A WORLD BANK POLICY RESEARCH REPORT

PRIVATE CAPITAL FLOWS TO DEVELOPING COUNTRIES

THE ROAD TO FINANCIAL INTEGRATION

SUMMARY

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Private Capital Flows to Developing Countries

The Road to Financial Integration

SUMMARY

The World Bank
Washington, D.C.

A Note to the Reader

This booklet contains the summary of *Private Capital Flows to Developing Countries: The Road to Financial Integration.* It also includes the foreword to the report and the table of contents for the text of the book.

The full-length report has been published by Oxford University Press for the World Bank. To order copies, please use the form provided at the back of this booklet.

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Foreword

FINANCIAL MARKETS AROUND THE WORLD ARE RAPIDLY INTEGRATING into a single global marketplace, and developing countries are increasingly part of this process. The process is being driven by advances in communications and information technology, deregulation of financial markets, and the rising importance of institutional investors that are able and willing to invest internationally. The good news is that developing countries are attracting private capital flows by improving macroeconomic policy and by establishing institutions and regulatory regimes that have increased creditworthiness and promise a more stable environment. Moreover, investors are also becoming more sophisticated in differentiating among countries and their economic fundamentals. Finally, after the Mexican crisis of 1994–95, the international community has realized that more should be done to reduce volatility and risks in international financial markets by improving market disclosure and strengthening coordination among national authorities.

Nevertheless, there remain reasons for concern. First, for the twenty or so countries that have been the major recipients, the management of private capital flows has not proved to be easy. It is not just the volume of flows, but the speed at which such investment pours in—and can be withdrawn—that present particular challenges to these economies. Governments need to build the kind of macroeconomic, regulatory, and institutional environments that channel this private capital into broad-based and sustainable growth. Second, the overwhelming majority of developing countries, in particular the smaller low-income economies, still need to create the conditions to attract private capital and must depend on declining official flows.

This report makes a serious and timely contribution to the analysis of these issues. It explores the nature of the changes that are leading to the integration of developing countries in world financial markets, and it analyzes the policy challenges these countries face in attracting and managing private capital flows. It concludes, for example, that countries receiving large capital inflows should avoid using them to finance

large fiscal deficits or consumption booms. The report also includes specific recommendations and warnings on regulatory design that may be useful to developing countries as they seek to maximize the positive contribution of capital inflows while minimizing their potentially disruptive effects.

This book, therefore, will be highly useful to policymakers in developing countries and, more generally, to all development specialists. But it will also be essential reading for members of the global financial community. Investors have seen in recent years how dynamic—and sometimes volatile—emerging markets can be. Understanding these opportunities and challenges is critical for everyone.

The report also comes at an important time for the World Bank. The challenge for the Bank and other development agencies is to create strategies to help developing countries leverage private capital flows so that all benefit. The research presented in this book is an important step in constructing such strategies.

Like previous volumes in the Policy Research Report series, *Private Capital Flows to Developing Countries* is designed for a wide audience. It is a product of the staff of the World Bank; the judgments made in the report do not necessarily reflect the views of the Board of Directors or the governments they represent.

Joseph E. Stiglitz
Senior Vice President
and Chief Economist
The World Bank

April 1997

Summary

THE WORLD'S FINANCIAL MARKETS ARE RAPIDLY integrating into a single global marketplace, and ready or not, developing countries, starting from different points and moving at various speeds, are being drawn into this process. If they have adequate institutions and sound policies, developing countries may proceed smoothly along the road to financial integration and gain the considerable benefits that integration can bring. Most of them, however, lack the prerequisites for a smooth journey, and some may be so ill prepared that they lose more than they gain from financial integration. Developing countries have little choice about whether to follow this path, because advances in communications and new developments in finance have made the course inevitable. They can, however, decide how they wish to travel, choosing policies that benefit the economy and avert potential shocks.

This volume describes the forces that have created and that sustain this road, analyzes the benefits and problems likely to be encountered on it, and examines the experiences of those who are farther along on the journey to see what can be learned from them.

