

Chapter III

International private capital flows

Standard economic theory argues that international private capital flows will make a major contribution to development to the extent that they will flow from capital-abundant industrialized countries to capital-scarce developing countries, and help to smooth spending throughout the business cycle in capital-recipient countries.

In recent years, reality has contradicted both aspects of this standard theory. For the last seven years, developing countries have transferred large amount of resources to developed countries. In addition to this, private capital flows to developing countries are highly concentrated in a group of large middle-income countries and are particularly insufficient for low-income and small countries. Secondly, private capital flows to developing countries have been highly volatile and reversible; as a consequence, they have been a major factor in causing developmentally costly currency and financial crises. Rather than smooth domestic expenditure, private capital flows seem to have contributed to making it more volatile.

These features are by no means inevitable. An appropriate domestic and international environment can improve the capacity of developing countries to benefit from private capital flows. The present chapter analyses both characteristics of private capital flows to developing countries and the policy options that would improve their development impact. It looks first at the main features of those flows, then follows with a deeper analysis of different categories of private flows (foreign direct investment (FDI), and financial flows, including bank credit and portfolio flows) and of the impact of derivatives. It then considers policy options to counter pro-cyclicality of private flows, the expected effects of the new framework for banking regulation (Basel II) on developing countries, and measures to encourage private flows to poorer and smaller developing economies. The chapter ends with some considerations regarding workers' remittances, which, although they do not constitute a capital flow, do represent one of the most dynamic private flows to developing countries.

Main features of private flows to developing countries

The volatility and reversibility of capital flows to emerging countries and the marginalization of many of the poorer and smaller developing economies with respect to financial markets are rooted in the combination of financial market failures and basic asymmetries in the world economy (Ocampo, 2001).

Instability is inherent in the functioning of financial markets (Keynes, 1936; Minsky, 1982). Indeed, boom-bust patterns in financial markets have occurred for centuries (Kindleberger, 1978). The basic reason for existence of these patterns is that finance deals with future information that, by its very nature, is not known in advance; therefore, opinions and expectations about the future rather than factual information dominate financial market decisions. This is compounded by asymmetries of information that characterize financial markets (Stiglitz, 2000). Owing to the non-existence or the large asym-

In theory, private capital should flow to capital-scarce developing countries and help smooth spending

In practice, there have been large net transfers from developing countries to developed ones and private flows have been very volatile.

Boom-bust patterns in capital flows have occurred for centuries ...

metries of information, financial agents rely to a large extent on the “information” provided by the actions of other market agents, leading to interdependence in their behaviour, that is to say, contagion and herding. At the macroeconomic level, the contagion of opinions and expectations about future macroeconomic conditions tends to generate alternating phases of euphoria and panic. At a microeconomic level, it can result in either permanent or cyclical rationing of lending to market agents that are perceived by the market as risky borrowers.

... but their depth and frequency seem to have increased

Herding and volatility are accentuated by some features of the functioning of markets. The increasing use of similar market-sensitive risk management techniques (Persaud, 2000) and the dominance of investment managers aiming for very short term profits, and evaluated and paid at very short term intervals (Griffith-Jones, 1998; Williamson, 2003), seem to have increased the frequency and depth of boom-bust cycles. The downgrade by a rating agency or any other new information available to investors may lead them to sell bonds and stop banks from lending to specific markets; simultaneously, reduced liquidity—owing, for example, to margin calls associated with derivative contracts in these markets—or contagion of opinions about the behaviour of different market segments that are believed to be correlated with a market facing a sell-off, will lead market agents to sell other assets or to stop lending to other markets. Through these and other mechanisms, contagion spreads both across countries and across different flows.

Different types of capital flows are subject, however, to different volatility patterns. In particular, the higher volatility of short-term capital indicates that reliance on such financing is highly risky (Rodrik and Velasco, 1999), whereas the smaller volatility of FDI vis-à-vis all forms of financial flows is considered a source of strength. The instability of different types of capital flows vis-à-vis developing countries will be explored in detail in the following sections of this chapter.

In turn, the basic asymmetries that characterize the world economy are largely (though not exclusively) of an industrialized country versus developing country character (Ocampo and Martin, 2003). In the financial area, such asymmetries underlie three basic facts: (a) the incapacity of most developing countries to issue liabilities in their own currencies, a phenomenon that has come to be referred to as the “original sin” (Eichengreen, Hausman and Panizza, 2003; Hausman and Panizza, 2003);¹ (b) differences in the degrees of domestic financial and capital market development, which lead to an undersupply of long-term financial instruments in developing countries; and (c) the small size of developing countries’ domestic financial markets vis-à-vis the magnitude of the speculative pressures they may face (Mead and Schwenninger, 2000).

Financial markets in the developing world are more “incomplete” than in the industrialized world

Taking the first two phenomena together, they imply that domestic financial markets in the developing world are significantly more “incomplete” than those in the industrialized world and therefore that some financial intermediation must necessarily be conducted through international markets. As a result, developing countries are plagued by variable mixes of currency and maturity mismatches in the balance sheets of economic agents. Naturally, such risks tend to become less important as financial development deepens.

Boom-bust cycles of capital flows are very damaging for developing economies

Owing to these asymmetries, boom-bust cycles of capital flows have been particularly damaging for developing countries, where they both directly increase macroeconomic instability and reduce the room for manoeuvre to adopt counter-cyclical macroeconomic policies, and indeed generate strong biases towards adopting pro-cyclical macroeconomic policies (Kaminsky and others, 2004; Stiglitz and others, 2005). Furthermore, there is now overwhelming evidence that pro-cyclical financial markets and pro-cyclical macroeconomic policies have not encouraged growth and, on the contrary, have increased growth

volatility in those developing countries that have integrated to a larger extent into international financial markets (Prasad and others, 2003).

The costs of financial volatility for economic growth are high, as it can generate cumulative effects on capital accumulation (Easterly, 2001). Indeed, major reversals of private flows have led to many developmentally and financially costly crises, which lowered output and consumption well below what they would have been if those crises had not occurred. Eichengreen (2004) estimated that income of developing countries had been 25 per cent lower during the last quarter-century than it would have been had such crises not occurred, with the average annual cost of the crises being just over \$100 billion. Griffith-Jones and Gottshalk (2006) have estimated similar though somewhat higher annual average cost of crises in the period 1995-2002, of \$150 billion in terms of lost gross domestic product (GDP).

Capital-account cycles involve short-term fluctuations, such as the very intense movements of spreads and interruption (rationing) of financing. These phenomena were observed during the Asian and, particularly, during the Russian crisis. However and perhaps more importantly, they also involve *medium-term* fluctuations, as the experience of the past three decades indicates. During those decades, the developing world experienced two such medium-term cycles that left strong imprints on the growth rates of many countries: a boom of external financing (mostly in the form of syndicated bank loans) in the 1970s, followed by a debt crisis in a large part of the developing world in the 1980s, and a new boom in the 1990s (now mostly portfolio flows), followed by a sharp reduction in net flows since the Asian crisis. The withdrawal of funds since the Asian crisis had initially reflected investors' perception of increasing risk of investing in developing countries, as a result of financial turmoil and crises. With the bursting of the bubble in technology and telecommunication stock prices in 2000 and the subsequent global economic slowdown, risk aversion on the part of investors also rose.

Improved economic conditions in developing countries, as well as the higher global growth and low interest rates, drove a recovery of private capital flows to developing countries in 2003 and 2004, perhaps signalling the beginning of a new cycle (table III.1). However, periods of increased volatility in yield spreads on emerging market bonds in 2004 and 2005, in response to uncertainty in the pace of interest rate increase in developed countries (particularly the United States of America), underscored the vulnerability of financial flows to acceleration in increases in interest rates.

More importantly, net *transfers* of financial resources² from developing countries have not experienced a positive turnaround and, on the contrary, continued to deteriorate in 2004 for the seventh year in a row, reaching an estimated \$350 billion in 2004 (see table III.2). Periods of negative net transfers of financial resources from developing countries (especially from Latin America) have been frequent throughout history; indeed, Kregel (2004) provides evidence that these negative net transfers have been the rule rather than the exception.

Recently, these large and increasing net transfers of financial resources are explained by the combination of relatively low net financial flows and accumulation of very large foreign-exchange reserves. Indeed, the most significant aspect of the net outflows from developing countries in recent years has been the growth in official reserves, particularly in Asia (table III.1). Accumulation of reserves had initially a large component of "self-insurance" against financial instability (or, as it is also called today, a "war chest" developed against financial crises), a rational decision of individual countries in the face of the limited "collective insurance" provided by the international financial system (see chap. VI).

Reversals of private financial flows can lead to developmentally costly crises ...

... and medium-term fluctuations are also very problematic

There has been a recovery of private flows to developing countries ...

... but net transfers remain negative and large

These transfers from developing countries are now largely a reflection of the accumulation of reserves

Table III.1.

Net financial flows to developing countries and economies in transition, 1993-2004

Billions of dollars				
	Average 1993-1997	Average 1998-2002	2003	2004
Developing countries				
Net private capital flows	151.5	48.3	92.1	152.3
Net direct investment	87.7	141.1	132.8	158.3
Net portfolio investment ^a	65.0	-8.5	-9.7	13.1
Other net investment ^b	-1.2	-84.3	-31.0	-19.1
Net official flows	12.3	9.3	-51.4	-55.9
Total net flows	163.8	57.6	40.7	96.4
Change in reserves	-79.3	-97.9	-328.2	-454.9
Africa				
Net private capital flows	6.0	8.9	12.7	9.0
Net direct investment	3.9	13.0	15.3	15.5
Net portfolio investment ^a	4.0	0.2	-0.6	2.9
Other net investment ^b	-1.9	-4.3	-2.0	-9.4
Net official flows	1.2	0.7	1.8	-1.2
Total net flows	7.2	9.6	14.5	7.8
Change in reserves	-7.2	-7.2	-22.9	-38.7
Eastern and Southern Asia				
Net private capital flows	73.4	-1.4	60.0	133.0
Net direct investment	48.1	60.5	72.3	88.6
Net portfolio investment ^a	21.7	-6.8	2.5	25.8
Other net investment ^b	3.7	-55.1	-14.9	18.5
Net official flows	4.2	1.9	-14.3	7.0
Total net flows	77.6	0.5	45.6	140.0
Change in reserves	-44.2	-93.1	-238.7	-356.0
Western Asia				
Net private capital flows	12.4	4.6	4.3	-2.3
Net direct investment	5.0	5.2	10.4	8.8
Net portfolio investment ^a	-1.0	-2.4	-1.5	-1.4
Other net investment ^b	8.5	1.9	-4.6	-9.7
Net official flows	4.3	-5.5	-47.6	-54.5
Total net flows	16.7	-0.9	-43.3	-56.8
Change in reserves	-9.0	-1.5	-30.8	-38.2
Latin America and the Caribbean				
Net private capital flows	59.6	36.2	15.2	12.7
Net direct investment	30.8	62.5	34.7	45.4
Net portfolio investment ^a	40.3	0.5	-10.1	-14.2
Other net investment ^b	-11.5	-26.7	-9.5	-18.5
Net official flows	2.7	12.2	8.7	-7.3
Total net flows	62.3	48.5	23.9	5.4
Change in reserves	-19.0	3.9	-35.8	-21.9

Table III.1 (continued)				
	Average 1993-1997	Average 1998-2002	2003	2004
Economies in transition				
Net private capital flows	8.5	1.0	27.4	13.5
Net direct investment	4.4	7.6	10.0	13.5
Net portfolio investment ^a	-0.2	-3.3	-3.4	-1.4
Other net investment ^b	4.3	-3.4	20.8	1.5
Net official flows	7.2	-0.3	-4.8	0.0
Total net flows	15.8	0.6	22.6	13.5
Change in reserves	-4.9	-9.0	-36.9	-57.1

Source: International Monetary Fund (IMF), World Economic Outlook Database, April 2005.

a Including portfolio debt and equity investment.

b Including short- and long-term bank lending, and possibly including some official flows owing to data limitations.

Table III.2.

Net transfer of financial resources to developing countries and economies in transition, 1993-2004

Billions of dollars												
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Developing countries	69.3	35.8	42.9	19.9	-5.2	-37.9	-127.4	-186.5	-153.7	-205.5	-274.8	-353.8
Africa	1.1	4.0	6.4	-5.8	-4.7	15.6	4.3	-26.2	-14.7	-5.6	-20.2	-32.8
Sub-Saharan (excluding Nigeria and South Africa)	8.6	6.7	7.4	5.3	7.5	12.1	9.1	3.0	7.9	6.4	6.5	3.9
Eastern and Southern Asia	18.7	1.0	22.1	18.5	-31.1	-128.2	-142.7	-121.3	-113.1	-142.1	-147.5	-167.8
Western Asia	33.1	13.2	15.6	5.3	6.2	28.5	-0.9	-39.1	-32.0	-26.7	-47.6	-79.9
Latin America	16.4	17.7	-1.2	1.8	24.5	46.2	11.8	0.1	6.1	-31.1	-59.5	-73.4
Economies in transition	1.8	-3.9	-2.3	-6.2	2.7	3.0	-24.0	-48.8	-30.5	-27.0	-34.4	-57.6
<i>Memorandum item:</i> Heavily indebted poor countries (HIPCs)	8.5	7.1	6.3	6.8	7.1	8.6	10.1	8.8	8.8	9.9	10.6	11.3

Sources: UN/DESA, based on International Monetary Fund (IMF), World Economic Outlook Database, April 2005; and IMF, Balance of Payments Statistics Database.

