerated repayment of public debt, trade liberalisation and floating of the exchange rate. Except for floating the exchange rate, all of these instruments were used by policymakers in recipient developing countries. The report discusses the use of other policy options such as intervention in the forex market and money market, increasing reserve requirements on domestic banks and financial institutions, tighter fiscal policies in dealing with capital inflows. There is also a need for adopting an effective exchange rate policy. In recent years an increasing number of economies have adopted 'flexibly managed' exchange rate systems, which give them the option of effectively using monetary policy. Empirical evidences cited in the Report suggest that crawling pegs remain a viable exchange rate option for developing countries. However, under such a system, the central parity should be managed so as to track, to the extent possible, the underlying long-run equilibrium real exchange rate. Large and persistent temporary misalignments should be avoided, as they threaten the sustainability of the regime and make speculative attacks more likely.

One Chapter of the Report is devoted to effects of integration on domestic financial institutions. The banking systems of the developing countries play a leading role in the process of financial integration. However, the transition towards greater financial integration also involves some risks for the banking sector as the banks may be adversely affected by increased macroeconomic volatility and by structural changes in banking sector. The main structural changes affecting the banking sector that result from integration are an increase in competition and exposure to new sources of risk that banks may not be prepared to manage properly. The mechanism generally involves a surge in capital flow leading to a lending boom, followed by a consumption boom and financial sector vulnerability.

The initial euphoria of accelerated economic growth induced by lending boom of banks leads to an increase in asset prices and financial wealth, which raises the value of loan collateral, increases households' aggregate consumption and further reinforces the process of the lending boom. However, when the unsustainable level of asset prices plunges ultimately, the economy experiences slow growth accompanied by reduction in consumption and investment spending. Firms and the households will have difficulty servicing their debts and banks will call back loans and liquidate the assets used as collateral. Because the banking system is vulnerable to confidence crisis, this sequence of events may lead to a bank run, further reducing total credit

and liquidity and aggravating the slowdown in economic activity. The Report cites empirical evidences that excessive bank lending leads to increase in the current account deficit, under-investment and over-consumption. In addition to amplifying the magnitude of the business cycle, a poorly regulated and supervised banking industry will tend to misallocate resources. Poorly capitalised and regulated banks, for instance, invest excessively in risky projects, such as real estate, or other sectors prone to boom-bust cycles. Also, poorly managed banks operating under distorted incentives will not diversify their portfolios adequately, thus exacerbating financial sector vulnerability. The weaker the initial conditions in the banking sector, higher will be the vulnerability to large downturns and the banking crisis will be more costly. In this connection, the policy makers should monitor the profitability, the capitalisation ratios, the level of provisions and non-performing assets, the magnitude of exposure to foreign exchange risk and portfolio composition of banks to assess the financial health, risk exposure and resilience to shocks of the banking sector and take timely action to prevent a banking crisis. Thus, financial integration puts a premium on the need for developing countries to reform the institutional and regulatory framework governing their banking sectors.

The last Chapter of the Report deals with the capital markets issues of financial integration as a growing proportion of flows to the developing countries is getting channeled through their capital markets. These investments provide an important opportunity for the developing countries and have been accompanied by a spectacular increase in activity in equity markets in these countries. For example, as a ratio to GDP, the average market capitalization of the 18 major developing countries went up from 7 per cent in 1985 to 40 per cent in 1996. Further financial integration has led to increase in foreign presence in domestic markets and increase in access to foreign markets for resources (through GDRs, ADRs, FCCBs, etc.). Capital market derives significant benefits from financial integration which helps foster investment. More directly financial integration expands, the supply of investment resources by tapping foreign resources and increasing the demand for domestic securities. In particular, the liquidity improves and the cost of equity capital declines. The corporate governance also improves under pressure from institutional and foreign investors. Foreign investment increases depth and liquidity of domestic capital markets, thereby reducing volatility. In addition, increasing foreign participation in domestic capital markets may induce improvements in accounting, information and reporting systems, as well as increase the sophistication of the domestic securities industry. However, shallow markets are prone to volatility. Further, with financial openness, domestic capital markets are exposed to new financial shocks such as changes in global interest rates, spillover effect from foreign stock markets and investor herding. When the share of foreign investors rises in the emerging markets, these potential external sources of volatility become important. Efforts by many developing countries aimed at improving domestic fundamentals and stabilizing their economic policies and improving capital market by reducing information asymmetrics and other market imperfection and building the necessary infrastructure have helped in reducing domestic market volatility arising from external shocks. However, most of the developing markets are still in early stages of development. In order to attract additional portfolio flows developing countries need to address investor concerns, especially the reliability and efficiency of infrastructure and trading systems and transparency and fairness. The Report highlights further improvements in market infrastructure of the developing markets in the areas of trading, clearing settlement, regulatory framework, etc. In particular, for attracting potential investors and reducing systemic risks the regulatory framework should protect investors from

abuse and fraud and promote competition by ensuring the market practices and rules that do not impose any unnecessary burden on competition.

Prima facie, the Report has a very optimistic note on the issue of prospect and sustainability of private capital flows to developing countries. It states that the policy reforms that are being embarked upon by the developing countries focussing on macroeconomic stability and the promotion of more deregulated, outward oriented and market based economies are likely to increase the productivity of investments in these countries. Thus there will be growing opportunities for foreign investors. With regard to contagion, the Report states that the period following Mexican crisis indicates that pure contagion is a relatively brief phenomenon; international markets were able to differentiate among emerging markets, so that those countries with the strongest economic fundamental saw a resumption in flows quickly. However, on the domestic side, developing countries are stated to be more susceptible to real and policy shocks which in turn result in greater volatility of capital flows and asset prices and returns. The Report argues that Asian financial crisis tends to give the impression that contagion may not be a purely temporary phenomenon. Net private capital flows to 29 emerging markets have fallen to an estimated $200 billion in 1997, down from their peak of $295 billion in 1996. It may further fall to about $170 billion in 1998. However, it goes without saying that the developing countries should aim at improving their macroeconomic management, put forth policies for averting overheating and limiting vulnerability, strengthen the banking system and the capital markets, so as to attract private capital flows on a sustained basis.

On the whole, the Report is very educative and informative on the subject. It discusses in threadbare all important aspects of private capital flows to developing countries and makes interesting reading for students of economics in general and international economics in particular.

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