



Current Issues in Emerging Market Economies

Organised by the Croatian National Bank

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Risk and Capital Flows to the Emerging Markets

Hotel "Argentina", Dubrovnik
June 28 - 30, 2001

Draft version
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RISK AND CAPITAL FLOWS TO THE EMERGING MARKETS¹

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Introduction

Progressive liberalisation of capital flows since late 1970s has transformed the external environment for policy-makers. The current account balance is no longer the simple constraint on policy it was up to the 1970s. The ease of financing current account deficits has been a recurrent source of surprise – and not just of course for developing countries. The result is that deficits were much larger in the 1980s and 1990s than they had been in the earlier decades of the post-war period.

Yet balance of payments crises have not disappeared. On the contrary, boom-and-bust cycles of capital flows have intensified crises in the developing world. In most of the recent examples (Mexico 1994/5, Asia 1997/98, Russia 1998), a period of heavy inflow and mounting indebtedness usually gave way, once the confidence of investors had been lost, to very heavy outflows. The current account then had to swing sharply to surplus to “cover” these outflows, a process that was typically supported by very large official assistance. Much the same was true of the Latin American debt crisis in the 1980s. Free capital movements have not eliminated the external constraint. Rather they have made it more subtle, and sometimes more abrupt.

But two key dimensions of the external constraint have not changed. The first is that any current account deficit means that debts are incurred or that non-residents acquire claims on domestic assets. This leads to future flows abroad of capital income or of profits. The second is that a current account deficit means that the domestic production of tradables falls short of consumption. Capital inflows are often associated with an appreciation of the real exchange rate that squeeze out marginal domestic producers of tradable goods, sometimes leading to unemployment. Capital inflows can of course quickly reverse. When this happens, the country has a problem because adjustments in the real economy usually take longer than shifts in financial markets. The sudden need to eliminate the gap between tradables production and tradables consumption can then lead to an over-depreciated exchange rate or a depressed economy. Or even both.

Capital flows and risk

Successive crises have focused attention on the risks associated with capital flows – both on the nature of the risk and on the distribution of risk. This has been a long and complex debate. With some oversimplification, five dimensions of capital flows can be identified in the debate about risk:²

¹ I wish to thank Philip Turner for his considerable help in preparing this note.

² Another dimension, not directly relevant here but still important, is that of **bank loans versus debt securities**. Loans are fixed in value. However, a decline in the market value of debt paper – eg because of changed market assessment of risk or higher interest rates – will be borne by the lender.

1. **Equity versus debt.** Equity forms of investment serve to transfer risk to the supplier of funds and away from the user of funds. Debt has to be serviced irrespective of the returns earned on the investment financed by borrowing. The servicing of equity liabilities, on the other hand, depends on the returns actually earned.
2. **Short-term versus long-term.** Borrowers reliant on long-term debt are less vulnerable to refinancing risk.
3. **Consumption versus investment.** If capital inflows are used to boost domestic investment, potential output is raised. If they are used to fund domestic consumption, then potential output is unchanged; as foreigners' claims on output increase over time and have to be serviced, domestic disposable income is reduced.
4. **Public versus private.** Capital flows to finance public sector deficits may be dangerous because they allow governments to delay measures of fiscal consolidation. By contrast, capital inflows that result from private sector decisions can be viewed as of much less concern to policymakers (the famous Lawson doctrine).
5. **Tradables versus nontradables.** Capital inflows usually mean that a country's foreign currency liabilities increase. National balance sheet considerations could suggest that such inflows should be used to invest in foreign-currency earning assets – that is in expanding productive capacity in tradables, rather than in nontradables.

The lesson that many drew from the succession of crises is that various policy distortions and other factors (including inadequacies in private sector risk management) encouraged the “wrong” type of capital inflow during the good times, when the country enjoyed the confidence of international financial markets. Too much of the inflow took the form of debt rather than equity; was short-term rather than long-term; and was often used for consumption or for wasteful investment projects.