However, reserve accumulation in Asia has now clearly exceeded the need in several countries for self-insurance, raising increasing questions about the balance of costs and benefits of additional accumulation, especially if such reserves are invested in low-yielding assets and particularly in a depreciating currency, the United States dollar.

Divergence in regional trends in private financial flows has also resulted in changes in regional distribution of these flows since the 1990s. The most striking aspect of such developments is the significantly increased concentration of flows to Eastern and Southern Asia, in particular, to China, at the expense of Latin America. Private financial flows to Eastern and Southern Asia recovered at the end of the 1990s and have risen strongly in the last four years. After financial turmoil and crises in the region in the last five years, private financial flows to Latin America, in contrast, have remained far below the 1997 peak (see table III.1).

An important policy issue is whether the new private flows are more stable

As private flows start to recover, an important question for policymakers in developing countries is whether they will be sufficient as well as more stable and less reversible than in the past, leading in turn to less demand for self-insurance through reserve accumulation, and thus eventually reversing the negative net transfer of resources that has characterized the world economy since the Asian crisis.

The dominance of FDI is encouraging, though derivatives may add hidden volatility

In this regard, the dominant role of FDI and the fact that it has been relatively stable in times of crises, are positive. However, as we will see below, not all components of FDI are equally stable. Furthermore, multinational companies, especially those producing for the local market, increasingly hedge their short-term foreign-exchange risks, particularly when devaluations seem likely. This can lead to major temporary outflows of capital and significant pressure on exchange rates (Ffrench-Davis and Griffith-Jones, 2003; Persaud, 2003). More generally, the increasing use of financial engineering and of derivatives (as well as the growing scale and complexity of derivatives discussed below) seems to make the hypothesis of a hierarchy of volatility, whereby some categories of flows are more stable than others, less clear-cut.

Another potentially positive effect is the greater interest shown by institutional investors (such as life insurers) in investing in emerging countries (European Central Bank, 2005). However, the large rise in “carry trade”—that is to say, investment in high-yielding emerging market instruments using debt raised at lower cost in mature markets—makes those flows vulnerable to narrowing of interest rate differentials. Furthermore, the large fall in emerging countries’ bond spreads (while naturally positive in itself for borrowing countries) has raised concerns that this may reflect a shift in the investor base towards crossover investors, which can increase the vulnerability of developing countries, especially those with large external financing, to changes in United States interest rates.

Finally, there are two structural trends that may add stability. The first is attested by the greater importance of local currency bond markets in developing countries; the second by the fact that international banks have increasingly “crossed the border”, lending from their local branches in local currency, and usually fund themselves via domestic deposits. This makes countries less vulnerable to crises, although it also implies that foreign banks are contributing less—or no—foreign savings.

Policy efforts are essential, in source and recipient countries, to encourage stable flows and discourage reversible ones

There are thus mixed signs in respect of whether the new inflows will be more stable than in the past. Therefore, policy efforts must be made, both in source and in recipient countries, to encourage more stable flows and discourage large flows that are potentially more reversible.

Foreign direct investment

Trends and composition of foreign direct investment

Net FDI flow to developing countries and economies in transition had grown rapidly in the 1990s, peaking in 2001. During the Asian financial crisis and subsequent financial crises in emerging market countries, FDI was the most resilient and became the consistently largest component of net private capital flow to these countries. The different modalities of FDI, greenfield investment and cross-border mergers and acquisitions (M&A) have different effects on the domestic economy, in terms of both net financial contribution and linkages with the host economy.

Liberalization of FDI through legislative and regulatory changes in a growing number of countries since the 1990s has supported high levels of FDI. At the same time, although extensive privatization, particularly in Latin American and Central and Eastern European countries, drove the surge in FDI in the second half of the 1990s, it has largely run its course in many countries. Acquisitions by international investors of distressed financial and non-financial institutions in Asia after the financial crisis also brought direct investment flows through cross-border acquisitions. In turn, the opportunities provided by low production costs and its growing domestic market have been the major sources of attraction towards China, the major recipient of FDI in the developing world.

Exhaustion of State assets available for privatization and mergers and acquisitions, joined by macroeconomic volatility in some developing countries, resulted in a brief decline in FDI in 2002-2003. However, this was followed by a broad-based recovery in FDI flows across developing regions and economies in transition owing to improvement in a combination of cyclical, institutional and structural factors.

Although FDI inflows to developing countries have been more resilient than flows from other sources, they are concentrated in a small number of mainly middle-income countries. The top 10 developing-country recipients of FDI accounted for almost three fourths of total FDI flow to developing countries in 2003. This is true even if estimates are adjusted by the size of the economy. The World Bank estimates that the ratio of FDI to GDP in the top 10 recipient countries was more than twice that in low-income countries in 2003 (World Bank, 2004a, p. 79).

FDI inflows to least developed countries have increased, nevertheless, from the late 1990s, albeit from low levels, raising the least developed countries' share in total FDI in developing countries from approximately 2 per cent in 1995 to 5 per cent in 2003 (World Bank, 2005). In particular, the least developed countries with large natural resource sectors have attracted growing amounts of FDI. There has also been some diversification of investment into the agricultural, brewing and light manufacturing sectors in some African least developed countries (United Nations Conference on Trade and Development, 2004b; Bhinda and others, 1999). In any case, FDI flows to least developed countries are smaller than official development assistance (ODA) in all but a few countries (United Nations Conference on Trade and Development, 2004b).

Growth has been accompanied by significant changes in the composition of FDI. The most important trend has been the rapid growth of investment in services since the 1990s. This process has been associated both with the expansion of transnational corporations into developing countries' service sectors, facilitated in many cases by privatiza-

Net FDI flows to developing countries and economies in transition have been resilient

FDI flows are concentrated in a small number of mainly middle-income countries

FDI flows to least developed countries have increased but remain low

FDI in services has grown rapidly at the expense of FDI in manufacturing

tion and the opening of domestic markets (for example, in financial activities, telecommunications and, to a lesser extent, public utilities) and, more recently, with the rapid growth of offshoring of services by transnational corporations. The share of services in the stock of inward FDI in developing countries increased from 47 per cent in 1990 to 55 per cent in 2002. At the same time, the share of manufacturing in FDI stock declined from 46 to 38 per cent. The small share of the primary sector remained unchanged at 7 per cent. FDI in services has grown at the expense of FDI in manufacturing in all developing regions except Africa. Until the 1990s, FDI in services was primarily in finance and trade, having accounted for over 70 per cent of total inward FDI stock in services by 1990. Since the 1990s, the share of FDI stock in other services, namely, business services, telecommunications and utilities, has increased, while that of finance and trade has declined (United Nations Conference on Trade and Development, 2004b, pp. 29-31 and 99).

The effect of FDI in banking on competition has not been positive in Latin America but it has been more positive in some other cases

The effect of FDI in the service sector on competition in the host country has varied among countries. Agosin and Mayer (2000) suggest that when FDI shifted towards services as the result of privatization in Latin America in the 1990s, there was a crowding out of domestic firms. In general, anti-competitive behaviour by transnational corporations can lead to more negative consequences in cases where domestic competition law is weak. Also, the impact of FDI on competitiveness has varied by country. In the case of large scale FDI in commercial banks in Latin America, the banking sector has not become more competitive (Economic Commission for Latin America and the Caribbean, 2005, p. 113), while the result of FDI liberalization in financial services in Thailand has been more positive (Asian Development Bank, 2004, p. 231). Similarly, in Eastern European countries, after multinational banks acquired a large market share, domestic bank lending to local enterprises increased, complementing multinational bank lending (Weller, 2001).

FDI in offshoring of services, involving relocation of lower value added corporate functions, including computer programming, customer service and chip design, has been increasing in a number of developing countries. This type of FDI has a relatively large spillover effect particularly through improvement of information and communication technologies (ICT) infrastructure and capacity-building in human capital, as in the case of the offshoring of software development in India (United Nations Conference on Trade and Development, 2004b, pp. 169-170). However, because of its relatively high-skill and ICT infrastructure requirements, FDI in offshoring is limited to a small number of countries.

The increase in South-South FDI flows diversifies sources of FDI but can increase volatility

An interesting long-term change in the pattern of FDI has also been the increase in South-South FDI flows. By the end of the 1990s, more than one third of total FDI inflows to developing countries were from other developing countries. This trend has meant the provision of access to more sources of FDI for developing countries, particularly small low-income countries (Akyut and Ratha, 2004). Offsetting this benefit is the possibility that investment flows from developing source countries are more volatile than those from developed source countries, undermining the stability of FDI flows (Levy-Yeyati and others, 2003). Cases in point are the sharp decline in FDI from Asian countries impacted by the 1997 financial crisis and the decline in FDI from Latin American countries in financial crisis in 2000-2002. Any differences in investment and financial strategies between developing-country and developed-country transnational corporations with regard to earnings reinvestment and intercompany loans can also have an impact on the stability of FDI flows.

How stable is FDI?

Total FDI flows to developing countries and economies in transition as a group have been resilient overall during and after economic crises. However, this overall trend masks significant variation in performance by region and country. Since the late 1990s, FDI in non-crisis countries has remained stable, but investment flows to crisis countries have declined (International Monetary Fund, 2004b, pp. 132-133). Further, the different components of FDI flows can differ significantly in their stability in economic crises.

Equity capital flows, which reflect primarily the strategic investment decision by transnational corporations, are the most stable of the three components of FDI. They are also the largest component having constituted more than two thirds of total FDI flows in the period 1990-2002. The size of this component varies by the sector of investment (World Bank, 2004a, pp. 86-87). Initial equity capital flows are extremely large in FDI in many infrastructure industries but smaller in investment in financial institutions and even more so in other service industries such as corporate services. Furthermore, under the conditions of significantly increased risk that existed in 2001-2002 in Latin America, new investment was postponed.

Earnings from foreign operations that are not repatriated and intercompany loans, the other two components of FDI flows, tend to be more volatile. On the one hand, these two categories of investment are sources of recurrent financing for investment in foreign affiliates after the initial equity investment. On the other hand, transnational corporations can adjust the flow of these two components to make short-term changes in their exposure to the financial risks in the host country (Working Group of the Capital Markets Consultative Group, 2003, pp. 25-28).

The share of non-repatriated earnings in total earnings has averaged about 40 per cent since the 1990s but has ranged from 35 to 65 per cent in different industries (World Bank, 2004a, pp. 82-84; United Nations Conference on Trade and Development, 2004b, p. 126). This category of FDI tends to be pro-cyclical with regard to host countries' economic conditions, as transnational corporations increase earnings repatriation and therefore reduce reinvestment to reduce their exposure to deteriorating local economic conditions, potentially exacerbating the situation. During and after the Asian financial crisis and the Argentine crisis, for example, there was a significant increase in repatriation of earnings (World Bank, 2004a, pp. 88 and 90).

Inflows of intercompany loans may be almost as volatile and pro-cyclical as international debt flows. Transnational corporations call loans to foreign affiliates when financial risk in the host country rises, as happened in Brazil during the last crisis. The negative trend in total FDI flows to Indonesia in the aftermath of the Asian crisis was the result of the large repayment of intercompany loans, outweighing steady capital equity inflow (World Bank, 2004a, pp. 87-88). Also, parent companies can reduce intercompany loans as a means of financing for foreign affiliates so as to reduce currency risk in anticipation of the depreciation of the currency of the host country. They may also avoid international capital markets when obtaining extra-corporate financing and turn to the local credit market of the host country, thereby reducing the inflow of capital to the host country at a time when it is most needed. The composition of overall FDI flows can therefore have a significant effect on the stability of net financial flow to developing countries (Kregel, 1996, pp. 59-61).

Total FDI flows have been stable ...

... but non-repatriated earnings and intercompany loans are more volatile

The level of non-repatriated earnings tends to be pro-cyclical

Inflows of intercompany loans may be as volatile and pro-cyclical as debt flows

These two FDI components are also affected by the financial condition of the parent company, which is in turn affected by conditions of the economy of the source country and the global economy. Earnings repatriation and/or intercompany loan repayments are increased when financial resources are needed to improve the overall balance sheet of the parent company (United Nations Conference on Trade and Development, 2004b, p. 127).

Adjustments in earnings repatriation and intercompany loans are less volatile in tradable sectors

In addition to the other features discussed above, adjustments in earnings repatriation and intercompany loans vary among companies in different sectors. Transnational corporations with investment in production of tradables are less quick to make these adjustments, as they are buffered by earnings in foreign exchange. With currency devaluation, the attractiveness of foreign investment in the tradable sectors is also enhanced. This was reflected in the resilience of non-repatriated earnings and intercompany loans flows to Mexico, the Republic of Korea, Thailand and Turkey after currency devaluations following financial crises in the 1990s (World Bank, 2003; Lipsey, 2001). In contrast, investors in non-tradable goods and services lack the foreign-exchange earnings and face a higher currency risk. The decline in FDI in Brazil and Argentina in 2002-2003, for example, illustrated this sensitivity of FDI in infrastructure and financial services. These sectoral differences suggest that a shift in FDI away from infrastructure and financial services and towards tradable services can have a stabilizing effect on FDI flows.

