Research Report

Enhancing the Flow of Private Capital towards Low-income Countries

1. Background and Objectives

The first half of the 1990's saw a massive expansion of private capital flows to developing countries. Unfortunately, three problems emerged.
First, poorer countries continued to have limited access to sufficient, and sufficiently long-term private flows; this became more accentuated in recent years due to crises in emerging markets and increased risk aversion. Second, private flows to emerging markets became volatile and reversible, leading often to crises that were developmentally very costly. This second problem gave origin to discussions on the need to reform the international financial architecture. Thirdly, since the Asian crisis, capital flows to all developing countries fell significantly.

The research project therefore became increasingly relevant. Though policy efforts to encourage flows became increasingly necessary it became more difficult for them to be fully effective.

The broad objectives of this research project were to contribute both to knowledge, and provide policy suggestions that would help to: increase the level of private flows to poorer economies; reduce their volatility and reversibility; and a shift towards longer maturities.

A central project hypothesis was that imperfections and inefficiencies in international capital markets played an important role in explaining why capital flows were too concentrated and too reversible. Therefore, measures in the source countries could play an important and positive role in encouraging more and more stable flows to low income countries.

The specific project objectives were:

1. Examine how pension funds, fund managers and banks decide to invest and lend to developing countries.
2. Evaluate if and how best their decisions can be modified to help channel higher more stable and more long-term flows to poorer countries.
3. Monitor progress of the new financial architecture. A particular focus became monitoring proposals on a new Basle Banking Capital Accord.

2. Methods

The work on private flows combined a variety of methods: literature surveys, a very large programme of interviews systematised in Gottschalk (2003), a detailed study of bank regulations in several papers on Basle by Griffith-Jones et al, and interaction with regulators; gathering of empirical data and econometric work, resulting in two papers, by Valpy Fitzgerald, and detailed discussions with policy-makers and private sector actors.

The work on private flows within this project had important synergies and complementarities with a parallel UNWIDER project, on private capital flows to developing countries, which Stephany Griffith-Jones co-directed. Papers were written by senior academics (John Williamson, Helmut Reisen), market participants (e.g. Avinash Persaud, David Lubin), and senior developing country policy-makers. The papers for this project are available on http://www.wider.unu.edu/publications/publications.htm and a refereed Palgrave/Macmillan book.

The work on private flows in this project also provides important support to the related policy study that Valpy Fitzgerald is carrying out for DFID on Institutional Investment, Poor Countries and the Millennium Development Goals.

The project also carried out work on monitoring the financial architecture by writing papers on the subject, especially a detailed one by Griffith-Jones and Ocampo; Griffith-Jones organising a major conference on enhancing private flows and the new financial architecture with senior policy-makers from developed and developing countries; responding to queries by DFID on financial architecture, both with very brief notes (e.g. on compensatory financing facility at World Bank) and with longer papers (e.g. on developing country participation at the World Bank), and organising several private sector group meetings on specific aspects of the architecture.

3. Findings

A. Private Flows

The focus on the source countries was based on the hypothesis – robustly confirmed in one of our papers – see FitzGerald and Krolzig (2003) - that capital flows to developing countries are mostly explained by source country factors.

To fill knowledge gaps we interviewed many financial actors based in London, New York, Chicago and other US smaller financial centres to provide information and insights into lenders' and investors' behaviour towards developing countries, and identify new elements since the crises of the late 1990s.

Griffith-Jones (2002) shows that these new elements include structural factors that to a large extent explain why since the financial crises of the late 1990s capital flows (other than FDI) to developing countries have declined dramatically. An important factor in the case of bank lending is a gradual shift from cross-border lending to within countries lending, as banks cross the border by buying or establishing subsidiaries. This implies a sharp reduction in foreign capital flows and foreign savings going to developing countries. In the case of portfolio equity, lack of sufficient large companies to invest in (because these have been acquired by foreign investors or because small, poor economies typically do not have many companies considered large enough) is a structural constrain for such flows.

