

# Post-crisis trends in private capital flows to developing countries

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## Key messages

Private capital flows have the potential to provide essential financing for developing countries for economic growth, but are subject to risks, as well as opportunities, that have been highlighted by the global financial crisis. This paper examines the related post-crisis trends and issues and propose policy options to support positive outcomes.

In this paper post-crisis trends in private capital flows to developing countries are discussed, focusing on the poorest and most vulnerable low income countries (“LICs”). It argues that **post-crisis trends in flows to LICs, whilst relatively small in absolute terms and relative to GNP, are positive**. In particular, FDI has expanded steadily and portfolio flows, which fell to negligible levels during the crisis, recovered in 2013 with strong sovereign bond issuances for selected LICs.

However, these flows bring **risks in relation to liquidity and foreign exchange** that may be sources of future financial fragility. In particular, they create vulnerability to changes in international monetary policy and investor appetite.

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# 1. Introduction

It is widely acknowledged that the financial system plays a vital role in economic growth in developing countries by mobilising and intermediating the required financial resources for structural transformation. Cross-border private capital flows<sup>1</sup> are an important part of this mobilization of resources because of their potential contribution to higher investment rates, the facilitation of capital market deepening and technological transfer, which can have positive effects on growth potential and levels of development (World Bank, 2014).

Cross border private capital flows can include foreign direct investments (“FDI”), financial flows, primarily consisting of banking lending, and portfolio flows, primarily consisting of short term equity and bond flows. They have multiple drivers which can be broadly classified as “push” and “pull” factors, where push factors are common to the global economy and “pull” factors are country specific (Calvo et al, 1996). Also contributing as a cause of larger capital flows has been the liberalisation of capital accounts and the rise of global investors, including investment banks and pension, insurance, hedge and private equity funds.

Aspects of cross-border capital flows remain problematic. In particular, there is controversy regarding the ideal composition of flows between FDI, financial and portfolio flows because of their relative impact on development and their differential volatility. FDI is typically considered the most desirable for development as it provides a stable and long-term source of investments funds<sup>2</sup>. However, by contrast, portfolio and debt flows are considered less desirable as they can be short-term and volatile.

In addition, volatility of cross-border capital flows, which has increased for all types of flows with the growth and liberalization of the global financial system and the integration of developing countries into that global system (IMF, 2011), has been associated with economic problems. These have included macroeconomic disruptions in relation to trade, exchange rates and inflation and boom-bust cycles in financial markets, as well as financial and economic crises (Massa, 2013; Griffith-Jones, 2013).

Much of the focus of both research and policy to date has focused on large MICs because of their increasing integration with the financial markets of advanced economies and because of their repeated experience of financial crisis, including through contagion effects during the global financial crisis. In addition, they are increasing important in their own right in international and regional financial markets and policy-making.

However, less focus has been given to LICs and smaller, and hence potentially vulnerable, MICs. These are the focus of the papers prepared for this workshop, particularly the impact on them of the global financial crisis and the subsequent reforms to the financial architecture. In this first paper, the focus will be the impact of the global crisis, and subsequent events such as QE and its tapering, on capital flows to LICs and smaller MICs. In the second paper, the focus will be on related risks and policy.

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<sup>1</sup> Excluded from consideration in this paper are Official Development Assistance (“ODA”) and current account flows, including remittances. Although such flows can be important, especially to certain countries, they are beyond the scope of this paper which focuses on private capital flows only.

<sup>2</sup> Although its volatility has been reported as having increased in recent periods (IMF, 2011)

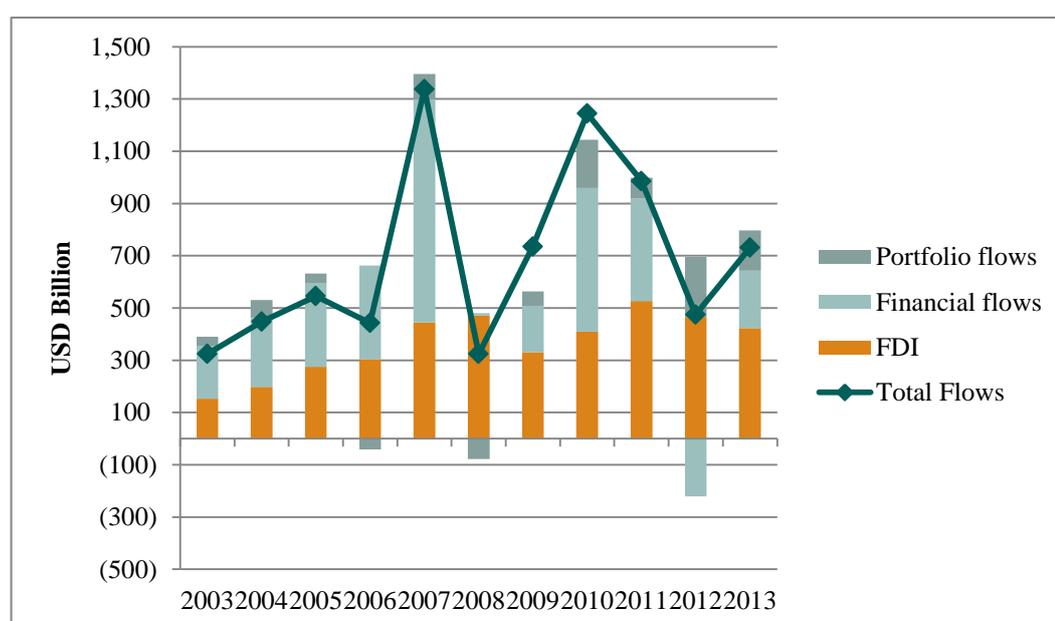
## 2. Post-Crisis Trends in Private Capital Flows to Developing Countries

