Capital Flows to Developing Countries

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Discussion Topics

- Changes in private external financing – The Open Jaws Phenomenon
- Prospects for debt capital flows – permanently lower?
- Prospects for FDI – views of investors

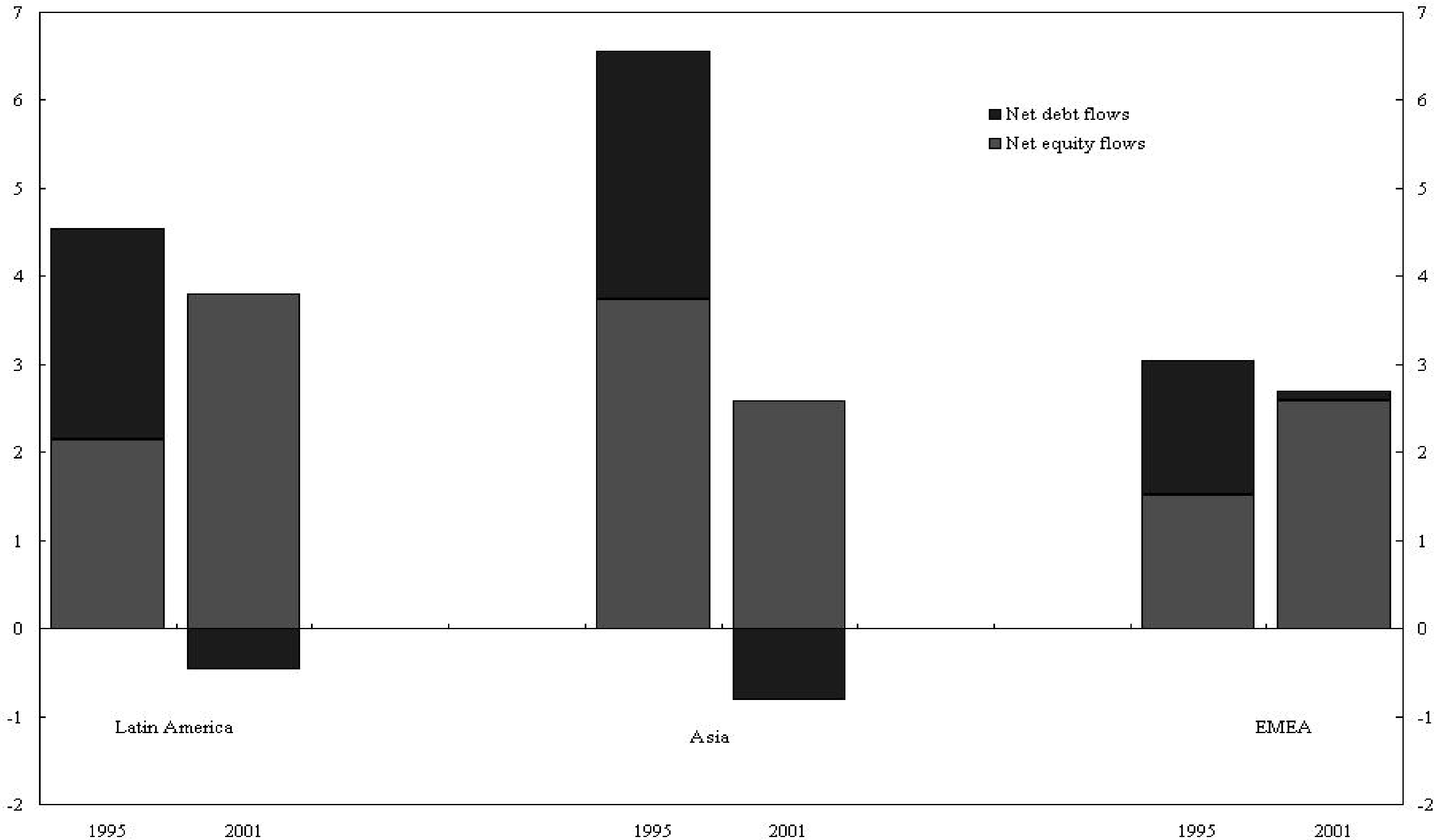
Composition of Capital flows: The story of the Open Jaws

