

***CAPITAL FLOWS, EMERGING  
MARKETS AND SOUTH  
AFRICA***

***BY***

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Opinions expressed, and conclusions arrived at, are mine, and are not necessarily to be attributed to the others. The work presented in here is my own and the references are acknowledged. The work has never been submitted to any other university.



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## ABSTRACT

Financial markets are rapidly integrating into a single global market place, and developing countries including South Africa, are increasingly part of this process. The process is being driven by both the push and the pull factors in both developed and developing countries. Nevertheless, the overwhelming majority of the developing countries still need to create the conditions to attract long-term capital flows.

Although South Africa has been attracting capital flows since the 1990s, the level is not sustainable because it mainly attracts short-term capital. It has failed to attract long-term capital on a sustainable basis because of economic and political crises facing the country. Thus, the South African government needs to build the kind of macroeconomic, regulatory and institutional environment that channels this private capital into broad - based and sustainable growth.

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## I INTRODUCTION

*During the early 1990s developing countries experienced an inflow of long-term capital directed particularly towards Latin American and Asian countries. As opposed to the debt-oriented short-term capital flows of the 1980s which were public driven, present capital inflows are private sector driven and to an important extent, are portfolio capital flows. Moreover, in Latin America the repatriation of flight capital has been an important factor in capital inflows (Strydom, 1995: 8).*

Khan and Reinhart (1995: 15-16) define capital inflows as the increase in net international indebtedness of the private and the public sectors, measured, albeit imprecisely, by the deficit on the capital account of the balance of payments. Therefore, except for errors and omissions, the capital account deficit equals the excess of expenditure over income plus the change in official holdings of international reserves. Thus, increases in capital inflows can be identified with larger current account deficits or an accumulation of reserves. It is the purpose of this study to investigate the changing patterns of foreign capital flows to emerging markets, the main determinants of these flows and to analyse the particular position of South Africa.

Section II describes the changing patterns in capital inflows to developing countries, analyzing the trends and describing the composition of these capital inflows with Foreign Direct Investment (FDI) and portfolio capital inflows taking centre stage in the 1990s.

Section III concentrates on the primary forces driving investor interest in developing countries. The issue of whether the inflows were primarily driven by sound domestic policies and market oriented reforms (i.e. the pull

factors) or declining international interest rates and poor returns in stock markets in industrial countries (i.e. the push factors) is the focal point of this section.

Whether these flows were responding primarily to conditions in the recipient countries or to external conditions, these sizeable capital inflows and the speed at which they entered the recipient country had important macroeconomic effects, such as helping to finance higher investment and stimulate growth. However, there were side - effects to these inflows, such as the real exchange rate appreciation, current account deficit increases, market volatility and capital reversals. Given these concerns, many developing countries have formulated appropriate policy responses to these developments.

Sections IV and V look into macroeconomic effects and appropriate policy responses to surges in capital flows.

Section VI describes the setting in which the sustainability of these inflows are explored. A critical question in most of the countries that experienced a surge in capital inflows is: to what extent will external and internal developments combine to make the flows endure?

Section VII focuses on the fact that although some developing countries have attracted long-term capital inflows, South Africa has been unsuccessful in attracting long-term capital on a sustainable basis since the 1990s. The section examines the magnitude of and the explanation for foreign capital flows into South Africa. The section also focuses on macro-economic policy and its implications for South Africa.

Section VIII concludes by discussing the changing patterns in capital flows, macroeconomic effects and policy responses, the sustainability of these inflows, foreign



capital flows into South Africa and the policy recommendations to be applied by South Africa in response to its unsuccessful attempts to attract long-term capital inflows on a sustainable basis.



## II CHANGING PATTERNS IN INTERNATIONAL CAPITAL INFLOWS

Many developing countries, including South Africa, were the recipients of a considerable volume of capital inflows in the 1990s. The pattern of capital inflows to different developing countries has varied significantly. During the 1970s and early 1980s, capital inflows were of a short-term nature while the pattern changed to long-term capital inflows during the late 1980s and early 1990s.

