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March 11, 1985

To: Members of the Executive Board

From: The Secretary

Subject: World Economic Outlook: Supplementary Note 10 - Trends in Capital Flows to Developing Countries

The attached note on trends in capital flows to developing countries provides background material for the Executive Board discussion on Monday and Wednesday, April 1 and 3, 1985 of the World Economic Outlook.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Blackwell (ext. 8980).

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World Economic Outlook: Supplementary Note 10

Trends in Capital Flows to Developing Countries

Prepared by the Research Department

Approved by Wm. C. Hood

March 11, 1985

Difficulties in projecting capital flows to developing countries arise at the present time because of essentially novel conditions in both the capital importing countries and the capital exporting countries. Among the former, many countries are still in relatively early stages of recovery from the disturbances of the past decade, and especially from the combination of the international debt crisis with the severe global recession. Following a decade during which inflation in the industrial world led to low real interest rates, and greatly facilitated the servicing of external debts, the developing countries are now confronted with borrowing costs at levels well above any witnessed for at least several decades prior to the 1980s (Chart 1). The ability and willingness of these countries to utilize capital inflows for any extended period under these conditions remains to be tested, quite apart from pressing questions regarding the availability of funds from the countries that would have to supply them.

Among the potential capital exporters, marked shifts in the composition and disposition of national savings have occurred over the past 10-15 years. Some of these proved temporary and have already been largely reversed, but others appeared to represent enduring trends. In particular, the widespread rise in the share of private saving absorbed by government borrowing in the industrial countries has implications for the availability and/or cost of credit for borrowers in developing countries.

Another complicating factor in forming judgments at the present time is uncertainty with respect to the world oil situation. Over the past dozen years, the sheer rapidity of the emergence and decline of the surpluses of oil exporting countries has obscured whatever underlying trends may be occurring in the global pattern of credit flows. Some countries that were leading suppliers of credit only a few years ago have become substantial net users, but the durability of the current pattern remains highly questionable.

The sudden emergence of the United States as a deficit country on a major scale casts doubt on whether the industrial world as a whole will resume its traditional role as a large-scale source of finance to developing countries. Unless or until U.S. national saving/investment relationships can be adjusted in a way that permits a higher proportion of domestic capital investment to be financed from domestic sources, the prospects for expansion of net capital movements from industrial to developing countries will tend to remain limited.

Still another profoundly complicating factor in the assessment of prospective international capital movements is the degree to which recent movements have been masked by the discrepancy in global summations of balance of payments statistics. Past World Economic Outlook Reports have given considerable attention to this problem in a current account context, where underreporting of receipts or overreporting of payments (or both) has made it impossible to identify the countries whose surpluses represent the counterparts of the developing-countries' current account deficits. 1/ The counterpart of the statistical discrepancy in the global current account is, of course, an equal and opposite discrepancy in the net aggregate of broadly defined capital flows (including the errors and omissions items in national statistics). Net inflows of such financing reported in countries' balance of payments statistics exceeded reported net outflows by close to $100 billion in 1982 and about $70 billion in 1983. In each of those two years, the non-oil developing countries, the oil exporting countries, and the industrial countries all reported sizable net inflows, while no major group indicated a net outflow. Although a comprehensive world total would include some nonreporting countries (mainly the U.S.S.R. and other nonmember countries of Eastern Europe), it is not possible that those countries--themselves generally capital importers--could have been the sources of missing net outflows on the scale indicated.

This massive statistical discrepancy in the aggregated balance of payments statistics of reporting countries precludes any systematic tracing of the sources of the large amounts of capital believed to have been received (net) by the non-oil developing countries in recent years. For this period, the most plausible assumption appears to be one attributing primarily to the industrial countries and secondarily to the oil

