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To: Members of the Committee of the Whole for the Development Committee

From: The Secretary

Subject: Developing Country Access to Private Capital Flows

Attached for consideration by the Committee of the Whole is a paper, prepared jointly by the staffs of the Fund and the World Bank, on developing country access to private capital flows. Some issues for discussion appear on pages 1 and 2.

This subject has been tentatively scheduled for discussion by the Committee of the Whole on Monday, April 5, 1993.

Mr. Edo (ext. 38752) or Mr. Collyns (ext. 37359) is available to answer technical or factual questions relating to this paper prior to the Committee meeting.

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DEVELOPMENT COMMITTEE MEETING

May 1, 1993

Developing Country Access to Private Capital Flows

(Prepared jointly by the staffs of the
International Monetary Fund and the World Bank)

March 12, 1993

Developing Country Access to Private Capital Flows

The attached paper, which has been prepared jointly by the staffs of the Fund and the Bank, discusses policies which could promote private capital flows to developing countries. It underscores the importance of sustained implementation of appropriate macroeconomic policies and market reforms in developing countries, while emphasizing the need for industrial countries to increase savings, notably by reducing fiscal imbalances, so as to assure better availability of resources to markets generally and developing countries in particular. Drawing on the attached paper, this covering note suggests some issues for discussion by the Ministers.

Issues for Discussion

1. A stable and prudent macroeconomic regime and an open trading environment are important in attracting foreign direct investment (FDI). Furthermore, freedom to remit dividends and repatriate capital, well-structured legal and regulatory frameworks, nondistortionary and transparent tax regimes, and efficient administrative and institutional arrangements are desirable to promote FDI. Ministers may wish to suggest specific actions that they have found productive in facilitating FDI in developing countries.

2. International portfolio investors may be deterred from investing in emerging markets in developing countries by risks related to illiquidity, lack of investor protection, and the limited availability of information. While progress has been made in a number of countries to address such difficulties, developing countries need to persevere with financial reforms aimed at increasing market efficiency and transparency, consistent with their stage of economic development. Ministers may wish to discuss where they see the priorities in raising regulatory and institutional standards in developing countries into line with those prevailing internationally.

3. The regulatory authorities in several creditor countries have responded to the improved situation of a number of developing countries by revising provisioning standards against bank exposure to those countries. It may be appropriate for other creditor countries to review the provisioning framework to avoid the existence of impediments to new bank lending while maintaining appropriate prudential standards. Consideration could also be given to establishing a more graduated risk-weighting system under the Basle capital adequacy guidelines. Ministers may wish to discuss the scope for such revisions and what impact their implementation might have on commercial bank lending.

4. Developing country access to international securities markets may also be affected by regulatory policies and practices in industrial countries. Consideration may be given to reviewing regulatory provisions, including (i) quality restrictions applied to domestic markets; (ii) regulatory

guidance provided to institutional investors on holdings of foreign assets; and (iii) restrictions on private placements, particularly for investor groups that are relatively sophisticated, and other measures that may help facilitate entry into international markets for less established borrowers. Any revisions to regulatory standards would have to be sensitive to the need to protect the small investor and maintain necessary prudential standards. Ministers may wish to comment on where they see regulatory impediments on portfolio flows to developing countries and on the feasibility of instituting changes without jeopardizing prudential standards.

5. The international financial institutions' (IFIs) role in catalyzing private investment depends mainly on the importance that commercial lenders attach to such factors as the IFIs' knowledge and assessment of prospects for developing countries, the IFIs' capacity for project appraisal, and the degree of comfort that commercial banks may draw from cofinancing instruments (e.g., guarantees, sharing clauses, and lender-of-record arrangements). The effectiveness of such financing depends on its successful application to influence creditor perceptions of country risk in developing countries actively seeking to regain market access. Ministers may wish to express their views on the appropriateness and risks of current cofinancing and guarantee activities by the IFIs.

6. A number of developing countries are experiencing strong capital inflows which, besides implying a rapid build-up in external liabilities, can complicate economic management. In responding to these inflows, policy makers have a range of instruments available. At the macroeconomic level, the overall stance of fiscal and monetary policies should aim to increase domestic savings, thus reducing the attraction of foreign savings and containing inflationary pressures. This is most effectively achieved through fiscal adjustment, although there may be practical limits to fine-tuning. If a fundamental improvement in the efficiency of the traded goods sector of the economy has taken place, and improved market access is considered permanent in nature, a real appreciation of the exchange rate may be an equilibrating response. Direct controls to slow capital inflows are likely to be effective only temporarily (if at all) and may involve a cost by introducing distortions in the market. In practice, countries have faced difficult choices in balancing the trade-offs among these alternatives, especially given the uncertainties about the underlying causes and the permanence of the increased capital inflows. Ministers may wish to discuss the reasons for heavy capital inflows and the actions that developing countries may find appropriate in response.

7. The recent experience of private capital flows to developing countries has demonstrated the critical importance of the sustained implementation of appropriate macroeconomic and structural policies. Nevertheless, many countries in the low-income bracket--even those that have followed ambitious reform programs over a number of years--have not attracted substantial private flows, and the immediate prospects for such flows remains poor. Ministers may wish to comment on what, if anything, could realistically be done to improve these countries' access to private capital flows.

