# Capital Flows, Growth and Poverty

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***EC205***

***2005-06***

# Topics

1. A Brief Review of the History through 1980s
2. The Patterns of Capital Flows and Poor People in the 1990s
3. The Theory used to argue for the free movement of Capital internationally and the Critique
4. The Policy Package to Stimulate Capital Flows is Complex
5. Implications for Poverty

AND IN LATER LECTURES

- The Crises of the 1990s
- Examples of the Possible "Boom-Bust" Nature of Capital Flows – Mexico & East Asia
- Policy Responses

# Topic 1. History 1870-1914 (Outbreak of War)

- Major Outflows from UK (5-10% of UK GDP)
- Most to USA, Australia Etc and mainly for Railways and Utilities
- Size of Inflows varied greatly (US 1%, Canada 7.5% Argentina 12-15% of GDP – as much as 40% of Total Investment
- Long-Term basis for most flows
- Defaults were not uncommon but mainly linked to cyclical falls in export earnings or excessive fiscal deficits (e.g. Egypt, Peru, Turkey)
- Close integration of Capital Flows with Migration of people and with Trade

# 1912-1929 (Great Depression)

- Far Greater role for Government Borrowing – partly associated with the refinancing of War-Time Debts
- Far greater role for the USA relative to UK
- Much less integration of Trade, Migration and Capital Flows
- More protectionist US trade policy from late 1920s made it increasingly difficult for debtors to service their loans

# 1930-1939 (Outbreak of War)

- Collapse of Industrial Output in Great Depression (17% on average) gave rise to massive defaults e.g. Germany in 1932 and most Latin American economies
- Causes other than the GD were excessive borrowing in the 1920s, poor risk assessments by lenders
- Output losses caused in major borrowing nations were huge (e.g. Peru = 26%). Cf. the “lost decade of the 1980s in LA
- Low Income Countries effectively lost access to International Capital Markets until the 1960s

# 1945-1972 (Post-War Recovery)

- A gradual restoration of international Capital Movements but based heavily of Public Sector lenders e.g.World Bank and IMF (created for this purpose)
- USA as the dominant lender both bilaterally and via the new multilateral institutions
- Recovery of World Trade and Capital Flows helped to achieve unprecedented high growth rates in many developing countries
- Official Development Assistance (ODA) plus Foreign Direct Investment (FDI) accounted for the bulk of all capital flows to developing countries (e.g. 85% in 1960) (WDR T.2.3)
- Other Private and Commercial Bank lending remained a small part of the total (<10%)
- The 17 debt re-schedulings through 1970 were rare events –mostly associated with chronic failures of economic management e.g.Ghana

# 1973 OPEC Oil Shock – First Consequences

- Major deterioration in the Current A/C Balance of Payments of both Developing and Industrial Countries (Oil P rose from $2.7 to $10 per barrel)
- Within TWO years situation in Industrial Countries largely corrected (albeit with mild recessions).
- Situation in Developing Countries go progressively worse (WDR T.3.1)
- Generic Reason – General International acceptance that it was OK for low-income countries to borrow to AVOID the necessary consequences of higher oil prices. (High level support for this still evident as late as Autumn 1981 – a few months before the crisis – e.g Paul Volcker and Margaret Thatcher)
- DEMAND for Credit was high because of (a)need to finance deficits (typically 4% of GDP or more – often fiscalised) and (b) low cost of borrowing for most of the 1970s
- SUPPLY of Credit was high because of (a) international banks held large $ liquidity via OPEC surpluses and (b)increased exposure was seen to be a food way to enhance bank profits (G,G,G) and (c ) new lending mechanisms developed by banks to enhance the safety of sovereign international Lending (WDR T. 2.3)

# The 1980s

- Mexican default in 1981 triggered an abrupt cessation of new gross lending by commercial banks
- Major debt restructuring called for in heavily indebted countries especially in Latin America (e.g. Brady plan and various debt relief accords)
- Major recession in many – hence slow growth for almost a decade
- Lending continued mainly on a concerted basis coordinated by IMF (macro adjustment) and World Bank (structural adjustment programs as started in 1981
- A few well functioning developing and emerging countries began to attract new forms of Private Capital Flows

# Topic 2: Patterns in Capital Flows 1985-2000

- **A High concentration of FDI – 10 developing countries account for 80% of total (EMEs)**
- **High concentration also for Portfolio and Commercial Bank capital flows**
- **Some significant aggregate stability over time of FDI flows but large instability of flows associated with Portfolio and Commercial Bank flows**
- **Very limited Private capital flows of any type to developing countries with the highest incidence of poor people – especially Africa**
- **There is a core group of around 40 low income countries (HIPC) where private flows are (a) small and (b) have declined in relative important in the past 15 years.**

# Trends in Net Capital Flows to Emerging Markets ($billion)

| | 84-89 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|
| **Total Private** | 12 | 142 | 211 | 224 | 115 | 66 | 67 | 36 | 116 |
| - Fgn Direct Inv | 13 | 81 | 96 | 119 | 141 | 151 | 154 | 141 | 141 |
| - Portfolio Flows | 4 | 105 | 41 | 80 | 39 | 0 | 5 | 17 | 33 |
| - Bank Loans | -5 | -44 | 74 | 26 | -66 | -86 | -92 | -123 | -56 |
| **Official Assist** | 26 | 5 | 16 | 2 | 53 | 55 | 13 | 20 | 10 |
| **Int. Reserves** 1/ | -11 | -68 | -117 | -110 | -63 | -32 | -64 | -97 | -108 |

