

International Capital and Economic Development : New Patterns in the Global Economy

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INTRODUCTION AND CONTEXT

The theme of this paper is the role of international banking and capital markets in the international capital transfer (ICT) process and their contribution to economic development. It is appropriate to focus on this issue at this time for three particular reasons:

- The world economy could be at the beginning of a major new phase of international development-capital flows which in turn could have a substantial impact on the evolution of the world economy. This is partly caused by, and will reinforce, potentially powerful changes in the balance of world economic power.

There are likely to be significant differences in four key areas in this new phase of the international capital transfer process compared with past periods of major international development capital flows: in the *geographical pattern* of capital flows; with respect to the *mechanisms* of channeling savings to investment, in the type of *contracts* involved, and with respect to the *status* of the borrowers.

Major new areas of investment opportu-

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nity are opening up following domestic economic and financial reforms in several capital-importing countries. Many regions of the world where economic development has been impeded by inefficient economic organisation have been dismantling the barriers that have impeded full economic potential from being realised. The common feature is that new areas of economic development need an inflow of capital in order to achieve full economic potential as the optimum level of investment exceeds the capacity to generate domestic savings. Overall it is possible that a new era is beginning where the economic potential of new parts of the world economy could be more effectively realised because past constraints are being removed.

The focus of this paper is on the role of international banking and capital markets in the flow of development capital. This will be referred to as the international capital transfer (ICT) process. Four particular dimensions of the ICT process need to be considered:

- The *geographical pattern* of flows of capital funds: where world savings are generated and where capital investments can profitably be made.
- The *mechanisms* used to channel savings into investment on a global basis, and in particular the relative role of banks and capital markets in the ICT process.

- The types of *contracts* involved: in particular the relative role of debt, equity, portfolio and direct investment contracts.
- The *status* of borrowers: in particular the relative role of private sector enterprises versus public sector agencies.

It will be argued that some mechanisms and contracts can be inappropriate and impede the process of economic development. For instance, while it was correct to identify Latin America as a major outlet for world savings in the 1970s, the mechanisms and contracts used (i.e. the role of banks with debt contracts) were inappropriate, and one of the causes of the region's economic adjustment problems during the 1980s.

The objective is to take a reflective look at the ICT process in the four dimensions identified. The analysis abstracts from unnecessary detail in an attempt to present an overview of likely trends over the remainder of this decade. A central theme is that substantial changes in global economic and political structures will lead to a new phase of the ICT process with significant differences compared with the past in each of the four dimensions: the geographical pattern, the mechanisms and contracts involved, and the agents. A broad sweep of history in these four dimensions is illustrated in Table 1. In many respects, the emerging patterns over the rest of this decade are more likely to be similar to those at the end of the 19th century than those of the 1970s and 1980s. In contrast to the pattern of the 1970s and

Table 1 : Patterns of Development Capital Flows

	Geographical Pattern	Mechanism	Contracts	Agent
1970s	OPEC to Latin America and Eastern Europe	Banks	Floating rate debt	Public sector
1980s	OECD to OECD	Capital market	Fixed rate debt	Public sector
1990s	OECD to Latin America, Eastern Europe, India, South East Asia, South Africa	Capital market	Equity and portfolio	Private sector

1980s, developments over the next decade are likely to involve capital flowing to existing- and newly-emerging markets, are likely to be through portfolio flows and capital markets, and are likely to involve equity rather than debt contracts. As was the case at the end of the 19th century, banks are likely to play a comparatively small role in cross-border international development capital flows. During the 1970s, banks were dominant in the ICT process although in the course of history this is likely to prove to have been something of an aberration. Overall, the broad pattern that is likely to emerge will involve a relative decline in the role of banks and a relative growth in the role of markets in the ICT process, and with an emphasis on equity rather than debt contracts in the process.

Global Context

The analysis begins with a consideration of the major pressures that are likely to influence the pattern and form of international capital transfers over the remainder of this decade: an identification of the major global pressures influencing the four dimensions of the ICT process. Six particularly powerful pressures are identified.

- A substantial shift in the balance of world economic power and in particular a shift in the centre of economic gravity from the north to the south and from the west to the east. In the process, major new areas of economic development and investment opportunities are opening up.

- A rehabilitation of Latin America after the dislocations of the 1980s which were due in part to inappropriate mechanisms and contracts in the ICT process in the 1970s. The experience of the 1970s demonstrates that, while international capital has the potential to accelerate economic development, it can also have a malign influence. However, after a decade during which they were largely excluded from international capital and banking markets, many countries in Latin America are now being rehabilitated and gaining new access to global capital.

- The general collapse of communism as a governing economic order has two particular dimensions: at the political level it removes substantial political barriers to inflows of private capital, and at the economic level the shift towards market-oriented economies creates more conducive conditions for an effective capital inflow. The substantial domestic reforms being undertaken in former communist countries, all of which move these economies in the direction of market-based systems, are likely to have a substantial impact on the ICT process.

- In some parts of the world, in particular in the Middle East and South Africa, political developments are creating more feasible conditions for international capital inflows.

- The dynamics of financial innovation will also have an impact on the ICT process. In particular, the further development of securitisation is likely to have a significant

impact on the *mechanisms* of capital flows.

- In addition, the current predicament banks in major industrialised countries such as to limit both their ability and willingness to play a major role in the ICT process over the next few years. In addition, banks have learned powerful lessons from the errors made during the 1970s. It is unlikely, therefore, that banks will play the role in the ICT process in the 1990s that they had during the 1970s. It will be argued that this is an entirely appropriate development.