- Since 1995 net equity flows increased substantially
- Starting from a similar level, net external debt flows have declined to negligible levels
- Looking at specific types of capital flows
  - FDI – now the most important net flow for all regions
  - Bank loans contracted sharply and in net terms have been negative since 1999
  - Bond issuance also fell but still is an important source of external financing
  - Equity portfolio flows have been more cyclical and linked with developments in mature markets

Private External Financing: All Developing Countries
(In billions of U.S. dollars)

	1995	1997	1999
Net private flows	239.0	285.1	194.7
Net equity flows	125.8	196.4	194.3
Net FDI	105.6	169.3	179.3
Net portfolio equity	20.2	26.7	15.0
Net debt-creating flows	113.2	89.1	0.5
of which:			
Bonds	23.5	38.4	29.6
Banks (medium and long term loans)	28.7	43.1	-5.9

Net private external inflows as percent of GDP, by region



Private External Financing: All Developing Countries

(In billions of U.S. dollars)

	1995	1997	1999	2001	2002
Net private flows	239.0	285.1	194.7	152.8	143.3
Net equity flows	125.8	196.4	194.3	177.6	152.3
Net FDI	105.6	169.3	179.3	171.7	143.0
Net portfolio equity	20.2	26.7	15.0	6.0	9.3
Net debt-creating flows	113.2	89.1	0.5	-24.8	-9.0
of which:					
Bonds	23.5	38.4	29.6	10.1	18.6
Banks (medium and long term loans)	28.7	43.1	-5.9	-11.8	-16.0

Underlying factors: Changing behavior of banks

- Increased risk awareness has led to
  - Greater scrutiny of credit quality
  - Partial shift of credit risk off balance sheets (structured products, CDS, etc.)
- Weak balance sheets and earnings in home markets contributed to the retrenchment
  - First, Japanese banks post Asian crisis
  - More recently, European banks

Underlying factors: Changing behavior of banks (continued)

- **Ongoing shift in business strategies of many money center banks**
  - **Greater emphasis on fee-based businesses**
  - **Cross-border lending being replaced by lending from local subsidiaries based on local currency funding**
- **Shrinking of traditional syndicated loan market**

These factors seem likely to persist

Underlying factors: Structural changes in demand for emerging market bonds

- Crises have led to a reassessment and repricing of risk
- Greater focus on specific credit quality and less on judging the asset class as a whole
- There have been important shifts in the investor base
  - Relative decline of dedicated EM funds, “leveraged investors”, and retail investors
  - Increased presence of cross-over investors
  - Increased share (in some cases dramatically) in local demand for external debt

Underlying factors: EMs are re-evaluating the risks of external borrowing

- Post-crisis adjustments have led to reduced financing needs of sovereigns and corporates
- Corporates and local banks are more aware of risks of currency mismatches
- Sovereigns are increasingly financing their debt in local markets, albeit in some case linked to fx
- The desire to reduce external debt by many large issuers, especially Russia, has kept supply down

These factors may persist

Three big, as yet unanswered, questions

- What is the potential for growth in foreign investors' appetite for debt issued in local currency?
- What are the prospects for greater cross-border portfolio investment into the private sectors of emerging markets?
- Why are emerging market countries so susceptible to crises induced by relatively small swings in the volume of external debt financing – the "drowning in puddles" phenomenon?