***1/ A minus sign indicates an increase.***
***SOURCE: IMF, October 2000 (2000, estimate; 2001, projection).***

***Note Negative Commercial Bank flows in 84-89 period and high magnitude of ODA versus Private flows – a huge contrast with the situation after the OPEC price hike***

# Private Flows By Region ($billion)

| | 84-89 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|
| Total Net Private Flows | 12 | 142 | 211 | 224 | 115 | 66 | 67 | 36 | 116 |
| Latin Am & Car | 0 | 40 | 46 | 64 | 68 | 62 | 40 | 48 | 66 |
| Asia Crisis C'tries | -3 | 34 | 54 | 67 | -16 | -28 | 3 | -22 | 10 |
| Other Asia | 13 | 36 | 38 | 53 | 22 | -12 | -1 | 5 | 13 |
| Middle East | 2 | 17 | 14 | 13 | 22 | 10 | 1 | -18 | 1 |
| Transition | -2 | 9 | 51 | 19 | 6 | 28 | 13 | 16 | 18 |
| Africa | 2 | 8 | 8 | 8 | 12 | 7 | 10 | 9 | 8 |

Asia Crisis Countries: Indonesia, Korea, Malaysia, Philippines, Thailand. This refers to the crises of the 1990s starting in 1996

# FDI by Region ($ billion)

| | 84-89 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|
| Fgn Direct Invt | 13 | 81 | 96 | 119 | 141 | 151 | 154 | 141 | 141 |
| LAC | 5 | 23 | 25 | 39 | 54 | 56 | 65 | 57 | 52 |
| Asia Crisis C'tries | 2 | 7 | 9 | 10 | 10 | 10 | 13 | 9 | 9 |
| Other Asia | 5 | 38 | 39 | 44 | 45 | 50 | 41 | 38 | 38 |
| Middle East | 1 | 5 | 8 | 8 | 7 | 8 | 5 | 8 | 10 |
| Transition | 0 | 5 | 13 | 13 | 17 | 20 | 21 | 22 | 24 |
| Africa | 1 | 2 | 2 | 5 | 8 | 7 | 9 | 8 | 9 |

***Note the relative stability of FDI through the crisis period***

# Portfolio Flows by Region ($ billion)

| | 84-89 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|
| Portfolio Flows | 4 | 105 | 41 | 80 | 39 | 0 | 5 | 17 | 33 |
| LAC | -1 | 63 | 3 | 38 | 19 | 20 | 9 | 7 | 18 |
| Asia Crisis C'tries | 0 | 12 | 19 | 26 | 8 | -8 | 13 | 13 | 3 |
| Other Asia | 2 | 7 | 3 | 4 | -1 | -7 | -9 | -8 | -1 |
| Middle East | 5 | 3 | -1 | -5 | -6 | -17 | -10 | -7 | -4 |
| Transition | 0 | 17 | 15 | 15 | 11 | 6 | -7 | 8 | 9 |
| Africa | 0 | 3 | 3 | 3 | 7 | 7 | 9 | 4 | 5 |

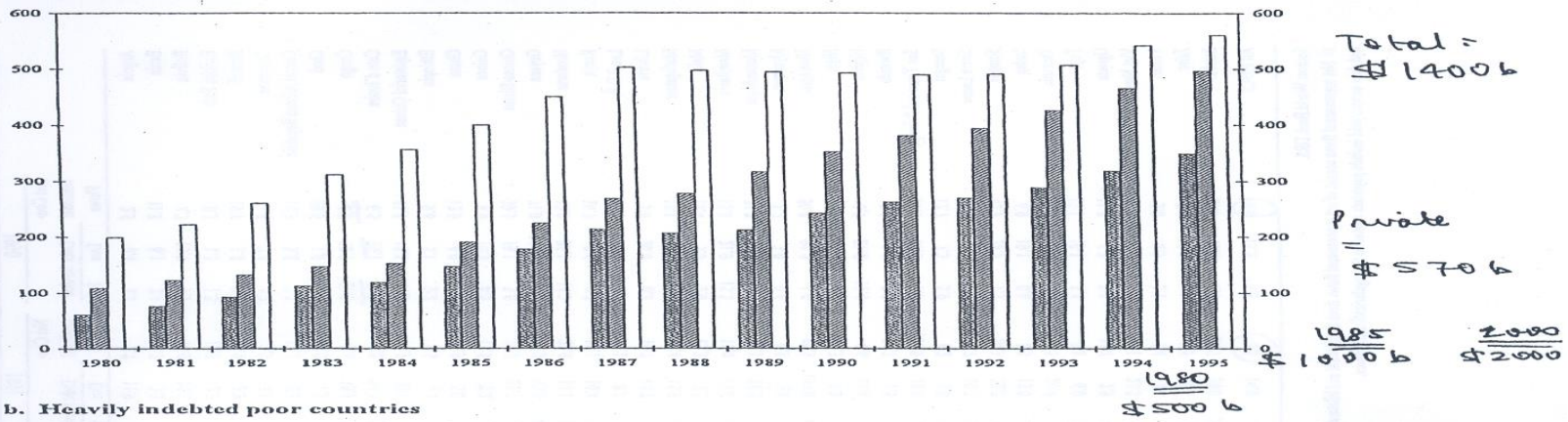
***Note the huge instability of these flows through the crisis period as well as the contagion effects on countries not directly involved in major crises***