The Changing Financial Environment

While the cyclical downturn in global interest rates provided an important initial impetus for the resumption of private capital flows to developing countries in the 1990s, these flows have now entered a new phase, reflecting structural forces that are leading to progressive financial integration of developing countries into world financial markets. The two primary forces that are driving investor interest in developing

countries are the search for higher returns and opportunities for risk diversification. Although these forces have always motivated investors, the responsiveness of private capital to cross-border opportunities has gained momentum as a result of internal and external financial deregulation in both industrial and developing countries and major advances in technology and financial instruments.

This process of financial integration is still unfolding. The pace of change will be especially rapid for developing countries, given their more insulated financial markets. Even in the more regulated economies, growing economic sophistication means that financial integration will increasingly not be a choice for governments to make. Markets are making the choice for them. As a result, the financial integration of developing countries is expected to deepen and broaden over the coming decade against a background of increasing global financial integration. As part of this process, gross private capital flows may be expected to rise substantially, with capital flowing not only from industrial to developing countries but also, increasingly, among developing countries themselves and from developing to industrial countries.

Given the continuing decline in investment risks, the higher expected rates of return in developing countries, and the underweighting of emerging markets in institutional portfolios, net private capital flows to developing countries in aggregate are likely to be sustained. The rate of growth, though, will inevitably diminish. There will undoubtedly also be considerable variation among countries, depending on the pace and depth of improvements in macroeconomic performance and creditworthiness. Such basic factors as domestic politics, the availability of resources, and the level of development that has been attained are bound to affect the flow of capital as well, so the process of financial integration can take many courses. In fact, in countries where economic and policy fundamentals are quite weak, the initial manifestation of growing financial integration may take the form of net outflows of private capital.

With changes in the international financial environment, there are likely to be considerable year-to-year fluctuations in private capital flows to developing countries, even in aggregate. These nations are, and will continue to be, highly susceptible to both domestic shocks and changes in the international environment, such as in global interest rates. Nevertheless, flows to developing countries in the aggregate are unlikely to suffer from major reversals as long as the probability of abrupt changes in the international environment remains low. The main risks of volatil-

ity and large reversals lie at the individual country level and stem from the interaction of domestic conditions and policies with international factors. And as markets become more discerning, contagion effects of the kind seen after the Mexican crisis are not likely to be long-lasting.

Winning and Losing in an Integrating Market

The experience of nations that have successfully managed financial integration suggests that the benefits of this process are likely to be especially large for developing countries. The direct advantages are twofold: these countries can tap the growing pool of global capital to raise investment, and they can diversify risks and smooth the growth of consumption and investment. The more important benefits of financial integration, however, are likely to be indirect. These include knowledge spillover effects, improved resource allocation, and strengthening of domestic financial markets. In addition, the increasing safety of financial operations in developing markets can support a shift to higher-return investments, with gains for both developing and industrial nations.

As the Mexican peso crisis has so forcefully demonstrated, however, these benefits are by no means assured. In fact, there are large potential costs if integration is not carefully managed. There are two reasons for this. First, although international investors are becoming more discerning, market discipline tends to be much more stringent when investor confidence is lost—a fact that can lead to large outflows—than during the buildup to a potential problem. Second, and more important, many developing countries lack the preconditions needed to ensure the sound use of private capital and manage risks of large reversals. Financial integration can magnify the effects of underlying distortions and institutional weaknesses in these countries and thereby multiply the costs of policy mistakes.

The challenge, therefore, for developing countries is how to exploit the growing investor interest in their markets and so to enter a virtuous cycle of productive financial integration rather than a vicious cycle of boom and bust. In a virtuous cycle, integration and access to external private capital lead to increased productive investment, momentum for policy and institutional reform, and greater resilience to potential instability. In contrast, when the necessary macroeconomic fundamentals are lacking, banking systems are weak, and domestic distortions are pervasive, countries may experience capital flight rather than capital in-

flows, or they may be unable to use inflows efficiently—with very high costs in terms of growth and instability.

The Lessons from Evolving Experience

This report provides perspectives on how developing countries can respond to these challenges, drawing on the evolving experience of the more rapidly integrating countries. Although the agenda confronting policymakers is necessarily broad and complex, ranging from macroeconomic issues to the so-called plumbing of markets, a number of strategic themes emerge from this study.