FDI in Emerging Markets Countries

- Rapid expansion in the 1990s—net flows peaked in 1999 ($179 billion)
  - FDI flows increased across all regions in the first half of the 1990s
  - Continued increase in flows to Latin America and Eastern Europe offset slowdown in flows to Asia in the second half
  - Heavy country concentration: China, Brazil, and Mexico account for about 60 percent of recent FDI flows
- Sharp increase in M&A activity – e.g., privatization, distressed asset sales in Asia
- Increasing amounts of FDI also went into the services sector

More Recently

- In last three years, FDI flows declined by about 20 percent
- Decline explained largely by a reduction in flows to Latin America
  - Decline concentrated in Argentina and Brazil
  - Regional recession and developments in Argentina have undermined incentives
  - Large-scale M&A in the region have declined sharply – mimics global trends in M&A activity
  - Process of privatization in many countries is winding down
- No significant change in FDI flows to other regions

Important Determinants of FDI: Investors' Perspective

- Political and economic stability
- Market size and prospects for growth
  - Increasingly, foreign investors are making choices primarily based on desire to build local product markets rather than for reducing global manufacturing costs
- Predictable rules for investment and a sound legal framework
- Availability of infrastructure
- Stability of the tax system is important, but tax incentives not critical in investment decisions

Financing and Hedging of FDI

- FDI is largely financed by the parent, including through borrowing from banks and securities markets
- Hedging generally limited to current flows and inventories
- At times of crises, banks hedge more actively by reducing cross-border lending to clients, repatriating earnings, and financial market activity
- Access to local financing is becoming increasingly important in determining FDI

Impacts of a weaker global economy and Argentina on FDI in EM

- The long time-horizon of FDI investors serves as a buffer to short-term macroeconomic disturbances and/or negative policy developments
- No large-scale withdrawal from EMs – but investors in a "digestive" rather than an expansionary mode
- The share of retained earnings in financing aggregate FDI is likely to grow, at least in the near term
- Certain sectors are likely to be more adversely affected
  - Banking – some foreign banks in Latin America have sold their business and expansion plans are on hold
  - Utilities – some investors badly burnt and will likely reduce their exposure

Prospects for FDI: Asia

- **Asia likely will remain the primary focus of FDI investors**
- **China: Large market with growing middle class; sound growth prospects; cost competitive – will dominate**
- **India: Large market; cost competitive; outsourcing based on human capital; but difficult business environment and unclear receptiveness to FDI competing with local companies**
- **Southeast Asia: Malaysia becoming high cost; interest in Thailand growing; political uncertainties inhibiting FDI to Indonesia, Philippines, and Vietnam**

Prospects for FDI: Latin America

- FDI prospects remain uncertain because the low-growth environment and concerns about the policy environment
- Brazil: Largest domestic market in the region; investors have a wait-and-see attitude; net FDI now primarily retained earnings and debt/equity conversions; improved growth could trigger a turnaround in investor sentiment
- Mexico: Despite large market, interest driven by NAFTA; concerns about labor costs; increased competition from China may be impacting FDI inflows
- Argentina: Few firms pulling out; most not repatriating current earning; utilities and banks the major concern
- Others: Political problems limit attractiveness of Andean countries, outside extractive industries; reliability of contracts now an issue for Peru; political stability supports FDI to Chile

Prospects for FDI: EMEA

- **Central Europe: Strong interest; cost competitiveness versus rest of EU; limited further interest in investment for domestic markets**
- **Russia: Large market with upside potential; outside of extractive sectors, interest in limited by governance and corruption concerns**
- **Turkey: Mid-sized market but unclear growth prospects; free-trade agreement with EU not yet a factor; interest limited by local politics and unclear receptivity to FDI**
- **South Africa: Mid-sized market with limited growth potential; concerns about politics, corruption, labor productivity, and HIV/AIDs**

FDI in the Caribbean Region

- FDI has been high as a share of GDP, 1999-2001
  - 5.6%, all countries, 6.2% (English-speaking countries)
  - Trinidad and Tobago, 7.1%
  - Jamaica, 5.3 %
  - Others, 6.5%
- Sectoral Concentration
  - Natural resources predominate – tourism, oil/gas, minerals
  - Domestic services have been important – banking, telecoms
  - Manufacturing has lagged

FDI in the Caribbean -- Challenges

- Stable macroeconomic framework remains essential
- External factors may be less favorable
  - Post 9/11, tourism growth and location uncertain
  - Wider trade liberalization and loss of current preferences
- Small-size economies limit interest in domestic markets
- Addressing competitiveness issues is key
  - Labor costs and labor productivity
  - Crime and security
  - Infrastructure