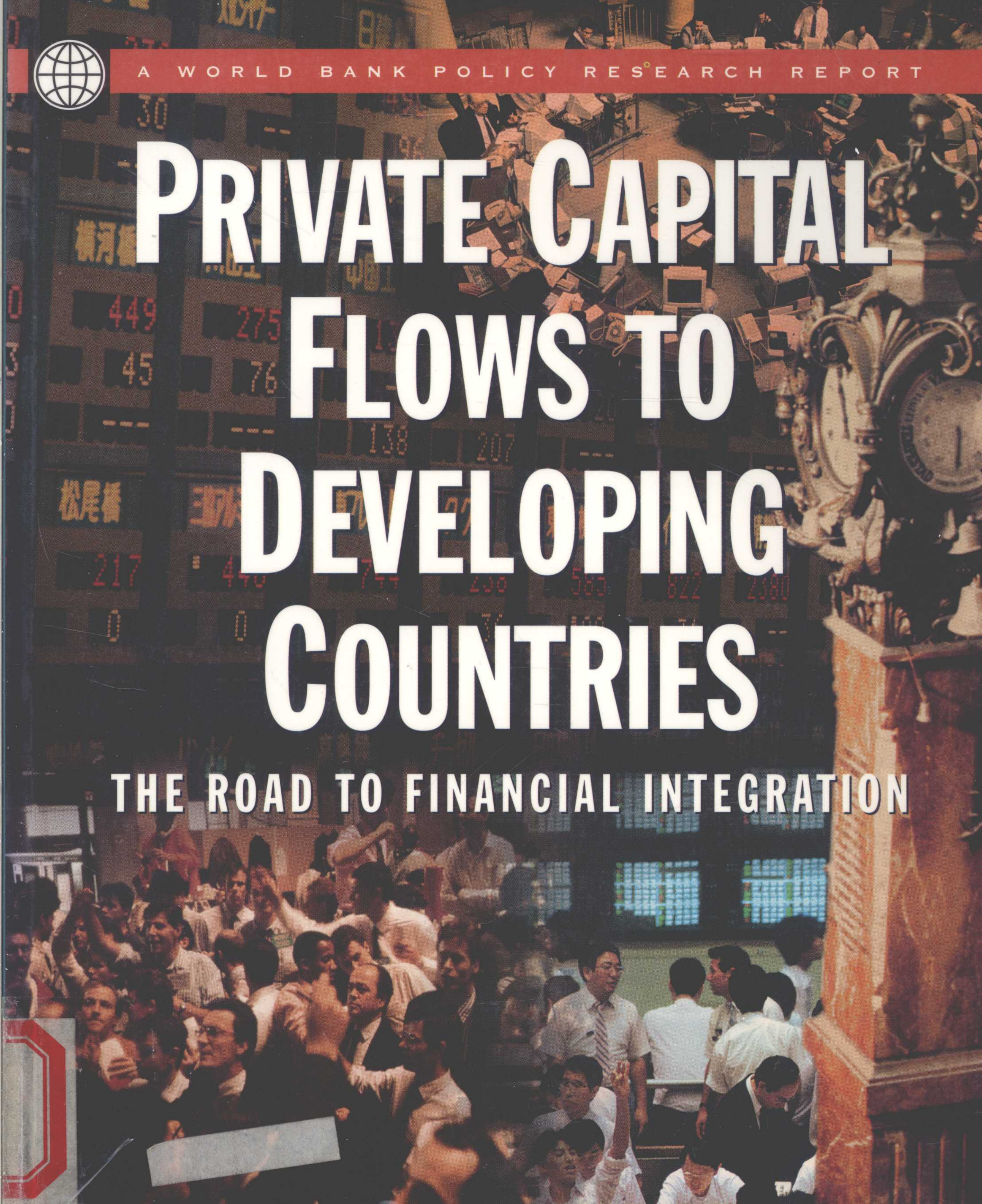
A WORLD BANK POLICY RESEARCH REPORT

PRIVATE CAPITAL FLOWS TO DEVELOPING COUNTRIES

THE ROAD TO FINANCIAL INTEGRATION



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The Road to Financial Integration

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Private Capital Flows to Developing Countries