I. Introduction

This paper explores issues related to developing country access to private capital flows that were raised in the paper on "Resource Flows to Developing Countries," discussed at the September 1992 meeting of the Development Committee. 1/ The paper first reviews the experience of developing countries with private capital flows in recent years. It then considers policies in developing and industrial countries to facilitate such flows, including to countries that have yet to gain (or regain) market access. The paper also examines the role of international financial institutions in this connection. The last section of the paper discusses prospects for private capital flows to developing countries. 2/

II. Recent Experience

After declining sharply following the 1982 debt crisis, private capital flows to developing countries began a steady recovery in the late 1980s. 3/ Much of the recent increase in private capital flows has occurred through the international securities markets. Total bond issues in international markets by developing countries increased from an average of US$5 billion per year in 1987-90 to US$12 billion in 1991 and US$23 billion in 1992 (Table 1). Placements by developing country companies in international equity markets also grew rapidly, with funds raised by these companies increasing from US$1 billion in 1990 to US$5 billion in 1991 and US$7 billion in 1992 (Table 2). 4/ Although comprehensive statistics are not available, fragmentary information indicates that portfolio investment directly in local developing country markets--including short-term government paper as well as equity--also increased substantially during this period.

Recent portfolio flows have been concentrated in a small group of countries. Four Latin-American countries (Argentina, Brazil, Mexico, and Venezuela), which had lost market access in the aftermath of the debt crisis, accounted for over half of recorded portfolio flows to developing

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1/ The term "developing country" as used in this paper refers to all low- and middle-income countries according to the World Bank classification.

2/ For further information, see "Private Market Financing for Developing Countries," IMF, December 1992, and "Global Economic Prospects and the Developing Countries, 1993," World Bank, February 25, 1993 (SecM93-207).

3/ The Development Committee paper on "Resource Flows to Developing Countries" (August 1992) provides a broad perspective on external finance for developing countries, including information on official and concessional flows which are outside the scope of the present paper.

4/ Many of these placements have been in the form of depository receipts traded on industrial country stock exchanges.

countries in 1991-92. China, Hungary, Korea, and Turkey accounted for a substantial share of funds raised by Asian and European countries. Low-income countries outside Asia, lower middle-income countries with unresolved debt problems, and most Eastern European and FSU countries in the early stages of transition have had virtually no access to international securities markets.

Although comprehensive information is not available on the investor composition of portfolio investment to developing countries, market participants report that such flows have mainly come from a limited range of investors. In the early stages of the market re-entry process, the largest source of capital flows to Latin American countries was reported to be returning flight capital. Over time, an increased role has been played by global investment funds and individual investors (particularly in the United States) attracted by high yields. By contrast, mainstream institutional investors, such as pension funds and insurance companies, still place only a small fraction of their portfolios in developing country securities, mainly in the largest Asian markets.

Foreign direct investment (FDI) in developing countries has also increased sharply, from an average of US$17 billion (net) per year in 1987-90 to US$29 billion in 1991 and an estimated US$37 billion in 1992 (Table 3). While a wider range of countries has attracted such flows, the bulk of the increase has been directed toward Latin American market re-entrants as well as some Asian and European countries. Some economies in transition, notably the former Czechoslovakia and Hungary, that have made significant progress toward market reform, have begun to attract sizable FDI flows.

In contrast to portfolio and FDI flows, commercial bank lending to developing countries has remained largely stagnant in recent years. A large share of recent bank credit commitments is accounted for by Asian countries with good debt servicing records (Table 4). Bank lending to other developing countries, particularly those that had experienced or are experiencing debt serving difficulties, has been limited, mainly confined to short-term trade financing and project financing.

III. Policies in Developing Countries

A host country's policies are the main determinant of the amount and character of private capital flows that it receives. In this respect, consistent and stable macroeconomic policies are fundamental for establishing creditworthiness and fostering a private sector conducive to investment and attracting foreign capital. Particularly important are ensuring a sustainable growth of domestic demand, a low rate of inflation, and appropriate relative prices (including a realistic exchange rate and the avoidance of distortions). The recent experience of Latin America (e.g., Argentina and Mexico) suggests that markets can recognize and reward improvements in creditworthiness quickly. For a number of those countries, market-related restructuring of commercial bank debt has facilitated re-entry to international capital markets, while contributing to an environment in which strong policies were easier to sustain.

It is also important that the foreign exchange regime ensure ready access to foreign currency for imported inputs and freedom to remit dividends and profits and to repatriate capital. Foreign exchange controls remain, albeit to varying degrees, in a number of developing countries. Recent experience in Chile, Korea, and Pakistan has shown that the removal of such controls generates increased investor confidence and spurs investment inflows.

Appropriate macroeconomic policies and an open foreign exchange regime alone may not be sufficient for developing countries to sustain large private capital inflows. Equity flows in particular, whether portfolio or FDI, also depend on a healthy private sector which demands an adequate legal framework, transparent tax codes, and modern and cost-effective transportation and telecommunications. In Asian and Latin American economies, well-established corporate sectors and extensive privatization programs have provided attractive investment opportunities. 1/ By contrast, the lack of international investors' interest in some Eastern European and FSU economies has reflected in part the still rudimentary character of the corporate and financial sectors. In countries with a generally low level of economic development, private capital inflows have also been limited.

In a number of countries (e.g., Egypt, Hungary, and Venezuela), improved legal frameworks and investment codes have contributed to the growth of investment inflows. A clear definition of and protection for private property rights is particularly important. The recent guidelines on the legal treatment of FDI issued by the Development Committee 2/ advocate open admission policies, subject to certain clearly defined and permissible restrictions (e.g., national security); recommend national treatment (foreign and domestic investor to be treated equally as a general principle); and provide for the free transfer of profits, dividends, and interest payments, and for the repatriation of capital.