A further new element we detected concerns the decline of dedicated developing country funds, particularly African funds. These types of funds had a solid information base. This allows them to act more as contrarians and adopt a bottom-up approach in investment decisions. They have been replaced by global funds that invest in developing countries, but are more prone to herding.

Gottschalk (2003) reviewed the theoretical arguments the business literature provides in support of international portfolio diversification: risk reduction for a given level of return (due to the relatively low degree of correlation between assets from different countries) and the possibility of outperforming world markets given that the latter is less than efficient.

Project paper by Kimmis, Gottschalk, Armendariz and Griffith-Jones (2002) sets out empirical evidence showing that acquiring developing country assets can be very rewarding for international investors over the long-term. In the case of both equities and bonds asset returns of a number of emerging market countries have been higher than those of developed countries. As building a diversified international portfolio is important to reduce risks, we found empirical evidence showing that investment in developing assets helps reduce portfolio risk, because the correlation of asset returns between developed and emerging markets is significantly lower than that of asset returns within developed countries. Investors can therefore utilise increased investment in developing country assets to obtain an optimal risk / reward mix that will maximise their return for any given level of risk.

This research on the benefits of diversification by investing in equities and bonds of developing countries is complemented by the project's empirical research on similar benefits of diversification, obtained by bank lending to developing countries. A clear case exists for investing and lending to developing countries, based on diversification benefits.

Given potential advantages for investing in and lending to developing countries, the project then examines major factors inhibiting it. One key factor is information. For poor countries, particular problems are acute 'information failure' and lack of information that can be quantified. A policy recommendation is the increase in the flows of information on developing countries.

The decision-making process consists of different phases –asset allocation, security selection and risk management, comprising what we call the <u>financial investment cycle</u>. During the first two phases of the investment cycle, diversity in investment behaviour is more important. Diversity has positive implications for developing countries (and information can play an important role). However, in times of high uncertainty, lenders' and investors' behaviour converges not only within the same categories of financial players, but across different categories of players. This is a key factor behind financial crises in developing countries.

An important policy theme that consequently emerged in the project is the need to encourage diversity among financial actors, to diminish the natural tendency of financial markets towards pro-cyclicality and short-termism. Financial regulators need to encourage greater diversity of models used and the use of models that "see through the cycle" (Griffith-Jones 2002). Regulators should also encourage or mandate more long term assessment of fund managers (beyond the traditional 1-3 months); this would be particularly beneficial for developing countries, with higher long-term growth performance.

Given the sharp decline of private flows to all categories of developing countries, and the danger that this may, to an important extent, reflect structural changes, policies to enhance these flows are becoming increasingly relevant and urgent. Project research defined and studied key areas for encouraging flows: 1) development and expansion of public guarantees and collateralisation of loans, 2) use of tax incentives in source countries (for example for pension funds), to invest and lend to developing countries; such tax incentives could be tapered, so that they only increase for longer term investment: 3) socially responsible investment funds (which constitute a large part of institutional investors assets), could be encouraged towards channelling funds to developing countries to support pro-poor growth. The idea that it would be obligatory that a very small part of UK pension funds' total portfolio (e.g. 0.25%) should be invested in low-income countries needs to be evaluated. 4) Different actors in the decision-making chains should be provided with information on benefits of investing/lending to developing countries, especially in terms of diversification of risks (as well as of potentially higher long-term returns); developing countries may also require assistance in improving key information they regularly provide and to whom it should be channelled.

B. Monitoring the international Financial Architecture and Regulation (IFA)

The research findings on international financial architecture are both at a broad and at a very specific level. In the former, international financial stability and efficiency can be defined as a global public good. The current focus of discussions on IFA should be broadened to achieve two aims: 1) avoidance, as well as better management of currency and financial crises (the sole or main focus of recent discussions) and 2) the equally important (but rather neglected) objective of adequate capital flows to different categories of developing countries, especially to poor countries. The rationing of poor countries from private financing even during periods of booming capital flows, and the contraction of private financing to developing countries since the Asian crisis, makes the second objective urgent.