Summary and Conclusions

The conclusions of the analysis may be briefly summarised as follows:

- Substantial changes in the geographic pattern of the supply and demand for world capital will emerge over the remainder of this decade. In particular, five areas are likely to emerge as major absorbers of global capital: what might be termed *existing emergent states* such as South East Asia and the Pacific Basin; *rehabilitated debtors* such as the countries of Latin America which were the heavy borrowers during the 1970s; *transition economies* (such as Russia and the countries of Eastern Europe) which are in the process of transition from rigidly centrally planned regimes to market-oriented economies; *new emergent states* (such as China and the Indian Subcontinent) which, as a result of substantial programmes of domestic reforms, could become new absorbers of capital in the same way as the countries of South East Asia have already become; and *political reform states* (such as countries in the Middle East and also South Africa) where political developments are creating a more conducive environment for capital inflows.
- The common feature of each of these five groups is that economic potential has been impeded by either economic or political structures which are now in the process of reform, and by a limitation

the volume of capital inflows to supplement domestic savings as a source of financing investment.

- A second common characteristic is that countries in these groups require both access to international capital (because the potential rate of return on capital is such that the optimum level of capital formation exceeds the countries' ability to generate domestic savings) combined with measures to increase the efficiency of domestic financial systems in order to establish an efficient allocation of capital.
- A third common characteristic of these potentially large absorbers of global capital is that further substantial and challenging reforms need to be made to domestic economic and financial arrangements (including fundamental reforms of the financial system) if international capital inflows are to be absorbed efficiently. Such reforms would simultaneously contribute to: (i) a capital reflow (i.e. a reversal of previous capital flight), (ii) new capital inflows, (iii) an increase in the domestic savings rate to increase the domestic supply of savings, and (iv) an increase in the efficiency of the domestic financial system so that a given volume of savings (domestically generated and imported) can be more efficiently allocated to productive investment. There is an evident requirement for further domestic economic and financial reform in many countries in the five potentially major capital-absorbing groups, and all need to shift yet further towards more market-oriented economies and financial systems. Although an inflow of international capital is desirable, it is not an alternative to domestic reforms which will simultaneously increase the domestic supply of savings and greater efficiency in their allocation.
- With respect to arrangements for the ICT process, the 1970s was, in retrospect, a big mistake. The picture of the 1970s is that banks were the predominant mechanism, debt was the main contract of the capital flows (especially on a floating interest rate basis), and public sector agen-

cies were the dominant borrowers. The ICT process as it occurred during the 1970s was seriously flawed in four major respects: the flows gravitated to governments rather than projects; borrowing countries were excessively dependent upon a single source of finance (i.e. banks); the contracts were seriously flawed, and excessive lending subsequently created major balance sheet problems for banks and a potential systemic hazard. Overall, the mechanisms of the ICT process during the 1970s created problems both for banks and for borrowers. As a result, many countries, most especially in Latin America and Eastern Europe, were effectively locked out of international capital markets for much of the 1980s.

- The mechanisms of the ICT process over the 1990s are likely to change compared with the 1970s and 1980s: in particular, there is likely to be a shift from banks towards the capital market (implying a relative decline in the role of banks and an increase in the role of markets in development finance flows), and an increased role in the ICT process for institutional investors (such as pension funds, insurance companies and mutual funds) in developed financial systems. Much of the investment through markets is likely to be undertaken by institutional investors.
- With respect to contracts, there is likely to be a shift from debt to equity contracts as portfolio investment flows are likely to become a more important source of development finance.
- It is also likely that, partly as a result of domestic reforms and privatisations, private sector borrowers will become more dominant than governments; the agents of borrowing are likely to shift from the public to the private sector.

CASE STUDY OF THE 1970s

The overall picture of the 1970s with respect to the ICT process was that the size of international imbalances increased substantially, surpluses were with OPEC and deficits with developing countries (most especially a small number of developing countries in Latin America), the mechanism of the capital transfer was through banks, the contracts were predominantly floating interest rate debt, and the borrowing agents were predominantly governments. The 1970s was an exceptional decade with respect to the role of banks and the form of contracts: in particular, it was characterised by there being no secondary markets in the form in which borrowings were made. Banks expanded their international intermediation role substantially during the 1970s: they borrowed predominantly from OPEC countries and made massive sovereign loans, most especially to countries in Latin America and Eastern Europe.

The outcome is now well known: banks over-expanded, they under-estimated risks, and competitive pressures induced them to under-price the risks they believed they were taking. During the 1980s, the pattern of international financial imbalances shifted towards industrial countries which were intermediated by capital markets. In effect, two structural shifts occurred in the 1980s: in the geographical structure of financial surpluses and deficits and in the way they were intermediated. Substantial problems emerged as a result of the over-lending by banks during the 1970s: several countries (most especially in Latin America) encountered serious debt-servicing problems during the 1980s, systemic risks emerged with the banking system in many countries becoming vulnerable due to the banks' exposure to a relatively small number of countries which were encountering debt-servicing difficulties, it induced inappropriate domestic policies by the borrowing countries, and the borrowers were effectively locked out of the international capital market for much of the 1980s. As a result of all of this, both banks and borrowing countries were required to make a series of painful

adjustments during the 1980s.

Four particular features of the ICT process during the 1970s made the international financial system simultaneously both crisis prone and subject to potential systemic hazards. Firstly, there was a bias towards non-specific general balance of payments sovereign lending rather than project-based lending. This meant that the debt servicing of the private sector was frequently pushed to the back of the queue if a country overall encountered difficulty in meeting its foreign currency liabilities. This, in effect, increased the relative risk of private sector projects as far as the lender was concerned. In addition, risk was effectively shifted only in terms of the performance of the country overall rather than individual projects. It also meant that the lenders had no effective role in the selection of projects to be undertaken. As a result of this, governments were able to pursue inappropriate policies because both foreign currency and budgetary constraints were removed: as a result, exchange rates were frequently over-valued, and budget deficits rose substantially. At the same time, necessary economic reforms were delayed. There was, therefore, a powerful moral hazard in banks making substantial funds available directly to governments rather than for the financing of projects. As a result of the inappropriate policies being pursued, and the failure to make necessary domestic reforms, a substantial capital flight occurred from many of the highly indebted countries of Latin America. This outflow of capital that occurred in the late 70s and early 80s, combined with the sharp cutback in lending by banks, reduced the supply of available financial resources for economic development.