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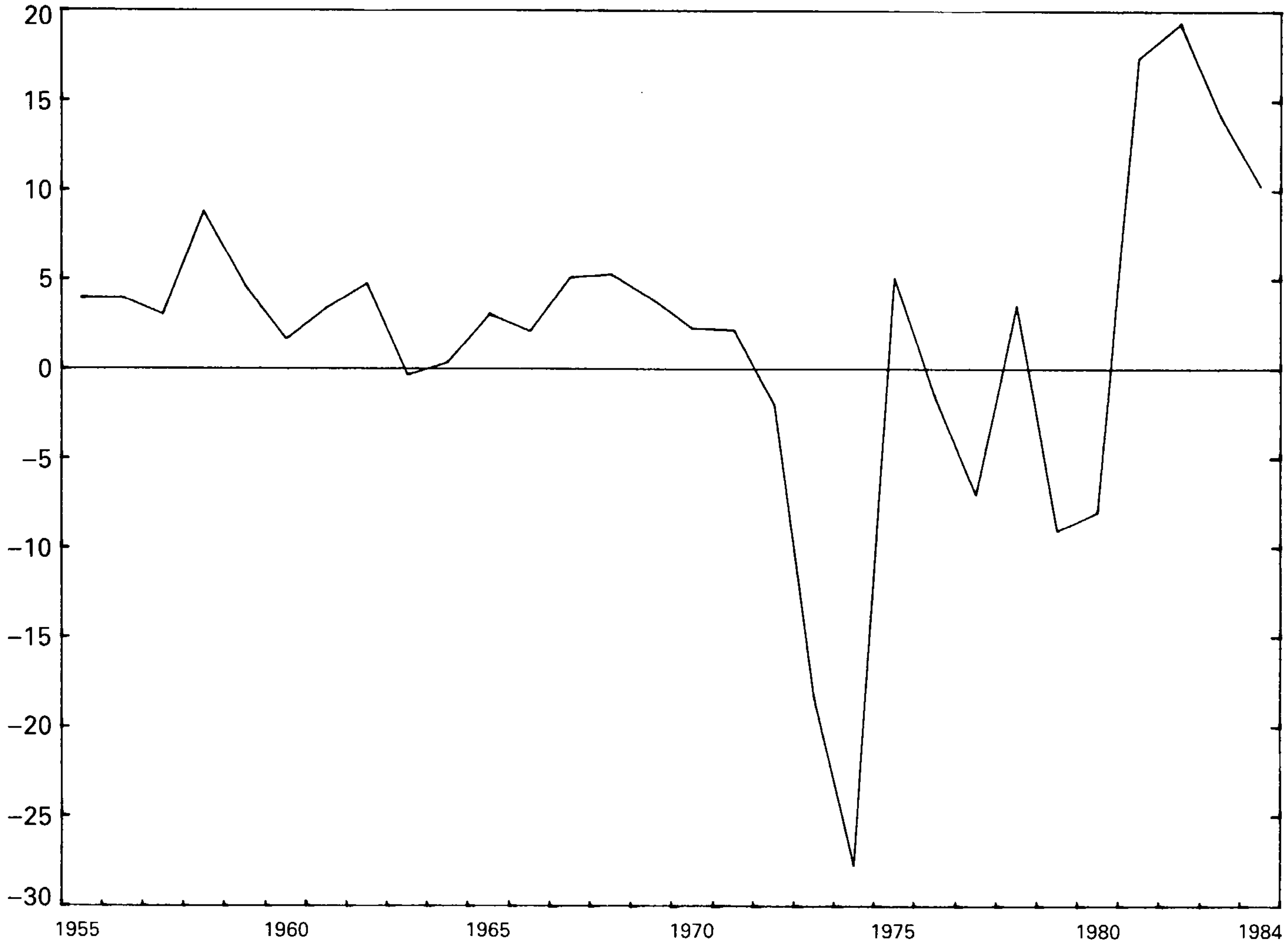
1/ In principle, it is not possible to be certain that the aggregate of those deficits is not itself overstated; however, past World Economic Outlook Reports have advanced cogent reasons--derived largely from the World Bank's debt statistics and the international banking statistics of the Bank for International Settlements (and recently, of the Fund as well)--for a presumption that the greater part of the misstatement with respect to current account balances may be presumed to reside in the accounts of the industrial and oil exporting countries.