Since the early 2000s cross-border capital flows have undergone dramatic changes in three identifiable phases. Firstly, from the early 2000s onwards, there was a large scale expansion of cross-border flows which was brought to an abrupt halt by the global financial crisis that started in 2007. During the acute phase of the crisis, from approximately 2007 to 2009, there was a sharp contraction in flows and a severe rise in their costs<sup>3</sup> as strong risk aversion swept global financial markets. After this acute phase receded, global cross-border capital flows recovered, but with high levels of volatility, including due to repeated shock events, such as the Eurozone-crisis and the unprecedented monetary easing in advanced economies, especially in the United States.

These trends were reflected in cross-border capital flows to developing countries and are illustrated in the figures below of capital flows to developing countries from 2003 to 2013 by type of flow. Figure 1 illustrates capital flows and figure 2 illustrates average flows for these three phases.

The broad trends that can be seen in these flows reflect predominantly<sup>4</sup> “push” factors in the global economy. As can be seen, pre-crisis, private capital flows were showing a steady expansion, especially in FDI and bank lending (financial flows) but portfolio flows were relatively unimportant.

**Figure 1: Net Private Capital Flows to Developing Countries (2003-2013)**

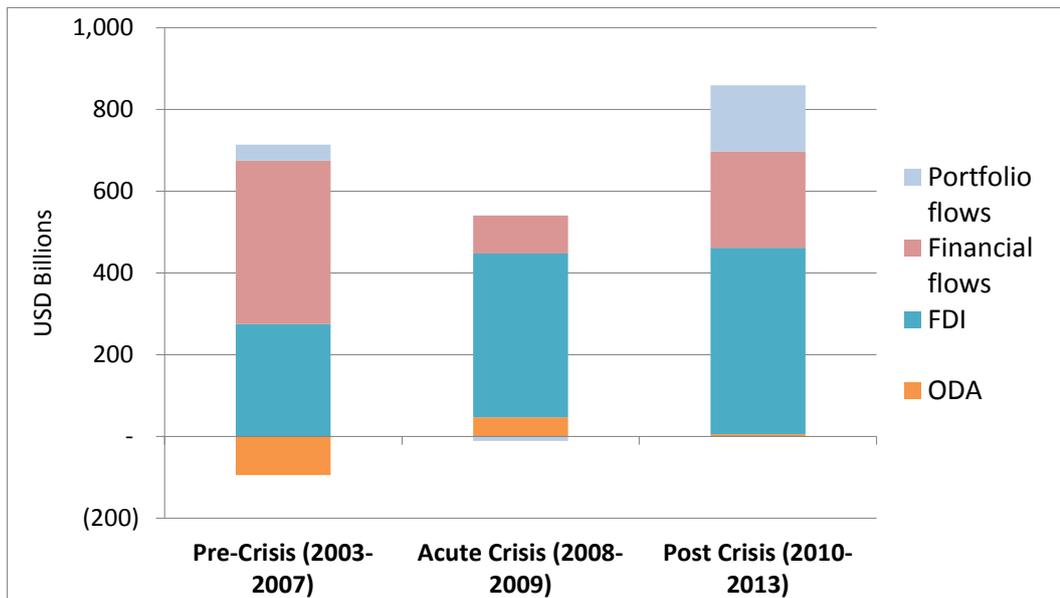


Source: World Economic Outlook, IMF

<sup>3</sup> Relevant costs are primarily interest rate spreads on debt instruments and bank lending

<sup>4</sup> The World Bank estimated global factors accounted for approximately 60% of the changes in capital inflows to developing countries between 2009 and 2013 with the remainder relating to country-specific factors (World Bank, 2014).

**Figure 2: Average Annual Net Private Capital Flows to Developing Countries (2003-2013)**



Source: World Economic Outlook, IMF (Elaborated by author)

These patterns were disrupted by the financial crisis. FDI responded relatively little in relation to the crisis, in contrast to other flows, with a peak in 2007 of \$445 billion, a slight increase in 2008 to \$472 billion and a sharp decline in 2009 to \$330 billion, before returning and then exceeding pre-crisis level from 2010 to 2013.