### 1. SHORT-TERM CAPITAL INFLOWS

The 1970s and 1980s were dominated by the development of short-term capital inflows which resulted in the accumulation of debt in many developing countries, especially those in Latin America. There was also a great slowdown in economic growth coupled with balance of payments problems as witnessed by major changes in the international payment system which started with a large current account deficit in the US. The dollar became inconvertible, the currency was devalued, and exchange rates were more volatile than ever before.

When the first oil shock took place at the end of 1973 and oil prices reached new highs, a financial process which led countries to opt for short-term capital flows began. Schatan (1984: 7) outlines the period 1974-80 as characterised by the following events: firstly, the most important oil-exporting countries, not being able to utilize domestically the vast financial surpluses generated by oil price increases, made huge deposits at various OECD financial institutions. Secondly, at the same time, a considerable number of middle- and high - income oil-importing nations decided to accelerate their rates of economic growth, notwithstanding the increase in oil prices. That policy was in sharp contrast with the

'stagflation' prevailing in the OECD countries.

Thirdly, in order to carry out their expansionary economic policies, many developing countries requested huge loans from OECD commercial banks, in order to afford massive imports of all kinds of goods other than oil.

Fourthly, the OECD banks with great liquidity and a weak domestic demand for funds started a wild competition to export capital to the more dynamic less-developed nations, which at that time had decided to turn to the international private banking system to obtain the money required to implement their expansionary economic policies.

Finally, concomitant with the final oil price shocks in 1979 and 1980, international inflation accelerated and interest rates rose to record high levels. The fixed gold price was abandoned and major industrial countries agreed to a managed floating exchange rate system. The balance of payment adjustment mechanism relied heavily on price changes through flexible exchange rates.

However, foreign exchange markets for a long time continued to display volatile patterns (Turner 1991: 10 - 11). In order to diminish the risk associated with these developments, the international banks decided to change the terms and conditions of the loans by concentrating on short-term lending. Moreover, the suppliers of short-term capital concentrated on debt rather than financial assets. The implication of this technical innovation, which also included attractive offers to developing countries was, that many developing countries were trapped in a balance of payments constraint. Their accumulated interest payments escalated beyond their debt-servicing capacities, since that increases in interest rates applied to the total outstanding debt and not only to the new loans.

The debt situation was worsened by extensive capital

outflows from developing to developed countries. Following the onset of the debt crisis in 1982, medium and long-term capital flows to developing countries, as a group, fell sharply, with net outflows in 1987 -1988.

South Africa was no exception. Although South Africa attracted substantial long-term capital inflows during the post World War I period until the early 1970s, there was a shift in favour of short-term debt-oriented capital flows, which resulted in the importance of foreign macroeconomic performance and the domestic investment process becoming more domestically driven. As stated by Strydom (1995: 7), overspending became evident through rising consumption ratios as well as a deteriorating fiscal deficit. South Africa imported more and more short-term capital and its foreign debt as a percentage of GDP increased to a high of 43 percent in 1985. Inflation accelerated and overspending in the public sector went hand in hand with a rising tax burden. From 1981 - 1984 the current account showed large deficits, confirming the degree of overspending. Capital inflows were insufficient to cover these large deficits and the country lost large amounts in net gold and foreign exchange reserves. To protect the rand against accelerating outflows of foreign capital, the government declared a debt "standstill" on foreign bank debt repayment.

Kahn (1989: 248) noted that the increased reliance on foreign loans implied that SA was becoming more vulnerable to external 'shocks' on the capital account. While the current account can be dealt with by increased foreign borrowing in order to allow for a smoother adjustment, a capital account shock usually comes about as a result of political instability (Smit & Mocke 1991: 113), which restricted South Africa's access to international capital markets.

The political crises in South Africa in 1976 and 1985 not only resulted in capital flight, but also made it difficult for South African borrowers to raise new loans to offset the effects of the capital outflow.

With the declaration of the debt standstill resulting into the debt repayment agreements, South Africa generated current account surpluses in order to repay its foreign debt. De Kock (1989: 274) states that in 1985 this surplus amounted to R5,9 billion and it increased in 1986 to R7,2 billion or about 5 percent of GDP. South Africa achieved this outcome by slowing down domestic economic growth significantly, particularly in terms of investment expenditure in both private and public sectors and by curbing imports. Real GDP fell and during the 1990s South Africa experienced its worst recession in the post-second World War II period.