Particular benefits of FDI

Benefits in technology transfer and market access are markedly uneven among host countries ...

In addition to its relatively higher resilience as a source of capital flow to developing countries, FDI is regarded as a potential catalyst for raising productivity in developing host countries through the transfer of technology and managerial know-how, and for facilitating access to international markets. The general conclusion from empirical studies points to net benefits for host countries but the benefits are markedly uneven, both among and within countries (Economic Commission for Latin American and the Caribbean, 2005; Asian Development Bank, 2004, pp. 213-269; United Nations Conference on Trade and Development, 2003a, pp. 142-144; Basu and Srinivason, 2002; Hanson, 2001). Potential negative effects include limited domestic linkages, exacerbating trade deficits, limiting competition and the excessive share of the investment risk assumed by the host country. Additionally, there is strong debate on the magnitude of, and lags in, the materialization of positive effects as well as on the mechanisms by which they are transmitted to the host economy.

There is general agreement that an enabling investment climate in the host country is a necessary condition for encouraging both domestic and foreign investment (see chap. I). In addition, the levels of human resource development and entrepreneurial capacity of the host country are significant factors in the location decisions of investors as well as in the transfer of technology and know-how and the linkages of local firms to international production networks and markets. Besides improving the investment climate and strengthening domestic capacity, developing countries have also put in place fiscal and other incentives to compete for FDI. Evidence suggests, however, that these incentives are relatively minor factors in location decisions of transnational corporations (Asian Development Bank, 2004, p. 260). They thus undermine the fiscal base of developing countries without yielding the desired results.

Developing countries have also historically implemented investment policies to promote the desired benefits and minimize the negative effects of FDI. While there has been a move away from investment policies in the last decade, and the effectiveness of investment policies has been varied, it may be desirable to reinstate the use of investment policies, particularly to promote linkages between foreign firms and the host economy. Moreover, individual countries should have the policy space within which to customize specific interventions that are consistent with their development objectives and concerns with respect to FDI (Asian Development Bank, 2004, p. 262; Economic Commission for Latin America and the Caribbean, 2005).³ Indeed, according to some analysts, the success of Asian countries was achieved by the Governments' commitment to assessing the results of their FDI policies on an ongoing basis to determine whether they were producing the expected benefits (Economic Commission for Latin America and the Caribbean, 2004a, p. 70).

Transnational corporations can play an important role in providing access to markets, thereby helping to build competitive export capacity in host countries. Intra-firm trade offers access to firm-specific technology and being part of the production network of transnational corporations can provide foreign affiliates with established brand names that have access to international markets. These benefits vary depending, in particular, on the export versus domestic market orientation of transnational corporations in specific countries. Transnational corporations played an important role in building competitive export sectors and expanding exports in China, Mexico and a number of countries in South-East Asia, Central America and Eastern Europe. In other countries, for example, Brazil, Argentina and African countries, these benefits did not materialize. In Brazil, the fact that transnational corporations imported capital goods and focused on selling to the domestic market in the 1990s had a negative effect on the current-account balance; similar results were observed in Argentina (United Nations Conference on Trade and Development, 2003a, p. 143).

Transnational corporations have been pursuing in recent decades a strategy of developing integrated international production networks to take advantage of the comparative advantage of different countries. This can result in the derivation of very different benefits from their activities by different recipient countries. While for some this would mean larger export markets for their higher-technology products, for others it might mean specialization in exports with low domestic value added (in the extreme, mere assembly activities). In turn, in the case of transnational corporations servicing the domestic market of the recipient country, it may lead to balance-of-payments pressures. Furthermore, mergers and acquisitions may actually result in the replacement of domestic suppliers by the international outsourcing chain of the new parent firm, thus leading initially to reduced domestic linkages. Over time, transnational corporations will tend to increase local inputs by transferring technologies to local suppliers so as to take advantage of geographical proximity and cost-effectiveness; just-in-time inventory management can provide an additional impetus for this strategy. However, this process is not necessarily rapid or smooth, and active linkage policies, including programmes aimed at accelerating technology transfers from transnational corporations to domestic firms, may thus play a role in speeding it up.

Transnational corporations can transfer not only production technologies but also managerial and organizational practices. Diffusion from foreign affiliates to the host country takes place more generally through competition with local firms, linkage with local suppliers, labour mobility from foreign affiliates to domestic firms, and geographical proximity between foreign and local firms. The transfer of technology and its efficient application depend on both transnational corporations' corporate policies and the level of devel-

Investment policies to promote linkages between foreign firms and the host economy should be re-considered in developing countries

Transnational corporations can provide access to international markets and can build export competitiveness

The effective diffusion of technology and managerial practices depends on TNC policies and the host country's level of development

opment in the host country, as manifested in local skills and capabilities and capacities of local affiliates to absorb technology transfer (United Nations Conference on Trade and Development, 2000, p. 175).

There may also be, in this regard, a significant difference between greenfield investment and mergers and acquisitions. Greenfield investment is more likely to involve technology transfer through introduction of imported new capital goods at inception (United Nations Conference on Trade and Development, 2000, p. 176). On the other hand, mergers and acquisitions are more likely to transfer technology and managerial capabilities to already existing local firms, targeting those with the capacity to be integrated into their production network. However, despite the different methods of technology transfer of these two forms of FDI, it is still unclear which exerts the stronger impact on technological upgrading of affiliates over time.

FDI in R&D has a large impact on technology upgrading but only for a limited number of host countries

Research and development (R&D)-related FDI has a relatively large impact on upgrading technology and knowledge capacity in host countries but it has been growing in only a limited number of countries. Since the 1990s, FDI in R&D has shifted from mainly developing products for local markets to reducing the cost of R&D in industrialized countries. This is part of a global trend of offshoring R&D enabled by advanced ICT as well as the emergence of increasing demand for scientific expertise on a global scale (United Nations Conference on Trade and Development, 2005a). A number of primarily middle-income economies place priority on FDI in R&D as a means of moving up the technology ladder and have offered fiscal incentives to encourage it (World Bank, 2005a, p. 173). Asian countries, mainly China and India, have been successful in attracting FDI in R&D because of their abundant supply of engineers and scientists available at relatively low wages, while Latin American countries have been relatively unsuccessful in attracting this form of FDI.

The backward production linkages between foreign affiliates and domestic firms can be a channel for diffusing skills, knowledge and technology from foreign affiliates to local firms. On a large scale, such transfers can in turn lead to spillovers for the rest of the host economy (United Nations Conference on Trade and Development, 2001b, pp. 129-133). However, not all linkages are equally beneficial. For instance, suppliers of relatively simple, standardized low-technology products and services may be highly vulnerable to market fluctuations and their linkages with foreign companies are unlikely to involve much transfer of knowledge. Where there is the requisite level of skill among domestic suppliers, transnational corporations have established supplier development programmes in host countries (Poland, Costa Rica, Brazil, Malaysia, Viet Nam and India) and often provided financing, training, technology transfer and information (United Nations Conference on Trade and Development, 2001b, p. 160).

Policies should target the creation of beneficial linkages

The objective of host countries should therefore be to promote linkages where they are beneficial. As linkage promotion policies are often a function of country circumstances, they need to be adapted accordingly. The focus appears to be on policies designed to address market failures at different levels in the linkage formation process. In this respect, measures to provide information for both buyers and suppliers about linkage opportunities and to bring domestic suppliers and foreign affiliates together in the key areas of information, technology, training and finance are important. Broader measures to strengthen the quality of local entrepreneurship are also vital in inducing foreign affiliates to form beneficial linkages. A few countries (the Republic of Korea, Singapore and Thailand) have introduced financial incentives for firms, including foreign affiliates, to invest in employee training (United Nations Conference on Trade and Development, 2001b, pp. 163-193).

Another way in which FDI can be linked to the domestic economy is via clusters, defined as “geographically proximate groups of interconnected companies, suppliers, service providers, and associated institutions in a particular field, linked by commonalities and complementarities” (World Economic Forum, 2004, p. 23). Examples are the software industry in India and the shoemaking industry in Italy. Such concentrations of resources and capabilities can attract FDI that responds to agglomeration economies. Foreign investors can also add to the strength and dynamism of clusters when they join them by attracting new skills and capital and thereby transmitting benefits to the domestic economy. A virtuous cycle thus builds up and generates the dynamic agglomeration economies, for example, financial services in Singapore and software in Bangalore, India (United Nations Conference on Trade and Development, 2001b, p. xix).

The success of clusters depends on an enabling investment climate and especially the competitiveness of domestic enterprises and the available pool of skilled labour. Given these imposing requirements, the development of dynamic clusters that are able to attract and develop a symbiotic relationship with transnational corporations may be more feasible for those developing countries that have the requisite enabling infrastructure and environment.

Financial flows

Bank credit

Trade finance, tied to international trade transactions, has important implications for development. It is provided by banks, goods producers, official export agencies, multilateral development banks, private insurers and specialized firms, and is indirectly supported by insurance, guarantees and lending with accounts receivable as collateral. This type of financing rose sharply in the 1990s up until the Asian crisis. Also, the average spread on trade finance had declined significantly from more than 700 basis points in the mid-1980s to 150 before the Asian crisis and on average was 28 basis points lower than spreads on bank loans over the period 1996-2002 (World Bank, 2004a, pp. 127-130).

Trade finance is particularly important for less creditworthy and poorer countries' access to international loans, as traded goods serve as collateral. Many low-income developing countries, which lack other forms of access to commercial banks, still can borrow for trade finance. In almost every year since 1980, the share of trade finance commitments in total bank lending has been higher for non-investment grade or unrated developing countries than rated ones.

Security arrangements linked to traded goods and government policies directed at promoting exports should make trade finance more resilient during crises, and help countries grow out of crises by exporting. However, the opposite pattern has been common during recent crises, as evidenced by the experience of Indonesia, Malaysia and Thailand during the 1997-1998 Asian crisis and by that of Argentina and Brazil in later years. The contraction in trade finance was sharper than justified by fundamentals and risks involved, and ended up exacerbating the crises. After the Asian crisis, more than 80 per cent of domestic firms and 20 per cent of foreign-owned firms showed a drop in trade credit. However, credit from suppliers and customers was more resilient compared with bank credit.

Clusters constitute a means of linking FDI with the domestic economy ...

... although their feasibility is limited to countries with the requisite infrastructure and capacity

Trade finance is important for less creditworthy countries as traded goods serve as collateral

The contraction in trade finance after financial crises has been sharper than justified by fundamentals and it has exacerbated the difficulties

The multilateral development banks' trade finance facilities and the activities of export credit agencies could be used to mitigate crises

Trade finance recovered following the expansion of developing countries' trade in recent years, but its stability in the future cannot be taken for granted. Governments can facilitate trade finance by providing legal standing for electronic documents and for the assignment of receivables. A more effective approach to alleviating the problem of trade finance collapse during crises could be built around multilateral developing banks' trade finance facilities, complemented by actions by official export credit agencies. The multilateral development banks have indeed used their trade finance facilities to support emerging markets during recent crises, but they could play a more prominent role. For instance, they could act as "insurer of record" on behalf of an emerging market borrower, providing transfer and convertibility risk mitigation through their preferred creditor status, but could reinsure much of the underwritten policy with other insurers.

Trade financing from export credit agencies, including guarantees, insurance and Government-backed loans, has so far declined relative to the private insurance companies, which accounted for nearly half of new commitments by international credit and investment insurers by 2002; the new commitments by private insurers are heavily skewed towards short-term export credit. However, export credit agencies could explore ways in which to play more of a counter-cyclical role, especially in the recovery stage, immediately after crises. This could include rolling over or expanding short-term credit lines and facilitating medium- and long-term financing. Export credit agencies might also give consideration to allowing a special exception to normal credit-risk practices in crisis situations. Formal international rules, such as the World Trade Organization rules on subsidies or the relevant Organization for Economic Cooperation and Development (OECD) guidelines, could be modified to remove the disincentives to counter-cyclical operations of export credit agencies.

Net bank lending to developing countries was negative from 1998 to 2002

Other bank lending to developing countries had witnessed a similar large upswing in the 1990s until the Asian crisis. Bank lending was assumed to be more stable than capital market financing; however, recent experience has shown that the dominance of short-term loans makes it easy for banks to rapidly retrench. About one third of international bank lending is short-term and this proportion had risen in the first half of the 1990s. Net international bank lending to developing countries collapsed with the East Asian crisis, and was negative from 1998 to 2002.

The sharp retrenchment following the Asian and Russian crises had occurred in the global context where banks have generally become more risk-sensitive because of banking regulation and greater emphasis on shareholder value. It reflected not only reduced willingness to lend but also a weaker desire for loans by borrowers. However, the improved economic climate of the last two years is supporting the recovery of bank lending to developing countries. Net bank lending turned positive in 2003.

Bank lending to developing countries has been recovering since 2003 and the maturity of loans has increased

In addition, maturity of bank loans has increased since the Asian crisis. According to World Bank data, the ratio of short-term to total international bank lending fell from 54 per cent in 1996 to 46.5 per cent in 2000 for all developing countries, with a particularly sharp decline in East Asia and the Pacific. Emerging market banks now have a more balanced external position vis-à-vis banks reporting to the Bank for International Settlements than in 1997-1998 and official reserve coverage of the banking system's net liability positions has increased (International Monetary Fund, 2004a, p. 36).