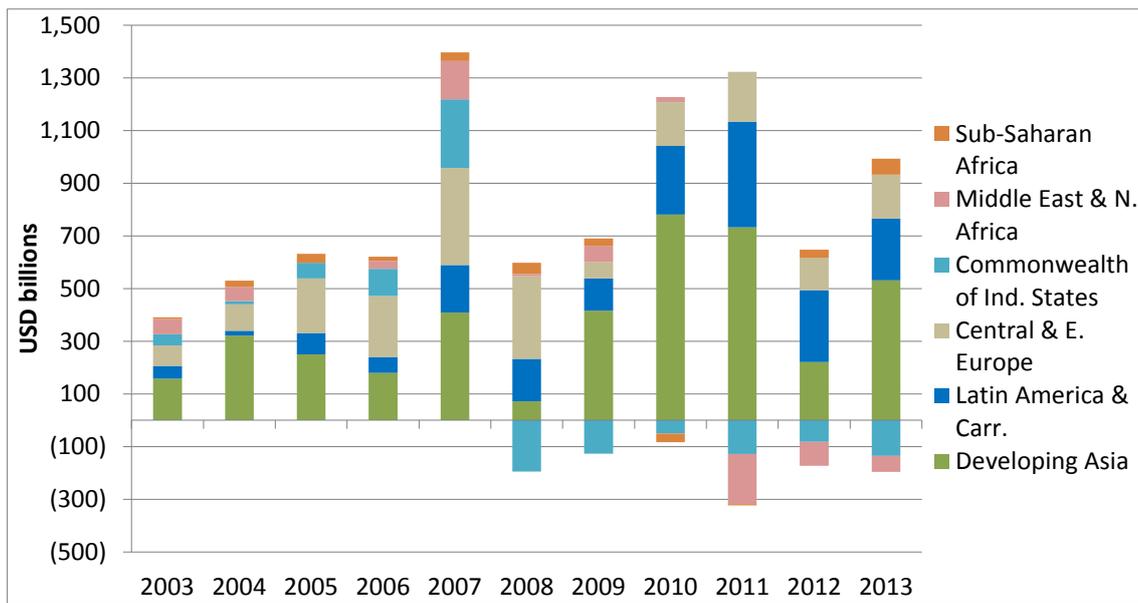
Bank lending, however, contracted sharply in response to the crisis, falling from a peak of \$853 billion in 2007 to a mere \$9 billion in 2008. Subsequently, banking lending has been volatile with peaks and troughs throughout the period, including a net outflow in 2012. This pattern reflects the shock of the crisis and subsequent risk retraction experienced by international banks in advanced economies, including losses from credit shocks in real estate markets and the Euro-crisis, as well as regulatory reforms that curtailed leverage. However, contraction in bank credit in Europe was offset by growth in Asia (Caruana, 2013) which is discussed further below.

Portfolio flows were also growing pre-crisis, but experienced a sharp contraction during the crisis before returning to strong, but volatile, post-crisis growth. Expansion of portfolio flows was particularly strong in 2010 and 2011, with a sharp contraction in 2012, before resuming in 2013. These factors reflected push factors in advanced economies as investors, including those in the shadow banking systems, sought yield opportunities outside of advanced economies where quantitative easing (“QE”) drove down interest rates, as well as periodic speculation relating to the reversal of quantitative easing, especially in early 2013.

However, these overall trends in cross-border private capital flows mask important “pull” factors relating to regional and country specific trends which have particular importance for the subject of this paper, LICs and smaller MICs. These are initially illustrated in figures 3 and 4 below, which again show global cross-border flows, but by region.