A second set of problems relates specifically to the role of banks in the ICT process. It implied that international risks were concentrated on a comparatively small proportion of the capital base of the global financial system. Because of this, risks were not efficiently spread. There also emerged certain systemic dangers because of the dominant role of banks in the process. In addition, because borrowing was concentrated

on a homogeneous set of institutions, the sources of development finance were not efficiently diversified which, in turn, created a 'feast to famine' problem: substantial lending during the 1970s and a virtual cessation during the 1980s. Borrowing countries were excessively dependent upon a single source of finance and homogeneous set of institutions all of which were likely to behave, and respond to shocks, in a similar way.

A third general problem is that the contracts offered by banks were in practice seriously flawed. Basing the ICT process on floating interest rate debt contracts created a perverse debt servicing obligation. If interest rates were to rise in the United States (as they did in the late 1970s and early 80s) this would necessarily increase the debt servicing obligations of borrowing countries at a time when they were least able to generate foreign currency to make debt servicing payments. In effect, there was no effective risk transfer or risk sharing between borrowers and lenders: all of the risk was placed on the borrower except in the event of default. It was inappropriate for economic development to be based so heavily upon debt contracts. At the same time, the nature of the contracts meant that there was no secondary market for the continuous pricing of risks and this in turn implied the loss of valuable market information.

Fourthly, a major hazard emerged in that the substantial sovereign lending of banks during the 1970s led to subsequent balance sheet problems in the 1980s. At one time a fear emerged that hazardous banking crises could emerge in several countries because of the excessive exposure of banks to a relatively small number of developing countries (most especially four major borrowers in Latin America).

Overall, the weakness of the ICT arrangements of the 1970s was that the borrowing countries were not efficiently diversified in terms of the structure of their liabilities and the nature and terms of the contracts; they became too dependent on a single source

Table 2 : Rate of Growth of International Bank Lending

	1974-81	1982-91
To developing countries	28%	3%
To developed countries	22%	17%
Total	22%	11%

of funding; and in particular the contracts were seriously flawed. There was also an evident moral hazard with borrowing being undertaken predominantly by governments and, largely because of this, inappropriate macroeconomic policies were pursued. It cannot, therefore, be claimed that the arrangements for the international transfer of capital during the 1970s were entirely satisfactory and the 1980s was a decade of problems both for banks and the borrowing countries.

RECENT TRENDS

To set the context for a consideration of future trends in the ICT process, a brief review is made of some salient recent trends in so far as they are relevant to the central themes of the paper. In particular, the concentration is on development capital flows (excluding inter-governmental flows and flows through international development agencies such as the World Bank) and no reference is made to the substantial volume of arbitrage and speculative capital movements that have dominated international markets in recent years.

Some of the more significant trends of recent years may be summarised as follows

- A sharp decline in the pace of international bank lending: in the period 1974-8 the average annual rate of growth of bank lending was 22% which was reduced to 11% in the period 1982-91 (Table 2).
- Table 2 also indicates substantial change in the geographical pattern of bank lending with a particularly sharp decline in the

Table 3 : Capital Flows To (+) and From (-) OECD

(\$ million)

	1975-79	1980-84	1985-90
Portfolio Flows	+4.8	+11.6	-2.4
Direct Investment	-15.7	-5.4	-40.4

rate of bank lending to developing countries. Thus while the overall pace of international bank lending decelerated sharply, that to developing countries collapsed in the 1980s. This is even more the case if reference is made to 'voluntary' lending as opposed to new flows as part of debt-rescheduling operations. In fact, the countries which were substantial net borrowers during the 1970s became net suppliers of funds to the international banking sector for much of the 1980s due to a combination of capital flight and debt service payments (interest and principal) exceeding the volume of new loans.

- Capital flight from many heavily-indebted countries has been reversed in the 1990s.
- There has been a significant shift towards securitised capital flows: as a proportion of the total funds raised from international bank loans and bond issues, the share of the securities market rose from 23% (1974-81) to 42% (1982-91).
- Since the mid-1980s, equity flows have risen as a proportion of total international capital flows. There has been a sustained increase in net equity outflows from the OECD area since the mid 1980s. Table 3 also indicates a sharp rise in net external direct investment flows from OECD countries after 1985. Overall, the proportion of total capital flows represented by portfolio, equity and direct investment has risen since the mid 1980s.
- Within the total, a large proportion of equity flows in the early 1990s has been towards emerging growth economies: in the period 1990-92, about 25% of new investment flows went to Latin America and South East Asian stock markets.
- Overall, global portfolio flows rose from

15% of total cross-border flows in the period 1975-79 to 75% in 1991: equity flows accounted for 5% in the late 1970s but 75% in 1991.

There has, therefore, already been a discernible shift in the pattern of global capital flows: from banks towards capital markets, from debt to equity contracts, towards new stock markets, and towards emerging and developing markets. At the same time, there has been a shift from public towards private sector borrowers.

An earlier section identified six general pressures which are likely to influence the ICT process over the remainder of this decade and beyond: changes in the balance of world economic power, the rehabilitation of Latin American debtors, the collapse of communism, financial innovation in capital markets, political developments in some countries, and the future constraints likely to be faced by banks. Consideration is now given to the first four.

The Balance of Global Economic Power

Changes in the balance of economic power in the world economy have powerful implications for the pattern of international capital flows. Three immediate observations are made:

- more countries than ever are likely to be industrialising over the next twenty years;
- this could mean that the world economy could have one of the biggest booms in history in the next twenty years; and
- major changes are likely in the balance of world economic power and in particular a shift from mature economies.

Overall, the balance of world economic power seems to be shifting away from the

west and towards the east and south.