There has been a general retrenchment of banks from cross-border lending since 1997 and a large scale shift towards lending via domestic subsidiaries, which grew on average by 29.4 per cent annually between 1996 and 2002 (see table III.3). North American and Japanese banks have sharply reduced their cross-border lending to developing countries, while European banks have increased their exposure and now account for nearly two thirds of such lending. Important structural changes also occurred in regional patterns of borrowing. International claims on East Asia and the Pacific declined sharply, although there have been some recent signs of revival. Claims on Latin American countries expanded between 1997 and 2000, but have since stalled. Lending to “emerging Europe” performed better, entirely accounted for by European lenders. In turn, emerging Europe and Latin America have experienced the fastest growth of lending by domestic subsidiaries of foreign banks. Also, as a result of greater lending by European banks, lending to the Middle East, Northern Africa, South Asia and sub-Saharan Africa has edged up compared with that of 1997. In contrast, the presence of banking entities from developing countries in London and New York has substantively contracted since 1996.

Although foreign entry could increase efficiency through competition and modernization, it could also result in the crowding out of domestic banks and vulnerable customers as foreign banks skim the cream off the market. Empirical studies indicate that the competitive pressures exerted by foreign banks vary by country (Clarke and others,

International banks have increased their lending through domestic subsidiaries in the local currency, particularly in Eastern Europe and Latin America

Foreign banks can increase efficiency in the sector ...

Table III.3.
Bank lending in emerging markets, 1993-2002

	Total lending 1996 (billions of dollars)	Average annual growth 1993-1996 (percentage)	Total lending 2002 (billions of dollars)	Average annual growth 1997-2002 (percentage)
East Asia				
Domestic banks	769.5	18.1	876.1	2.4
Local subsidiaries of foreign banks	29.8	15.4	84.9	21.2
Cross-border	282.2	29.0	130.3	-11.6
Latin America				
Domestic banks	563.7	17.3	484.8	-2.7
Local subsidiaries of foreign banks	58.5	28.6	241.7	31.2
Cross-border	199.9	6.2	166.1	-2.8
Eastern Europe				
Domestic banks	242.5	9.4	252.8	0.8
Local subsidiaries of foreign banks	9.6	80.5	96.3	48.5
Cross-border	74.7	1.6	70.4	-0.6
All emerging markets				
Domestic banks	1 575.7	12.7	1 613.7	0.4
Local subsidiaries of foreign banks	97.8	24.4	422.8	29.4
Cross-border	556.7	14.5	366.9	-6.5

Source: International Monetary Fund, *Global Financial Stability Report, September 2004* (Washington, D.C., IMF), p. 128.

2001, p. 17), and that domestic banks displaced by foreign competition might seek new market niches, for example, through providing credit to small and medium-sized enterprises (Bonin and Abel, 2000). One survey in 38 developing and transition countries found that foreign bank penetration improves firms' access to credit, although it benefits large enterprises more than small ones (Clarke and others, 2002, pp. 20-21).

... but there is concern that they might retrench more rapidly during crises

There is legitimate concern in developing countries that foreign banks may curtail their lending more than local banks in times of crisis owing to their risk management system. The sharp drop in lending by foreign banks following recent emerging market crises, confirms this fear. For instance, the real supply of credit had fallen almost continuously in Mexico since the 1994 crisis, dropping from 35 to 10 per cent of GDP by 2001. Although this was basically a reflection of a deep domestic financial crisis, the rapid penetration of foreign banks during those years did not in any way counteract the process. Also, after the Argentine crisis, restrictions on support to ailing subsidiaries severely limited funds supplied by parent companies (Economic Commission for Latin America and the Caribbean, 2003, pp. 140-142).

Foreign banks are also more sensitive to shocks originating in advanced economies. Excessive exposure to banks from a single country increases such risks. There is concern that Latin American banking sectors have become vulnerable to economic fluctuations in Spain owing to the dominance of Spanish banks (Clarke and others, 2001, p. 18).

Portfolio flows

Net portfolio flows tend to be volatile and pro-cyclical

Net portfolio flows tend to be pro-cyclical as well as volatile. Net portfolio investment flows had surged in the early 1990s and at their peak surpassed the level of FDI, but this was followed by a collapse during the series of crises that started in East Asia in 1997. The rapid growth of bond financing was matched during the boom by the increase of foreign purchases of developing-country stocks; both declined thereafter. In the case of stocks, the initial surge had been associated to the privatization processes; later, as foreign investors resorted to direct investment to acquire control of privatized companies, portfolio equity flows declined.

Portfolio debt flows began a downturn in 1997 that lasted until 2003-2004

From 1997, the level of portfolio debt flows, measured by net issuance of debt in the international market had begun a major downturn, reaching a trough in 2001. In 2003-2004, there was a broad-based rebound: net issuance levels reached \$82 billion in 2004, far above the \$46 billion annual average in 1999-2003 but below the previous peak of \$94 billion in 1997 (Bank for International Settlements, 2005, p. 36). In spite of persistent large reversals, net portfolio debt flows became the major source of debt financing for emerging market countries, particularly in Latin America.

While there has been an overall decline in net portfolio debt flows to developing countries since the Asian financial crisis, the pattern differs significantly between crisis and non-crisis countries (International Monetary Fund, 2004b, p. 133). Since 1998, there have been large net portfolio debt outflows from Asian crisis countries. Similarly, in 2000-2002, countries in financial crisis or turmoil, such as Argentina, Brazil and Turkey, experienced sharp declines in net portfolio debt flows. On the contrary, flows to other countries increased.

Countries' sudden loss of access to primary markets for international bonds is measured as a level of very low issuance activity. The across-the-board market closure following the Russian crisis in 1998 was an extreme case of such an episode, while in 2002, loss of access was limited to a small number of countries. The riskiest borrowers were most likely to lose access to financing. Borrowers with lower credit ratings regained access after lower-risk borrowers when markets reopened (World Bank, 2004a, pp. 50-51). When developing countries do not totally lose market access, they are often subject to sharp increases of risk premiums, which are also characterized by significant cross-correlation among issuers (contagion effects). The pro-cyclical downgrades of credit rating agencies often exacerbate both lack of access to the bond market and the spreads at which such bonds can be issued.

Market access can depend on investor reaction not only to events specific to emerging market countries but also to conditions in global financial markets. While the former were dominant in the late 1990s, the latter appear to be exerting an increasing effect on emerging market bond market closure and reopening in recent years (International Monetary Fund, 2004b, p. 66). This was illustrated by the market closure in 2002. In the subsequent rally in emerging bond markets, financial conditions had a positive effect on emerging markets, an experience similar to that of the early 1990s. Low international interest rates and increased investor search for yield was reflected in an increase in the appetite for risk. However, the negative impact of international factors on the emerging market bond market was underscored again when expectations of larger-than-anticipated United States interest rate increases were raised in April 2004 and early 2005, resulting in abrupt and sharp reversals in the tightening of yield spreads of emerging market bonds. Although emerging market countries were able to weather the heightened volatility, these developments raise questions about the sustainability of the favourable external financing environment for developing countries. Currently, there are some signs of increasing risk in emerging bond markets (Institute of International Finance, 2005).

Recent developments in bond markets have also affected the composition of debt flows. The upgrading of credit ratings of a number of developing countries, including the increased number of investment grade emerging market bonds, has broadened the investor base. The increase in "crossover" investors, including institutional investors, who invest in emerging market debt as a supplement to their traditional portfolio of mature market debt, has also made a larger source of funds available. However, crossover investors can generate greater volatility, as their decisions are more sensitive to the returns of other investments in their portfolios. Also, to the extent that international banks have historically had a more diversified portfolio than other investors, increased bond issues by developing countries is not a substitute for the reduction of cross-border bank lending, and may lead to a concentration of capital flows in those countries that are regarded by the market as low-risk borrowers, at the cost of a further marginalization of high-risk borrowers (Bank for International Settlements, 2003, pp. 51-52).

There has also been a rapid development of domestic bond markets in many emerging market economies since the late 1990s aimed at mobilizing domestic saving, reducing dependency on external financing and lowering currency mismatch (see below). These domestic capital markets have attracted increasing financing from domestic as well as foreign investors, but they are not immune to volatility in interest rates. A case in point was the sharp rise in local currency bond spreads in Brazil and Turkey when emerging market bond yield spreads spiked in April and May 2004 (International Monetary Fund, 2004b, p. 23). Also, the stress on Asian local currency bond markets (China, the Republic

A sudden loss of access to international bonds markets results in a loss of financing and increases in risk premiums for developing countries

The recent increase in "crossover" investors in emerging market debt has led to a broadening of the investor base but can also generate greater volatility

Rapidly developing domestic bond markets are not immune to interest rate volatilities

of Korea and Thailand) in 2003 emanated from the sell-off in United States Treasury bonds (Bank for International Settlements, 2004, pp. 74-75). These experiences raise some questions about the effectiveness of local capital markets as a complete buffer against the volatility of external portfolio debt financing.

Net portfolio equity flows have experienced a cycle similar to that of bond financing, but their relative magnitudes differ. They declined sharply between 1997 and 2002 after reaching a peak in the early 1990s but have remained a small source of external financing for emerging market economies, even after the rebound in 2003-2004. The strength of the recovery was concentrated in Asia, with a high level of issuance by China and India.

Volatility in emerging market portfolio equity flows since the late 1990s can be attributed to a sudden loss of access to primary markets, as in the case of portfolio debt flows. In addition, synchronization with mature markets makes emerging market stocks more susceptible to international developments as evidenced by the ramifications of the bursting of the information technology bubble in 2000.

An underlying factor in a long-term decline of portfolio equity flows was the lower risk-adjusted return on emerging market stocks compared with return on portfolio debt investment in the 1990s, making the latter the preferable investment (World Bank, 2003, pp. 100-101). Underdeveloped stock markets, lack of minority shareholder protection, and limited disclosure requirements contribute to the higher risk of emerging market stocks for international investors. Also, higher volatility of returns to emerging market equities relative to bonds in an environment of macroeconomic instability reflects the seniority of debt over equity in bankruptcy proceedings. In addition, as investors seek to exert more control over the operations of enterprises and to protect their own interests, they have shifted from portfolio equity investment to FDI.

Recent liberalization of ownership and other restrictions in emerging markets has helped strengthen portfolio equity flow. This has been particularly evident in China and India where economic liberalization and prospects for sustained strong economic growth have boosted portfolio equity flow. China has succeeded in raising large amounts of foreign capital for its most successful State-owned enterprises through the listing of shares in the major international stock exchanges, although this limited fund-raising capacity for smaller domestic enterprises (Euromoney, 2004, pp. 92-99).

Impact of derivatives

The 1990s saw an explosion in the global derivatives market. Financial derivatives became an important factor in the growth of cross-border capital flows, including emerging markets. In Mexico, for example, banks used derivatives to leverage their currency and interest rate exposure. When pressure on the exchange rate began to build, these positions contributed to the Mexican crisis. Bank lending and portfolio flows, especially to Asian developing countries, were increasingly intermediated through structured derivative instruments.

The growth in derivative products is in large part due to their ability to unbundle and isolate risks. Floating exchange rates gave a major impulse to this growth by generating demand by investors to hedge against changes in exchange rates. Derivatives can redistribute risk away from those who do not want it to those theoretically better able to manage it. Derivatives can also provide a tool for pricing different risks, thus increasing

Net portfolio equity flows declined sharply after 1997 but rebounded in 2003-2004

Recent liberalization in emerging markets has helped strengthen equity flows

The 1990s saw an explosion in the volume of global derivatives

Derivatives can help redistribute risks ...

market efficiency. They give investors the ability to hedge specific risks and gain access to others, creating opportunities for portfolio diversification.

At the same time, however, derivative products increase leverage in markets, provide tools for short-term speculation and can increase macroeconomic volatility. Because derivatives are often complex, non-transparent and poorly regulated, they can also be used for tax avoidance, manipulation and fraud. Thus, the use of derivatives has added to systemic risk and macroeconomic volatility, especially for developing countries (see chap. VI regarding systemic risk).

Standard derivative contracts used to hedge risk, such as forwards, futures and options, are quite well known. While foreign-currency forwards are traded over the counter (OTC), many basic futures and options contracts are standardized and traded in organized and regulated markets. Futures and forward contracts illustrate how derivatives can transfer risk. The wheat farmer, for example, risks a loss in income from a fall in the price of wheat, while the baker risks a loss from a rise in price. Both risks can be eliminated if, at the beginning of the planting season, they agree to the price at which they will exchange wheat at harvest time. However, in the absence of perfectly offsetting risks, contracts increasingly simply transfer risk from one agent to another. In the absence of a baker, the farmer will transfer his risk to whoever is willing to guarantee the contracted price on the stipulated date. For these agents, contracts are primarily for trading rather than hedging purposes.

Forward contracts in foreign exchange constitute the most liquid derivative instrument traded in emerging markets. In these contracts, counterparties agree to buy one currency and sell the other on a specified date at an agreed upon price. Originally used for hedging purposes, forwards foreign-exchange contracts have increasingly been used for currency speculation. For example, in the early 2000s speculators used forwards as the main tool for betting on an appreciation of the Chinese renminbi. Forward contracts also offer implicit access to the interest rates of the currency being bought, funded by the currency being sold. In what is called the “carry trade”, investors use currency forwards to invest in high short-term local interest rates in developing countries, funded by lower United States dollar, yen or euro rates. Forwards also give speculators the ability to short the local currency.