A World Bank Policy Research Report

Foreword

FINANCIAL MARKETS AROUND THE WORLD ARE RAPIDLY INTEGRATING into a single global marketplace, and developing countries are increasingly part of this process. The process is being driven by advances in communications and information technology, deregulation of financial markets, and the rising importance of institutional investors that are able and willing to invest internationally. The good news is that developing countries are attracting private capital flows by improving macroeconomic policy and by establishing institutions and regulatory regimes that have increased creditworthiness and promise a more stable environment. Moreover, investors are also becoming more sophisticated in differentiating among countries and their economic fundamentals. Finally, after the Mexican crisis of 1994–95, the international community has realized that more should be done to reduce volatility and risks in international financial markets by improving market disclosure and strengthening coordination among national authorities.

Nevertheless, there remain reasons for concern. First, for the twenty or so countries that have been the major recipients, the management of private capital flows has not proved to be easy. It is not just the volume of flows, but the speed at which such investment pours in—and can be withdrawn—that present particular challenges to these economies. Governments need to build the kind of macroeconomic, regulatory, and institutional environments that channel this private capital into broad-based and sustainable growth. Second, the overwhelming majority of developing countries, in particular the smaller low-income economies, still need to create the conditions to attract private capital and must depend on declining official flows.

This report makes a serious and timely contribution to the analysis of these issues. It explores the nature of the changes that are leading to the integration of developing countries in world financial markets, and it analyzes the policy challenges these countries face in attracting and managing private capital flows. It concludes, for example, that countries receiving large capital inflows should avoid using them to finance large fiscal deficits or consumption booms. The report also includes specific recommendations and warnings on regulatory design that may be useful to developing countries as they seek to maximize the positive contribution of capital inflows while minimizing their potentially disruptive effects.

This book, therefore, will be highly useful to policymakers in developing countries and, more generally, to all development specialists. But it will also be essential reading for members of the global financial community. Investors have seen in recent years how dynamic—and sometimes volatile—emerging markets can be. Understanding these opportunities and challenges is critical for everyone.

The report also comes at an important time for the World Bank. The challenge for the Bank and other development agencies is to create strategies to help developing countries leverage private capital flows so that all benefit. The research presented in this book is an important step in constructing such strategies.

Like previous volumes in the Policy Research Report series, *Private Capital Flows to Developing Countries* is designed for a wide audience. It is a product of the staff of the World Bank; the judgments made in the report do not necessarily reflect the views of the Board of Directors or the governments they represent.

Joseph E. Stiglitz
Senior Vice President
and Chief Economist
The World Bank

April 1997

The Report Team

THE REPORT TEAM WAS LED BY AMAR BHATTACHARYA AND comprised Pedro Alba, Swati Ghosh, Leonardo Hernández, Peter Montiel, and Holger Wolf. Substantial background input was also provided by Andrea Anayiotos (chapter 2), Soonhyun Kwon (measurement of financial integration), Maria Soledad Martinez-Peria (chapter 5), and Michael Pomerleano (chapter 6). The main research assistance was provided by Jill Dooley, Matthew Anderson, and Jos Jansen. Bakhodir Atahodjaev, Madeleine Li-Chay-Chung, and Alok Garg also provided research assistance. Deborah Davis edited the first draft of the study, and Anatole Kaletsky provided editorial input on the summary and chapter 1. K. Anna Kim provided logistical and secretarial support for the overall study, and Hong Vo for chapters 2 and 5. The study was initiated by and carried out under the direction of Michael Bruno and Masood Ahmed. Joseph Stiglitz provided guidance in the closing stages of the study.

The editorial production team was led by Anthony Pordes. The team was assisted by Paola Brezny, Amy Brooks, and Audrey Heiligman. Joyce Gates provided production support.

Acknowledgments

THE REPORT HAS BENEFITED FROM DISCUSSIONS WITH AND comments and contributions from many persons outside and within the World Bank. Special thanks are due to those who have provided guidance and feedback from the inception to the completion of the study. These include Gerard Caprio, Stijn Claessens, Richard Frank, Morris Goldstein, Sarwar Lateef, Diana McNaughton, Gary Perlin, D. C. Rao, Jed Shilling, and Paulo Vieira da Cunha. Special thanks are also due to Mariano Bengoechea, Claudia Morgenstern, Susan Pascocello, Ester Saverson Jr., and Robert Strahota for their extensive feedback on chapter 6. The report also benefited from discussions with Ismail Dalla, Jack Glen, Ross Levine, Millard Long, and Andrew Sheng. We would like to acknowledge support from staff and management of the International Monetary Fund; Sunil Sharma participated in a mission to prepare a background paper, and Donald Mathieson, Anthony Richards, and Michael Spencer provided valuable comments.