A clear and non-distortionary tax regime is an important consideration for foreign investment, whether portfolio or direct. The absence of a double taxation treaty increases the cost of foreign investment and thus deters foreign interest. A number of developing countries impose a capital gains tax that cannot be set off against source country liabilities, thus

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1/ It is estimated that roughly a quarter of total privatization proceeds, which amount to more than US$50 billion over the 1988-92 period, was financed by external capital flows, with the balance accounted for by debt/equity conversions and local financing.

2/ See the Development Committee paper, "Legal Framework for the Treatment of Foreign Investment," September 1992.

raising the cost to equity investors, particularly when the tax is not adjusted for inflation. Furthermore, the capital gains tax base is often not clearly defined and measured.

For foreign direct investment, weak institutions and obtrusive regulations discourage flows. Institutional problems are found in areas such as over-stringent bureaucracy and the involvement of too many institutions. In a number of countries (e.g., former Czechoslovakia, Mexico, and Thailand), the streamlining of inter-agency procedures and the creation of a single investment enabling agency have facilitated increased FDI, and similar arrangements could be considered elsewhere. In addition, inefficient regulatory structures for FDI often create distortions in the economy. Foreign interest can also be discouraged by high-cost public sector monopolies that raise the price of basic services, by limits on entry into certain sectors of the host economy, and by excessive restrictions on the freedom to employ expatriates. It is important for developing countries to sustain efforts to establish a transparent regulatory framework that is internationally competitive and does not discriminate between domestic and foreign investors.

International portfolio investors are concerned about the risks inherent in emerging market transactions, especially those related to high volatility in prices, low liquidity and poor information. These factors have sometimes led to swings in portfolio flows, even while the underlying macroeconomic situation has remained fundamentally sound, as demonstrated by experience in a number of Asian stock markets. Despite a tremendous growth in recent years, developing country stock markets remain relatively small (e.g., few listed firms, limited market capitalization, and low turnover), and prices volatile. Efforts should be made to encourage market development by removing tax biases against public share offerings; improving trading systems (in particular, through lower commissions and reduced barriers to entry); and enhancing the reliability of clearance and settlement procedures. It also needs to be emphasized that a basic prerequisite for the development of efficient capital markets is a sound and competitive banking system, including the avoidance of interest controls that keep the cost of local bank borrowing artificially low.

Further risks to international portfolio investors arise because securities laws and investor protection laws in developing countries generally fall short of internationally acceptable standards; they are often either rudimentary or not rigorously enforced. 1/ National regulators in developing countries need to enforce contracts more strictly and to establish credible policing of insider trading. It is also important to

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1/ A recent IFC study shows that out of the 22 emerging markets, only six countries--Brazil, Chile, India, Korea, Malaysia, and Mexico--have investor protection laws of internationally acceptable quality. A few emerging market countries do not even have an agency for regulating stock market activities. See IFC Emerging Markets Factbook 1992.

strengthen accounting and disclosure standards to ensure the quality of information available to investors. Prudential regulations in the form of capital adequacy requirements for securities firms and margin requirements on trading also need to be strengthened to safeguard the integrity of the markets.

Terms of entry and exit may also affect the inflow of portfolio capital. In recent years, several developing countries--notably Argentina, Brazil, Colombia, Korea, Malaysia, and Pakistan--have liberalized registration procedures, and foreign investors can purchase listed stocks freely, albeit sometimes subject to a ceiling. Liberalization has been followed by considerable inflows. For example, in Korea net inflows amounted to over US$2 billion in 1992. Nevertheless, in many countries important barriers to entry into and exit from emerging securities markets remain.

Developing country borrowers looking to raise project financing--which inevitably requires relatively long commitment periods--have been faced with particularly severe lender concerns with credit risk. In some instances, these concerns have been addressed through carefully structured financing operations involving safeguards such as the channeling of export receipts into escrow accounts for future debt service payments. Such mechanisms have facilitated funding for private borrowers. Their use in public projects, however, may raise issues regarding the subordination of other creditors and the flexible management of foreign exchange by the borrowing countries.

Against this background, some developing countries have shown growing interest in non-recourse project finance. Under this arrangement, investors and creditors have recourse only to the security of the project, not to general public assets, although such projects may carry additional assurances from the host government (e.g., an undertaking on pricing in the power sector). A particular non-traditional type of project finance is the so-called BOT (Build-Operate-Transfer) scheme, which has been implemented in infrastructure projects--often in connection with privatization of public entities--in a number of countries, including Malaysia, the Philippines, Turkey, and Venezuela. 1/ However, the small number of completed projects suggests that interested external creditors find it difficult to overcome the complexities of country risk (representing not only sovereign risk but also a variety of specific local factors). There is also a concern on the part of host countries that BOT projects might bias incentives against longer-term economic benefits by shortening the project horizon. Countries--especially those that face a heavy public sector debt service burden--may want to consider how this type of financing may be structured, with possible support from the international financial institutions, so as to meet these concerns.

IV. Policies in Industrial Countries

At a global level, the potential availability and cost of financing for developing countries depends on the balance between savings and investment in the industrial economies. The resurgence of private flows to developing countries in 1991-92 coincided with a period of weak demand in the main industrial economies and lower international interest rates. In the period ahead, these conditions are likely to be reversed as the global recovery gathers momentum. Policies that reduce fiscal imbalances and promote private savings in industrial economies will thus be important in determining whether adequate financing is available to developing countries.

The profitability of investment in developing countries is influenced by these countries' access to industrial country markets. Steps to promote an open international trading system, including through removal of import barriers, subsidies, and other market distortions, would help to foster an international environment conducive to capital flows to developing countries. A successful conclusion to the current Uruguay Round trade negotiations would be a major step towards this objective.