CHART 1

INDEBTED DEVELOPING COUNTRIES[1]:

REAL INTEREST RATES[2], 1955–84

(IN PERCENT PER ANNUM)



[1]All developing countries except eight Middle Eastern oil exporters.
[2]As measured by the differential between nominal dollar money market interest rates and changes in the unit values (in dollars) of exports by indebted developing countries.

exporting countries substantial net capital outflows over and above those reported in their own balance of payments statistics. Some additional net capital outflows--e.g., in the nature of "flight capital"--could also be imputed to non-oil developing countries for several recent years. However, the scope for such an imputation would seem limited because sizable amounts of presumed flight capital movements are already reflected in the "errors and omissions" components of their respective individual balance of payments statistics. These individual "errors and omissions" figures are included with recorded financial-flow statistics for World Economic Outlook purposes, and thus are already netted out in calculation of the global excess of net inflows on capital account. Only additional flight capital movements could be hypothesized as a means of reducing that excess.

Although a discrepancy in the global balance of payments summations has existed as long as the statistics have been compiled, it was relatively minor in size until the past few years. Accordingly, it does not seriously obscure the historical record of capital movements during the 1960s and 1970s. That record is reviewed below by way of background for considerations relating to the medium-term projections.

1. The traditional global pattern of net capital flows

Prior to the sharp swings in capital flows of the past decade or so, deficits and surpluses among major groups of countries conformed to a rather clearly defined pattern. Throughout the 1950s, 1960s, and early 1970s, the industrial countries as a group were net suppliers of both real resources (reflected in a combined current account surplus) and the associated financing (reflected in net outflows) to the developing countries. Underpinning this role were, inter alia, the relatively high incomes of the industrial countries, which generated savings somewhat in excess of their domestic investment outlays, and a propensity to invest these excess savings abroad. For the industrial group as a whole, that meant chiefly in the non-oil developing countries, 1/ where broadly opposite basic conditions existed. With relatively low per capita incomes, many developing countries were unable to generate domestic savings sufficient to match domestic investment opportunities and sought foreign resources, both real and financial, to accelerate the pace of development.

1/ During the early part of the period under discussion, there were large investments in countries that came to be classified during the 1970s and 1980s as oil exporters. However, toward the end of the period, even before the major oil price increase of 1973-74, the external position of the oil exporting group had shifted. By the early 1970s, its aggregate current account balance was already in moderate surplus, and it was supplying rapidly growing amounts of capital to international financial markets (chiefly, at first, through investment of official reserves).

Although the payments positions of individual developing countries varied widely from year to year, the aggregate current account balance of the whole group of non-oil developing countries was remarkably steady--around a moderately rising trend--during the two decades prior to 1973. It averaged about $3 1/2-4 billion during the second half of the 1950s, $5 billion from 1961 through 1966, and $10 billion from 1967 through 1972. This last figure was equivalent to some 2 1/2 percent of GDP, compared with roughly 1 3/4 percent for the preceding six years. On an annual basis, the ratio showed considerable variation, rising fairly sharply during recessions and falling (or rising less rapidly) during strong advances. After increasing from 1.6 percent in 1966 to 2.3 percent in 1967, for example, it fell back to 2 percent in 1969; and after rising above 3 percent in 1971, it dipped to 2 percent again in 1973. However, these fluctuations were very mild compared with those witnessed subsequently, partly because cyclical developments in the various industrial areas were not closely synchronized before the mid-1970s. Perspective on these swings is provided by Chart 2, where current account balances of major groups of countries are expressed as percentages of world trade in order to emphasize short-term fluctuations around the rising long-term trend of nominal balance of payments aggregates.

Perhaps mainly as a result of the lack of cyclical synchronization, the geographical sources of the industrial group's surplus savings shifted back and forth during the late 1960s and early 1970s. Japan's share, for example, ranged from 1 percent to more than one third during particular years of the period, and the variation in the U.S. share was even wider. Nevertheless, since changes in external placements of savings by individual countries were to a considerable extent inversely correlated during those years, the total net outflow from the whole group of industrial countries displayed a relatively steady rising trend. On average, over the whole six-year period ended in 1973, somewhat more than half of the net outflow originated in Europe, about one fifth in Japan, and roughly one fourth in the United States. (It should be remembered, in this context, that the outflows from Europe and Japan included their investments of official reserves in financial claims on the United States, against whose outflows these placements were netted).