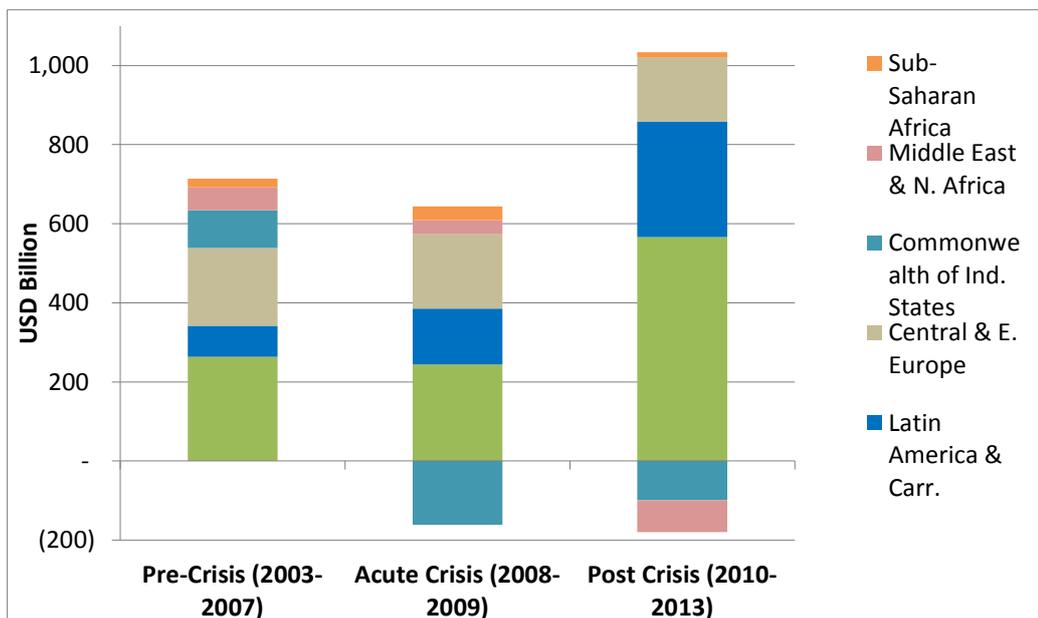
As can be seen, flows are differentiated by region. In particular Developing Asia not only received the majority of flows, but saw stability of flows during the crisis and subsequent post-crisis resumption of growth, with post-crisis flows being more than double those pre- and inter-crisis. Similarly, Latin America and the Caribbean saw a slight contraction of flows during the acute phase of the crisis, followed by a strong resumption, with post-crisis flows four times pre-crisis averages. Central and Eastern Europe saw a sharp reductions in flows during the crisis, especially in 2009, before they recovered, but to below pre-crisis levels.

**Figure 3: Net Private Capital Flows to Developing Countries by Region (2003-2013)**



Source: World Economic Outlook, IMF

**Figure 4: Average Annual Net Private Capital Flows to Developing Countries by Region (2003-2013)**



Source: World Economic Outlook, IMF (Elaborated by author)

However, as illustrated by figure 5 below, these patterns are largely driven by flows to MICs, particularly large MICs. In fact, MICs received 98% of all inter-crisis flows and 96% of all post-crisis flows with three countries - China, Brazil and India - receiving 26% of flows during the acute phase of the crisis and 34% post crisis.

**Figure 5: Private Capital Flows to Developing Countries as a Percentage of Total Flows**

	<b>Pre-Crisis (2003-2007)</b>	<b>Acute Crisis (2008-2009)</b>	<b>Post-Crisis (2010-2013)</b>
<b>China, Brazil &amp; India</b>	27.9%	26.6%	34.5%
<b>All MICs</b>	98.2%	98.0%	96.8%
<b>LICs</b>	1.8%	2.0%	3.2%

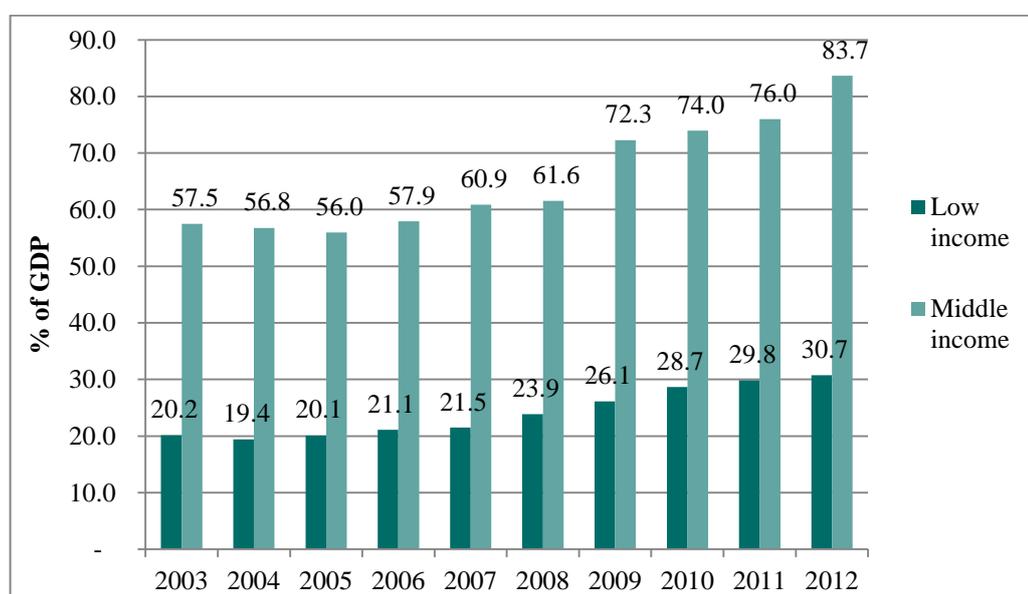
*Source: World Economic Outlook, IMF (Elaborated by author)*

### 3. Post-Crisis Trends in Private Capital Flows to LICs

As can be seen from figure 5, LICs received a small share of developing country cross-border flows and, at first glance, these low shares of global capital flows for LICs might seem disappointing. However, in fact, there is a positive trend for LICs, including for Sub-Saharan Africa, the region which contains the majority of LICs<sup>5</sup>. This is because, firstly, although the percentage of global flows to developing countries received by LICs are small, they have consistently expanded, reaching 3.2% post-crisis. Further, flows have consistently grown in absolute terms as a percentage of GDP, reaching, by 2012, 6.5%, above the average of 6% for all developing countries (World Bank, 2014).