Over the next two decades the number of countries achieving over 3 per cent real income growth could more than double. It is possible for real incomes to double by the year 2013 in those countries which now account for 70 per cent of the world's population and yet only 44 per cent of world output. If the countries of Eastern Europe and Russia are added, these numbers rise to 75 per cent and 50 per cent. On the face of it, these figures may seem exaggerated. However, six countries (China, India, the former Soviet Union, Indonesia, Brazil and Mexico) account for over half the world's population and a quarter of its GNP. Every one of them is likely to exceed 3.5 per cent annual real income growth over the next two decades. It is a simple question of arithmetic that fast growth by big economies, such as China, India and Indonesia, means that their economic importance increases at a substantial rate. Between now and the year 2013, for instance, China's share in world GDP could more than double from 7.5 per cent to 16 per cent and that of Asia rise from 20 per cent to 36 per cent. Meanwhile, the OECD share could fall from 55 per cent to 35 per cent. The change even from one year to another can be appreciable: for instance, between 1990 and 1992 China's share in world GDP rose from 6.25 per cent to 7.5 per cent, and Asia's from 18 per cent to 20 per cent.

Thus by the year 2040 it is likely that more than 50 per cent of world GDP will be produced in the Pacific Rim which compares with a figure of 35 per cent now. However, within this area there will also be substantial structural changes: the relative dominance of Japan is likely to decrease while that of China, Hong Kong and the Taiwan axis will increase. Overall, therefore, we are likely to experience a relative economic decline of the OECD area.

Several factors lie behind these projected trends: the application of new technology in emerging economies, their generally cheap labour costs, a substantial programme of market and industrial reform, and the fact

that the debt problem has eased in many previously highly-indebted economies. At the same time, the trend towards privatisation of large parts of the industrial and commercial base, and substantial measures of economic deregulation, will contribute substantially to economic development. With respect to the last mentioned, for instance, after years of burdensome hurdles, India is now opening up and Western firms are entering on a significant scale.

The general theme is that many new parts of the world economy will see their latent economic potential more fully realised within the next 20 years once economic and political impediments have been removed. Although this potential has always existed, it has not been exploited because of inappropriate economic and political structures. These countries include many in Latin America, Eastern Europe, South East Asia and also South Africa. The common theme is that there have been economic, structural and political impediments to the inflow of foreign capital. This is obviously the case for countries in Eastern Europe but it also applies to South Africa. South Africa has substantial economic potential: it has valuable and abundant resources; it is a big market and, as such, attractive for foreign investors; it has efficient and well-developed infrastructure; it has an efficient and well-regulated financial system and it has a vast pool of labour and skills often not abundant in other African economies. South Africa also has a potentially powerful entrepot or 'spring-board' role in the development of other African countries:

- its financial system has the potential to act as an 'entrepot' financial centre for the African continent; and
- it could prove to be an attractive destination for foreign capital as a means of access to other African countries.

While the current uncertainties are not underestimated, the political will towards reform is undoubted and this in itself could open up a major new area of relevance to the ICT process. However, its growth potential has been impeded by a lack of for-

ign investment associated with the policy of economic sanctions. As South Africa becomes more integrated with the world economy it is likely that it will be a net recipient of substantial direct investment and portfolio capital inflows after the 'sanctions years' during which there were frequently net capital outflows. South Africa represents an example of substantial economic potential with the capacity to utilise capital inflows but whose economic potential has been impeded by a lack of international capital inflows due to political considerations. This is likely to change in the years ahead and the country could become a major capital importer not only because of its own economic potential but because it has the potential to act as a 'spring board' for other parts of the African continent.

As it is generally the case that rapidly industrialising countries do not have current account surpluses, the changes identified in the balance of world economic power have major implications for the pattern of international capital flows. It is likely, therefore, that the geographical pattern of international transfers will come to reflect changes in the balance of world economic power. In particular, five broad categories of countries could emerge as major recipients of international capital:

- what might be termed *existing emergent states* such as South East Asia and the Pacific Basin;
- *rehabilitated debtors* such as the major debtor countries of Latin America;
- *transitional economies* such as those of Eastern Europe and Russia (these are economies in a transitional phase from rigid centrally planned organisation to more market oriented economies);
- *new emergent states* such as China and the Indian subcontinent; and
- what might be termed *political change states* which could include countries of the Middle East and South Africa.

This last group of countries are identified where there is likely to be greater political

stability and acceptability over the next twenty years which in turn will make for a more conducive environment for foreign capital inflows. The common feature of these five groups (most especially the last four) is that economic and political reforms will simultaneously accelerate their economic development and make for a more conducive environment for the capital inflows that are a prerequisite for their economies' future economic development. As has already become evident in some countries, once the impediments to economic development have been removed, they are likely to become major recipients of international capital flows and a virtuous circle can be created.

In order to illustrate the thesis, consideration is given to two of the groups: the rehabilitation of Latin America and developments in Eastern Europe and Russia.

Rehabilitation of Latin America

The substantial build-up of debt during the 1970s, which resulted from the substantial borrowing from banks during that decade created major problems for Latin American countries. These led to their virtual exclusion from voluntary borrowing in the international capital markets during the 1980s. In effect, the excesses of the 1970s created a shortage of finance during the 1980s. The excessive borrowing from banks on the basis of floating-rate debt contracts created several problems: it undermined governments' anti-inflation policies, it led to inappropriate macroeconomic policies because it removed both budget and foreign exchange constraints, and much of the borrowing was used to finance consumption rather than investment expenditure. The problem culminated in the debt crisis of the early 1980s when debt-servicing obligations of the major debtor countries of Latin America exceeded their ability to finance debt commitments. This in turn forced governments to make substantial adjustments to macroeconomic policies (which in the short run created recession, increased unemployment and lowered real wages) and to introduce major programmes of domestic

economic and financial reform.

