



Benefits of Capital Flows: New Role for Public Institutions

By Jane D'Arista, Financial Markets Center

After a worldwide removal of regulatory constraints, market forces have assumed a dominant role in the international financial system. The role of the public sector has been sharply curtailed, rendering it ineffectual in its efforts to handle essential functions: liquidity management and imposition of countercyclical policies to offset the boom/bust of business cycles. To remedy this problem, it will be necessary to rebuild the powers of the public sector to promote stability and growth in the global economy.

Cross-border securities transactions in the recurrent boom/bust cycles have plagued emerging markets in the

Key Points

- Foreign portfolio investment replaced bank loans as the primary channel for international capital flows in the 1990s.
- Privatization programs and the removal of capital controls facilitated the rise of foreign portfolio investment in emerging markets.
- Rising securities prices allowed foreign capital to be absorbed more rapidly and in larger amounts than in the past, intensifying boom/bust cycles in developing countries.

1990s. The establishment of a public international investment fund promoting steady, sustainable growth in developing countries while providing a basic, guaranteed return to investors, should be considered by policymakers.

Growth in cross-border securities investments mushroomed in the 1980s as portfolio investment became increasingly attractive and lending by international banks declined. By the end of the decade, these trends strengthened, as many countries removed capital controls and privatized state

enterprises. Securities markets expanded dramatically in the developing world, Eastern Europe, and the former Soviet Union. With growth in the volume and mobility of capital flows, global integration accelerated.

Major shifts in saving and investment patterns in the large industrialized countries also contributed to the rise in foreign portfolio investment during the 1980s and 1990s. Increasingly, individuals have shifted savings from banks to pooled funds (e.g., private pensions, life insurance, and mutual funds) that invest in securities. Between 1978 and 1998, the share of total U.S. financial sector assets held by institutional investors rose from 32% to 54% while the share held by depository institutions fell from 57% to 27%.

U.S. and U.K. insurance companies and pension funds initiated the first wave of portfolio investment in emerging markets in Asia in the late 1980s. Interest soon shifted to Latin America—notably to Mexico, Brazil, and Argentina—as the repatriation of flight capital deepened those markets and as privatizations expanded the stock and diversity of new securities

issues. Investments in emerging markets as a portion of industrialized countries' securities investment flows rose from 0.5% in 1987 to 16% in 1993. Foreign portfolio investment (\$325 billion) replaced bank lending (\$76 billion) as the dominant source of private capital flows to developing countries in the period 1990-1994.

In the early 1990s, the switch from bank lending to portfolio investment drove up securities prices. Foreign capital surged into certain developing countries, rising rapidly as a share of GDP. For example, from 1990 to 1993, capital flows into Mexico totaled \$91 billion—20% of all net inflows to developing countries. Two-thirds of Mexico's net inflow was portfolio investment. Most of it was invested in the Mexican stock market, which rose 436% during this period.

In early 1994, the rate of foreign portfolio investment abated as the recession in industrialized countries eased, demand for credit rose, and the U.S. Federal Reserve Board hiked interest rates, thereby narrowing the spreads between U.S. and emerging market debt issues. Prices of Mexican stocks fell, eroding their value as collateral for bank loans and forcing liquidations. As that source of financing for its current-account deficit dried up, Mexico issued dollar-indexed, short-term debt. But political shocks and dwindling dollar reserves had unnerved investors. Their pullout in anticipation of a forced devaluation made the December 1994 decision to devalue the peso unavoidable.

After the Mexican peso crisis, discussion focused on how developing countries should handle capital inflows. According to the International Monetary Fund, heavy inflows into most emerging market countries caused exchange rate appreciation that eroded the competitiveness of export sectors, drove up asset prices, and increased the vulnerability of their financial systems.