Further, private sector credit, as illustrated in figure 6 below, has also consistently expanded, including steady progress during and after the crisis, reaching an average of 30.7% by 2012. Levels remain well below those of MICs - which, may, in fact, be excessive in some cases for maximising growth - but steady improvements have been made. However, there is significant variation around this average between countries. For example, in 2012, private sector credit as a percentage of GDP was 36.6% in Kenya, 49.4% in Bangladesh 49.4% and 55.8% in Nepal, compared to 6.2% in Sierra Leone, 5.6% in Chad and 8.2% in DR Congo.

**Figure 6: Private Sector Credit to LICs as a Percentage of GDP**



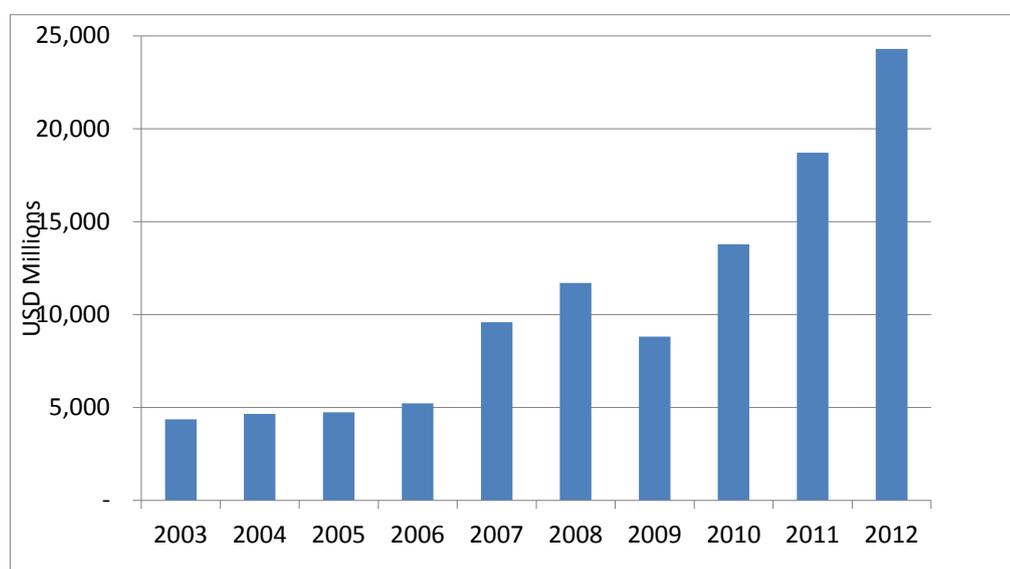
Source: World Development Indicators, The World Bank.

<sup>5</sup> LICs are comprised of 36 countries of which 28 are in Sub-Saharan Africa countries. They are Afghanistan, Bangladesh, Benin, Burundi, Burkina Faso, Cambodia, Central African Republic, Chad, DR Congo, Comoros, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kenya, DR Korea, Kyrgyz Republic, Liberia, Madagascar, Malawi, Mali, Mozambique, Myanmar, Nepal, Niger, Rwanda, Sierra Leone, Somalia, South Sudan, Tajikistan, Tanzania, Togo, Uganda and Zimbabwe.

Examining these trends by flow type, FDI is consistent with these trends with steady growth since 2002 and this growth was sustained, with a minor dip in 2009, throughout and subsequent to, the global crisis. This is illustrated in figures 7 and 8 below. In 2012<sup>6</sup>, FDI to LICs reached \$24.3 billion, six times the 2002 level, and also was a maximum as a percentage of flows to developing countries at 3.9% and as an average percentage of GDP at 5.2%. Trends in FDI include increasing participation in FDI sourced from other developing countries, notably China, India and the UAE as well as growing inter-regional FDI from South Africa, Kenya and Nigeria (United Nations, 2013b). There has also been some diversification away from previous concentrations in extractive industries towards services, including tourism and the financial sector (Source: Financial Times).

Such growth in FDI, however, remains concentrated in a few selected LICs with other receiving minimal levels of FDI. For example, in 2012, FDI was 47% of GNP for Bangladesh, 71% in Cambodia, 77% in Mozambique and 25% in Tanzania, but there were 10 LICs<sup>7</sup> that received negligible levels below 1% of GNP.