However, Latin America has now returned as a significant borrower in the international capital markets. In the first six months of 1993, for instance, Latin American countries raised close on \$11 billion in foreign bond issues. Equity flows are also beginning to move into Latin America and in 1992 a total of \$5.6 billion was raised in this way, compared with less than \$440 million in 1989. Although Latin America has re-emerged as a borrower, the flows are not being conducted predominantly through banks but through the capital market, equity investments and foreign subscription to privatisation issues in these countries.

There are several reasons why Latin America has been able to re-emerge as a borrower in the international markets and these contain lessons for other potential capital absorbers. Firstly, as a result of substantial domestic stabilisation programmes, the economic performance of debtor countries has improved substantially since the late 1980s. In particular the rate of inflation has been reduced substantially. Partly as a result of this, capital flight (which was substantial at times during the 1980s) has been reversed and the domestic savings ratio has risen. A second factor is that, as a result of these measures and the improved economic performance, together with substantial debt-rescheduling operations, the external debt problem of Latin American countries has eased substantially since the late 1980s, and is now of manageable proportions. Thirdly, many governments have embarked upon major domestic reform measures which include a shift towards more market-oriented economies, substantial programmes of privatisation of state-dominated industries, and a general policy of deregulation of economic and financial markets. Fourthly, and as part of these programmes, the economies have generally been opened-up to foreign investment. In addition, there has been a significant development of domestic equity markets which makes it more feasible for foreign capital to move into equity investments. Finally, the easing of exchange con-

trol and the greater commitment to free trade has removed some of the inhibitions to foreign investment in Latin American economies. The power of this has been put by the Managing Director of the International Monetary Fund: "The Jury is no longer out on this issue: the verdict is clear - the more open economies have been the most successful". In general, competition from overseas is a major impetus to efficiency.

Overall, the recent experience of Latin America demonstrates a conclusion noted earlier: that market-oriented domestic economic reforms and credible stabilisation policies lead simultaneously to an increase in domestic savings, the reversal of capital flight, the inflow of new capital from overseas, and an increase in the efficiency of domestic financial systems. The net result is that the first three increase the overall volume of savings resources for the finance of productive investment, while the fourth leads to an increase in the efficiency with which savings are allocated within the economy. The benefit of such reforms, therefore, lies both in an increase in the availability of savings (both domestic and foreign) and an increase in the efficiency in their allocation. Both are important ingredients of viable strategies for economic development.

The Transitional Economies

The collapse of Communism was identified as one of the major factors influencing the future pattern of international capital movements. This has both an economic and political dimension to the ICT process.

The economic development of Russia and the countries of Eastern Europe has been substantially impeded by a combination of grossly inefficient forms of economic organisation (based on rigid central planning), a low level of capital accumulation, an inefficient financial system which did not allocate capital resources on the basis of risk/reward criteria, and the absence of capital inflows. In addition, the savings that

were generated were not allocated efficiently. Russia in particular has enormous latent potential based upon vast economic resources, a huge potential consumer market, and an educated work-force. Several features of the economic regime of many countries in Eastern Europe have combined to inhibit economic development:

- central planning arrangements were rigid and in many cases produced an arbitrary allocation of resources,
- the inefficiency of the financial system both reduced the level of domestic savings and also meant that the savings that did take place were allocated inefficiently,
- the absence of independent financial institutions based on market principles meant that financial systems made little, if any, independent contribution to economic development,
- the automatic 'bail-outs' of state enterprises and the absence of bankruptcy principles meant that there was no clearly-defined concept of risk in the allocation of funds and therefore that savings were not allocated on standard risk/reward criteria,
- the absence of freely-determined interest rates also impeded the internal allocation of financial resources, the absence of clearly-defined property rights impeded the development of secondary markets, the general absence of discipline on the users of financial resources meant that there were very weak incentives to increase efficiency, the lack of competition had the same effect, and overall, the limited role of prices and markets in the allocation of resources meant that resources were not allocated to their maximum efficiency.

In these rigidly centrally planned economies finance was regarded as part of the national economic plan and of the overall budgetary process.

As a consequence of all this, the countries

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of Eastern Europe have not been substantial recipients of international capital. This has been partly because inflows were resisted by the political authorities but also because, given the absence of private ownership and markets, there was no obvious mechanism through which private capital could be injected into enterprises. Weaknesses in the economy, and political inhibitions to dealing with communist countries, also impeded an inflow of capital for development purposes.

This environment has been radically changed as a result of the general collapse of Communist regimes in the late '80s and early '90s. The significance of this for international capital movements should not be underestimated. Firstly, it has resulted in a substantial increase in the number of market-oriented economies in the world and, given their economic potential, the development of markets and private firms is likely to increase the supply of international capital to the transitional economies. Secondly, changes in political regimes have removed political inhibitions to capital inflows. Thirdly, the economic potential of these countries has substantially widened global investment opportunities. Many of the countries of Eastern Europe (and Russia itself) have substantial economic potential which has been impeded by inappropriate and inefficient economic and political structures. This group of countries could now be set for a catching-up process. As is the case with many countries whose economic potential has not been realised, the optimum level of investment exceeds the available supply of domestic savings and the gap can be filled only by net capital inflows. However, although the countries of Eastern Europe have embarked upon major economic and financial reform programmes, much still needs to be done. It is necessary to create the conditions both for generating capital inflows but also for creating mechanisms to allocate savings more efficiently within the economic system.