In 1995, the Bank for International Settlements reported widespread agreement that controls on short-term transactions should not be liberalized until the soundness of a country's financial system was assured. However, this view conflicted with U.S. policies favoring the elimination of controls on international capital flows. The U.S. Treasury Department did not, therefore, use its influence to promote guidelines for or restraints on speculative transactions. Despite the heavy economic and social costs of volatile investment flows, the U.S. stepped up pressure for full capital account liberalization, both before and after the Asian crisis began to unfold in 1997. The Treasury Department ignored the call for reforms that could have averted the contagion brought on by unregulated financial flows to emerging markets.

The major flaw in U.S. policy is its pursuit of objectives that cripple the primary instrument that national governments have used to moderate boom/bust cycles and ensure stable economic growth: countercyclical monetary operations. Instead, its policies promoting capital flows liberalization encourage procyclical investment behavior, thereby worsening volatility rather than dampening dangerous volatility in capital flows.

Traditionally, central banks have had the power to cool economic activity through countercyclical policies, e.g., raising interest rates. However, high interest rates may attract, rather than discourage, increased foreign inflows, thereby stimulating economic expansion rather than contraction. And attempts by central banks to revive economic activity by lowering interest rates may prove ineffectual when such action precipitates or intensifies capital outflows and reduces the flow of credit in a national economy.

Institutional investors can currently shift their holdings of bonds and equities from one market to another in response to cyclical developments that raise or lower returns. By rejecting efforts to moderate these procyclical flows, U.S. policy has systematically undermined the ability of central banks to control credit expansion and contraction.

Industrialized countries also experience the negative effects of volatile foreign investment flows. In the 1980s and 1990s, capital inflows produced effects in the U.S. similar to those in Mexico and other emerging markets: rising equity prices, currency appreciation, large current-account deficits, and a boom in consumption.

In the early 1980s, foreign capital flowed into the U.S. in response to the combination of easy fiscal and tight monetary policies that drove up the value of the dollar and real interest rates. However, massive capital inflows continued throughout the 1980s, even as monetary policy eased and the dollar depreciated. Highly indebted developing countries exported goods to the U.S. to earn dollars and then exported those dollars to repay debt; countries with financial surpluses invested dollars in the U.S. market in order to build foreign exchange reserves—raising the value of the dollar, lowering the prices of imports, and making additional credit available to U.S. borrowers.

U.S. consumers borrowed the recycled dollars to buy even more foreign goods. As foreign capital flowed in,

the aggregate debt of all U.S. borrowers—government, households, and businesses—doubled between 1983 and 1990, rising from \$5.4 trillion to \$10.9 trillion and pushing debt to GDP ratios in these sectors to unprecedented levels for a period of low inflation. Meanwhile, the amount of debt owed to foreigners also increased in both nominal terms and as a share of GDP.

Unsustainable debt levels in the U.S. and other industrialized countries contributed to the depth and duration of the recession at the beginning of the 1990s. Moreover, central banks in the U.S. and other industrialized countries had difficulty reviving economic activity. Instead of reigniting economies, interest rate cuts sparked outflows of portfolio investment. Though these outflows only lengthened the U.S. recession by a few months, subsequent outflows from emerging markets had a much greater impact, crippling those countries and weakening the global economy.

Meanwhile, abetted by an immense consumer credit structure, the chronic U.S. current-account deficit poses a growing concern. The U.S. has become dangerously dependent upon the continued willingness of foreigners to invest in its economy. With its huge external debt, the U.S. may be increasingly susceptible to harsh judgments by the liberalized financial system. Ironically, U.S. policies imposed this liberalized system on the rest of the world.

The U.S. government and other advocates of financial liberalization believe that greater capital mobility will spur, not undermine, national economic growth and development. The U.S. Treasury regards capital outflows as an inevitable response to poor policies and an acceptable tool of market discipline. Emerging market countries are urged to adjust stocks of foreign exchange reserves to cover foreign liabilities. Such views assume that a country's primary obligation is to assure returns on investments rather than to promote the welfare of its citizens.