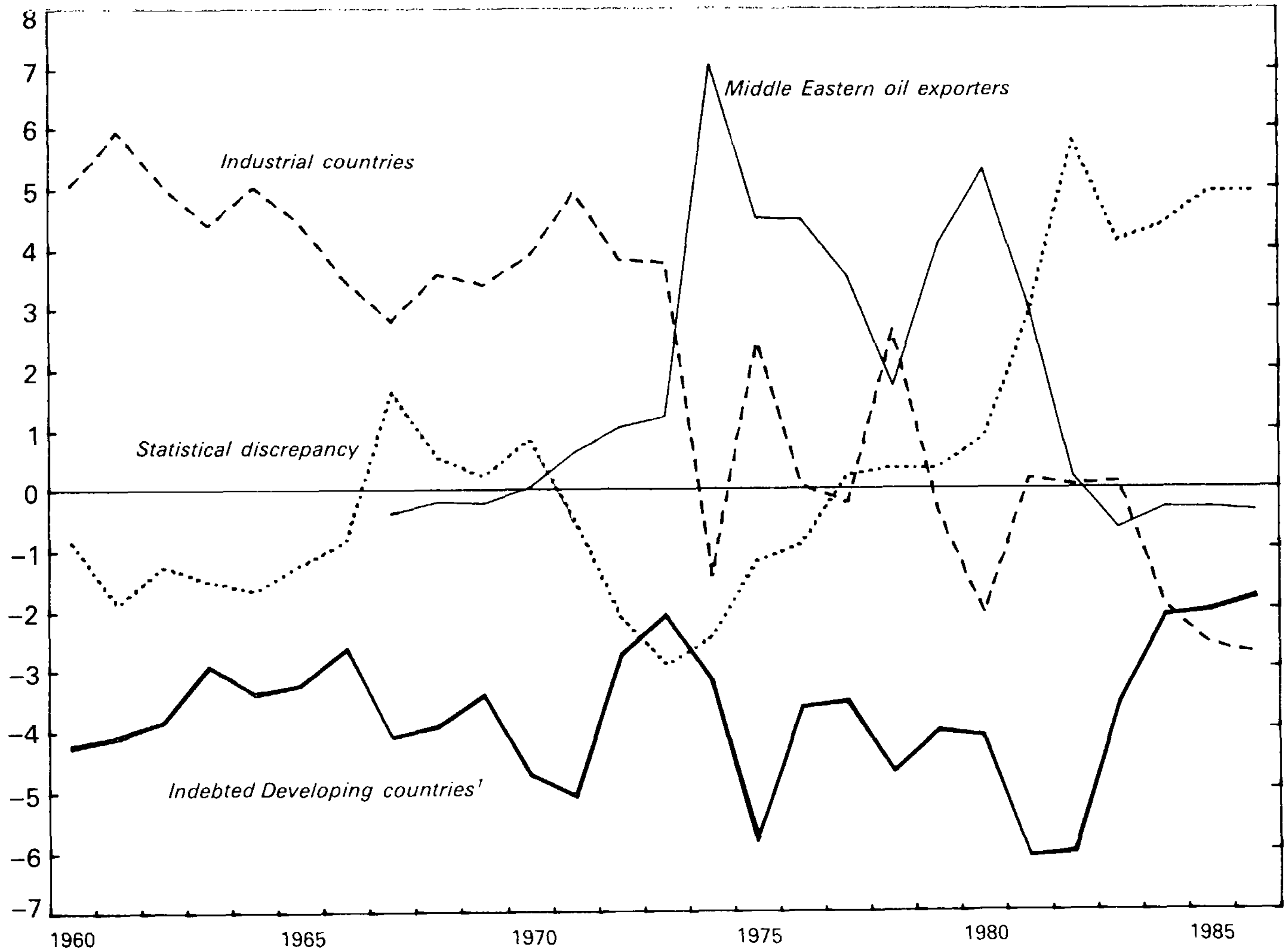
During the early 1960s, the non-oil developing countries were receiving, on average, net external financing equivalent to slightly less than one tenth of their domestic gross capital formation, according to very rough staff estimates. This proportion tended to rise as a number of countries succeeded in obtaining progressively more private financing, especially from commercial banks. For the period 1967-72, the net inflow averaged an estimated 12 percent of gross capital formation in the non-oil developing countries. In relation to net capital formation (for which estimates are not available), the contribution of external financing would represent a much higher percentage in both periods.