1/ The BOT, which was first developed in the 1970s, is a non-recourse project financing scheme under which one or more sponsors from the private sector form a special company to undertake a project. The sponsors typically include a major international engineering or construction firm, and one or more equipment suppliers. The project company raises the bulk of the financing required for the project from commercial lenders, including export credit agencies, and possibly bilateral and multilateral financial institutions. The essential feature of these agreements is that an attempt is made to separate project risks from country risk: lenders advance money against the cash flow of the project rather than the government's sovereign guarantee. The equity contribution of the consortium members might typically range between 10-30 percent of the total project cost.

As well as general macroeconomic conditions, private capital flows to the developing countries are also affected by financial market developments and policies in the industrial countries. The continued caution of international banks towards developing countries has reflected the difficult financial situations of many major banks and their efforts to adjust their balance sheets to meet the Basle capital adequacy standards, as well as concerns that, as in the 1980s, unsecured bank debt would be treated as a junior claim if countries encountered debt servicing difficulties in the future. In addition, provisioning requirements against exposure to countries that have experienced debt servicing difficulties increase the overall cost of funding new loans to these countries, and thus may hinder the resumption of bank lending.

Over the past year or so, regulatory authorities in a number of industrial countries have removed several countries--such as Chile and Mexico--from provisioning requirements and permitted lower provisions on others in response to their improved performance and prospects. Moreover, in other regulatory regimes, where greater reliance is placed on banks themselves to judge the appropriate level of provisions, provisioning has tended to decline against exposure to countries where creditworthiness has improved. Nevertheless, in some creditor countries further review of regulatory standards may be appropriate, to allow increased responsiveness to sustained good performance, while maintaining prudential standards. There may also be scope in some regimes to allow greater differentiation between types of claim to reflect the varying degree of risk involved.

Concerns have been expressed that the international bank capital adequacy standards established under the Basle accord may discriminate against creditworthy developing country borrowers. Under the accord, a risk weight of zero is applied to claims on government borrowers in OECD/GAB countries, compared to a 100 percent risk weight on such borrowers in other countries. 1/ The higher risk weighting applied to these other borrowing countries tends to raise interest rate spreads and generally deter new lending to these borrowers as banks look to increase their risk-weighted capital ratios. For that reason, suggestions have been made to refine the system of risk weights to provide risk categories that more closely reflect variations in creditworthiness. For such a new system to be effective, it would need to provide adequate reliability and coverage.

Developing country access to international securities markets has been facilitated by the continuing trend toward international portfolio diversification, the introduction of sophisticated financial techniques for risk management, and the liberalization of market restrictions. Notably, the relaxation of restrictions on the private placement market in the United

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1/ GAB refers to the Fund's General Arrangements to Borrow. Detailed information on the Basle Accord was provided to the Development Committee in spring 1992. See the Annex to the "Implementation of the Debt Strategy--Progress Report" (EB/CW/DC/92/2) March 9, 1992.

States introduced by the Security and Exchange Commission's Rule 144a has facilitated access by developing country borrowers to this market where information requirements are less rigorous than the stringent listing standards for public issues in industrial countries. 1/ Developing country access to the private placement market can help companies gain exposure to international institutional investors and pave the way for eventual public registration. Similar measures to remove restrictions on private placements should be considered in other countries, especially for investor groups that are relatively sophisticated and where access to off-shore markets is limited.

Recent steps to liberalize quality restrictions on international securities issues have also helped to facilitate access for developing countries. For example, in 1991 the Japanese authorities lowered the minimum credit rating for sovereign borrowers in the "Samurai" market, which has permitted continued access to this market for some developing countries. More generally, institutional investors are typically subject to regulatory guidance on holdings of foreign assets as well as sub-investment grade paper, while limits are placed in some countries on the sale to retail investors of paper issued on non-approved exchanges. Regulations governing institutional and retail investors should be reviewed to identify possible unnecessary impediments to developing country access. In reviewing such regulations, however, it is important to pay due regard to the protection of small investors and the maintenance of sound prudential standards.

FDI may also be facilitated by appropriate tax and regulatory policies in source countries. 2/ Bilateral investment treaties between host and source countries can help to ensure that tax policies do not distort investor decisions to unduly discourage FDI. A number of industrial countries provide incentives for outward FDI. While this has encouraged direct investment from these countries, it may also discriminate against host country investors and other foreign investors who do not have access to subsidies. Industrial countries have worked to develop general rules

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1/ Public registration in some industrial countries requires up to five years of financial data on the borrower, which may be difficult to compile in a country with a history of high inflation. Rule 144a serves to make private placements more attractive to investors by permitting qualified institutional buyers to trade privately placed securities immediately without waiting the stipulated two-year holding period that would otherwise apply.

2/ A detailed review of policy measures to facilitate foreign direct investment flows to developing countries was provided to the Development Committee in spring 1991. See Section III of "The Role of Foreign Direct Investment in Development" (EB/CW/DC/91/2), March 7, 1991.

against subsidizing foreign investment as well as guidelines for foreign investors aimed at increasing the responsiveness of FDI to host country development objectives. 1/

V. Role of International Financial Institutions

International financial institutions (IFIs) encourage private investment flows to developing countries through the provision of policy advice and the financing of policy reforms in host countries; the financing of physical and social infrastructure; direct operations that deal with the private sector or catalyze private flows; technical assistance; and the dissemination of information.

Policy advice and financing from the IFIs help to provide support for stabilization and reform programs in host countries that establish an environment conducive to private capital flows. 2/ IMF support helps countries to implement macroeconomic adjustment and structural reforms aimed at achieving sustainable growth and external balance, without recourse to counter-productive trade or exchange restrictions, and typically contains provisions for further liberalization of these regimes. The World Bank and regional development banks provide financial sector adjustment loans to support the liberalization of financial markets and the development of local capital markets, while access to imported inputs and to export markets has been enhanced by Bank-supported trade reforms. Project lending by the World Bank and regional development banks has contributed directly to strengthening physical infrastructure and human resource development (for instance, in education and health) that improve productivity and cost efficiency. Where the overall policy framework is appropriate, both the Fund and Bank provide financing in support of commercial bank debt and debt service reduction operations.