To fulfil these objectives, the international financial architecture must provide: a) appropriate transparency and regulation of international financial loan and capital markets, as well as mechanisms to encourage sufficient private flows when these are lacking; b) provision of sufficient international official liquidity in crisis conditions, c) accepted mechanisms for standstill and orderly debt workouts at the international level, and d) appropriate mechanisms for development finance.

Progress so far has suffered from serious problems. First, there has been no agreed international reform agenda. The United Nations 2002 Monterrey Conference on Financing for Development (to which this research project contributed in several ways) went some way to define such a full international agenda. Second, progress made has been uneven and asymmetrical in several key aspects. The focus of reforms has been largely on strengthening macroeconomic policies and financial regulation in developing countries --i.e., on the national component of the architecture--, while far less progress has been made on the international components. Another set of asymmetries relates to the excessive focus of the reform effort on crisis prevention and management, mainly for middle-income countries. This may have led to neglect the equally --if not more important-- issues of appropriate official liquidity and development finance for low-income countries. Third, some advances in the international financial architecture run the risk of reversal. Fourth, the reform process has been characterised by an insufficient representation and voice of developing countries in key institutions –such as the IMF, the World Bank and the Bank for International Settlements—and their exclusion from others --the Financial Stability Forum and the G-10 Basle Banking Committee.

An area where there has been much activity is the development of codes and standards in capital recipient countries. Nonetheless, institutional, legislative and human resource constraints in implementing these policies have proven to be high, particularly for small and poor countries.

The creation of the Financial Stability Forum (FSF) was very positive. Nonetheless, this advance has been partial due to the lack of participation of developing economies the main body of the FSF.

In this research project, we have focussed a great deal on monitoring the proposed major changes to the Basle Capital Accord, as it could have a fairly large effect (unfortunately mainly negative) on international bank lending to developing countries. Based on this research, we have established a dialogue with the Basle Committee, DFID, the Bank of England, developing countries and the press, suggesting modifications that would make the new Capital Accord less negative for developing countries, especially low income ones.

Our first concern on Basle II relates to the risk that it will create greater pro-cyclicality of bank lending to developing countries, as well as of bank lending within countries (Griffith-Jones and Spratt 2001). The use of Market based risk sensitive measures to determine level of banks' capital as proposed in Basle II has several advantages but it is inherently pro-cyclical; during an upturn average probability of default falls and incentives to lend increase; during a downturn, probability of default for the same portfolio grows, and a credit crunch develops. Developing countries will be particularly badly hit. Furthermore, if downturns turn into financial crises in developing countries, these are particularly damaging in terms of welfare, as so many people whose income may fall, are near or below the poverty line. The need for introducing explicit counter-cyclical measures, at the same time as Basle II is introduced is therefore seen as very important, from a development perspective; forward looking provisions are a valuable mechanism.

Our second concern is that as shown in recent detailed research (Griffith-Jones, Segoviano and Spratt 2002), the current Basle proposal would quite significantly overestimate the risk of international bank lending to developing countries; this would increase capital requirements excessively on such lending, leading to a sharp increase in the cost of bank borrowing by developing countries, as well as to an important fall in the supply of bank loans. This negative effect would be most strongly felt amongst the poorest countries. This is a particularly serious issue now, as recently bank lending to the developing world has already fallen sharply.

How do current Basle proposals overestimate risk of lending to developing countries? A major benefit of lending to developing countries is their relatively low correlation with mature markets. In our research, we have carefully tested this hypothesis empirically and found very strong evidence – for a variety of variables, and over a range of time periods – that correlation between developed and developing countries is significantly lower than correlation only amongst developed countries.