# Basic Facts about the Poorest Countries

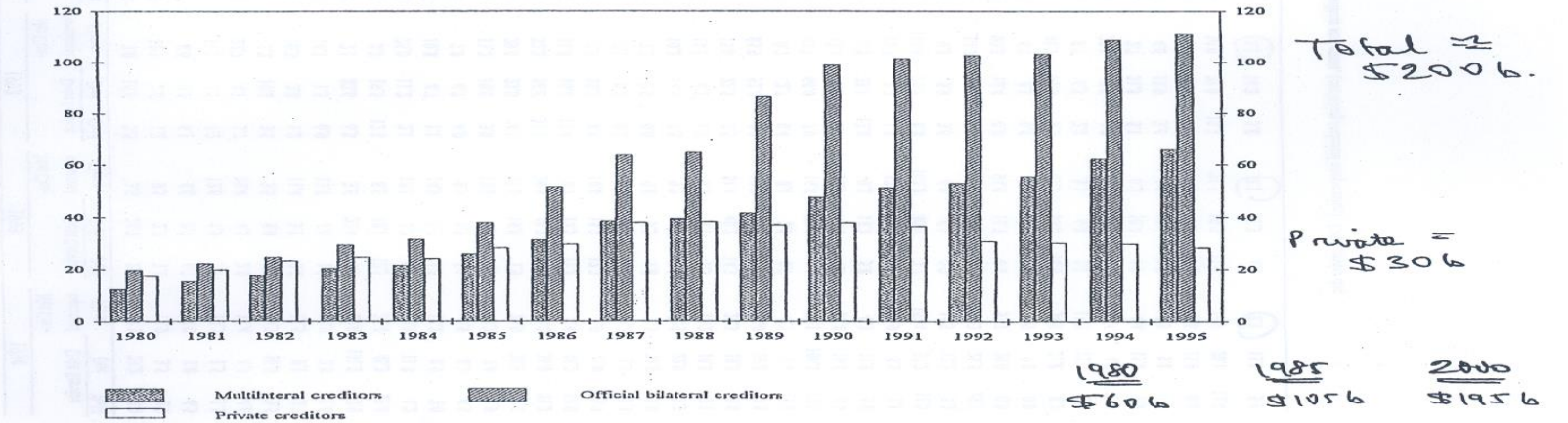
- Low Income Countries (LICs) have low ABSOLUTE Levels of External Debt
- LICs have a Large Proportion of Debt to (i) Official Bilateral Creditors and (ii) Multilateral Agencies but not much to (iii) Private Creditors
- Most remaining LIC Debt is very concessional (low cost)
- But in spite of this the debt burdens are excessive in some 41 Countries (HIPCs)
- Causes are various: Civil wars, bad Fiscal management, Corruption etc.