Direct external financing of the private sector in developing countries by the IFIs is typically accomplished through private sector affiliates, such as the World Banks's IFC. Nearly half of the IFC's operations have been joint ventures between foreign and local partners, which has facilitated the transfer of technology and managerial and marketing know-how. The IFC's support has been particularly important in Africa--through, for example, the Africa Project Development Facility and the Africa

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1/ OECD, Declaration on International Investment and Multinational Enterprises, Paris, 1976.

2/ Private sector development has become an increasing concern of IFIs' adjustment and investment operations. For example, typically two out of every three World Bank operations include specific components that support the private sector. A background paper entitled "Private Sector Development: A Progress Report" is being sent at the same time to the Development Committee.

Enterprise Fund--and in Eastern Europe. Like the IFC, the private sector affiliates of regional development banks undertake loan and equity investments in private enterprises in developing countries and facilitate and participate in foreign joint ventures. 1/

The World Bank has undertaken cofinancing with private investors through parallel financing arrangements, as well as export credit cofinancing, which is normally private commercial financing with insurance or guarantee coverage from export credit agencies of industrial countries. 2/ Under the expanded cofinancing operation (ECO) program, the Bank also has authorization to provide partial guarantees to catalyze private sector financing, although to date utilization of this program has been limited. The limited use of Bank guarantees under the ECO program may reflect in part the fact that this program has been in effect restricted to countries that have not restructured their debt in the previous five years, and that it has been targeted primarily at commercial banks precisely at a time when they were withdrawing from international investment. Looking ahead, the effectiveness of cofinancing and guarantees will depend on the degree to which they can be successfully applied to influence creditor perceptions of country risk in countries actively seeking to regain market access.

The IFC plays a particularly important role in mobilizing additional project funding from private investors and lenders, either in the form of cofinancing or through loan syndications. 3/ Private participation in infrastructure investments and operations has been encouraged by IFIs through innovative financing mechanisms that allow joint private consortia of domestic and foreign contractors (e.g., BOT agreements). The IFC's ability to catalyze commercial bank resources for projects in the developing world is enhanced in syndications where it is the lender of record (meaning that in effect the debtor country cannot differentiate between debt service

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1/ These affiliates include the Asian Finance and Investment Corporation (AFIC) founded in 1989 on the initiative of the Asian Development Bank (ADB), and the Inter-American Investment Corporation (IIC) established by the Inter-American Development Bank (IDB) in 1985. The ADB also directly undertakes nongovernment guaranteed loan and equity investments in private enterprises. The African Development Bank (AfDB), often in cooperation with other IFIs including the Islamic Development Bank (IsDB), has also provided support to African countries. The European Bank for Reconstruction and Development (EBRD) has no private sector affiliate but directly carries out equity investment and lending programs to promote the private sector in Eastern Europe and the FSU.

2/ Over the last five years, the cofinancing through parallel financing arrangements has averaged around US$1 billion per year and export credit cofinancing about US$2 billion per year.

3/ Loan syndications approved by the IFC reached a record US$1.4 billion for 39 projects in FY92.

payments to the IFC and to other participating commercial institutions). The IFC and private sector affiliates of other IFIs have also undertaken underwriting activities that have brought private corporations to market.

Regional banks have also been active in cofinancing, particularly the ADB. Under its Complementary Financing Scheme, the ADB is the lender of record for commercial bank syndications which it prearranges in parallel with its own loans. Often such cofinancing is combined with a late-maturity guarantee. 1/ The scheme, which is comparable to IFC guarantees and syndications in the degree of comfort afforded to commercial lenders, has been successful in attracting new nonbank lenders (e.g., insurance companies) to participate.

Insurance of FDI against long-term noncommercial risk is offered by the Multilateral Insurance Guarantee Agency (MIGA). Risks covered are foreign currency transfer, expropriation, war and civil disturbance, and breach of contracts. The number of guarantees issued has increased to 21 in FY92 and 14 during the first six months of FY93, for a cumulative maximum contingent liability of US$774 million. The total amount of investments in which MIGA's guarantee program has participated, alone or together with other insurers, is close to US$4 billion, mainly in Latin America, Europe and Asia.

Each of the IFIs has an extensive technical assistance program relevant for creating an economic setting conducive to private flows. The IMF and the World Bank provide assistance to promote transparent and non-distortionary tax systems, appropriate public expenditure priorities, regulatory reforms to reduce barriers to entry for private firms, and exchange system liberalization. Moreover, the IFIs have assisted banking system reform and capital market development, including to establish stock markets and to improve institutional structures and regulatory frameworks in a number of countries. Specialist technical advice has also been provided on debt restructuring, privatization, investment codes, and external debt management. The IFC has been particularly active in support of equity portfolio flows to developing countries: for instance, the IFC pioneered the introduction of country funds targeted at emerging stock markets. 2/ Finally, the World Bank has recently expanded its technical assistance programs in risk management involving the use of swaps, options, and futures contracts in several countries (e.g., Chile, Costa Rica, and Turkey) to improve developing countries' hedging capacity, including hedging by the private sector.

1/ The scheme has mobilized more than US$500 million for some 30 projects since its introduction in 1984.

2/ A total of around US$7.5 billion has been channeled to developing countries through such funds, mainly to Asia and Latin America.