CHART 2.

MAJOR GROUPS OF COUNTRIES:

CURRENT ACCOUNT BALANCES, 1960–86

(AS PERCENT OF WORLD EXPORTS)



[1]All developing countries except eight Middle Eastern oil exporters.

This same net flow represented, of course, a considerably smaller share of national saving in the industrial countries. Even in that perspective, however, it was by no means inconsequential. Staff estimates (necessarily very crude, if only because of the uncertainties involved in translating domestic statistics valued in national currencies into a common currency unit) would indicate that the share of gross national saving invested (or transferred concessionally) by the industrial countries to other countries (primarily the non-oil developing countries) averaged about 2 1/2 percent during the six years ended in 1972. A moderrate additional amount of saving that originated in the oil exporting countries during those years might be viewed as having reached non-oil developing countries through the capital and credit markets of the industrial countries, where most of it was initially placed by the oil exporters. (Of course, these placements lost their identity when invested in such financial claims as bank deposits or government securities in the industrial countries, and cannot be traced beyond that point. The receipt of such placements is netted out in the capital accounts of the industrial countries, so that the net outflow aggregated from their balance of payments statistics is less than the amount that would appear in a bilateral record of flows between the industrial countries and the non-oil developing countries.)

2. The period of "recycled" oil surpluses

The pattern of international capital movements during the years from 1974 through 1981 was dominated by the two waves of major oil price increases, the resultant massive--though short lived--upsurges in investable cash surpluses of the oil exporting countries, and the closely associated expansion of lending to non-oil developing countries by private commercial banks. Over this eight-year period, the combined current account deficit of the non-oil developing countries averaged some 65-70 percent higher in relation to their combined GDP than during the relatively calm years from 1967 through 1972. The corresponding net inflow of financing (including unrequited transfers, as well as capital flows) was equivalent, on average, to about 16 1/2 percent of domestic gross capital formation in the recipient countries.

This large step-up in the availability of foreign resources eventually proved unsustainable and left a legacy of burdensome problems; but it did contribute importantly to an expansion of domestic investment while it lasted. This expansion, although very uneven within the non-oil developing group, raised that group's average ratio of gross capital formation to GDP from about 21 percent during the period 1967-72 (and less than 20 percent in the early 1960s) to more than 25 percent from 1974 through 1981.

The origins of the temporarily enlarged flow of capital (including aid) to developing countries during the 1974-81 period were radically different from the traditional pattern (Chart 2). With the sharp change in world oil prices in 1974, the savings of the industrial countries dropped precipitately in relation to their domestic investment expenditures, and the net flow of their own financial resources into international channels was sharply curtailed. At the same time, however, large new sources of funds were generated in the oil exporting countries, mainly in the form of officially held surpluses of foreign exchange earned through oil exports. Indirectly, through the so-called "recycling" process, these became in effect the principal source of capital flowing to non-oil developing countries during the years 1974-77 and again from 1979 through 1981. The bulk of this capital was disbursed, as before, by banks, governments, and enterprises of the industrial countries, so that these countries became in effect intermediaries in the process of channeling funds to deficit countries. The national savings of the industrial countries themselves were used only to a very limited extent to finance net flows to the nonoil developing world. During the entire eight-year period from 1974 through 1981, net outflows of capital (and unrequited transfers) appear to have absorbed only about 3/4 of 1 percent of the aggregate national saving of the industrial countries, compared with something on the order of 2 1/2 percent during the preceding six or seven years.

Because of the rising statistical discrepancy in recorded financing flows, it is quite possible that capital outflows from the industrial countries were appreciably larger, or inflows smaller, toward the end of the 1974-81 period than the statistics show. It is most unlikely, however, that more accurate and consistent balance of payments statistics would alter the general conclusion that net international flows of savings during most years of the 1974-81 period originated predominantly in the oil exporting countries, and that the share sourced in the industrial countries was small despite the leading role of their financial institutions and markets as intermediaries in the channeling of saving flows to non-oil developing countries.