- *Given the growing trend toward financial integration, developing countries need to vigorously pursue policies that will enable them to benefit from global capital flows and avoid the associated dangers.*

There is broad consensus—based on lessons from country experience and the considerable literature on the sequencing of reforms—that the most important prerequisites for successful financial integration are a sound macroeconomic policy framework, in particular a strong fiscal position, the absence of large domestic price distortions (for example, those arising from import protection), a sound domestic banking system with an adequate supervisory and regulatory framework, and a well-functioning market infrastructure and regulatory framework for capital markets. All these are key elements of the broader policy agenda that developing countries need to adopt in any case, and financial integration only makes their pursuit more urgent, for several reasons.

First, progress on these prerequisites will help improve a country's creditworthiness and attractiveness to foreign investors. Second, these preconditions will encourage capital flows (such as foreign direct investment) based on long-term fundamentals rather than short-term returns. Third, attainment of these preconditions will ensure that capital inflows are well used, ultimately determining whether countries can reap the benefits from financial integration and avoid its risks. Fourth, the more robust a country is with regard to these preconditions, the greater will be its latitude in responding to surges and volatile flows.

- *How countries respond to the initial surge of capital inflows, which is often associated with the opening phase of integration, will largely deter-*

mine their success in dealing not only with overheating pressures but also with potential vulnerability.

Countries have typically used a combination of policies to respond to large surges of capital inflows. Capital controls, when combined with other policies, appear to have been at least partially successful in reducing the magnitude of inflows and altering their composition. Sterilized intervention has been the most widely used instrument and has been generally successful as an initial response in curbing the growth of base money and building up reserves. Most important, countries that have resisted real exchange rate appreciation by placing greater emphasis on fiscal tightening have tended on average to have lower current account deficits, a mix of absorption oriented toward investment, and faster economic growth.

The main lesson for macroeconomic policy from recent country experience is that a heavy reliance on fiscal policy, supported by sterilization and some nominal exchange rate flexibility—and in the more extreme cases by temporary taxes or controls on inflows—can be an effective response to overheating and can reduce the likelihood of vulnerability to large reversals of private capital flows. More generally, countries are likely to suffer a loss of investor confidence when the real exchange rate is perceived to be out of line, the government's debt obligations are large in relation to its earning capacity and external reserve position, fiscal adjustment is perceived to be politically or administratively infeasible, or the country's growth prospects are bleak.

- *There is much merit in curbing lending booms associated with capital inflows while addressing the underlying weaknesses in the banking system.*

The banking system plays a dominant role in the allocation of capital in a developing country, and the health of this system largely determines whether a country will be able to exploit the benefits of financial integration and avoid its pitfalls. In many developing countries, banking systems have only recently been deregulated, incentives for banks are distorted toward excessive risk taking, banks are poorly capitalized, and adequate prudential regulation and supervision capabilities have not yet been established.

Addressing the underlying weaknesses of the banking system becomes more urgent in a globally integrated environment because banks

can increase lending more easily and incur greater risks. The standard tools for bank monitoring and supervision are rendered less effective. Institution building, removing incentive distortions (for instance, in the form of excessive insurance), and strengthening bank supervision capabilities are therefore crucial.

Since reforms of the banking system will take time to implement, it will probably be necessary to curb the lending booms associated with capital inflows by using macroeconomic policies, as well as more targeted restrictions, such as raising reserve requirements or adopting risk-weighted capital adequacy requirements. This will help alleviate overheating pressures resulting from surges in capital inflows and will reduce the vulnerability of the banking system.

- *Development of well-functioning capital markets will reduce risks of potential instability as well as attract the growing pool of portfolio investment.*

Investors are concerned with the unreliability of emerging markets in three main areas: market infrastructure (where the consequences include high transaction costs, frequent delays in settlement, and outright failed trades); protection of property rights, in particular those of minority shareholders; and disclosure of market and company information and control of abusive market practices. Unfortunately, there are no simple solutions to preparing capital markets for financial integration, which requires concerted action across a broad array of areas to improve market infrastructure and the regulatory framework.