Forward contracts highlight several important characteristics of derivatives and their potentially very problematic impact on developing countries. First, they add leverage to the markets, exacerbating problems of short-term capital flows and hot money. Derivative products that allow investors to leverage currency risk have increased volatility in exchange markets and exacerbated boom-bust cycles in developing countries. For example, open currency and interest rate positions in Asia in the mid-1990s grew to excessive proportions relative to domestic GDP and were a major factor in the Asian crisis (International Monetary Fund, 2002a). This was especially pronounced in Indonesia where, prior to the crisis, otherwise viable companies had been speculating on the exchange rate through foreign-exchange forwards and swaps. These companies were then forced into bankruptcy when the currency devalued. When pressure on the currency built, foreigners sold their local currency positions, and domestic speculators were forced to buy dollars to cover their dollar shorts, causing the currency to fall further.

The forwards foreign-exchange market also demonstrates the difficulty of regulating derivatives. As a response to the crisis, Asian central banks attempted to use capital controls to restrict currency speculation through the forwards market. However, the global nature of derivatives, combined with their lack of transparency, made it harder to enforce capital-account regulations. The result has been the growth of offshore or non-deliverable forwards markets designed to circumvent domestic restrictions. For example,

... but they can also foster speculation and increase macroeconomic volatility

Derivatives add leverage to markets, exacerbating boom-bust cycles in developing countries

It is difficult to regulate derivatives ...

tightening of controls since the Asian crisis has led to new growth of such markets, so that Asian non-deliverable forwards markets now make up over 70 per cent of all global non-deliverable forwards markets (Ma, Ho and McCauley, 2004).

... partially because offshore markets are hard to control

Because the non-deliverable forwards markets are offshore, it is harder, albeit still possible, for domestic regulators to control them. When Malaysia imposed capital controls during the Asian crisis, it made ringgit deposits abroad illegal, and determined that those held abroad by nationals had to be repatriated. These decisions were aimed at eliminating the offshore market, which had been used by speculators to manipulate the currency (Khor, 2005).

A consideration of the differences between onshore and offshore forward contracts also provides some insight into how derivatives isolate risk. One of the main risks associated with over-the-counter derivatives is local counterparty risk. During the Russian crisis, for example, many foreign investors bought local treasury bills and then hedged the currency risk with Russian local banks through currency forwards. During the crisis, local banks went bankrupt, and refused to honour their contracts. The non-deliverable forwards markets are dominated by foreign banks, and trades outside the developing country (for example, in New York or London); hence, the risk of counterparty default is significantly lower than with onshore forwards. Onshore contracts expose countries to domestic settlement risk and the risk that the central bank will impose currency controls. Non-deliverable forwards markets are not subject to these risks.

Other derivative products unbundle risks even more. For example, contracts can be written that limit exposure to convertibility risk, local settlement risk, etc. The result in respect of these packages is a change in the credit-risk characteristics of the bond whereby risks are shifted to different individuals. Investors can use these products to gain access to their desired emerging market exposure, and borrowers can use them to reduce the cost of funding. However, because of their complexity, they can also be used to hide risks from regulators and, sometimes, even from the investors themselves. In addition, like forwards, they can also increase systemic risk and macroeconomic volatility. In a number of countries where severe restrictions in the cash market prevail, these derivative products allow investors to go around such restrictions (Chew, 1996, p. 49). However, in doing so, they often circumvent the intended limits on short-term hot money.

Complex derivatives hide risks from regulators

The difficulties created by these products can be seen most clearly in the context of the structured credit derivative contracts that expanded rapidly during the late 1990s, one example involving the structured note with an embedded option, often linked to an emerging market currency. These notes carried a higher coupon because they contained an embedded short position in interest rate or foreign-exchange options. In other words, when an investor bought a structured note, she simultaneously sold an interest rate option. Less knowledgeable investors did not realize that by buying these securities, they were selling options or engaging in leveraged bets, because those features were concealed (Chew, 1996, pp. 54-55).

Swaps allow a market that trades without funding

Another structured credit derivative is the total return swap. The objective of this swap is to allow counterparties to exchange risks without actually transferring assets. The borrower receives the total return (coupons plus capital gains or losses) on a reference asset and generally pays the London Interbank Offered Rate (LIBOR) plus a spread. Total return swaps can be tied to almost any asset, index or basket of assets and, like structured notes, can be designed to include the amount of leverage the parties choose to agree on. Swaps allow a global market that trades without any actual funding, and is not affected by any of the limitations of the cash market.

Structured products have also been the basis for the growing market in credit default swaps, which are currently the most popular form of credit derivatives. Credit default swaps are credit swaps embedded in structured notes. Under the terms of the swap, the counterparty buying protection against a credit event makes a periodic payment to the seller. She is paid by the seller if the credit event occurs. Unlike total return swaps, credit default swaps provide protection only against agreed upon credit events, such as bankruptcy, a change in credit ratings, a debt moratorium or a debt restructuring. The most liquid credit default swaps contracts are on sovereign external debt.

While the credit default swaps market provides an efficient tool for pricing credit risk it also opens the way to abuses, and can be particularly difficult to monitor and regulate since, like the non-deliverable forwards market, the credit default swaps market is not domestic. Most trades experience no geographical limitations. Furthermore, credit default swaps can mask the true ownership structure of a country's debt. This becomes an issue if a country goes into default. All bondholders have equal rights to negotiate a settlement; but there can be bondholders who also have a short position through swaps, and might negotiate against other bondholders' interests.

The increasing use of credit derivatives has reduced transparency and increased the difficulty in assessing the final return on funds provided. Many of the contracts used include embedded options and leverage that increase the risk of the position often beyond the investors' knowledge.

Many of these structured products have been expressly designed to hide risk exposure by providing credit enhancements. It is not surprising that bank regulators in emerging economies had difficulty discovering or controlling them. Even in developed countries, regulators have found the monitoring of derivative transactions to be a complicated matter, as was seen in the cases of Long-Term Capital Management (LTCM) and Enron. In developing countries, with weaker institutions and undeveloped markets, poorly regulated derivatives can have an even greater destabilizing effect.

In theory, derivatives can be used to decouple risks, giving investors the opportunity to diversify their portfolios. At the same time, they should lead to additional sources of financing for borrowers, and help develop local capital markets. Furthermore, new instruments can limit risks through diversification.

However, derivatives can also destabilize markets and have contributed to boom-and-bust cycles in emerging markets. The way in which particular swap contracts and credit derivatives combine currency risk and market price risks explains why these markets tend to move in sympathy, creating contagion that can produce unexpected declines and excessive instability in both currency and asset markets during crises. Also, the characteristics of the derivative contracts suggest that they are often motivated by factors not directly related to the allocation of funds to their highest global returns. Rather, they are linked to attempts to circumvent particular prudential regulations and provide banks with fee and commission income, rather than to profit from assessing relative risk-adjusted returns.

Yet, derivatives in developing countries appear set to continue to grow. Recent figures indicate a recovery of cross-border bank lending. In particular, inflows into China have increased substantially, driven by an anticipated appreciation of the Chinese currency. These flows have been encouraged by China's decision to adopt more liberal rules on Derivatives Business of Financial Institutions from March 2004 which allow foreign banks to expand their derivatives activities with Chinese companies. The new rules permit over-the-counter derivatives trades for any commercially reasonable purpose, not just for hedging purposes, as previously required.

Credit default swaps can mask ownership of a country's debt

Even in developed countries, regulators find it difficult to monitor derivatives

Derivatives are often motivated by factors not linked to the best allocation of funds

Derivatives are set to grow in developing countries

One lesson to be derived from the history of derivatives in the 1990s is that short-term instruments linked to currencies and money markets can be particularly destabilizing. The experience of Malaysia, however, shows how well-designed regulations and controls can effectively restrict this market, and can even be used to cut off the development of an offshore market. In the case of China, the new derivatives regulations still require banks to comply with foreign-exchange restrictions. In other words, the new rules do not permit derivatives involving renminbi, so that leveraging or shorting the currency is still apparently restricted. However, the rapid development of derivatives in China may entail new risks that it may be difficult for regulators to monitor.

Derivatives tied to longer-term instruments are perhaps less risky, and some risks can be potentially minimized through well-designed regulations (Dodd, 2005). When opening their markets in order to obtain the benefits that derivatives can offer, policymakers need to focus on new regulatory structures so as to minimize not only risk to the investor but above all systemic risk, and undesired potential macroeconomic effects.

Well-designed regulations can reduce the risks posed by derivatives

Measures to counter pro-cyclicality of private flows

To counter the boom-bust pattern that characterizes private capital flows, several options are available to developing countries. We consider in the present section two alternatives: (a) designing mechanisms to encourage more stable private flows (counter-cyclical guarantees) or that distribute better the risk faced by developing countries throughout the business cycle (indexed bonds and bonds denominated in the currency of developing countries); and (b) introducing prudential regulations on the capital account. We also consider the likely effect of the New Basel Capital Accord (Basel II) on the cyclical patterns of capital flows to developing countries. The use of local currency bond markets to reduce currency mismatches and the design of explicit counter-cyclical prudential regulations were analysed in chapter I. The pro-cyclical pattern of private capital flows gives a compensatory role also to official financing; this issue will be considered in chapters IV and VI, in relation to official development financing and to emergency (balance of payments) financing, respectively.

Counter-cyclical financing instruments

One way of addressing the problems created by the inherent tendency of private flows to be pro-cyclical is for public institutions to issue guarantees that have counter-cyclical elements (Griffith-Jones and Fuzzo de Lima, 2004). In this regard, multilateral development banks and export credit agencies could introduce explicit counter-cyclical elements in the risk evaluations they make for issuing guarantees for lending to developing countries. This would imply that when banks or other lenders lowered their exposure to a country, multilateral development banks or export credit agencies would increase their level of guarantees, if they considered that the country's long-term fundamentals were basically sound. When private banks' willingness to lend increased, multilateral development banks or export credit agencies could reduce their exposure. This implies that the models used to assess risks should utilize measures of risk focused on long-term fundamentals and would therefore be less affected by the short-term fluctuations that tend to influence markets.

To counter boom-bust cycles, measures can be designed to encourage more stable private flows

Alternatively, there could be special stand-alone guarantee mechanisms for long-term private credit that had a strong explicit counter-cyclical element. This could be activated in periods of sharp decline in capital flows and its aim would be to try to catalyse long-term private credit, especially for infrastructure. Multilateral development banks could also play a more active role in issuing guarantees to bonds issued in private capital markets by developing countries during periods of limited risk appetite.

The introduction of counter-cyclical elements in guarantees would become more meaningful if the number of guarantees issued by multilateral and regional development banks expanded to offset the decline in guarantees issued by some export credit agencies. As we will see in chapter IV, existing problems—such as excessive restrictiveness of criteria and approval processes for granting and other related costs—would need to be addressed, and the resources of the international financial institutions should also be better leveraged in providing guarantees.

Commodity-linked bonds can also play a useful role in reducing developing countries' cyclical vulnerabilities. Examples of commodity-indexed bonds include oil-backed bonds, including Petrobonds, which were first issued on behalf of the Government of Mexico (Atta-Mensah, 2004). In such instruments, the coupon or principal payments to the buyer are linked to the price of a referenced commodity. By issuing this type of bond, the developing country can shift some of the risk of a fall in commodity prices to its bond investors. However, commodity-linked bonds can be expensive, owing to the greater complexity of these instruments, in comparison with conventional bonds (Dodd, 2004).

There have also been proposals to introduce GDP-indexed bonds. The coupon payments on these bonds would vary in part with the growth rate of the debtor's economy, being higher in years of rapid growth of GDP (measured in an international currency) and lower in years of below-trend growth. It has been argued that such instruments would improve the cushioning of emerging market borrowers against adverse shocks by making debt payments more contingent on the borrower's ability to pay. GDP-indexed bonds would therefore restrict the range of variation of the debt-to-GDP ratio and hence reduce the likelihood of debt crises and defaults. At the same time, they also reduce the likelihood of pro-cyclical fiscal policy responses to adverse shocks.

This instrument would allow countries to insure against a broader set of risks than would commodity-linked bonds, and thus is likely to be more useful for those developing countries that have fairly diversified production and exports and therefore do not have a natural commodity price to link to bond payments (Council of Economic Advisers, 2004; Goldstein, 2005). However, the introduction of GDP-indexed bonds may encounter some obstacles, such as concerns about the quality of GDP data in some developing countries. Their introduction would thus need to be preceded by efforts to improve the quality of macroeconomic information.

It has been suggested that the advanced industrialized countries should issue these instruments first. This would have a demonstration effect and make it easier for developing countries to join in (Shiller, 2005). The precedent of introducing collective action clauses into bonds, undertaken first by developed countries which were later followed by developing countries, would seem to indicate that such demonstration effects can be very effective in introducing innovations in financial instruments.

