<u>Highlight Summary</u>

ENHANCING THE FLOW OF PRIVATE CAPITAL TO LOW-INCOME COUNTRIES

To propose changes that can effectively alter lenders' and investors' behaviour in a way that leads to an increase in stable flows to developing countries, a research project led by IDS investigated how these actors operate and what factors and constraints are key in their lending and investment decisions. Moreover, it identified new elements since the financial crises of the late 1990s, to understand better why capital flows to all developing countries have fallen so dramatically. Also, the project monitored reform of the financial architecture, and studied policy proposals to encourage flows.

Through the use of a variety of methods that included literature surveys, a very large programme of interviews, detailed statistical and econometric work, and discussions with regulators, policy-makers and private sector actors, it emerged that:

- Important structural factors explain to a large extent why since the financial crises of the late 1990s capital flows (other than FDI) to developing countries have declined dramatically. These include a gradual shift from cross-border lending to within countries lending, the lack of sufficient large companies to invest in.

- The current Basle proposal may reinforce the declining trend in capital flows to developing countries, by overestimating the risk of international bank lending to developing countries. This would lead to a sharp increase in the cost of bank borrowing by developing countries, as well as to a fall in the supply of banks' loans. This would be most strongly felt amongst the poorest countries.

- To provide arguments in support of more capital flows to developing countries, the hypothesis that risks can be reduced through the inclusion of developing countries in international portfolio diversification was tested and confirmed for equity, bonds and bank lending. Based on these results, the project shows that, while the current share of investors' assets in developing countries is two to three percent, there is an economic justification for holding at least ten percent.

- Given the potential advantages for investing in, and lending to developing countries, the project then examined some of the major factors that inhibit such investment happening. One key factor is information. For poor countries, particular problems are acute 'information failure' and lack of information that can be quantified.

- Another key finding is that diversity in investment behaviour has positive implications for developing countries. Thus, an important theme that emerged is the need to encourage diversity among financial actors, so as to diminish the natural tendency of financial markets towards pro-cyclicality and short termism.

Given the sharp decline in private flows to all categories of developing countries, policies to enhance these flows are becoming increasingly relevant and urgent. The project research defined key areas for encouraging flows in source countries:

- Developing and expansion of public guarantees and collaterisation of loans.

- Use of tax incentives in source countries, to invest and lend to developing countries.

- Socially responsible investment funds could be encouraged towards channelling funds to developing countries to support pro-poor growth; education and better systematic information on developing countries could play a key role in this.

- 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).

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Sources

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Key words

Private capital flows; volatility; investors' behaviour; diversification; financial crises; herding.

Geographic focus

Developed countries; developing countries; poor countries.

Funded by

UK Department for International Development (DFID), 2001-2003