The IFIs provide a wide range of promotional and advisory services. MIGA, for example, organizes investment promotion conferences and investment campaigns, bringing together foreign investors with host government officials and business executives for possible joint ventures. A number of training programs for business executives have also been conducted by MIGA and other IFIs. The Foreign Investment Advisory Service (FIAS)--a joint venture of IFC, MIGA and the Bank, specializing in FDI-related advisory functions--has been actively engaged in providing advice to host developing countries on policy and institutional changes necessary to overcome impediments to direct investment.

The efficient dissemination of information is important in reducing perceived risks inherent in foreign investment. The IFIs--most importantly the Fund and the Bank--publish extensive data and analytical reports, reviewing the latest developments in the economic and regulatory environment affecting international capital flows. The IFC maintains an extensive database on emerging stock markets, providing timely price information and benchmark indexes to portfolio investors.

VI. Prospects

The history of private capital flows to developing countries has included repeated episodes of surges in flows, followed by a market correction, debt servicing difficulties, and a curtailment of access. Market corrections have been triggered by a range of factors, including economic mismanagement, adverse movements in commodity prices, and a tightening of external financial conditions, and have usually involved a fundamental reappraisal of the risks involved in such financing. Accordingly, the issue arises of whether the recent access to private flows can be maintained and extended to countries that have yet to gain market access.

Based on recent experience, countries that already have access to a relatively broad investor base are likely to continue to attract private flows, provided that they continue to pursue sound policies. This expectation is supported by the fact that a number of Asian and European economies have maintained or even expanded market access over the last decade, notwithstanding shifts in external conditions and a curtailment of access of other developing countries. Moreover, the general trends in the international financial system that have facilitated flows to developing countries--including the globalization of markets and the diversification of investor portfolios--are likely to be irreversible.

For the recent market re-entrants, the investor base is still relatively narrow. To maintain the scale of flows to these countries, this base must be expanded. In this connection, the consolidation of economic and political stability is obviously critical, not least because it would lead to investment grade credit ratings that would facilitate access to institutional investors, which have represented a growing share of industrial country savings. In addition, the diversification of the investor base requires adequate protection against the risks of operating in a less sophisticated financial system, including through reforms to deepen local capital markets, to enhance financial regulation and supervision, and to bolster accounting and disclosure standards.

Prospects for private flows to developing countries with limited market access are divergent. Some may be able to attract significant private resources by sustaining progress toward creditworthiness and developing corporate and financial sectors with appropriate tax, regulatory, and legal frameworks. Moreover, for countries with heavy external indebtedness and significant arrears, debt restructuring operations and the normalization of creditor relations can be expected to improve the scope for access to international capital markets. International financial institutions have an important role to play to facilitate private capital flows to these countries, mainly through the provision of financial support (including for debt operations) and policy advice, as well as the diffusion of information about borrowing countries.

For many developing countries, however, the scope for private capital inflows is likely to remain tightly constrained. This would seem particularly so for low-income countries in Sub-Saharan Africa with poor resource endowments and locations remote from major markets as well as in regions of political instability. To date, medium- and long-term private financing for these countries has been mainly confined to enclave-type projects for off-shore oil and mining. Moreover, for countries at a relatively low level of development, it will not be feasible to establish a fully fledged domestic capital market conducive to portfolio inflows quickly. More generally, many low-income countries will need to continue building up their physical and social infrastructure, supported by domestic savings and concessional external finance, before there will be realistic prospects of accessing private capital markets on a significant scale.

As an increasing range of countries has gained access to private capital inflows, it needs to be emphasized that even with improved economic performance and increasingly sophisticated markets, such flows (particularly portfolio flows) are potentially volatile. Integration into international capital markets brings benefits but also increases exposure to shifts in global financial conditions. Moreover, domestic or international events may lead to shifts in investor sentiment, as occurred in the second half of 1992 in the wake of sharp declines in domestic stock markets and the turbulence in world foreign exchange markets in September. Thus, there should be sufficient resilience in the economic systems of host countries to ensure that shifts in investor sentiment can be met without loss of market access.

To cope with adverse events, developing countries need to sustain appropriate macroeconomic and structural policies and be prepared to take additional adjustment measures as needed. It will also be relevant to pay attention to the structure and use of external financing and the balance between obligations falling due and potential variations in foreign exchange earnings. In this respect, excessive reliance on short-term financing should be avoided, while increasing the role of equity as opposed to debt financing enhances the flexibility of response to adverse events. In addition, there may be a role for the use of hedging techniques to reduce vulnerability to swings in external conditions.

As well as implying a possibly unstable build-up in external liabilities, heavy capital inflows may complicate economic management by threatening to undermine stabilization programs--either through excessive monetary growth or an exchange rate appreciation that may imply a loss of external competitiveness. 1/ To respond to such inflows, policy makers have a range of options. Most fundamental in its impact would be a tightening of financial policies to moderate the growth of domestic demand, and thus offset the effect of the capital inflows. A complicating factor, however, is that acting through monetary and credit policy alone may be counter-productive, because the resulting higher domestic interest rates can fuel further capital inflows and intensify pressures on the exchange rate. Fiscal adjustment is likely to be more effective, although there would be practical limits on the ability of the government to fine-tune tax and spending policies in response to capital inflows, as well as trade-offs against long-term tax and spending objectives.

In a number of countries, the authorities have adopted more direct means to slow capital inflows, including setting minimum quality restrictions on issuers, introducing queuing systems, tightening prudential standards on banking activity, setting reserve requirements on foreign borrowing, and imposing withholding taxes. However, these steps can impose costs by distorting economic decisions. Moreover, given the incentives for evasion, it is questionable whether such controls can be effective for long in a relatively open economy. In any event, the attempt to suppress a movement in the real exchange rate may not be sustainable. A real appreciation of the exchange rate may be an equilibrating response if there has been a fundamental improvement in the efficiency of the traded goods sector of the economy which has regained access to international capital markets.