Another alternative for better managing the risks faced by developing countries throughout the business cycle consists in the introduction of local currency-denominated bonds. These bonds offer, in particular, a cure against the currency mismatches that characterize the debt structure of developing countries. At the domestic level, the development

Introducing counter-cyclical elements in public guarantees can help smooth flows

This would become more meaningful if the volume of multilateral guarantees increased

Commodity-linked and GDP-linked bonds can reduce the likelihood of debt crises and of pro-cyclical responses to shocks

Industrialized countries should issue such bonds first, to set a precedent

Local currency bonds help countries manage risks

of domestic capital markets, especially bond markets, also creates a more stable source of local funding for both the public and private sectors, thereby mitigating the funding difficulties created by sudden stops in cross-border capital flows (some limitations of these instruments, particularly the relative incapacity to isolate domestic markets from external market shocks, were discussed above). Chapter I has outlined the progress made in developing domestic capital markets in developing countries and the policy options for further encouraging this trend.

Diversified portfolios of local currency debt can make investment in local currency bonds more attractive to foreign investors

In addition to proposals for institutional measures to develop local capital markets, there have also been innovative proposals to make local currency investments more attractive to international investors. Spiegel and Dodd (2004) have suggested raising capital in international markets by forming diversified portfolios of emerging market local currency debt issued by sovereign Governments. These portfolios of local currency government debt securities (LCD portfolios) would employ risk management techniques of diversification to generate a return-to-risk that competed favourably with other major capital market security indices. Based on data starting in 1994, the authors show that a portfolio of emerging market local currency debt can raise rates of return relative to risk that compete with those of major securities indices in international capital markets. The insight offered by portfolio theory is that a portfolio consisting of different securities whose returns are sufficiently independent (especially if they are negatively correlated) can yield risk-adjusted rates of returns superior to those of the individual securities. Thus, the volatility of the whole is less than the sum of its parts. The proposed LCD portfolio would consist of local currency government debt instruments from many different developing countries, so as to have a return and variance that were competitive in international capital markets.

However, the authors admit that there are some challenges that need to be overcome. The first is the disappointing history of local currency funds in the mid- to late 1990s which has led investors to be wary of this asset class. This relates to funds that took large concentrated bets in a few countries, and thus did not maintain a diversified portfolio. As local currency bond markets have continued to develop, there is now a greater possibility of benefiting from portfolio diversification. The second is that Governments may not respond to the interest of foreign investors in local debt by easing regulations and transactions costs involved with investing in these markets. This may be due to the fact that foreign financing may be more attractive, since it is often cheaper than domestic financing. Some countries may also fear the impact that surges and reversals of short-term hot money could have on small domestic capital markets. In this light, regulations can be viewed as a means of restricting capital flows. Given the legitimacy of these concerns, the challenge becomes to construct the portfolio in such a way as to still give policymakers the option to continue to selectively use capital-account regulations to limit short-term inflows. According to Spiegel and Dodd, this can indeed be done and they cite the example of Hungary where foreigners were given permission to buy into long-term closed-end funds even when they were not allowed to access the local bond market directly.

Multilateral development banks can help develop domestic bond markets

As suggested in chapter IV, multilateral development banks could play an active role in the development of domestic bond markets.

Prudential capital account regulations

In the previous section, we suggested a set of financial instruments that could be used in international financial markets to either smooth out private flows to developing countries or manage better the risks they generate. However, there are also important policy measures that can be taken nationally to either smooth private flows or manage such risks, particularly prudential regulations on the capital account and counter-cyclical prudential regulations. The latter were analysed in chapter I; we consider the former in the present section.

The accumulation of risks that developing countries face during capital-account booms depends not only on the magnitude of private and public sector debts but also on maturity and currency mismatches on the balance sheets of financial and non-financial agents. Thus, capital-account regulations potentially have a dual role: as a macroeconomic policy tool with which to provide some room for counter-cyclical monetary policies that smooth out debt ratios and spending; and as a “liability policy” designed to improve private sector external debt profiles (Ocampo, 2003e).

Viewed as a macroeconomic policy tool, capital-account regulations aim at the direct source of boom-bust cycles: unstable capital flows. If successful, they provide some room to “lean against the wind” during periods of financial euphoria through the adoption of a contractionary monetary policy and/or reduced appreciation pressures. If effective, they also reduce or eliminate the quasifiscal costs of sterilized foreign-exchange accumulation. During crises, they provide breathing space for expansionary monetary policies. In both cases, capital-account regulations improve the authorities’ ability to mix additional degrees of monetary independence with a more active exchange-rate policy.

In their role as a liability policy, capital-account regulations recognize the fact that the market rewards sound external debt profiles (Rodrik and Velasco, 1999). This reflects the fact that, during times of uncertainty, the market responds to gross (and not merely net) financing requirements, which means that the rollover of short-term liabilities is not financially neutral. Under these circumstances, a maturity profile that leans towards longer-term obligations will reduce domestic liquidity risks. An essential component of economic policy management during booms should thus be measures to improve the maturity structures of external and domestic liabilities.

Overall, the experiences with capital-account regulations in the 1990s were useful for improving debt profiles, giving Governments more latitude in pursuing stabilizing macroeconomic policies, and insulating countries from some of the vagaries of capital markets. There is much evidence that, if well implemented, the benefits far outweigh the costs (Stiglitz and others, 2005; Epstein and others, 2003; Ocampo and Palma, 2005).

A key question for countries considering capital market interventions is what form the interventions should take. They can be either price-based (unremunerated reserve requirements or taxes) or quantity-based (administrative restrictions on certain forms of borrowing). Aside from price- and quantity-based interventions in capital markets, other domestic prudential regulations can also be used to affect both the ability to borrow abroad and the associated returns. They include limits on banks’ short-term foreign borrowing; regulations that force banks to match their foreign currency liabilities and assets; and regulations that restrict them from lending in foreign currencies to firms that do not have equivalent revenues in those currencies, or impose higher capital adequacy requirements or loan-loss provisions for short-term lending in foreign currency and lending that involves a currency mismatch. Authorities can also apply adverse tax or bank-

Capital-account regulations can provide room for counter-cyclical monetary policies and improve external debt profiles

If well implemented, the benefits far outweigh costs

Interventions can be price- or quantity-based, or both

ruptcy treatment to foreign-denominated borrowing. These interventions are not mutually exclusive, and thus Governments can use a mix of instruments to manage the risks associated to foreign borrowing.

The basic advantages of price-based instruments are their simplicity and their focus on averting the build-up of macroeconomic disequilibria and, ultimately, preventing crises. A highly significant innovation in this sphere during the 1990s was the establishment in Chile and Colombia of an unremunerated reserve requirement for capital inflows. Since the unremunerated reserve requirement could be substituted by a payment to the central bank of its implicit costs, it also operated as a tax on capital inflows. It created a simple, non-discretionary and preventive (prudential) price-based incentive that penalized short-term foreign currency liabilities more heavily.

The effectiveness of reserve requirements has been the subject of debate (for review of different positions, see Ocampo, 2003e). It is noteworthy that institutions such as the International Monetary Fund and the Bank for International Settlements have increasingly concluded that these controls were effective in important aspects. There is broad agreement that they were effective in reducing short-term debt flows and thus in improving or maintaining good external debt profiles. There is greater controversy about their effectiveness as a macroeconomic policy tool. Nonetheless, given solid evidence on the sensitivity of capital flows to interest rate spreads in both countries, it can be asserted that reserve requirements influenced the volume of capital flows at given interest rates or (an aspect on which there is broader agreement) helped countries maintain higher domestic interest rates during periods of euphoria in international financial markets. Therefore, in terms of some, and probably most, of their main objectives, the Chilean and Colombian experiences were broadly successful. They clearly helped lengthen maturities and increased space for increasing interest rates, thereby contributing to macroeconomic equilibrium.

On the other hand, traditional foreign-exchange market interventions and quantity-based capital-account regulations might be preferable when the policy objective is to reduce significantly domestic macroeconomic sensitivity to international capital flows. These traditional controls in essence segment the domestic and foreign-exchange markets, basically by limiting the capacity of domestic firms and residents to borrow in foreign currency (except in the cases of some specific transactions such as trade financing and long-term investment) and limiting the capacity of foreign residents to hold some types of domestic financial assets or liabilities.

Indeed, simple quantitative restrictions of this sort are also preventive in character and can be easier to administer than price-based controls, but an administrative capability must be in place in order for these regulations to work and to prevent the corruption that could be generated by the discretionary decisions that might be involved in their use. Some of them can also be mixed with price-based regulations or with other domestic prudential regulations mentioned in the beginning of this section. Thus, during the 1990s, Chile established a minimum stay period for foreign capital (one year) and was responsible for the direct approval of issuance of American Depository Receipts (ADRs), and Colombia maintained direct regulations on the inflows and composition of the portfolios of foreign investment funds operating in the country.

The experience of the Asian countries that maintained quantity-based restrictions throughout the 1990s suggests that those restrictions might indeed also be particularly effective in preventing crises. China, India, Taiwan Province of China and Viet Nam offer successful examples in this regard. Despite the slow and cautious liberalization that

Unremunerated reserve requirements were an important innovation and were broadly successful

Simple quantitative restrictions may be easier to administer

Quantitative restrictions can be very effective in preventing crises

has taken place in several of these economies since the early 1990s, the use of such traditional regulations has helped them prevent contagion from the East Asian crisis (see, for example, in relation to India, Reddy, 2001; Rajaraman, 2001; and in relation to Taiwan Province of China, Agosin 2000).

Malaysia offers one of the most interesting examples of effective use of quantitative regulations during the 1990s. In January 1994, it had introduced outright restrictions on short-term inflows and prohibited non-residents from buying a wide range of short-term securities. These other measures proved highly effective in reversing the booming capital inflows of the previous years (Palma, 2002). In September 1998, Malaysia established quantity-based restrictions on outflows, which basically aimed at guaranteeing that the local currency would be used only in domestic transactions, and thus at eliminating offshore trading of the currency.⁴ In February 1999, these regulations were replaced by an exit levy (that is to say, a price-based regulation), which was gradually reduced in later years. Kaplan and Rodrik (2001) show that the Malaysian regulations successfully closed the offshore ringgit market and reversed financial market pressure, and gave the government space within which to enact expansionary monetary and fiscal policies that contributed to the speedy recovery of economic activity.

Although quantity-based restrictions can be effective if authorities wish to limit capital outflows during crises, crisis-driven quantitative controls generate serious credibility issues and may be ineffective in the absence of a strong administrative capacity. This implies that a tradition of regulation may be necessary, and that the tightening or loosening of permanent regulatory regimes through the cycle may be superior to the alternation of different (even opposite) capital-account regimes. In broader terms, this means that it is essential to maintain the autonomy needed to impose capital-account regulations, and thus the freedom to reimpose controls, if necessary (United Nations, 2001a; Reddy, 2001; Ocampo, 2003e). This is indeed a corollary of the incomplete nature of international financial governance, particularly of the absence of a lender-of-last-resort at the global level.

It should be emphasized, in any case, that capital-account regulations should always be seen as an instrument that provides an additional degree of freedom to the authorities with respect to their adopting sensible counter-cyclical macroeconomic policies, but never as a substitute for those policies.

Basel II and developing countries

The right regulatory and supervisory regime is essential for maintaining domestic financial stability. In a globalized economy, some common standards of regulation and supervision may be also essential to guarantee global financial stability and to avoid regulatory arbitrage by international banks and other financial agents. This has been the major motivation behind the principles adopted by the Basel Committee on Banking Supervision in recent decades. The second generation of these standards (Basel II), agreed to in June 2004, takes a further step in aligning regulatory capital with the risks in banks lending, and in adapting regulations to the complexities of risk management in the contemporary world. Also, the standardized approach contains several positive features from the perspective of developing countries, such as the reduction of the excessive incentive to short-term lending, which existed in Basel I.

Permanent regulatory regimes that are tightened or loosened through the cycle are superior to ad hoc interventions

Basel II has a number of positive features

However, there is a risk that it will increase the pro-cyclicality of bank lending ...

... reduce such lending to developing countries and increase its cost

The internal-ratings based (IRB) approach overestimates risk of lending to developing countries ...

... because it ignores the benefits of international diversification

Incorporating the benefits of diversification of lending to developing countries would reduce capital requirements and pro-cyclicality

However, when judged from the perspective of some of the main market failures that should be addressed by banking regulation, the new regime has a number of problems: it is complex where it should be simple; it is implicitly pro-cyclical when it should be explicitly counter-cyclical; and although it is supposed to more accurately align regulatory capital to the risks that banks face, in the case of lending to developing countries it ignores the proved benefits of diversification.

There are thus fears that Basel II creates the risk of a sharp reduction in bank lending to developing countries and of an increase in the cost of a significant part of the remaining lending, particularly in the case of low-rated borrowing countries, which also have a limited or costly access to international bond markets. This is contrary to the stated objective of G-10 Governments, which is to encourage private flows to developing countries, and use them as an engine for stimulating and funding growth. An equal cause for concern is the danger that Basel II will accentuate the pro-cyclicality of bank lending, which is damaging for all economies, but particularly so for fragile developing ones, which are more vulnerable to strong cyclical fluctuations of financing.

Indeed, the proposed internal ratings-based (IRB) approach of Basel II overestimates the risk of international bank lending to developing countries, primarily because it does not appropriately reflect the clear benefits of international diversification. One consequence of the adoption of this approach by internationally active banks would be that capital requirements for higher-rated borrowers will fall, while those for lower-rated borrowers will rise. This is likely to lead to an excessive increase in regulatory capital requirements and, to the extent that regulatory capital requirements feed through into the pricing of loans, will cause the pricing of loans to lower-rated borrowers—those concentrated in developing countries and particularly the lower-rated borrowing countries—to rise significantly. It has been argued that this is acceptable, since it merely reflects a more accurate assessment of the risks. However, there is a great deal of evidence that by failing to take account of the benefits of international diversification at the portfolio level, capital requirements for loans to developing countries will be significantly higher than is justified on the basis of the actual risks attached to this lending (see, for example, Griffith-Jones, Segoviano and Spratt, 2004a).