**Chart 1. Developing Countries: Public External Debt by Creditor, 1980-95 1/2/**
(In billions of U.S. dollars)

a. All developing countries




b. Heavily indebted poor countries

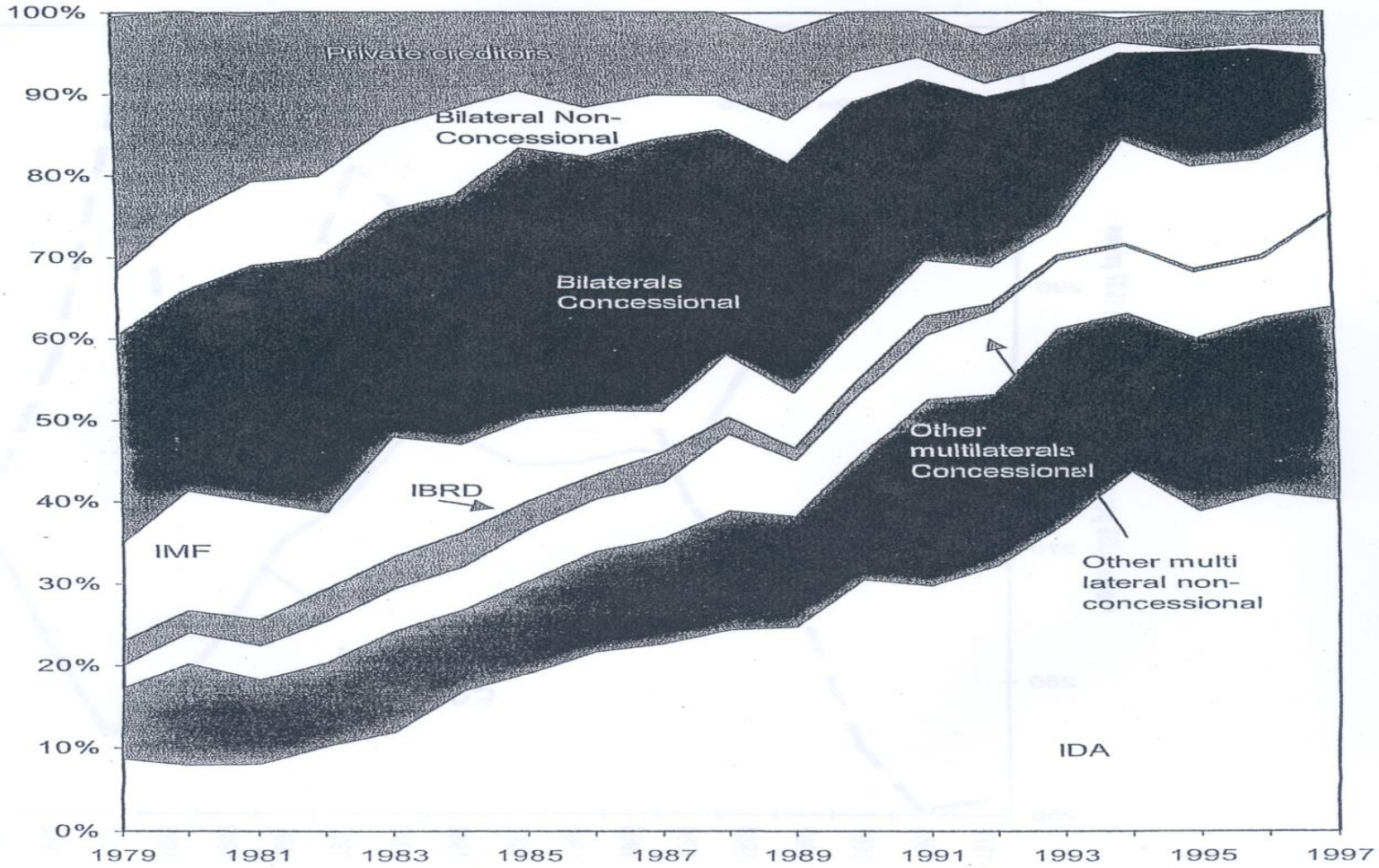



Sources: World Bank Debtor Reporting System (DRS); and IMF staff estimates.

1/ Medium- and long-term public and publicly guaranteed debt; including to the IMF.
2/ The estimates for 1995 are provisional.

RESULTS OF 20 YEARS OF DEBT RELIEF

**Figure 5: Composition of gross disbursements to HIPCs**




Debt Relief 1989 – 1997 = $33 b
New Borrowing " – " = $41 b.

# Implications

**Study of the links between capital flows and poverty need to be segmented as between**

- **the 10 or so relatively successful emerging market economies plus the aspiring new EMs (e.g. Russia, Central Europe ….)**

- **the 40 or so HIPC-type countries on the other.**

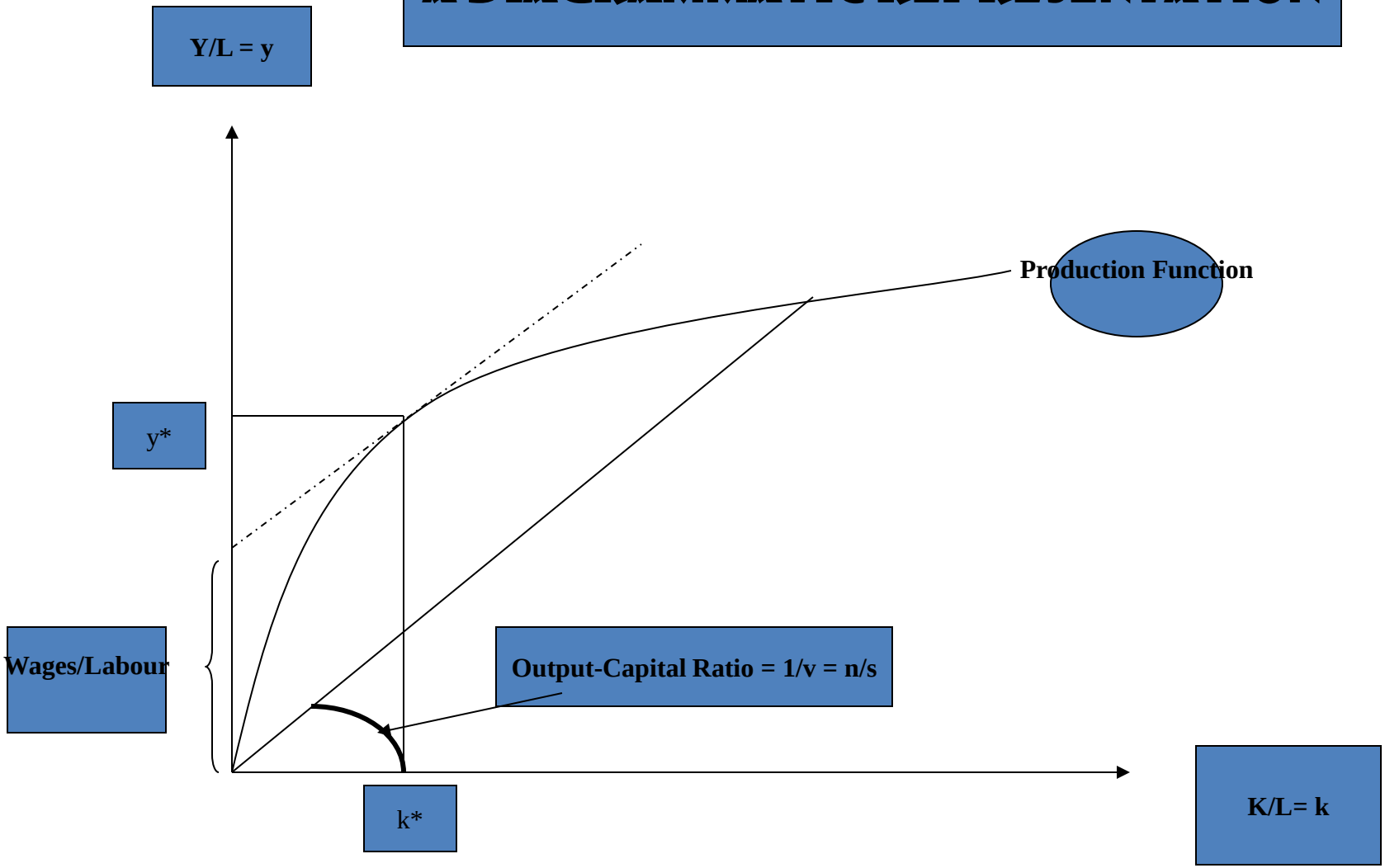
**Current International Financial Architecture-type initiatives arguably have relevance only for a small number of developing countries currently.**