The policy environment

This lesson has led to several changes in the policy environment since the early 1990s. Three have been particularly important:

- **More flexible exchange rates.** The combination in the past of a temporary exchange rate peg and a much higher level of domestic interest rates encouraged very lucrative short-term arbitrage. The problem of course was that such positions could be unwound almost instantly once confidence in the peg wavered. The move to flexible exchange rates has largely removed this powerful incentive to short-term capital flows since even modest month-to-month changes in the exchange rate make such arbitrage very risky.
- International banks, their supervisors and the rating agencies are all now **more aware of the risks of lending** to countries or companies whose underlying prospects are poor. Banks have lost money; they have not always been bailed out by the public sector. The regulators have strengthened their oversight. Changes in private sector oversight have reinforced this development. In particular, the rating agencies – which were heavily criticised for failing to foresee

the Asian crisis – are now much more likely to downgrade countries when conditions begin to deteriorate.

- Restrictions of the **acquisition by foreigners of equity stakes** – that is, ownership - have been relaxed in many developing countries. This has applied in particular to foreign direct investment.

Reduced capital inflows

The consequences of these changes have been twofold – first, a large decline in the total flows and, secondly, a significant change in composition. According to IMF data, net private capital flows to the emerging markets have declined to around \$33 billion, compared to well over \$100 billion a year before the Asian crisis (Table 1).

The key change in the composition of flows is a big decline in flows that lead to increased indebtedness. There has been a major reduction in international bank lending, with loans outstanding to the developing countries falling from \$940 billion in mid-1997, just before the Asian crisis, to about \$750 billion by the end of 2000. Net issuance of international bonds has also declined, but has still remained positive.

Table 1 **Net private capital flows to emerging economies**
(annual rate; \$billion)

	1993-96	1997	1998	1999	2000
Net private capital flows	170	120	53	70	33
<i>Of which:</i> Foreign direct investment	89	145	151	150	144
Portfolio investment	80	43	1	22	25
other	1	-68	-99	-102	-136
<i>Memo</i>					
International bank lending to emerging economies	110 ²	70	-72	-75	-36
International bond financing of emerging economies ¹	43	83	38	36	40

¹ Net issues. ² 1996. Figures for earlier years not strictly comparable

Sources: IMF, *World Economic Outlook*; BIS.

One important trend that emerges from these developments is that debt finance to developing and transition economies is being increasingly intermediated by financial markets, with intermediation through banks declining. Outstanding international bonds issued by entities in developing countries have during the last five years increased by \$250 billion – while international bank lending has been declining (Table 2).

Table 2 **Developing countries debt: international bank loans and debt securities outstanding**
(\$billion, at year end)

	1995	1996	1997	1998	1999	2000
Bank loans	804	899	946	872	805	753
International bonds	168	238	311	357	388	418

Source: BIS.

Increased FDI: a reason for reassurance?

Foreign direct investment has risen considerably. In recent years, net FDI inflows into the developing world have been running at around \$150 billion a year, compared with around \$50 billion a year in the early 1990s.

Many observers have drawn comfort from the increased importance of FDI relative to bank or portfolio inflows. Considering the five dimensions outlined above, a case can be made that FDI is indeed a “good” capital inflow in the sense of minimising the vulnerability of the capital importing country. It represents equity rather than debt; it is long-term rather than short-term; it is associated with increased domestic capital formation; it tends to go to the private sector; and because foreign companies tend to be export-orientated, it tends to boost capacity in the tradable sector. Hence on the five dimensions outlined above, FDI scores pretty high.

There is much to support this thesis and there is no doubt that FDI brings with it substantial benefits to the recipient country. Yet there are also at least three reasons for caution. One is that all forms of capital inflow have macroeconomic implications that can eventually prove to be problematic. A very high level of FDI can lead to transient exchange rate overvaluation. This can damage the tradable sector and expose the economy to disruptive currency depreciation when such inflows cease. And foreign direct investment leads over time to increased earnings of foreign subsidiaries that will tend to increase future current account deficits. As stressed at the beginning, the external constraint has not disappeared.

Secondly, many of the precise implications depend on the exact nature of FDI inflow. For example, FDI by a major foreign manufacturer to build a new factory boosts domestic fixed capital formation; it is in the private sector; and it often adds to capacity in the tradable sector. But much recent FDI has been to acquire shares in newly privatised companies. In terms of the saving/investment dimension, this type of FDI may not necessarily add to domestic fixed capital formation. Indeed receipts from privatisation often allow governments to run larger budget deficits. So it could be argued that such FDI actually permits a reduction in the saving ratio, and does not lead to an increase in domestic investment. On the public/private dimension, it does involve a shift of assets from public to private ownership, and may increase the productivity of assets. So even if such FDI does not increase the investment/GDP ratio, it could still raise the productivity of investment. Such examples could be multiplied.