1/ For a more extensive discussion of these issues, see the forthcoming Fund staff paper on "Recent Experience with Surges in Capital Inflows."

Table 1. International Bond Issues by Developing Countries 1/

(In millions of U.S. dollars)

	1987	1988	1989	1990	1991	1992
Developing countries	3,676	6,418	4,470	5,994	12,260	22,938
Africa	49	471	159	90	236	725
Algeria	49	433	159	90	--	--
South Africa	--	38	--	--	236	725
Asia	2,411	2,632	1,308	1,459	3,337	5,686
China	1,415	912	--	--	115	1,359
India	377	715	450	274	227	--
Indonesia	50	221	175	80	369	494
Korea	332	130	258	1,105	2,609	3,177
Malaysia	216	361	425	--	--	--
Nauru	--	32	--	--	--	--
Pakistan	21	--	--	--	--	--
Thailand	--	261	--	--	17	656
Europe	866	2,438	2,170	1,856	1,960	4,562
Bulgaria	--	--	101	--	--	--
Former Czechoslovakia	--	130	--	375	277	129
Former Soviet Union	--	333	--	--	--	--
Hungary	555	816	879	888	1,186	1,242
Turkey	311	1,159	1,190	593	497	3,191
Western Hemisphere	350	877	833	2,589	6,727	11,965
Argentina	195	--	--	21	795	1,570
Barbados	--	40	--	--	--	--
Brazil	--	--	--	--	1,731	3,415
Chile	--	--	--	--	200	--
Colombia	50	--	--	--	--	--
Mexico	--	--	570	2,306	3,373	5,848
Panama	--	--	--	--	50	--
Trinidad & Tobago	105	79	--	--	--	100
Uruguay	--	--	--	--	--	100
Venezuela	--	758	263	262	578	932
Memorandum items:						
Global issues in international bond markets	177,292	227,143	252,132	226,059	301,342	343,617
Share of developing countries in global issuance	2.1%	2.8%	1.8%	2.6%	4.1%	6.7%

Sources: IMF and World Bank staff estimates based on reports in Euromoney Bondware; Euroweek; Financial Statistics Monthly; Financial Times; International Financing Review; and OECD.

1/ Including note issues under EMTN programs. Figures for 1987 and 1988 are based on OECD data and are not strictly comparable to those for 1989-92, owing to different coverage.

Table 2. International Equity Issues by Developing Country Companies 1/ 2/

(In millions of U.S. dollars)

	1990	1991	1992
Developing countries	1,047	5,037	7,256
Africa	--	143	270
South Africa	--	143	270
Asia	825	683	2,708
China	--	11	1,049
India	--	--	240
Indonesia	633	168	262
Korea	40	200	150
Malaysia	--	--	382
Pakistan	--	11	48
Philippines	53	99	432
Thailand	99	194	145
Europe	124	91	67
Hungary	68	91	33
Turkey	56	--	34
Western Hemisphere	98	4,120	4,211
Argentina	--	356	504
Brazil	--	--	150
Chile	98	--	129
Mexico	--	3,764	3,058
Panama	--	--	88
Venezuela	--	--	282
Global issues in international equity markets	8,152	15,546	22,632
Share of developing countries in global issuance	12.8%	32.4%	32.1%

Sources: IMF and World Bank staff estimates based on reports in Euromoney Bondware; Euroweek; Financial Times; IFC; International Financing Review; and Lipper Analytical Services.

1/ Includes depository receipts and China "B-shares." Excludes direct equity purchases by foreign investors in local stock markets, including by new country funds.

2/ New country or regional funds for developing country stock markets are estimated to have reached: US$607 million in 1986; US$761 million in 1987; US$1,095 million in 1988; US$2,199 in 1989; US$2,867 million in 1990; US$1,273 million in 1991; and US$2,164 million in 1992.

Table 3. Net Foreign Direct Investment Flows to Developing Countries 1/

(In billions of U.S. dollars)