# Topic 3: The Theory of Capital Flows

Arguments in favour of free capital movements rely mainly on differential rates of return in Rich versus Poor countries

- remember the neo-classical production function and how diminishing returns reduce the rate of return as capital intensity increases
- So poor economies SHOULD be attractive to capital flows
- But this ignores the weaknesses of the N-C model and the real world fact that **increasing** returns, the economies of agglomerisation etc. play an important part in real world development
- Certainly no evidence that global capital moves inexorably in the direction of poorer economies (cf HIPCs)

# A DIAGRAMMATIC REPRESENTATION



# Arguments in favour ……continued

- Creates opportunities for portfolio diversification (for lenders). Should result in higher risk-adjusted rates of return. e.g. plants abroad may face shocks that are not correlated with those occurring at home (e.g. Markovitz)
- Borrowers (or companies, individual within them) can use international flows to smooth cyclical patterns of demand and so avoid compressing consumption and investment as fully as would otherwise be called for. Also better deals possible.
- Creates opportunities for efficient specialisation – not all countries need to develop deep base of financial services – some can find it more cost efficient to import some of these services from abroad. But this needs a liberal policy towards capital flows ( controversial in the developing country context)

# Three Main Market Failures see IMF Occasional Paper (1998)

- Asymmetric Information (between borrowers and lenders) can lead to all or some of:
  - adverse selection (before the event risks)
  - moral hazard (after the event risks)
  - Herding behaviour (e.g. low-quality portfolio managers relying on "evidence" gleaned from the behaviour of better portfolio managers)

Additionally recent crises have owed much to:

- The distorting effects of explicit or implicit government guarantees (in the host countries)
- The distortions in the USE of capital associated with ongoing controls on domestic finance and trade e.g. excessive import duties raising the return on capital in "inefficient" sectors or interest subsidies achieving the same outcome

# How do Host Countries mitigate these failures?

See later discussion

# Topic 4: The Package to Attract Capital?

- Stable macroeconomy including inflation
- Liberal trade and trade financing;
- Low fiscal deficits;
- Increased privatisation;
- De-regulated domestic markets;
- Stable and predictable legal environment;
- Low political risks including corruption

# FDIs- Morgan Stanley Study

- A USAID funded study of 67 emerging economies, Morgan Stanley Dean Witter, July 1998 (titled *"Foreign Direct Investments and its determinants in Emerging Economies.)*
- *This study's main* results were as follows:
  - *Finding 1*: Foreign investment inflows are influenced very little by generic variables such as:
    - locational advantage,
    - proximity to financial centers,
    - total population,
    - size of the country.

    These variables show little significance throughout the regressions.

# Continued

- *Finding 2:* **On the other hand, foreign investments are heavily influenced by the countries' policies and institutions.**

- *Finding 3:* **Although initial, country-inherent conditions may play a certain role, they can be overcome by sound policies and their thorough implementation**

- *Finding 4:* **Economic policies allowing for free open markets, investment and trade are key determinants of FDI inflows (Economic Openness had the highest coefficient value).**

# Continued

– *Finding 5:* **The key determinants of "Economic Openness" were:**

- **Little government interference in markets; that is, "free" markets with minimum directive regulation.**
- **Open import and export regimes.**
- **An exchange rate that reflects a currency's true value, with no controls on currency exchange.**

# Morgan Stanley Model

| | Standardized Coefficients Beta | t-value |
|---|---|---|
| (Constant) | 0.898 | -2.105 |
| Econ.Openness | 0.789 | 3.052 |
| Corruption | 0.171 | 1.926 |
| Tax on Pvt. Sector | -0.061 | -3.101 |
| Credit Availability | 0.007 | 1.969 |
| **Adjusted R-square** | **0.38** | |

# THE (WASHINGTON) CONSENSUS – 1980-1990

**Main Ingredients**

- Fiscal Discipline –
- Re-Direction of Public Expenditures
- Broader Tax Bases and Lower Marginal Rates
- Trade Liberalisation – Lower Tariffs and Fewer QRs
- Positive Real but Market Determined Interest Rates
- Competitive Exchange Rates
- Openness to Foreign Direct Investment
- Privatisation of State Enterprises
- Deregulation – but with key exceptions (Finance, Environment)
- Better Legal Protection of Private Property Rights

**Issues**

- Macro Balance is Central to Growth
- Favour Education and Health to "Enable" the Poor
- Financing Industry by Taxing Agriculture worsens Economic Well-Being
- Discipline Trade via WTO Rules
- Remove State Control of the Business of Banks
- Private Sector assisted by FDI is the Driver of Development

# Topic 5: What are the Links with Poverty?

- Significant evidence of a link from growth to poverty reduction (e.g. Dollar and Kray v White)

- Some evidence that the factors influencing capital flows also influence growth

- But several case examples where capital inflows have damaged growth at least in the short term (e.g Latin America generally in 1980s and Mexico, Argentina more recently)
- No particular reason to expect that capital flows *per se* will have a direct influence on POVERTY

# Poverty Issues - What Might Go Wrong?

**Examples:**

- **Trade reforms which destroy jobs in previously protect labour-intensive sectors**
- **Domestic trade de-regulation which destroys certain (say) agricultural markets formerly relied upon by poor farmers**
- **Interest rate reforms which raise the financial costs in ways which undermine unemployment of certain self-employment activities**
- **Privatisation which down sizes state-run activities and the employment within them**
- **Exchange- Rate Overvaluation which harms traded goods of interest to poor producers e.g Dutch Disease in oil/gas.mining rich countries**