The clear implication of these empirical findings is that a bank's loan portfolio that is diversified between developed and developing countries has a lower level of risk, implying likely lower unexpected losses than one focussed exclusively on lending to developed economies. Given that capital requirements which Basel regulators determine should help banks cope with unexpected losses, it is extremely unfortunate that the current Basle proposals do not incorporate explicitly the benefits of international diversification. In this aspect, capital requirements will not clearly reflect risk, and thus will both incorrectly and unfairly penalise lending to developing countries. We have urged the Basle Committee to incorporate these international benefits of diversification into its next revision of Basle II. It is both particularly important and difficult, to defend the positions of developing countries in the Basle Capital Accord as they are not represented at all in the Basle Banking Committee.

Our research on IFA concludes that one of the best ways to support progress on an international financial reform that is more supportive of development and poverty reduction is to strengthen the voice of developing countries in that discussion. To do that, it is important not just to increase participation of developing countries in the key fora, and enhance their technical knowledge of increasingly complex issues.

4. Dissemination

Our project has been extremely active in terms of dissemination. Here we will focus only on main activities.

We have immediately posted our research findings on the GlobPov website; we also circulated them widely where relevant to policy-makers. We presented our results to the media, where our research has received a great deal of attention.

Griffith-Jones organised a major conference in London, with very senior policy-makers from developing and developed countries, as well as from IFIs on the subject of our research project. This conference was organised with the Commonwealth Secretariat, the World Bank, the IMF and the Commonwealth Business Council who provided ample core financing and intellectual input. The conference was attended among others, by many Central Bank Governors of Commonwealth countries, and senior officials from DFID. The proceedings (written by Griffith-Jones and Gottschalk) were a paper for the Commonwealth Finance Ministers meeting in September 2002. A book is being published.

The material from our project was an input into the preparation of the UN Financing for Development (FfD) conference and in the drafting of the Monterrey Consensus, Griffith-Jones and Gottschalk organised specific briefing events for FfD developing country delegates in London and Basle.

Our ongoing research was presented at two workshops which Griffith-Jones organised as co-director of a parallel UNWIDER project on private flows to developing countries, in which Fitzgerald also wrote a paper. This offered new possibilities for dissemination. Our research has also been presented in seminars at DFID and in our Private Sector Group meetings.

Project members have participated in numerous conferences, that have helped disseminate project results. Griffith-Jones was appointed to the advisory panel of the Initiative for Policy Dialogue, led by Joseph Stiglitz.

The research work on this project has also provided important inputs into the study and policy work that Fitzgerald is leading for DFID on institutions investment in poor countries.

A further dissemination activity will be carried out in May in London when project results will be presented at a special workshop in London of our expanded Private Sector Group.

List of publications

FitzGerald, V. and Krolzig, D. (2003) 'Modelling the Demand for Emerging Markets Assets', mimeo, Oxford, January. To be published as QEH Working Paper

Gottschalk, R. (2003) 'How Do International Lenders and Investors Really Behave? What the Markets Tell Us We Didn't Know', mimeo, IDS, March. To be published as IDS Working Paper

Griffith-Jones, S. and Gottschalk, R. (2002) 'Enhancing Private Capital Flows to Developing Countries in the New International Context', report on a major Commonwealth Secretariat, World Bank and Commonwealth Business Council Conference, August. To be published in a book edited by the Commonwealth Secretariat.

Kimmis, J., Gottschalk, R., Armendariz, E. and Griffith-Jones, S. (2002) 'Making the Case for UK Pension Fund Investment in Developing Country Assets', mimeo, IDS, July. To be published as a Policy Briefing.

Griffith-Jones, S. (2003) Capital Flows to Developing Countries: Does the Emperor Have Clothes? Refereed published in a book by Palgrave/MacMillan.

Griffith-Jones, S., Spratt, S. (2002), 'The Pro-Cyclical Effects of the New Basel Accord', in New Challenges of Crisis Prevention, a chapter in a book by Fondad.

Griffith-Jones, S., Segoviano, M., and Spratt, S. (2003) Basle II and Developing Countries: Diversification and Portfolio Effects, a brief version has been published in Central Banking.

Griffith-Jones, S., Ocampo, J.A. (2002) What Progress on International Financial Reform? Why So Limited, refereed published by Swedish EGDI in a book.