3. The situation since 1982

Even in 1981, the current account surplus of the oil exporting countries--and hence their net acquisition of external financial claims--was shrinking rapidly from its peak following the second round of major oil price increases. By 1982, the combined current account balance of the oil exporting countries had swung into deficit, and it has continued to show a deficit in subsequent years. The absence of net inflows from that source has been one of the factors tending to tighten the supply side of the international credit market.

In principle, the circumstances that shrank and reversed the current account surplus of the oil exporting countries must have produced an equal and opposite swing in the combined balance of payments accounts of other countries. The reported statistics, however, show no revival of recorded net outflows of capital from the industrial countries, and a decline in financial inflows to non-oil developing countries that is much smaller than the massive swing in the position of oil exporters. In each of the years 1982-84, aggregation of individual countries' data produces the anomalous result that all three of these major groups of countries were net recipients of external financing, and none of them were net suppliers. Such a pattern reflects, of course, the existence of large inconsistencies in the balance of payments statistics of individual Fund members. These inconsistencies are now being investigated, in cooperation with national statistical authorities, by a working group under sponsorship of the Fund and other interested international organizations; but their nature remains essentially a mystery at the present time.

Although it is to be hoped that the puzzle will be at least partly resolved by the working group, its study will require considerable time. Meanwhile, since few observers seem willing to assume that the apparent inflow of external finance reported by the developing countries is largely illusory, the most plausible tentative judgment is that financial flows from the industrial and oil exporting countries are larger than these countries themselves have recorded. If so, it seems likely that a significant part of them originates in the industrial countries, where the volume of external financial transactions is so large that errors and inconsistencies representing rather small fractions of the gross flows involved could create discrepancies that were large in relation to the net capital movements.

By 1984, the net external financing estimated to have been received by non-oil developing countries was lower in relation both to their own domestic investment and to national saving in the industrial countries than at any time since 1973. In the aggregate, the amount involved would not suggest any strain on the ability of the industrial countries to supply it, given the apparent ease with which they had supplied relatively much larger amounts in the past. However, those larger amounts were supplied under conditions featuring generally lower government demands for credit than the ones prevailing at present. A prerequisite for substantial recovery of net outflows from the industrial countries may thus be progress in reducing fiscal deficits.