Key Problems

- The U.S. ignores the extensive damage done by massive capital flows and continues to press developing countries to open their financial markets.
 - Capital flows into the U.S. also contribute to rising equity prices, currency appreciation, large current-account deficits, and a boom in consumption.
 - The ability of central banks to conduct countercyclical policies has been weakened by large and rapid shifts in foreign portfolio investment across open markets.
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It is increasingly recognized that both development and debt repayment depend upon stable and long-term capital inflows. Reliability assures realistic cash-flow assumptions and repayment schedules. As crises in the 1980s and 1990s illustrated, private bank loans funded by short-term deposits are not a suitable source of financing for development.

Key Recommendations

- Establishing a closed-end investment fund for emerging markets would eliminate surges in foreign portfolio investment while harnessing the potential of this foreign investment to provide long-term capital for development.
- Managed by a public international agency, such a fund would focus on the economic performance of enterprises and countries rather than seeking short-term financial returns.
- Holdings of government securities of industrialized countries would provide a capital cushion and guarantee for pension funds and other beneficiaries whose savings are currently at risk.

Foreign portfolio investments could provide an expanding source of long-term capital in developing countries if surges in capital flows could be moderated to prevent the boom/bust cycles that have characterized the use of this channel to date. U.S. policymakers should consider promoting measures that limit the destabilizing impact of portfolio investments in foreign markets.

Establishing a closed-end investment fund for emerging markets would be an effective way to address the problems associated with foreign portfolio investment. Closed-end funds contain stabilizing features that make them preferable to open-end funds.

The typical, open-end mutual fund issues and redeems its shares on demand, buying and selling assets to accommodate purchases and redemptions. A closed-end fund would provide stable, patient capital to emerging markets. Although shares in the closed-end fund could be traded, share price fluctuations would not prompt purchases or sales of the underlying investments in emerging markets. A closed-end fund would, thereby, help countries avoid problems accompanying surges in either inflows (e.g., rising exchange rates and inflated asset prices) or outflows (e.g., collapsing asset prices and exchange rates).

The fund should be adequately capitalized. Between 10-20% of the value of shares sold to investors should be used to purchase and hold government securities of major industrial countries in amounts roughly proportional to the closed-end fund shares owned by residents of those countries. Thus, the fund would provide a channel for retirement investments and other pooled funds to diversify their holdings and earn a basic,

guaranteed return in addition to dividends and interest on investments in emerging market securities.

The fund would issue its own liabilities to private investors. In consultation with developing country governments and citizen groups, it would then buy stocks and debt obligations of private enterprises and public agencies in developing countries. Both the number of countries and the size of the pool should be large enough to ensure diversification.

The creation of one or more public international investment funds would reduce the need for capital controls, especially in countries that choose to accept foreign portfolio investment solely through the proposed fund. The proposed fund would also build the capacity of public and private institutional investors in developing countries to manage their own pension funds. Working together, developing country investors and public international funds could share the cost of investment information and collectively combat the lack of disclosure by domestic issuers in these emerging markets.

Governments must take the lead in laying the groundwork for a closed-end fund. The U.S. government has initiated other public-purpose market innovations, beginning with the Reconstruction Finance Corporation in the 1930s and culminating in the development of the secondary mortgage market in the 1970s. In today's globalized market, it makes sense to devise similar investment and development instruments on an international level.

Management of the proposed fund would be consistent with the charter of the World Bank Group, which facilitates private investment in developing countries and issues its own liabilities in global capital markets. The World Bank or its affiliate, the International Finance Corporation, could be encouraged to partner with governments and civil society organizations to ensure that needs are met for long-term investment and socially and environmentally sustainable development. Given the shifts in channels for international capital flows and their destabilizing impacts on the economies of emerging market countries, a review of current methods and programs for extending assistance to these countries is long overdue. Rather than blindly staying the course of financial liberalization, the U.S. government should promote a new role for public institutions in managing international financial flows and advancing sustainable development.

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