**Figure 7: Net FDI Inflows to LICs (2003-2012)**

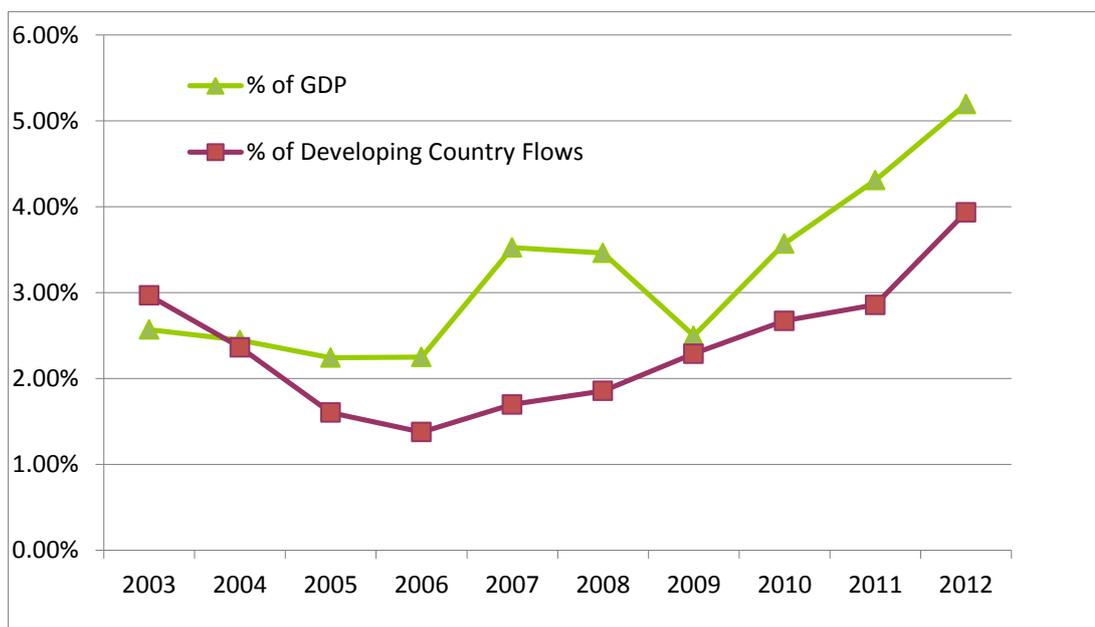


Source: World Development Indicators, the World Bank.

<sup>6</sup> 2013 data have not yet been made available by the World Bank

<sup>7</sup> South Sudan, Burundi, Guinea-Bissau, Burkina Faso, Central African Republic, Afghanistan, Comoros, Togo, Malawi, Somalia

**Figure 8: Net FDI Inflows to LICs as a Percentage of GDP & of All Developing Country FDI (2003-2012)**



Source: World Development Indicators, the World Bank (Elaborated by author).

Portfolio and financial flows have seen positive, but more mixed, trends post-crisis. As illustrated in figures 9 and 10 below, during the crisis, portfolio and financial flows to LICs were negligible. However, in 2011 and 2012, there was slight improvement in flows. This was primarily due to portfolio flows, with bank credit remaining subdued although improving in 2013 (World Bank, 2014; IMF, 2014b).

However, in 2013, there was a strong surge in portfolio flows because of LIC sovereign bond issuances totalling \$1.7 billion (Hou et al, 2014). Countries that participated in sovereign bond issuances included Tanzania, Kenya, Rwanda, Mozambique and Uganda with Bangladesh planning issuances.

The push factor in these flows has been the search for alternative, high yielding investments by international funds including a number of newly established “frontier market” funds, but the pull factor – reflected in the concentration of this issuance in countries with strong macroeconomic fundamentals and growth expectations - has also been important. Such countries have been successful because of their stronger macroeconomic fundamentals and more stable political environment that make them attractive to international investors.

However, while the ability to tap into international capital markets by these countries is positive, risks are attached. Firstly, private sector issuances had lower maturity and higher costs than previous concessional financing. Indeed, the 2013 issues had an average maturity of 8.7 years, compared with 28 years for existing debt, and an average coupon rate of 8.2% compared to 1.6% for existing debt, reflecting their non-concessional terms (Hou et al, 2014; Stiglitz & Rashid, 2013). Bonds yields also increased in 2013 due to speculation relating to QE unwinding (Hou et al, 2014). Also, issuing yields can be volatile and maturities short, relative to long-term government financing needs.

Secondly, bond issuances have almost exclusively been in US dollars, leaving foreign exchange risk with sovereigns, and yields have been dependent upon USD base rates as well as credit risk of the issuing country<sup>8</sup>.