4. Considerations relating to prospective capital flows

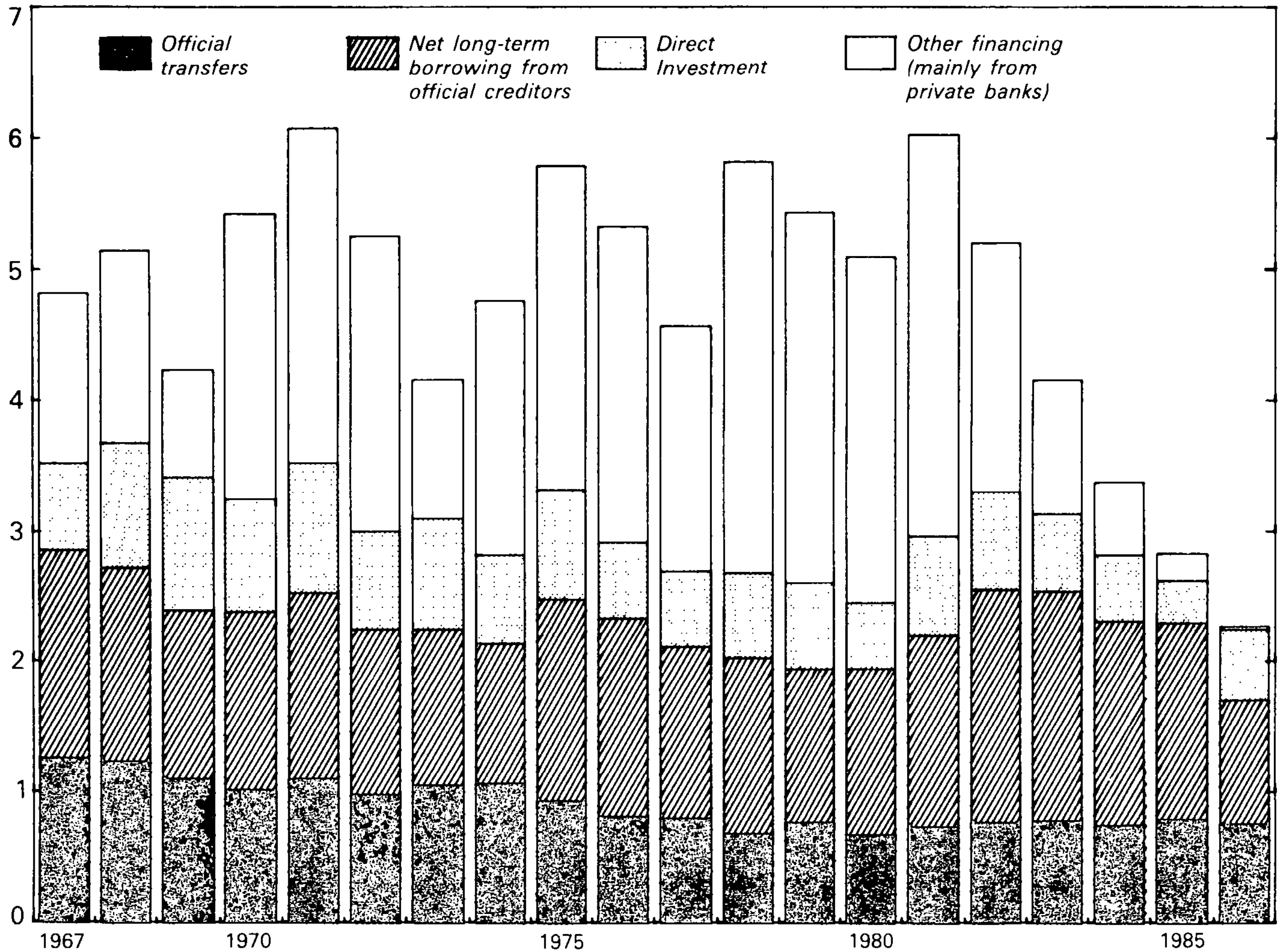
Recent flows of financing to developing countries have not only been much smaller than during much of the 1970s, but also rather different in composition, as shown in Chart 3. In 1984, net private financing covered only a small fraction of the current account deficit of the indebted developing countries, reflecting the reluctance of foreign commercial banks to make any additions to their claims on many of those countries. The financing came, instead, from long-term official credits, official transfers, and direct investment. These relatively stable sources, which were not greatly affected by the debt crisis, provided more than sufficient funds to cover the reduced aggregate current account deficit, permitting substantial net additions to reserves. From 1977 through 1981, in contrast, private lending, mainly by commercial banks, had provided almost half of the relatively much larger amounts required in those years to finance current account deficits and reserve accretions of the indebted developing countries. At no time since 1973 has the role of private lending institutions in this financing been as small as it is at the present time.

The emergence of the United States as an unprecedentedly large international borrower is a dominant feature of the present pattern of global capital movements. In 1984, absorption of surplus savings from other industrial countries by the United States dwarfed the combined absorption by all developing countries. Although no early end of this phenomenon can be envisaged, its eventual reduction is of major importance in enhancing the availability of international credit to developing countries. Conversely, continued credit demand from the United States on the present scale could severely limit expanded access to external financial resources by many developing countries, even if they manage their own economies satisfactorily.

Pursuit by the United States and other major industrial countries of fiscal and monetary policies approximately along the lines assumed in the staff's baseline scenario would at least open the door to a gradual renewal of growth in capital flows to developing countries. The scope for such growth would nevertheless remain uncertain, partly because the major changes of the 1970s and early 1980s have made it hard to judge what constitutes a sustainable pattern of supply of net international saving. Twice in the past dozen years, the sourcing of international flows of saving has shifted massively and suddenly from the industrial countries to the major oil exporting countries and then--less suddenly, but still rather rapidly--back again. Since revival of large financial surpluses among the oil exporters seems unlikely during the remainder of the current decade, the outcome will depend--insofar as the supply of credit is concerned--on the ability and willingness of savers and investors in the industrial countries to resume their former role as net suppliers of funds in international markets.