Emphasis needs to be given to the twin requirements of economic and financial reform: neither will be effective without the

other. Thus, for financial resources to be allocated efficiently there needs to be economic reform so that prices reflect true economic value, and signals emerge for the allocation of financial resources. Without this, there are no sensible criteria for the financial system to allocate financial resources amongst competing ends. However, if economic reform is made without financial reform (i.e. the financial system is not governed by market principles) again the financial system will not allocate funds efficiently. Above all, the countries of Eastern Europe need efficient market-oriented financial systems. Economic reform alone is not enough: if prices are efficiently determined an inefficient allocation of financial resources still emerges if the financial system is not governed by market criteria. Similarly, financial reform without economic reform still means that the financial system has no sensible way of allocating financial resources. In effect, economic and financial reform are two parts of the same process. An efficient financial system is important for several reasons. Firstly, it is itself an important industry and therefore its cost structure influences the economy generally. Secondly, the more efficient is the financial system the greater incentives there are for savings. Thirdly, a major requirement for an efficient financial system is that it allocates available capital in a way which maximises the risk-adjusted rate of return. Fourthly there is an important requirement for an efficient pricing and allocation of risk. Fifthly, it is necessary to impose financial discipline on the users of finance if financial resources are to be used efficiently and in a way that maximises the development potential of the economy. All this means that if the countries of Eastern Europe are to be significant absorbers of international capital, the resources need to be allocated efficiently which in turn requires an efficient and market-oriented financial system. Financial institutions and markets need to be governed by market principles.

There are several ingredients to the reform of financial systems in the transitional econo-

mies:

- The starting point must be the creation of adequate information, auditing and accountancy standards in a transparent manner.
- Incentives need to be created for the development of savings. This includes the development of efficient institutions and markets which are also free to set interest rates.
- Overall, there needs to be a set of markets and institutions which are able to respond freely to economic and financial signals efficiently created.
- It is necessary to give financial autonomy and responsibility to enterprises.
- Capital needs to be allocated via markets and market-oriented institutions rather than through the central budget, the central plan, or through inter-enterprise financial flows.
- As markets need to be able to set prices related to value and risk, interest rates need to be freely adjustable.
- Financial institutions themselves should be granted autonomy and operate in a competitive environment. Above all, lending institutions need to be able to refuse credit for projects they consider non-viable.
- Bankruptcy concepts and laws need to be established.
- Property rights need to be more clearly defined if secondary markets in ownership are to be developed as an integral part of an efficient financial system. Markets in property rights and ownership of enterprises need to be created. Efficient secondary markets play an important role in market-oriented financial systems; in general, the more efficient are secondary markets the more effective and efficient are the primary markets for the raising of new funds.

- In line with the development of secondary markets, mechanisms need to be developed for the redeployment of productive assets via mergers and take-overs of private enterprise companies.

There is a particular need for substantial reform of the banks in the countries of Eastern Europe: above all their balance sheets need to be restored. Without this, they will be substantially under-capitalised, a moral hazard will emerge with weak banks becoming the captive of bad customers as the banks will be induced to support bad loans and bad enterprises, and also a version of Gresham's Law may emerge: in effect, bad loans will crowd-out good loans. This is a substantial problem because the banks in many of the transitional economies have precariously weak balance sheet positions which can be strengthened only by action to remove bad debts from the balance sheet. The European Bank for Reconstruction and Development has estimated that 60 per cent of assets on the balance sheets of the largest East European banks may be virtually valueless. At the same time capital needs to be injected in order to raise the lending capacity of banks. In effect, a substantial recapitalisation of the banking systems of the transitional economies is needed. In addition, an efficient regulatory and supervisory regime is required. The overriding requirement is for the creation of a set of financial markets and institutions to perform the basic functions of a market-oriented financial system which

were previously undertaken via the budget and central plan.

The central imperative, therefore, is to create financial institutions and markets which are based on market-oriented principles which can increase the volume and efficient allocation of savings resources. Net capital inflows are an important part of the development process, but without an efficient domestic financial system full economic potential will not be achieved. It is necessary both to increase the available supply of financial resources and increase efficiency in their allocation. In this respect, capital inflows are not an alternative to measures designed to increase the efficiency of domestic financial arrangements.

Financial Innovation and Securitisation

The issues discussed in previous sections relate to external factors influencing the ICT process. Equally powerful, however, are the internal dynamics of markets and institutions and in particular the role of financial innovation. The pattern and mechanisms of financial intermediation flows are determined both by the preferences of the ultimate suppliers and demanders of funds (the mechanisms, instruments, and contracts chosen), and the relative efficiency of different and alternative mechanisms. The process of financial innovation increases the efficiency of financial intermediation by

creating new markets, new instruments, and by increasing the number and variety of alternative instruments and contracts available. Some forms of financial innovation also enable transactors to price and shift risk more efficiently.

The pace of financial innovation has accelerated markedly, most especially in money and capital markets. This has resulted in an increase in the efficiency of markets relative to institutions partly because markets now offer a wider range of alternative instruments. A major issue in financial intermediation and the ICT process is the relative role of institutions and markets. A particular example of the impact of financial innovation is the shift towards securitisation in both domestic and international financial systems.

In many countries banks have been losing some of their traditional advantages vis a vis the capital market, most especially for corporate sector business (see Table 4). For instance, in the United States bank lending as a proportion of funds raised in credit markets by companies declined from 49 per cent in 1980 to less than 17 per cent by the end of the decade. At the same time the process of securitisation of bank assets has progressed substantially. In this respect, a distinction is made between *primary* and *secondary* securitisation. The former relates to the process of raising new finance by issuing securities on the capital markets, while secondary securitisation is the repackaging of existing bank loan assets into securities which are sold to market investors and removed from the balance sheet of the originating institution.

The growth of securitisation implies a potential decline in the demand for services traditionally provided by banks, especially for the corporate sector. Overall, the capital market has become a more formidable competitor to banks and this is likely to develop further in an increasing number of countries. A related hypothesis is that some of the banking business undertaken during the 1970s and 1980s (especially lending to developing countries and some lending

Table 4 : Percentage of Net Funds Raised by Non - Financial Companies

	1970		1980		1990	
	Banks	Others*	Banks	Others*	Banks	Others*
France	90	10	60	40	25	75
UK	95	5	80	20	20	80
USA	45	55	55	45	(-65)	(70)
Germany	100	0	95	5	80	20

* Bonds, shares and short term securities.