Therefore, one clear way in which Basle II could be improved so as to reduce the negative and technically incorrect effects on developing countries would be to introduce the benefits of diversification into the internal-ratings based approach. One of the major benefits of investing in developing and emerging economies is their relatively low correlation with mature markets. This hypothesis was tested empirically using a wide variety of financial, market and macro variables (Griffith-Jones, Segoviano and Spratt, 2004a). Every statistical test performed, regardless of variable, time period or frequency, showed that the correlation between developed markets only was higher, in every case, than that between developed and developing markets. Different simulations that compared estimated unexpected losses of portfolios that were diversified across both developed and developing countries with the losses of portfolios in developed countries only, have estimated that the former were from 19 to 23 per cent lower.

The evidence clearly supports the hypothesis that a bank's loan portfolio that was diversified between developed and developing-country borrowers would benefit in terms of lower overall portfolio risk relative to one that focused exclusively on lending to developed countries. Therefore, if risks are measured precisely, this should be reflected in lower capital requirements. Indeed, the Chair of the Basel Committee on Banking Supervision, Jaime Caruana, acknowledged in July 2004, in his speech to the Annual Conference of Latin American Regulators (ASBA), held in Mexico City, that “geographical

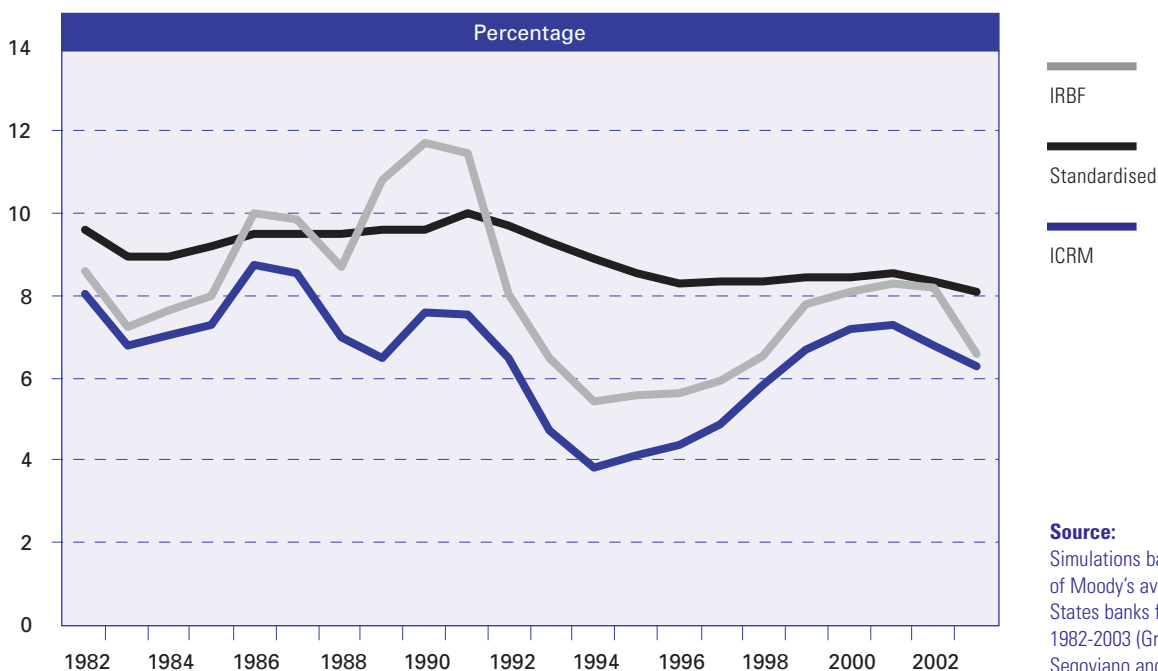
diversification effects clearly occur. Others have commented on failure of the New Basel Capital Accord (Basel II) to take account of diversification effects as being its major flaw. For example, the Governor of the Mexican Central Bank suggested in July 2004 that “any postponement of incorporating the benefits of diversification runs the risk of discouraging large international banks from maintaining and expanding their loans to emerging markets”. He also expressed his serious concern about the negative effects that the new Accord could have on volatility of capital flows to emerging economies (Ortiz, 2004). These concerns have also been expressed by several senior private bankers.

An additional positive effect of taking account of the benefits of diversification is that this makes capital requirements far less pro-cyclical than they otherwise would be. Indeed, if the benefits of diversification are incorporated, simulations show that the variance over time of capital requirements will be significantly smaller than if these benefits are not incorporated. Therefore, introducing the benefits of geographical diversification significantly decreases, though it does not eliminate, the higher pro-cyclicality that the internal-ratings based approach implies. This difference may well be significant enough to prevent a “credit crunch”.

This lower pro-cyclicality of capital over time of an internal-ratings based approach that incorporates the benefits of diversification (the Full Credit Risk Model (ICRM)) compared with an internal-ratings based approach that does not incorporate those benefits can be seen in figure III.1. However, even if the benefits of diversification are incorporated, the internal-ratings based approach will still be more pro-cyclical than the standardized approach, which is closer to the principles of the first Basel Capital Accord (Basel I) (see, again figure III.1). Therefore, as well as introducing the benefits of diversification, it seems desirable to introduce counter-cyclical measures (for example, counter-cyclical provisioning against losses) at the same time as Basel II is implemented in 2007.

Counter-cyclical provisioning is also desirable when Basel II is introduced

Figure III.1.
Capital requirements for the United States of America using three regulatory regimes, 1982-2003



Source:
Simulations based on a data set of Moody's available for United States banks for the period 1982-2003 (Griffith-Jones, Segoviano and Spratt, 2004b).

Introducing the benefits of diversification would be technically sound

Introducing the benefits of diversification soon would therefore: (a) clearly lead to a more precise measurement of risk, the main aim of Basel II; (b) appropriately reduce the excessive and inappropriate increase in cost of lending to developing countries, caused by the current lack of precision in measuring risk; and (c) diminish pro-cyclicality in the capital requirement, which will imply incentives for both greater stability in bank lending and greater stability of the whole banking system. It would be technically wrong not to do introduce such changes soon.

Some of the problems in the New Basel Capital Accord may be linked to the fact that developing countries are not at all represented in the Basel Committee on Banking Supervision (see chap. IV for a discussion of the urgent need for developing countries to participate in the Basel Committee).

A greater challenge: encouraging private flows to lower-income developing countries

Most poor countries are also small economically ...

One of the pervasive features of poor countries is a low per capita income associated to sub-standard consumption levels and the vulnerability of a large part of their population. The human asset index, which measures nutrition, education and health status, is significantly below the average of developing countries (United Nations, 2003a). Table III.4 lists 57 low-income developing countries for which information is available. The concentration of countries in the lower left bottom of the table indicates not only that these countries are poor but that their population—and hence their economic size—is generally quite small.⁵ In fact, of the 57 countries, 63 per cent have a gross national income (GNI) below US\$ 3.25 billion. Most of these countries are in Africa.

... putting them at a disadvantage in attracting financial flows

By and large, the factors that determine private flows—FDI and financial flows—to this group are the same as in middle-income developing countries. Economic size is also an important determinant in FDI and private financial flows. Not only does economic size allow the taking advantage of economies of scale when products go to the domestic market but large markets tend to ease the domestic supply of inputs: available labour with diverse skills and intermediate goods and services, particularly services with large non-tradable components that cannot therefore be imported from abroad.

The economies of these countries are also more vulnerable to shocks

The countries in this group tend to face greater challenges to attracting foreign resources to spur long-term growth. A number of them are post-conflict countries, in many of them the natural resources base is scanty, they are generally more vulnerable to changing climate conditions and fluctuations in primary commodity prices,⁶ their skilled labour is scarce and their infrastructure is limited. Very few of them have experienced sustained growth for a significant number of years. Their credit-rating indicators signal a comparatively high risk (World Bank, 2004d). In fact, they receive a very small share of private financial flows going to developing countries and only 5 per cent of FDI, most of which goes to a few oil-exporting countries.⁷

Special national and international efforts are needed to increase private financial flows to these countries ...

The above suggests that increasing private flows to these countries requires special efforts at the national and the international level, particularly when the type of flows needed help spur long-term development. Policies that enhance the domestic environment, as discussed in chapter I, are necessary. It will take time before substantial flows materialize—unless there is a significant potential in exploitation of natural resources, particularly

Table III.4.
Distribution of least developed countries and other
low-income countries by population and economic size, 2002^a

Population (millions)	Gross national income (billions of dollars)			
	Up to 3.25	Over 3.25 to 7.5	Over 7.5 to 15.0	Over 15.0
Over 40		Ethiopia	Myanmar	Bangladesh Nigeria
Over 20 to 40		Nepal Uganda	Afghanistan Democratic People's Republic of Korea Kenya United Republic of Tanzania	
Over 10 to 20	Burkina Faso Malawi Mali Niger	Cambodia Madagascar Mozambique Zambia	Angola Côte d'Ivoire Sudan Yemen	
Over 5 to 10	Benin Burundi Chad Lao People's Democratic Republic Rwanda Somalia Tajikistan	Democractic Republic of the Congo Guinea Haiti Senegal		
Over 2.5 to 5	Central African Republic Congo Eritrea Liberia Mauritania Mongolia Sierra Leone Togo			
Up to 2.5	Bhutan Cape Verde Comoros Djibouti Equatorial Guinea Gambia Guinea-Bissau Kiribati Lesotho Maldives Samoa Sao Tome and Principe Solomon Islands Timor-Leste Tuvalu Vanuatu			

Source: UN/DESA.

^a Comprising all least developed countries and those countries whose per capita gross national income (GNI) measured in dollars at current exchange rates was below \$735 in 2002, whose per capita GNI measured in purchasing power parity was 2.5 times that figure or less, and whose Human Assets Index was 70 or below.

oil. In the meantime, international financial cooperation—official flows and technical assistance—can facilitate the transformations required.

... and determine which flows should be encouraged

In each country, it is the national development strategy that should define the type of external flows to be encouraged as well as the sectors where such flows could be channelled. One key aspect of FDI is the impact on the rest of the economy: diverse types can have very different externalities and their diffusion to the rest of the economy can be large or virtually nil (see above). ODA-financed programmes can be catalytic in encouraging private flows. Renewed, more targeted work of the International Finance Corporation of the World Bank and similar organs of the regional and subregional development banks could lead to the mobilization of additional private resources from sources in developed and developing countries.

Poor countries need risk mitigation instruments suited to their circumstances

Since the Asian crisis, two issues—although not new—have focused the attention of many private players: risk mitigation and improved information flows for potential investors (United Nations, 2004d). In poor countries, market instruments to mitigate risks (for example, future exchange-rate markets) are often unavailable. The various bilateral and multilateral instruments that have been developed to deal with risk mitigation for private investments in developing countries (insurance and guarantee schemes) rarely benefit the countries in the group considered here, since most schemes adhere to rather strict commercially based criteria. It would be useful to undertake an evaluation of existing schemes, in particular their actual impact on different groups of target countries.⁸

Increased donor support for multilateral and bilateral instruments to cover political and other non-commercial risks in these countries should be considered

Donors could also consider providing targeted funding with additional resources to multilateral agencies (such as the Multilateral Investment Guarantee Agency (MIGA) and the political risk insurance facilities being opened up in regional banks) and bilateral agencies to cover political and other non-commercial risk at a lower cost in these countries.⁹ Also, a new facility could be set up in the form of a separate fund owned by international financial institutions specifically for these countries to address both the entry cost and post-entry risk barriers for investors. This fund would assist private investments by offering domestic currency loans, and quasi-equity investment capital and guarantees—and by retailing a simplified form of MIGA cover for political risk. Another avenue is to create more effective regional risk cover capacity by an effective decentralization of MIGA operations or by creating regional multilateral political risk insurance agencies affiliated with the regional development banks (United Nations Conference on Trade and Development, 2003b, p. 162).

Further modalities to deal with exchange-rate and regulatory risks in infrastructure are required

In the case of infrastructure projects, which increasingly include operations by the investor once the investment is over, exchange rate and regulatory risks are perceived by foreign investors as some of the most important ones. Several modalities have been developed or proposed to deal with these risks, some of which are applicable to these countries for example, the establishment of credit enhancement arrangements by donors and multilateral development institutions for mobilizing available domestic funding to reduce currency risk. More generally, foreign assistance could help in deepening the domestic financial sector. Its further development would facilitate risk management.

The quality and quantity of information for foreign investors needs to be increased and focused on these poor countries ...

In a rapidly changing world economy and with institutional adaptations in many countries, investment opportunities and risks are not always evident for foreign investors. Often, access to credible and transparent information—including on the intricacies of the foreign investment law and bilateral investment treaties and the progress achieved in macroeconomic management and structural policies—is lacking. Reliable, relevant information on country business environments and opportunities is key to private investments decisions. It might also mitigate risks. The Government has a role to play in providing such information. One avenue that has proved useful is public/private collabo-

ration to increase the quality and quantity of information. Yet, most of the countries in this group need special assistance—multilateral and bilateral, including from other developing countries—in this regard. Open web-based information portals have become a highly cost-effective vehicle for the dissemination of information.