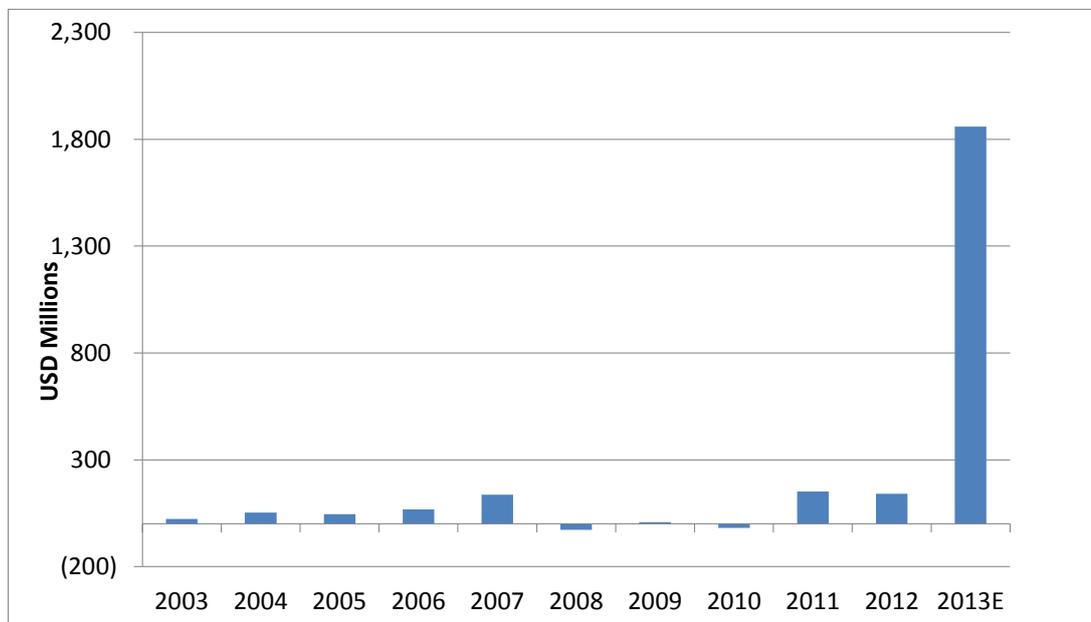
Further, the growth in speculative “frontier funds” can be a source of financial instability as inflows from such funds into immature financial systems can be disruptive. Such flows were important causal factors in, for example, the Asian Crisis of 1997 (Griffith-Jones, 1998) and, worryingly, drove sharp rises in some LICs stock

<sup>8</sup> Bonds have been fixed rate issuances. However, the fixed rate are typically set at issuance based upon spread over US treasuries for US dollar bonds. The spread reflects the perceived credit risk of the bond.

markets in 2012 and 2013. For example, stock markets rose 25% in Tanzania, 44% in Kenya, 62% in Malawi, 33% in Uganda and 32% in Zimbabwe (Source: Investing in Africa).

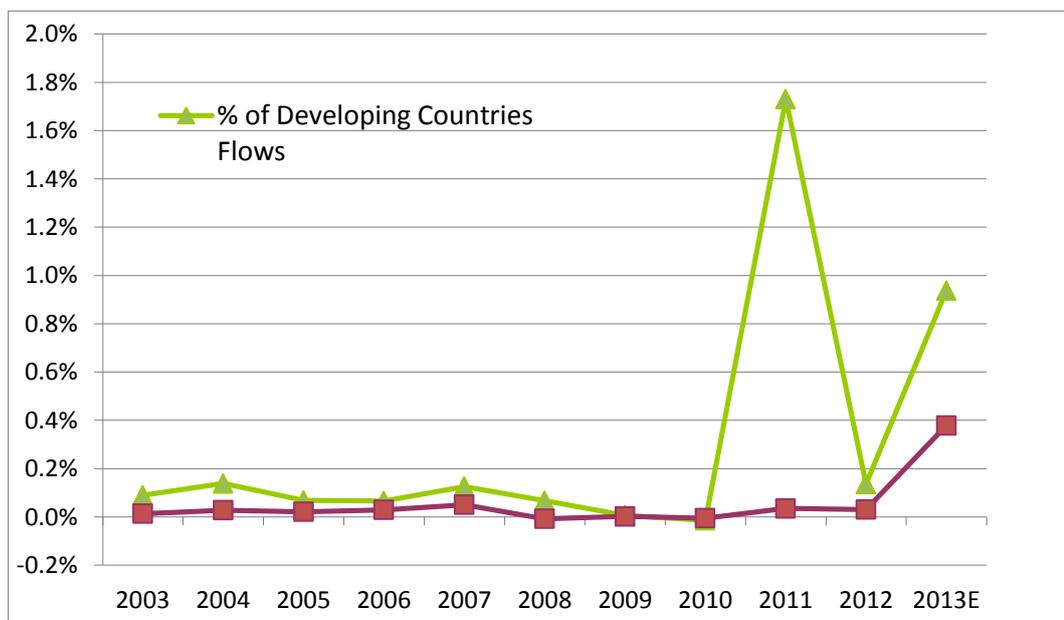
These risks will be discussed further in the paper *Maximising International Finance for Development in the Poorest and Most Vulnerable Countries*.