() Billions of US dollars.

business to the corporate sector) has proved to be unsustainable in the long run.

The pressures towards securitisation and the substitution of capital market finance for intermediation by banks are of two kinds: internal to banks and internal to the capital markets. To the extent that banking costs have risen and banks face a capital constraint, internal pressures have induced a switch at the margin by borrowers into securities markets. Increased competitive conditions also erode the potential for banks to cross-subsidise some of their on-balance sheet business including some components of lending to the corporate sector. Also, because of the increasing significance of capital in the development of banks' strategies, profitability rather than balance sheet size and growth has become a more central and strategic objective. In some countries, and following the substantial losses and deterioration in overall financial performance in the late 1980s and early 1990s, banks have become more risk-averse.

At the same time the impact of technology in reducing transactions and information costs, the emergence of rating agencies, new disclosure laws applicable to companies, and financial innovation widening the range of capital market options, all have the effect of increasing the relative efficiency of capital markets vis a vis banks. Factors internal to banks and the capital market have eroded some of the traditional comparative advantages of banks most especially with respect to business with the corporate sector. At the same time, *secondary* securitisation is sometimes motivated by a strategy of banks to alleviate capital constraints.

Overall, therefore, a general trend in national financial systems is likely to be a relative shift from institutions to markets in the channeling of funds from ultimate savers to ultimate investors (Table 4). It is likely, therefore, that this will also be the case with respect to the ICT process. This means that, most certainly compared with the experience of the 1970s, banks are likely to play a smaller role compared with

capital markets. Indeed, this is already evident in trends over the past few years. The relative decline in the role of banks compared with markets that is likely to occur at the international level is only part of a more general structural shift in the pattern of financial intermediation in national financial systems.

A VIEW OF THE FUTURE

At the outset, four dimensions of the ICT process were identified: the geographical pattern of flows, the mechanism of the flows, the contracts involved, and the borrowing agents. The pressures identified in earlier sections are likely to have a significant impact in each of these dimensions and will influence the nature and pattern of the ICT process for the remainder of this decade. It was suggested at the outset that a major new phase of international capital movements may be beginning. The paper concludes by a brief discussion of the likely future evolution of the ICT in the four dimensions identified.

Geographical Pattern of Flow

The likely geographical pattern of international capital movements will be substantially influenced by the changes in the balance of world economic power. Capital is generally attracted to strong-growth economies in two respects: capital is attracted by the potentially high rates of return that can be earned, and on the demand side high-growth economies frequently have optimum levels of investment which exceed the ability to generate internal savings. On both counts, world savings are likely to be attracted towards high-growth economies. The recovery of the economies of Latin America and the continued strong growth of Asian economies is already proving attractive to international investors. Financial flows to these countries have begun to accelerate and this is being accompanied by a shift away from a dependence on debt towards increased inflows of direct and portfolio

investment. Net capital flows to developing countries in general have risen substantially over the last couple of years and in 1992 alone reached 3.3 per cent of their GNP compared with an average of 2.3 per cent in the period 1985-89. Net capital flows less interest and dividend payments have moved even more substantially from being negative for most of the latter half of the 1980s, to positive flows of over \$50 billion or 1.5 per cent of GNP in 1992. There has been a substantial capital inflow into China since 1990.

As a result of changes in the balance of global economic power, and the various other considerations discussed in earlier sections, the likely pattern of international capital movements will be from the developed countries within the OECD area towards five major groups identified earlier as: *existing emergent states* (the South East Asia region and Pacific Basin in particular), the *rehabilitated debtors* (principally Latin America), *transitional economies* (Eastern Europe and Russia), *new emergent states* (such as China and the Indian subcontinent), and *politically reformed states* (such as countries in the Middle East and South Africa). The common feature is that countries in each of these groups have had their economic potential impeded because of domestic economic and political arrangements. The likelihood is that, as a result of various reform measures put in place, international capital inflows will increase and contribute towards realising economic potential more fully.

Mechanisms

A central issue in financial intermediation involves the *mechanism* of financial transfers and in particular the relative role of markets and institutions. The 1970s was a decade dominated by banks accepting deposits from OPEC and making loans to a small number of developing countries. For the future, the likelihood is that markets will become relatively more important than banks in the ICT process. However, at the same time, the role of investment institutions (such as pension funds, insurance

companies, and mutual funds) will also increase as a route for international capital movements.

There are several reasons why it is unlikely that banks will play a dominant role in the ICT process in the years to come. Firstly, the experience of the 1970s and the problems that this produced for the 1980s has left an enduring legacy and banks are unlikely to see international lending as a major part of their strategy. Secondly, banks are increasingly operating with a capital constraint which will limit the extent of overall balance sheet growth. Thirdly, the general weaknesses of bank contracts that were discussed earlier in the paper are now generally recognised, and that bank contracts are not always an efficient way of transferring development capital. Fourthly, there will be less official encouragement towards bank lending to developing countries compared with the 1970s. Finally, financial innovation has substantially increased the relative efficiency of the capital market.

Securitised lending has already increased sharply. Capital flows to developing countries in general have risen over the last three or four years, accompanied by a shift in emphasis away from debt towards direct and portfolio investment. Debt now provides only 40 per cent of total flows compared with well over half in the latter part of the 1980s. The make-up of debt financing has also changed with a move towards securitised lending (with secondary markets) and a smaller role for commercial banks as providers of external financing for developing countries. Latin America has been the major recipient of these higher investment inflows, attracted by the improved domestic investment environment and the more promising outlook for growth in the region. The private sector is now the main user of foreign savings and domestic investment is rising.

There has been a move towards securitised lending, implying a rise in debt instruments held by investors other than commercial banks. Bond finance rose to nearly \$8 billion in 1991, compared to an average of \$4

billion in the previous few years, and commercial bank loans of \$4 billion. Gross bond finance rose to \$14 billion in 1992, accounting for over 40 per cent of funds raised by developing countries in international markets. It is likely that this trend towards securitisation and the increased relative role of markets rather than institutions is likely to continue.