The outcome will also depend vitally on the policies followed by developing countries themselves. For the time being, and probably for several years ahead, they have no option but to adjust their absorption of external goods and services to levels dictated by their actual export

CHART 3
INDEBTED DEVELOPING COUNTRIES[1]:
FINANCING OF CURRENT ACCOUNT DEFICITS AND ACCUMULATIONS OF RESERVES, 1967–86
(AS PERCENT OF WORLD EXPORTS)



[1]All developing countries except eight Middle Eastern oil exporters.

earnings and the greatly reduced net financial flows that remain available to them. These net inflows are currently sufficient, in the aggregate, to cover only about 10 percent of domestic gross capital formation in the non-oil developing countries, even though the ratio of domestic investment to GDP has been cut back to something like its 1970 level.

This relatively low ratio, if it were to persist, would seriously set back the development efforts of these countries. It would limit the scope for gains in productivity and real income among countries comprising the bulk of the Fund's membership. Accordingly, they are likely to seek renewed growth of supplementary resources from abroad as soon as such resources can be made available consistently with prudent management of future debt service obligations. Meanwhile, the present high costs of international borrowing impinge unfavorably on prospective rates of return for investors in real capital assets in developing countries. There is thus an appreciable constraint on the flow of credit to these countries from the demand side of the market, quite apart from the reluctance of lenders to supply it.

Restoration of confidence on both sides is essential to raise the flow of capital to developing countries substantially above the low level to which it has fallen in the wake of the recent international debt crisis. Among other things, such a restoration of confidence requires rectification of the overindebtedness generated by many years of relatively very high current account deficits. Bringing down excessive debt ratios requires several years during which current accounts may have to be held below levels that may eventually prove sustainable.

The policies and developments that would help promote such a result are discussed at length in companion papers of the present WEO series and are embodied, to a realistic degree, in the staff's medium-term projections. These assume a gradual adjustment extending over several years in a policy environment generally and consistently geared to basic long-term considerations. Under such assumptions, the supply of credit to borrowers in developing countries could be expected to increase as government credit demands recede in the United States and other industrial countries. Declines in real interest rates would also make external borrowing more appealing to developing countries--and more feasible. In the staff's baseline scenario, these countries would obtain from foreign sources a somewhat higher proportion of their domestic investment financing than at present, though a considerably lower share than during the period from 1974 through the first half of 1982. The share of foreign support for investment implied by the projections would thus be closer to the average of the late 1960s and early 1970s, before the subsequent high inflation and unexpectedly large import bills, coupled with unduly accommodative monetary policies in a number of industrial countries, stimulated excessive use of external credit by many developing countries. A full return to the relative magnitudes of the 1974-81 period would be undesirable, even if it were possible, because of the likelihood that such large inflows would again prove unsustainable, ending in another round of disruptive adjustments.

To the extent that some recovery in the relative magnitude of capital flows to developing countries is feasible, it will probably have to come mainly through a revival of confidence and of lending operations on the part of private banking institutions. Governments in the industrial world are operating under budgetary constraints that make any marked rise in their lending unlikely, despite the urgent needs of many developing countries. Even the maintenance of the present levels of official financing in real terms may prove difficult. Accordingly, it is hard to envisage any substantial rise in the scale of capital flows to developing countries without active utilization of private banking channels. Needless to say, however, renewed utilization of that channel must proceed at a decidedly more moderate pace than in the 1970s if it is to be sustained. Moreover, it cannot proceed at all unless the potential lenders gain confidence in the policies of the borrowing countries.

Greater confidence in the economic policies of those countries would also encourage flows of direct investment capital. Larger proportions of direct investment in the total net inflow not only would tend to facilitate acquisition of the technology and managerial skills that are usually associated with such investment, but also would avoid the vulnerability and rigidities associated with debt service obligations. Despite these advantages, however, it would not be realistic to count on direct investment as the principal medium for the movement of resources to developing countries. The expansion of its role projected by the staff is therefore very moderate.