Thirdly, capital is fungible. A foreign investor with fixed FDI-related assets in a country that are difficult to sell at short notice can always cover his exposure by “shorting” the local currency or local equity market in the host country.

The conclusion, to summarise, is that one should be beware of any simplistic conclusion about the stability or sustainability implications of the greater weight of FDI in capital flows. One still needs to look a little closer.

Less flows to the developing world?

The change in total flows has been very striking. In recent years, many developing countries have become net exporters, not importers, of capital to the industrial world. The aggregate balance of payments statistics that are available are too unreliable to know how large the true flow is, but the direction of the change is quite clear. The decline in international bank lending and bond issuance has been particularly large. According to BIS statistics, net repayments amounted to about \$185 billion over the three years 1998–2000. On the face of it, this is highly anomalous. In theory, savings should flow from the developed world where the returns on investment are (or should be theoretically) low to the developing world where returns are high. Should we worry that too little capital is now flowing to some developing countries? Should we worry that, much of the developing world is a net provider of capital to the richer developed countries?

These are very difficult questions. One reassuring answer is that the present situation is merely temporary, reflecting substantial and rather persistent current account surpluses in Asia. In particular, it reflects retrenchment by Asian countries that had, up to the crisis, grown too fast and borrowed too much. During the last three years, fixed investment in many dynamic Asian countries fell from around 40% of GDP in the mid-1990s to a little over 20% of GDP. This has reduced the corporate sector’s need for finance, domestic or foreign. Conversely, the export/GDP ratio has risen. The resultant current account surpluses have been invested in foreign exchange reserves which rose from less than \$90 billion at end-1997 to almost \$200 billion by end-2000.³ As these economies strengthen, and domestic capital formation rises, these surpluses can be expected to decline.

The worrying view is that this shift in direction of transfer of savings (ie now going from much of the developing world to industrial countries) may be rather permanent. The key point is that the investment is driven not only by expected returns, but also by the expected variance of returns. Perceptions of riskiness may explain a certain reluctance of investors to invest in some developing countries. The world’s investors want to acquire financial assets in the industrial world – especially the United States - because such assets are perceived as safer. The long history of stability and respect for the integrity of financial claims in major industrial countries helps to explain this preference.

The implication of this for policymakers in developing countries is that policies that reduce the perceived riskiness of investing in their countries are of key importance. Legal, institutional and other

³ Sum of Indonesia, Korea, Malaysia, the Philippines and Thailand.

reforms may be needed to ensure the “reliability” of financial claims – proper governance to make the equity market work well, efficient arrangements that allow creditors effective claim on collateral given for loans etc. Even if such policies do not increase the average return that foreign investors can expect, they can nevertheless ensure that foreign investment is attracted on better terms because perceived riskiness is reduced.

Conclusion

I have tried to suggest in these remarks that a careful analysis of risk is essential to understanding capital flows. The general conclusions I would like to suggest are three. The first is that the lower level and changed composition of capital flows in recent years means that emerging markets as a whole are probably less vulnerable to the sort of contagious crises seen in the past decade. There is now much better appreciation of the risks involved on both the lender and the borrower sides. Given the present uncertain situation of the world economy, this surely provides some reassurance.

The second conclusion is that FDI flows are probably a safer form of capital inflow. But this should not be overstated. In particular, there are undoubtedly risks for those countries where FDI inflows are very heavy or reflect one-off developments such as privatisation.

The third conclusion concerns the recent steep decline in flows from the industrial to developing world. On the face of it, this is somewhat paradoxical: capital flows, one thinks, should flow to the developing countries which can offer high returns. This trend, however, may be telling us less about perceptions of mean expectations of rates of return, and more about the expected variance of returns. In other words, it is telling us about risk. Even if investors expect high returns from the emerging markets, they may be worried about risks. Behind this is the issue of confidence – confidence in the economic policies followed by developing countries, confidence in the reliability of local financial contracts and institutions etc.

The demands on present-day policy-makers have thus become more onerous than they were when the need to balance the current account was policy-makers’ main preoccupation. The external constraint has not gone away.