	1987	1988	1989	1990	1991	1992 Estimate
Developing countries	10.0	18.2	19.6	20.9	28.6	36.8
Africa	1.0	1.3	3.3	1.5	1.4	1.7
Algeria	-0.1	--	--	--	-0.1	--
Botswana	-0.1	0.2	0.1	0.2	0.1	0.1
Cameroon	--	--	--	--	--	0.1
Gabon	0.3	0.2	--	-0.1	-0.2	-0.1
Morocco	0.1	0.1	0.2	0.2	0.4	0.6
Nigeria	0.6	0.4	2.4	0.6	0.6	0.5
Senegal	0.1	0.1	0.1	0.1	0.1	0.1
Tunisia	0.1	0.1	0.1	0.2	0.2	0.2
Other	--	0.2	0.2	0.3	0.3	0.2
Asia	4.7	7.3	8.6	9.8	11.2	14.3
China	1.7	2.3	2.6	2.7	3.7	5.6
India	0.2	0.3	0.3	0.4	0.2	0.4
Indonesia	0.5	0.6	0.7	1.2	1.5	1.7
Korea	0.4	0.7	0.5	-0.1	-0.2	-0.3
Malaysia	1.0	1.1	1.8	3.0	3.0	3.6
Pakistan	0.1	0.2	0.2	0.3	0.5	0.7
Papua New Guinea	0.1	0.1	0.2	0.1	0.2	0.2
Philippines	0.3	1.0	0.8	0.5	0.7	1.0
Sri Lanka	0.1	--	--	--	--	--
Thailand	0.2	0.9	1.4	1.6	1.2	1.0
Other	0.1	0.1	--	0.3	0.4	0.2
Europe	-0.9	1.4	-0.2	0.7	2.9	4.4
Former Czechoslovakia	--	--	0.3	0.2	0.6	1.1
Hungary	--	--	0.2	0.3	1.5	1.4
Poland	--	--	--	--	0.1	0.3
Romania	--	--	--	--	--	0.1
Former Soviet Union	-1.0	1.0	-1.3	-0.7	-0.2	0.3
Turkey	0.1	0.4	0.7	0.7	0.8	1.1
Former Yugoslavia	--	--	--	0.2	0.1	0.1
Latin America	4.0	6.8	6.2	7.2	11.7	14.5
Argentina	--	1.1	1.0	2.0	2.4	2.4
Brazil	1.1	2.9	0.7	0.3	0.6	3.0
Chile	0.1	0.1	0.3	0.6	0.5	0.5
Colombia	0.3	0.2	0.5	0.5	0.4	0.6
Costa Rica	0.1	0.1	0.1	0.1	0.1	0.1
Dominican Republic	0.1	0.1	0.1	0.1	0.1	0.2
Ecuador	0.1	0.1	0.1	0.1	0.1	0.1
Guatemala	0.1	0.1	0.1	0.1	0.1	0.1
Jamaica	0.1	--	0.1	0.1	--	--
Mexico	1.8	1.7	2.6	2.5	4.8	6.0
Panama	--	--	--	--	0.1	--
Trinidad & Tobago	0.1	--	0.1	0.1	0.1	0.2
Venezuela	--	0.1	0.2	0.5	1.9	0.7
Other	0.2	0.3	0.3	0.3	0.4	0.6
Middle East	1.3	1.4	1.6	1.7	1.5	1.8
Egypt	1.1	1.1	1.2	0.7	0.4	0.3
Oman	--	0.1	0.1	0.2	0.2	0.2
Saudi Arabia	--	--	--	0.1	0.1	0.2
Yemen Arab Republic	--	-0.3	-0.4	--	--	--
Other	0.1	0.5	0.7	0.7	0.8	1.1

Source: IMF WEO data base (February 1993 update).

1/ Net of FDI abroad.

Table 4. Bank Credit Commitments to Developing Countries

(In billions of U.S. dollars)

	1987	1988	1989	1990	1991	1992
Developing countries 1/	25.1	19.5	16.7	21.0	20.8	16.2
Africa	0.7	0.5	0.5	0.6	0.2	0.6
Algeria	0.4	0.4	0.2	--	0.1	--
Angola	--	--	--	--	--	0.3
Côte d'Ivoire	--	--	--	--	--	--
Ghana	--	--	--	0.1	0.1	0.1
Morocco	--	0.1	--	0.1	--	--
Nigeria	--	--	--	--	--	--
South Africa	--	--	--	--	--	--
Tunisia	--	--	--	--	--	0.1
Zimbabwe	--	--	0.1	--	0.1	--
Other	0.3	--	0.2	0.4	--	0.1
Asia	8.5	7.8	8.2	12.0	12.9	9.7
China	3.3	2.7	1.6	1.5	2.3	2.7
India	1.8	1.6	1.4	0.7	--	0.2
Indonesia	1.6	0.5	2.3	3.9	5.0	1.8
Korea	0.9	1.2	0.7	2.0	3.5	1.8
Malaysia	0.3	0.8	0.1	0.5	0.2	1.2
Pakistan	0.1	0.1	0.4	0.4	0.1	--
Papua New Guinea	--	--	--	0.1	0.3	--
Philippines	--	--	--	0.7	--	--
Thailand	0.3	0.8	0.8	1.3	1.6	2.0
Viet Nam	--	--	--	--	--	--
Other	0.1	0.1	0.2	0.1	--	--
Europe	5.4	4.4	4.1	4.9	1.9	2.1
Bulgaria	0.3	0.1	0.3	--	--	--
Czechoslovakia	0.2	0.2	0.3	--	--	--
Hungary	1.4	0.2	0.8	--	0.1	0.2
Turkey	2.6	1.7	1.7	1.8	1.6	1.8
Former U.S.S.R.	0.8	2.2	0.9	3.0	--	--
Other	0.1	--	0.1	0.1	0.2	0.1
Middle East	0.3	0.3	2.0	0.2	4.8	2.9
Egypt	--	--	0.5	--	--	--
Jordan	0.2	0.2	--	--	--	--
Saudi Arabia	--	--	0.7	0.1	4.5	2.9
Other	0.1	--	0.7	0.1	0.3	--
Western Hemisphere	10.1	6.5	1.9	3.3	1.0	0.9
Argentina	2.1	--	--	--	--	--
Brazil	--	5.2	0.1	--	--	0.2
Chile	--	0.2	--	0.3	--	0.4
Colombia	0.1	1.0	1.6	--	0.2	--
Mexico	7.7	--	0.2	1.6	0.6	0.2
Uruguay	--	--	--	--	0.1	--
Venezuela	--	0.1	--	1.4	--	0.2
Other	0.2	--	--	--	0.1	--
Memorandum items:						
Offshore banking centers	0.3	0.4	3.5	3.7	1.5	1.6
Total international bank credit commitments	91.4	125.6	121.1	124.5	116.0	117.9
Share of developing countries in total	27%	16%	14%	17%	18%	14%

Sources: Organization for Economic Cooperation and Development, Financial Statistics Monthly.

1/ Excludes offshore banking centers.