The report would not have been possible without the willingness of the private sector to share its perspective on investing in emerging markets. The report has drawn on interviews with many fund managers and pensions funds, information provided by global custodians, and discussions with many others in the financial community. Although they are too numerous to mention, we would like to make special note of the support received from the Frank Russell Company; Citibank, N.A.; the Bank of New York; INTERSEC Research Corporation; and the International Federation of Stock Exchanges (FIBV).

The report drew on background papers or inputs by Reena Aggarwal, Philip Brock, José de Gregorio, Persephone Economou, Ian Giddy, Morris Goldstein, Naoko Kojo, Elizabeth Morrissey, Gabriel Perez-Quiros, Maria Scattaglia, and Charles Seeger. The study has also drawn on a number of country studies that we intend to include in a subsequent volume. The Asian component of the review of country experiences was undertaken collaboratively with the Asian Development Bank (ADB). The study has also benefited from a joint ADB–World

Bank workshop on “Private Capital Flows: Implications for Capital Markets in Asia,” and we would like to thank the participants in that workshop. Many individuals in the International Economics Department provided data needed for the study; we would like to make special acknowledgment of the support received from Punam Chuhan and Himmat Kalsi.

Many Bank staff members provided valuable comments, including Noritaka Akamatsu, Suman Bery, Francis Colaco, Uri Dadush, Asli Demirgüç-Kunt, Cevdet Denizer, Hinh Dinh, Daniela Gressani, Norman Hicks, Akira Iida, Ronald Johannes, Johannes Linn, Will Martin, Vikram Nehru, Ngozi Okonjo-Iweala, Guillermo Perry, Thierry Pujol, Zia Qureshi, Jean-François Rischard, Hemant Shah, Robert Shakotko, C. K. Teng, John Williamson, and Roberto Zagha. Finally, we have benefited from comments received at a Board seminar on the draft report.

Data Notes and Abbreviations

Data Notes

HISTORICAL DATA IN THIS BOOK MAY DIFFER FROM THOSE in other World Bank publications if more reliable data have become available, if a different base year has been used for constant price data, or if countries have been classified differently.

- *Billion* is 1,000 million.
- *Trillion* is 1,000 billion.
- *Dollars* are current U.S. dollars unless otherwise specified.

Abbreviations and Acronyms

ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
C&S	Clearance and settlement (securities)
CPI	Consumer price index
FDI	Foreign direct investment
IFC	International Finance Corporation
IFCI	IFC Emerging Markets Index
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISSA	International Society of Securities Administrators
GDP	Gross domestic product
GNP	Gross national product
SRO	Self-regulatory organization

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Summary

THE WORLD'S FINANCIAL MARKETS ARE RAPIDLY integrating into a single global marketplace, and ready or not, developing countries, starting from different points and moving at various speeds, are being drawn into this process. If they have adequate institutions and sound policies, developing countries may proceed smoothly along the road to financial integration and gain the considerable benefits that integration can bring. Most of them, however, lack the prerequisites for a smooth journey, and some may be so ill prepared that they lose more than they gain from financial integration. Developing countries have little choice about whether to follow this path, because advances in communications and new developments in finance have made the course inevitable. They can, however, decide how they wish to travel, choosing policies that benefit the economy and avert potential shocks.

This volume describes the forces that have created and that sustain this road, analyzes the benefits and problems likely to be encountered on it, and examines the experiences of those who are farther along on the journey to see what can be learned from them.

The Changing Financial Environment

While the cyclical downturn in global interest rates provided an important initial impetus for the resumption of private capital flows to developing countries in the 1990s, these flows have now entered a new phase, reflecting structural forces that are leading to progressive financial integration of developing countries into world financial markets. The two primary forces that are driving investor interest in developing