# Key Issue for the Pro-Poor Debate

**Are the OPPORTUNITIES created by Capital Flows more or less beneficial to the Poor than the DANGERS created by the enhanced probability of Crisis?**

**Sub-issues.**

**1. Inflows - their direct destination is unlikely to be pro-poor. But the INDIRECT effects via increased employment, enlarged tax take/expenditures, returning capital flight, improved products/lower prices are harder to predict. e.g. Mining**

**2. Crises - the "rich" can defend their wealth and livelihoods more readily but will the poor benefit from(e.g.) the collapse of prices (c.f Kraay and Gini Coefficient evidence for Indonesia, Korea and Thailand)**

# Poverty Indicators are badly affected by crisis

## Box 2.1 Poverty and crises

WHEN CRISES OCCUR AND LENDERS BECOME MORE risk averse, small firms are the first to be rationed from access to credit, which is an important reason why small business failure rates soar during financial crises. Not surprisingly, then, poverty can rise sharply and remain high for some time following a crisis.

**Number of people living in poverty**

| Year | Indonesia | Republic of Korea | Thailand |
|---|---|---|---|
| 1990 | 80.9 | 14.7 | 18.4[a] |
| 1996 | 50.6 | 4.7 | 7.5 |
| 1998 | | 9.1 | 7.6 |
| 1999 | 76.3 | | 9.7 |
| 2000 | 70.3 | 6.0 | 8.7 |

*Note:* Figures for 2000 are estimates.
a. 1988 data.

# Continued

**<u>3. Government Budgets.</u> Are these constrained during the upswing stage by the need to "pander" to investor sentiment? Certainly they will be constrained during crisis phases by (a) the need for lower overall deficits and (b) the pressure on primary deficits from higher interest charges.**

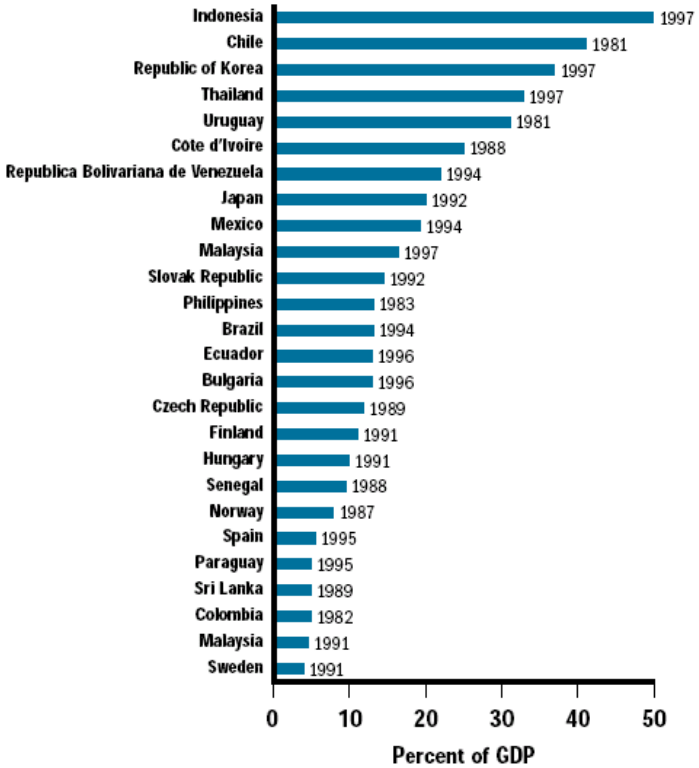
**<u>4. Re-direction of spending</u> away from Social Priorities by:**

- **Costs of sterilisation and reserve accumulation**
- **Higher debt service costs ?**
- **New administrative burdens associated with Codes and Standards**

# Note some Crucial Implications of Crises (Bank Failures)

- If the loan losses that have led to insolvency relate to loans to large SOEs, the authorities ideally need to resolve these productive sector problems *in parallel* with restructuring banks (Poland experience in 1990s)
- should this be done by the (reformed) banks or by a special government agency?
- If either case how are the loan recoveries allocated government v. banks and how should INCENTIVES be aligned to ensure the best outcome

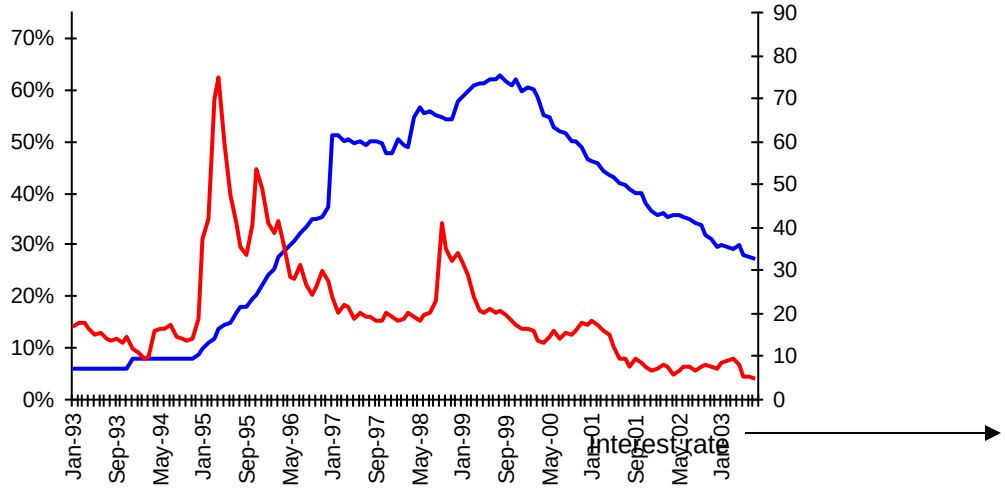
**Figure 2.1 Total fiscal costs (increases in the stock of public debt) relative to the flow of GDP in the year of crisis**




*Source:* Honohan and Klingebiel (2000); Caprio and Klingebiel (1999).