International standards for market infrastructure provide excellent medium-term benchmarks for emerging markets, although they need to be tailored to fit individual country circumstances. The experience of the more advanced emerging markets, especially those in Asia, indicates that it is possible to improve market infrastructure in a relatively short period by leapfrogging to state-of-the-art systems. This experience, however, together with the not infrequent weaknesses in emerging market financial intermediaries, also suggests two cautionary notes. First, improving the speed of settlement and custody functions should not be achieved at the expense of reliability. Second, despite the importance of promoting competition among financial intermediaries, membership standards in key capital market institutions should be set high to bolster market safety and improve investor confidence.

A regulatory model based on disclosure and self-regulation is gaining wide acceptance in emerging markets because it has strong advantages over direct government regulation. But government regulation and oversight are still essential, and the state can play a crucial role in capital market development in partnership with the private sector, providing the basic legal structures, for example, and fostering vital market institutions. Given the weaknesses in the regulatory systems of many emerging markets and their susceptibility to "reputational risk," the tradeoff between market development and effective regulation required to develop and maintain market confidence is less pronounced than is sometimes thought.

Emerging markets should also promote the development of domestic institutional investors. By mobilizing significant amounts of resources, these investors can serve as a counterweight to foreign investors and thereby assuage fears of excessive foreign presence; they also reduce the vulnerability of domestic capital markets to foreign investor herding, and their presence may reassure foreign investors about the nation's respect for corporate governance and property rights.

All these policy and institutional initiatives to attract foreign investors and contain the potential negative impact of financial integration on capital market volatility will significantly help the development of domestic capital markets. In turn, there is increasing evidence that well-functioning capital markets make an important contribution to the overall growth process.

- *Developing countries need to build better shock absorbers and develop mechanisms to respond to instability because they will remain highly vulnerable to economic disturbances for some time.*

Growing financial integration may require three types of shock absorbers. First, the level of international reserves needs to be established in relation to the variation in the capital account, rather than in terms of months of imports, since the level of gross flows is higher following integration. For countries where investor confidence is less firm, there is a case for an even larger cushion of reserves. International reserves can also be buttressed with contingent lines of credit, as Argentina has done recently. Second, financial integration heightens the need for fiscal flexibility, which in turn will depend on the level of public debt, among other things. Third, there is strong merit in building up cushions in the

banking system. Authorities should use periods of credit boom to increase bank capitalization and provisioning requirements as a way to promote sound banking practices and increase the resilience of banks.

Even with these shock absorbers, countries need to have well-delineated mechanisms that enable policymakers to deal with crises promptly and effectively. This is particularly important for the banking system, where delaying actions intended to contain a crisis will only increase its cost.

- *International cooperation between regulators and adequate disclosure of information at all levels are increasingly important to ensuring safe and efficient markets.*

The globalization of financial markets, along with new forms of investment and the growing prevalence of financial conglomerates, increases the number of channels that transmit systemic shocks across borders and sectors and the speed at which these shocks travel. At the same time it reduces the transparency of the marketplace.

Despite the worldwide integration of financial markets, the authority of regulators has remained mainly national in scope. In a global marketplace, it is difficult to assess the risk exposure of financial intermediaries, and such complex operations as derivatives trading make risk evaluation even more uncertain. To address these problems, regulatory authorities from industrial countries are increasingly cooperating and coordinating with one another. In addition, to reinforce market discipline, these regulators are emphasizing the supervision of the quality of risk management by financial firms (rather than the position of a firm at a particular moment in time) and improved disclosure practices.

In this new environment, reducing information asymmetries across borders will have a significant payoff for emerging markets. At the macroeconomic level, more accurate and timely disclosure of country information would decrease the likelihood of cross-country contagion of financial shocks. Adequate disclosure of the risk profile and financial status of financial intermediaries would increase the effectiveness of market discipline and facilitate supervision by regulators. And for regulators, there will be a large payoff in coordination and information-sharing agreements, with both industrial and other emerging markets, in particular with those likely to share financial institutions and sources of financial shocks.

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