Contracts

The type of contracts involved in the ICT process are important not least because they determine the nature, form, and determinants of debt servicing obligations. The major distinction is that between debt and equity contracts. As already noted in the discussion of the 1970s, debt contracts can be a hazardous form for the ICT process. Indeed, it can be argued that the debt crisis that emerged in the early 1980s was largely due to the inappropriate contracts through which the ICT process was conducted during the 1970s. The type of contracts involved are closely related to the mechanisms of the ICT. It is also necessary to distinguish between debt financing with secondary markets as opposed to bank debt financing.

In general, there is likely to be a shift from debt towards equity, direct investment, and portfolio flows. There are several reasons why portfolio and equity flows (including major inflows into new and emerging stock markets in developing countries) will become more significant in the years ahead:

- the reduced role of banks means that the role of debt contracts is also likely to decline; the emergence of more private companies in capital-importing countries (and their good economic prospects) is likely to encourage more direct equity capital inflows;
- the privatisation programmes adopted by many developing countries are also increasing the feasibility of equity capital inflows;

- there has been a substantial development of stock markets in emerging countries and turnover is increasing;
- in many developing countries there has been a significant liberalisation of financial markets and in particular stock markets have been opened up to foreign investors. Overall, foreign access to stock markets and equity investments has been liberalised in a wide range of countries;
- in general, governments have adopted a more welcoming approach towards equity investment by foreigners;
- the easing of exchange control has reduced some of the impediments to investment institutions investing in emerging capital markets because they are more free to subsequently withdraw funds;
- the increased role of investment institutions is itself likely to induce a shift towards equity and portfolio investments as a means of financing;
- such institutions are also likely to develop internationally diversified strategies in the years ahead;
- the development of information and trading technology is also likely to increase the efficiency of trading and settlements procedures in new stock markets.

There has already been a shift from debt towards equity. Portfolio flows to developing countries, defined as investments in local stock and debt markets, are only just beginning, although have risen fast in the last couple of years, reaching \$27 billion in 1992. Over half of these flows have been going to Latin America, with a large proportion to Mexico. Between 1985 and 1989 debt provided over half of LDCs financing needs but by 1992 this was down to around 40 per cent. Equity finance, particularly direct foreign investment, has been growing strongly, accounting for almost 30 per cent of the total in 1992 after increasing by 50 per cent in just two years. When foreign investment in emerging stock markets is

included this source of capital now provides well over a third of all financing for developing countries. Global portfolio investment was less than 15 per cent of total cross border movements in the period 1975 to 1979, which rose to 35 per cent in 1991. Equity flows amounted to 35 per cent of the total in 1991 compared with 5 per cent in the late 1970s. One third of such flows were equity investments in new stock markets of Latin America and the Pacific rim.

The overall conclusion is that the significance of financial reform, privatisations and the development of stock markets as a factor influencing the pattern and contracts of international capital movements should not be underestimated. Already, there has been a significant rise in the number of investment funds specialising in emerging markets in the major financial centres within the industrialised world. For instance, there are now six specialist equity funds on India in the London market.

It is also likely that direct investment will become a major source of capital for many of the countries identified in this paper. Multinational companies are likely to relocate many of their operations and also to be purchasers of companies in high-growth economies of the world. Multinational companies now control about one third of world private productive assets. The annual growth of foreign direct investment averaged 13 per cent per annum over the past 20 years, although in the period since 1986 this growth has been close to 30 per cent per annum. There are many advantages for a capital importing country of direct investment: it contributes directly to the development of industry, the investment also includes skilled management of projects, there is often an important transfer of technology, there is usually no debt involved in the investment, and frequently the profits are reinvested in the company. Foreign direct investment can also be a major source of innovation for a capital importing country.

The overall conclusion, therefore, is that direct investment, portfolio and equity contracts are likely to become relatively more

important in the future as part of the ICT process.

Borrowing Agents

As a result of all of these trends (and in particular the declining role of the state in economic activity in many reforming countries) the public sector will be less important as an agent of borrowing while private sector companies are likely to become more important. This again contrasts with the experience of the 1970s. Overall, the private sector is becoming more important in potentially high-capital-importing countries. The economic reforms and privatisation strategies introduced by many potentially large capital-importing countries have made them attractive propositions for portfolio investors in capital exporting countries. In many cases, legal obstacles to foreign ownership and access to stock markets have been removed or eased.

CONCLUSIONS

An attempt has been made in this paper to establish the global context of the ICT process and to identify the pressures that will influence the geographical pattern, mechanisms, the contracts involved, and the borrowing agents. The overall conclusion is that there will be substantial changes in each of the four dimensions identified.

The main conclusion is that the early 1990s could be the beginning of a major new era of international development capital flows. However, it is likely to be different than in the most recent past. This reflects the changed balance of world economic power. In particular, new areas are likely to emerge as major capital importers, there will be an increased role of markets and decreased role of banks in the process, the contracts are more likely to be equity than debt, and the borrowers are more likely to be private sector than public sector. However, it is also likely that institutional investors will become major suppliers of capital.

A central theme has been that the economic potential of many parts of the world has hitherto been impeded by inappropriate political and economic structures. These impediments could be removed in the future although it has been emphasised that important domestic reforms still need to be made and developed if international capital is to be attracted and for this to contribute to economic development. In particular, a series of reform measures should simultaneously contribute to: increased domestic savings, the reversal of capital flight, new net inflows of capital, and an increase in the efficiency of domestic financial systems. Combined, these should both increase the availability of financial resources and increase efficiency in their allocation. In the final analysis, international capital and the tapping of foreign savings can never be an alternative to efficient domestic arrangements both within the economy generally and in the financial system in particular. ■

INTERNATIONAL STUDY VISIT

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