# Financial Meltdown: Mexico Post 1994-Crisis

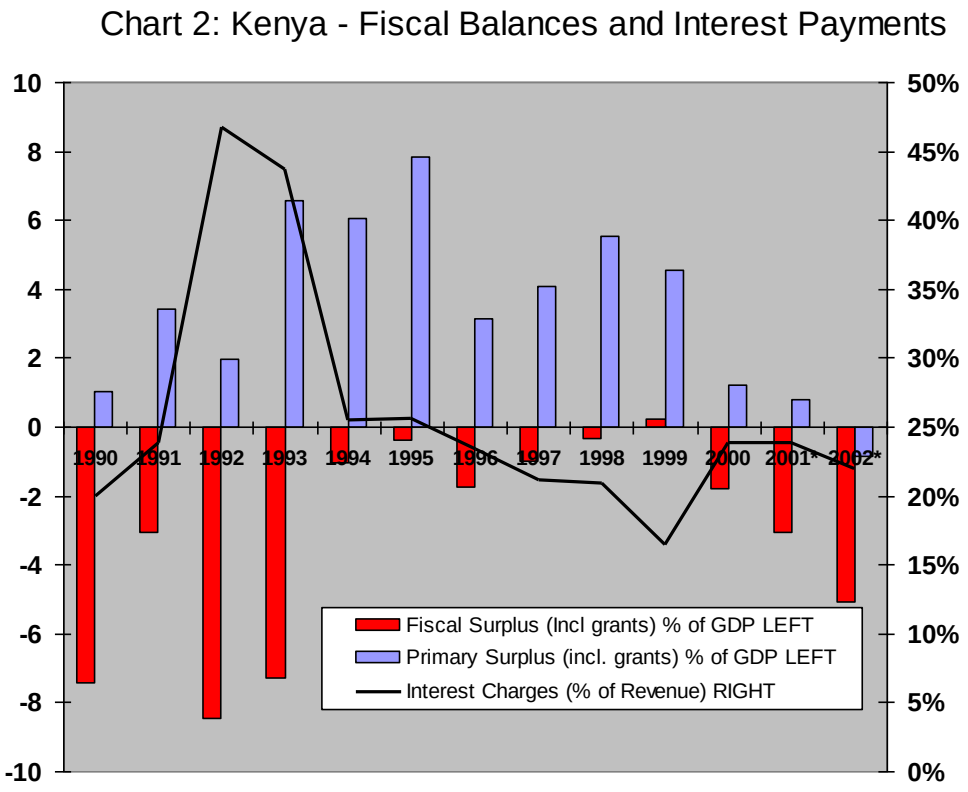
**NON-PERFORMING LOANS & INTEREST RATE**
**(% of the total bank loans)**




Non-Perf loans

Source: Inegi

# Financial Liberalisation going Wrong



# Implications

**The message is:**

**(a) that the "standard" reforms should not be adopted blindly where, for example, the pre-requisites for their success are absent and**

**(b) even if adopted should be designed in full awareness of the poverty side effects.**

# The Transmission from Capital Flows to Poverty Reduction

- **For FDI the main pre-requisites are:**

- **that host country is largely free from serious price and other distortions**
- **that informational inefficiencies do not result in chronic misallocations of funds by the foreign (source) investor**
- **that the host government is operating a reasonably efficient and equitable tax system that provides for a degree of redistribution of marginal tax receipts**
- **that the general macroeconomic configuration of the economy is broadly stable, sustainable and also able to adapt to external shocks**

# Pre-requisites Continued

**For Portfolio flows additional pre-requisites would include:**

- **that information problems (adverse selection, moral hazard, herding) do not result in chronic inefficiencies in the use of intermediated funds.**

- **that the domestic intermediary institution is reasonably efficient and unencumbered by political or other non-commercial interventions which could compromise the returns on, or safety of funds.**

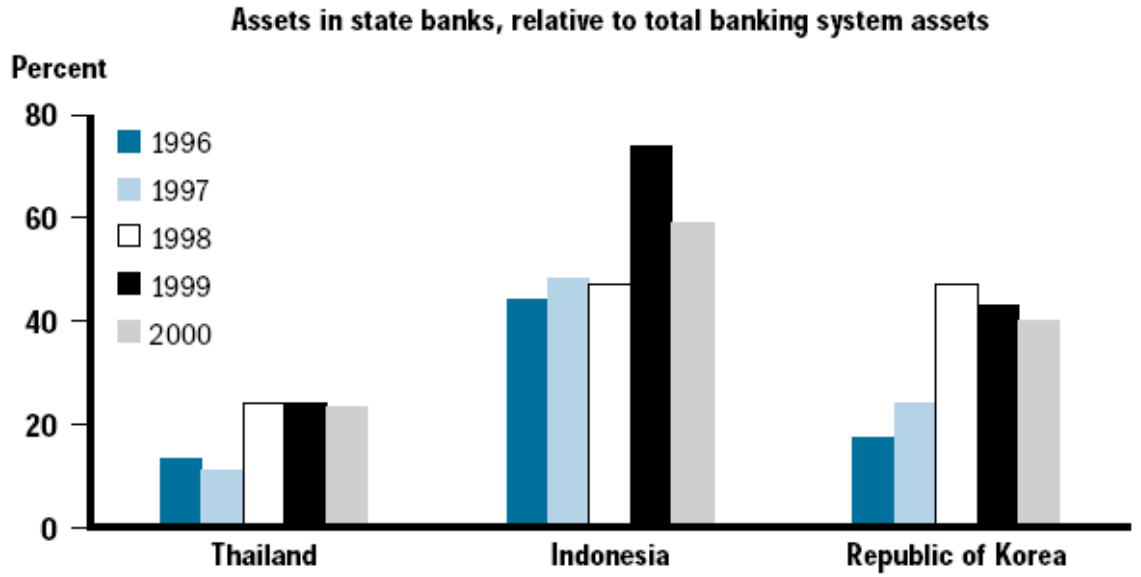
- **that stock market institutions demonstrate reasonable stability and have realistic disclosure rules, and arrangements for handling minority interests**