One important source of information for prospective investors comprises the perceptions of within-country domestic and foreign entrepreneurs regarding the investment climate. Work in this area has expanded considerably through private firms, business associations such as the World Economic Forum, and international institutions, particularly the World Bank. Most of this work is focused in middle-income developing countries. Special efforts will be required to expand this kind of information to the countries considered here.

Additionally, as seen in table III.4, the large majority of these countries are small. Thus, special attention should be paid in the national development strategy to the links between investment, in particular foreign investment, and exports. No small-sized economy has been able to grow on a sustained basis without a dynamic export sector. For all small-sized economies, economies of scale are a fundamental consideration if a reasonable degree of efficiency is to be achieved. The minimum size of operations needed for the production of many goods or services with a reasonable degree of efficiency can be large.

Developed countries' preferences for least developed countries have opened important investment opportunities. Regional integration among countries can also spur exports and attract foreign investments. The Southern African Development Community (SADC) has facilitated larger FDI flows from the comparatively larger economies (for example, South Africa) to less developed members. Regional integration can also give impulse to regional stock markets and joint infrastructure projects, which might attract additional private external flows (Economic Commission for Africa, 2004, pp. 141-142).

Remittances

Since most migrant remittances are savings from wage earnings transferred to families in home countries, this flow of funds does not fit the definition of capital flows. However, remittances have become a significant source of foreign exchange for many developing countries and an important source of financial support for recipient families.

Remittance flows have been growing quite rapidly in the last decades, reflecting the increasing flows of migrants around the world; to some extent, it is also a reflection of improvement in the quality of remittance statistics. Global remittances amounted to about US\$ 69 billion in 1990, and in 2004, they are over US\$ 172 billion. In 1990, developing countries received about US\$ 29 billion, in 2004 they received over US\$ 116 billion, with an annual rate of growth of over 8 per cent. Regionally, in 2003 Latin America and the Caribbean received 30 per cent of total remittance flows, the highest share of all regions, with absolute numbers well over US\$ 42 billion today. Although sub-Saharan Africa has a low share in global remittance flows, just slightly over 5 per cent, it has been growing very rapidly in recent years—22 per cent growth per year (Ratha and Vijayalakshmi, 2004; Solimano, 2005).

For many small countries in various parts of the world, remittances constitute one of the main sources of foreign exchange, reaching in some cases levels of 15 per cent of GDP or more (see table III.5). For example, remittances sent to Middle Eastern countries helped reduce the current-account deficit and improved the region's debt-service abil-

... with special attention given to information on investment climate

National development strategies for these countries should focus on the link between foreign and domestic investment and building a dynamic export sector ...

... which can be promoted by regional integration and developed country trade preferences

Migrant remittances are a significant source of foreign exchange for many developing countries ...

... and have grown rapidly in the past decade

Remittances are an important source of foreign exchange ...

Table III.5.

**Countries or areas with the highest ratio
of remittances to gross domestic product, 2004**

Percentage of GDP	
Country or area	
Lesotho	39.0
Tonga	24.0
Lebanon	23.0
Samoa	20.0
Jordan	18.5
Bosnia and Herzegovina	17.5
Kiribati	17.0
Cape Verde	16.5
Albania	16.0
West Bank & Gaza	15.0

Source:

UN/DESA, based on IMF,
Balance of Payments Statistics
Database; and World Bank,
World Development Indicators
2004.

... particularly for
smaller economies ...

ity in the 1970s and 1980s (Burney, 1987, p. 756). For Latin American countries such as El Salvador and Nicaragua, the amount of remittances is equivalent to more than 60 per cent of the total foreign currency obtained through exports of goods and services, representing about 14 per cent of their GDP in the late 1990s. Notwithstanding Haiti's acute poverty levels, remittances to this country helped to alleviate the need of foreign exchange in the amount of \$720 million, 220 per cent of exports of goods and services (Inter-American Development Bank, 2001).

... but also for some
larger economies

Remittances are also becoming quite important for some larger countries. The Central Bank of Mexico reports that remittances, growing at a 20 per cent annual rate during the past three years and expected to continue to grow at equal pace, are becoming the most stable source of foreign exchange for Mexico, similar in magnitude (US\$ 16.6 billion) to FDI in 2004 and second only to oil exports, which have been favoured by a recent price hike. Similar patterns are observed in several other mid-size Latin American countries, such as Colombia and Ecuador.

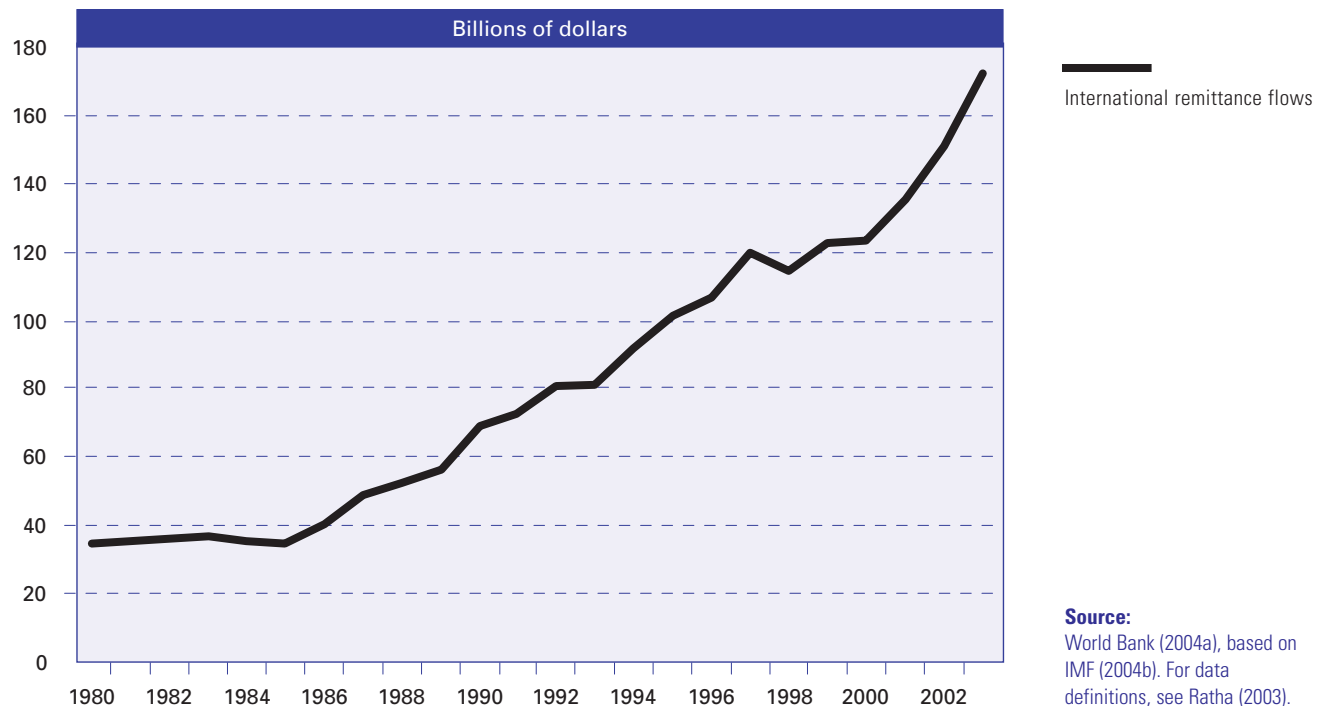
Aid remains crucial for
many poor countries
where remittances are
not a large source of
foreign exchange

Even for sub-Saharan countries, where these flows are smaller—owing to a large extent to transmission through informal channels, which are thus officially unrecorded—remittances have had significant effects in some countries. For instance, during the 1980s, remittances financed 80 per cent of the current-account deficit in Botswana; equalled almost three quarters of total commodity export earnings in the Sudan; and formed more than half of Lesotho's foreign-exchange earnings. Similarly, Somalia has received remittances of about \$500 million annually, representing “four times the value of livestock, (its) main export” (Sander and Maimbo, 2003, pp. 15-16). Still, the fact that for the majority of the poorest African countries remittances do not represent a large source of foreign exchange provides an incontrovertible additional reason why extra sources of ODA are required for these countries.

Remittance flows are
more stable than
private and official
financial flows

The stability of their flows is a widely accepted and distinctive feature of remittances in relation to private capital, particularly financial flows. Indeed, in sharp contrast to financial flows with their high volatility, remittance flows continued to grow steadily during the 1990s and the first half of the current decade (see figure III.2). Since the late 1990s, this may have reflected increased remittance flows because of deterioration of the economies in their countries of origin. Indeed, if remittances are more sensitive to times of

Figure III.2.
World remittance flows, 1980-2003



economic hardship in home countries than to downturns (particularly in labour-market conditions) in host countries, as some studies find, these flows would have counter-cyclical characteristics (United Nations, 2004a, pp. 95-126; Adams, 2004). In terms of the “life cycle” duration of individual remittances, theory holds that the longer the duration of migrant status, the lower the probability of large flows of remittances. However, immigrant groups vary in this regard, with some sending still substantial amounts after 5 or 10 years of migrant status.

From the perspective of poor migrant households, remittances may be a vehicle through which to reduce poverty levels by spending on improving nutrition, financing children’s schooling or basic health care, or constructing their own home (Adams, 1998, p. 170; Stahl and Habib, 1989, pp. 269-285; Kapur, 2004; Cox and Ureta, 2003). Indeed, a recent survey for Guatemala found that the level, depth and severity of poverty are significantly reduced in households receiving remittances, although the greater impact is on reducing the severity rather than the level of poverty.

The use of formal or informal channels for transmitting remittances may have an effect on the potential uses of remittances. For instance, many remittance senders and receivers use informal channels because, often, they lack access to the financial system in the host country and/or the home country. A combination of the high transaction cost of remittances, and the socio-economic deprivation of migrant families—for example, that of recipients living in rural sectors and/or with low schooling levels—may be the most important factor in the continued use of informal channels. Indeed, the use of remittances for less immediate uses or for more investment-oriented purposes would call for access of remitters and receivers to the financial system. Some financial intermediaries in host and

Remittances reduce poverty in recipient households

The high cost of transmitting remittances through formal channels can limit the amount and use of remittances

Policy initiatives are under way to leverage the development finance potential of remittances

home countries have been more active in competing for the remittances market during the last several years by reducing the transmission costs of remittances or offering savings accounts, microcredit and insurance to migrants' families (United Nations, 2004b).

Important policy initiatives have been developed and are currently in process for multiplying the leverage and socio-economic impact that remittances could have in migrants' families and communities and in recipient countries in general. For example, hometown associations have succeeded in sponsoring community investment projects in villages of Mexico and El Salvador, sometimes in partnership with their respective Governments. Similarly, remittances could be a powerful tool with which to finance projects in the tourism industry that could include the construction of large-scale hotels where immigrants participated as shareholders. Remittance-backed housing purchases are a promising engine for transforming remittances flows into better living standards of recipients. Larger access to financial services by immigrants and their families can be linked to the marketing of innovative financial products such as pension funds, and special financial assets for channelling the savings of migrants to the countries of origin may unleash the potential of remittances to serve as an instrument of financing for development. At the global level, mechanisms to reduce the transaction costs of remittances and to use them as a mechanism for "banking" the poor migrants and recipient families have been discussed as part of the initiatives for designing "innovative sources of financing" (see chap. IV).

Notes

- 1 The literature also indicates that, in the case of developing countries that have been able to issue such liabilities, they are largely used as coverage by foreign investors in those countries. This implies that, even in those countries, there is not net demand by foreign residents for assets denominated in the domestic currency.
- 2 The net financial transfer of resources statistic adds receipts of foreign investment income and financial inflows from abroad, but subtracts payments of foreign investment income and financial outflows, including increases in foreign reserve holdings. The net financial transfer of a country is thus the financial counterpart of the balance of trade in goods and services. A trade surplus is generated when the total value of domestic production exceeds domestic consumption and investment, with the excess invested abroad instead of being used domestically, and vice versa for a trade deficit.
- 3 It should be recalled in this regard that domestic contents and export requirements were used widely in the past for this purpose, but were severely limited by the World Trade Organization rules on trade-related investment measures.
- 4 The use of the ringgit was restricted to domestic transactions by residents. It became illegal to hold ringgit deposits abroad, and all such deposits held by nationals had to be repatriated. Trade transactions had to be settled in foreign currency. Ringgit deposits in the domestic financial system held by non-residents were not convertible into foreign currency for one year.
- 5 One fourth of these countries have a population below 2.5 million and half of them below 5 million.
- 6 Their economic vulnerability index is well above the average of developing countries (see United Nations, 2003a).
- 7 Most of the comparatively small amount of FDI in these 57 countries goes to only 5 oil producers: Angola, Chad, Equatorial Guinea, Nigeria and the Sudan.
- 8 As of recently, some donor countries (for example, Norway and the United States) have refocused their efforts to reach lower-income countries.
- 9 Many of these countries are parties to the Cotonou Agreement which offers support for investment and private sector development including a reinsurance scheme to cover FDI. Also, some of these countries can benefit from the activities of the Inter-Arab Investment Guarantee Corporation which offers an intraregional insurance scheme.