**Figure 9: Net Portfolio Inflows to LICs (2003-2013)**



Source: World Development Indicators, The World Bank. (2013 Estimate: Hou et al, 2014)

**Figure 10: Portfolio Inflows to LICs as a Percentage of GDP & of All Developing Country Portfolio Flows (2003-2013)**



Source: World Development Indicators, The World Bank and 2013 Estimate, Hou et al, 2014 (Elaborated by author)

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In addition, as for FDI, some LICs have been excluded from participation in international capital markets. Indeed, only a small proportion of LICs were recipients of portfolio flows, with for example, 27 LICs<sup>9</sup> receiving no portfolio flows in 2012 or 2013. This means that, for excluded LICs, portfolio flows remain a very limited source of potential cross-border capital. However, ODA has been an important source of funding for such LICs, in both absolute and relative terms. For example, some of the top recipients of ODA, as a percentage of GNP, in the post-crisis period are Afghanistan, Haiti, Ethiopia, the Democratic Republic of Congo and Somalia. Such ODA flows to these countries, arguably the least able to participate in private sector flows remain an important source of support.

Finally, before discussing the issues arising from the above trends, there is also a need to differentiate among MICs. As noted, large MICs are dominant recipients of cross-border private capital flows, reflecting the scale and growth of their economies. However, between this group and LICs, are smaller MICs, some of which may be subject to similar vulnerabilities that, despite their higher per capita GNP, are similar to LICs. For example, there are a number of small MICs that either have low levels of cross-border flows relative to GNP or that have a high dependency on ODA for financing. For example, a number of MICs receive less than 5% of GNP in total cross border flows<sup>10</sup> or receive ODA which represents more than 50% of cross-border capital flows<sup>11</sup>. Such countries need similar consideration in policy discussions relating to cross-border capital flows as LICs.

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<sup>9</sup> Burundi, Benin, Burkina Faso, Central African Republic, Comoros, Eritrea, Ethiopia, Guinea, Gambia, The, Guinea-Bissau, Haiti, Cambodia, Liberia, Madagascar, Mali, Myanmar, Niger, Nepal, Korea, Dem. Rep., Somalia, South Sudan, Chad, Togo, Tajikistan, Congo, Dem. Rep., Zimbabwe

<sup>10</sup> Dominican Republic, Cameroon, Papua New Guinea, Gabon, Tunisia, Bulgaria, Belarus, Morocco, Uzbekistan, Guatemala, El Salvador, Botswana, Jamaica, Suriname, Sri Lanka, Syrian Arab Republic, Paraguay, Yemen, Ecuador, Cuba and Angola

<sup>11</sup> Yemen, Papua New Guinea, Suriname, Kiribati, Tuvalu, Cuba, Micronesia, Samoa, Timor-Leste, Bhutan, Tonga, Palau, Solomon Islands, Senegal, Cote d'Ivoire, Cape Verde, Vanuatu, Moldova, Djibouti, Sao Tome and Principe and the Marshall Islands

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## 4. Conclusion

As can be seen from the preceding discussion, although LICs remain minority participants in global cross-border private capital flows, post-crisis trends are positive. In particular, FDI continues to show steady growth in absolute and relative terms, and increasing diversification of sectors and sources, including growing importance of flows from other developing countries and inter-regionally. Similarly, portfolio flows, while low, are growing and, for selected countries, sovereign bond issuances have been strong.

These positive trends present a great opportunity for LICs to mobilise resources for structural transformation. In particular, the trends in FDI can potentially support pro-development investment in the private sector and those in portfolio flows support government-led debt management programmes and infrastructure investments (Velde et al, 2013).

However, future trends are subject to risks, including disruption due to changes in “pull” factors relating to global economic conditions and from “push” factors within domestic economies. In particular, there is anticipation that flows will be affected by unwinding of quantitative easing (World Bank 2014; IMF 2014). Indeed, the recent World Bank report predicted a gradual normalization of global monetary conditions would be accompanied by a only modest and gradual retrenchment of private capital inflows to developing countries, returning them to pre-crisis averages. However, it also commented that a disorderly unwind could be much more disruptive, forecasting reductions in short-term capital flows of 50-80% in such a scenario (World Bank, 2014). Given the recent volatility in emerging market in January 2014 such a scenario should be considered.

In Paper ‘*Maximising International Finance for Development in the Poorest and Most Vulnerable Countries*’, this discussion of the post-crisis trends in cross-border capital flows will be extended to consider the related risks and policy options.

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