# Divestiture often reversed by Crises

Examples:

- Chile in late 1970s
- Mexico after 1994
- East Asian Economies after 1997

**Figure 3.5 Government ownership of banks during the East Asia crisis**

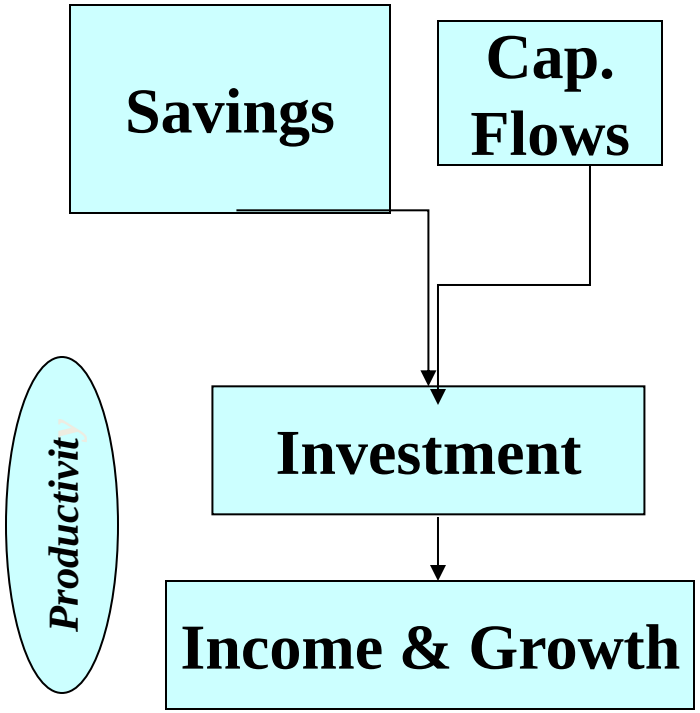



*Note:* Data is for year-end, except for the latest data, which is March 2000 for Thailand, and June 2000 f
*Source:* World Bank.

# The Demonstrated Failure of a Linear View of Development

## Example: Capital and Growth

- Harrod-Domar-type Models suggest a Clear Relationship from Capital Accumulation to Growth
- But See Results from Bill Easterly et al.
- Result has been intensified enquiry into the sources of Productivity Growth



# Zambia 1960 to 1993: 30 years of Aid

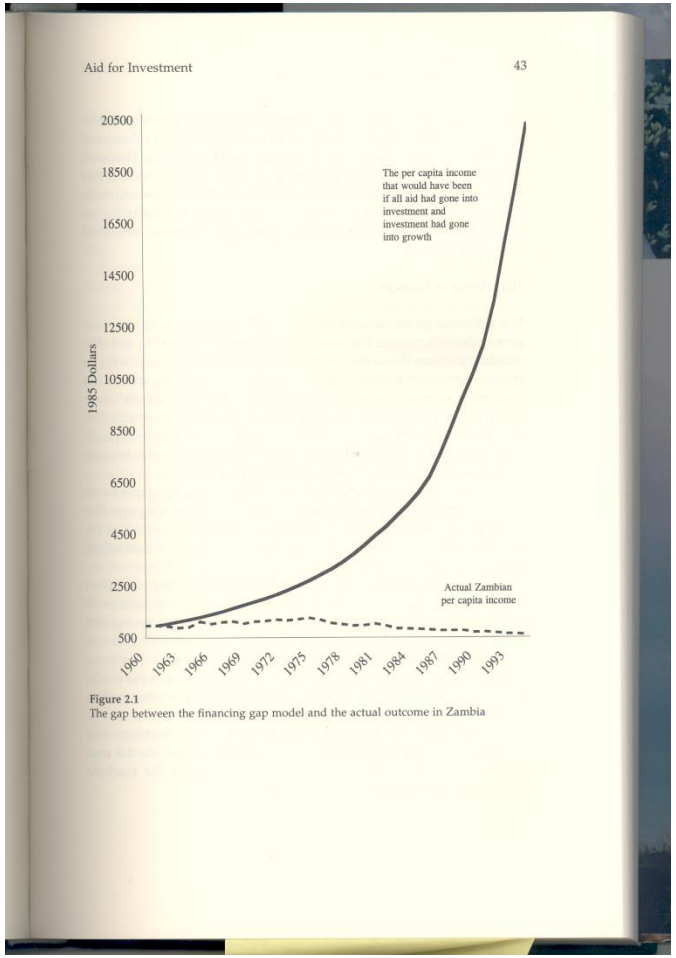



**Figure 2.1**
The gap between the financing gap model and the actual outcome in Zambia