During the early 1980's Latin America, turned its disastrous trade situation into a huge surplus, through a drastic curtailing of imports. The total value of imports began to decline after 1981, but the most important decline took place between 1982 and 1983, with a decrease of nearly \$30 billion to a level close to \$80 billion, which remained fairly stable throughout 1984 and 1985.

## 2. LONG-TERM CAPITAL INFLOWS

As the debt problems were addressed and the implementation of sound policies restored confidence in developing countries toward the end of the 1980s and the 1990s the medium - and long-term capital flows began to rebound strongly and have since risen rapidly, with the composition shifting substantially over the period 1990 - 1993.

There was a slowdown in capital inflows in early 1994 following the crisis in Mexico and following increases in

United States interest rates in the beginning of February 1995. Although there was a substantial decline in capital flows to developing countries in the immediate aftermath of Mexico's currency crisis, in most cases capital flows have resumed and by mid-1995 have been sustained at relatively high levels. Despite the increases in United States interest rates from 1994, private flows increased by a further 55 percent during the past three years (Hernández & Rudolph 1995:7).

In 1992 and 1993 net private capital inflows to developing countries for the first time since the international debt crisis of the early 1980's surpassed the volume of official flows to developing countries (Gooptu 1994: 7). Private flows accounted for almost 60 percent of net flows to developing countries due to a fall in interest rates on international financial markets.



Table:1 Net Private Capital inflows to 21 Developing Countries, 1988 - 95 (Percentage of GDP)

Country	1988	1989	1990	1991	1992	1993	1994	1995	Cumulative flows to GDP at end of period
Argentina				1.3	3.8	2.9	3.1		9.7
Brazil					2.8	2.3	1.9	4.8	9.4
Chile		33	8.6	3.1	7.4	6.3	7.7	4.0	25.8
Colombia					1.8	5.6	6.2	6.2	16.2
Costa Rica	10.6	12.0	4.4	4.7	9.2	9.1	2.5	5.3	44.0
Hungary						17.5	8.5	18.4	41.5
India					1.1	1.7	2.7	1.7	6.4
Indonesia			2.5	1.9	1.3	0.2	1.1	3.6	8.3
Korea				2.6	2.5	0.6	2.4	3.5	9.3
Malaysia		2.9	5.7	11.1	15.3	23.2	1.2	6.6	45.8
Mexico		2.6	2.2	7.5	7.6	8.5	3.3		27.1
Morocco			4.6	2.9	2.5	3.0	5.0	3.2	18.3
Pakistan					2.5	4.9	3.8	3.3	13.0
Peru			3.9	5.4	5.3	4.6	10.8	8.2	30.4
Phillipines		2.1	3.9	4.4	2.3	4.4	7.9	5.2	23.1
Poland					4.1	6.8	3.1	12.0	22.3
Sri Lanka				3.9	5.3	8.2	6.5	3.5	22.6
Thailand	7.4	10.4	12.3	12.3	8.6	7.7	8.3	12.1	51.5
Tunisia					4.1	7.1	5.1	17.6	17.6
Turkey					1.9	4.1			5.7
Venezuela					3.3	2.0			5.4

SOURCE: WORLD BANK (1997)

The composition of flows in the 1990s has changed dramatically from that prevailing during the debt and pre-debt crises periods.

During the 1990s these flows have been primarily in the form of foreign direct investment and portfolio investment (through bonds and equities). They have led the way to a surge in capital private flows. The fall in interest rates in developed countries encouraged investors in industrial countries to look elsewhere for higher returns. Moreover, falling interest rates improved the creditworthiness of all developing countries, especially the highly indebted ones by reducing the cost of servicing their, debt.

In the late 1970's and the 1980's bank loans and public sector borrowers dominated net capital flows. By contrast, in the 1990s non-debt flows and private sector borrowers started dominating capital flows to developing countries, the fastest growing components being bonds and equity investments which have increased more than ten-fold since 1990 (Goldstein 1995: 3).

There remains a considerable country and regional concentration in the destination of private capital flows. These flows have been mainly destined for Asia and Latin America. Apart from these regions, China was the recipient of nearly 30 percent of all foreign direct investment in developing countries during 1990 - 1994, which suggests that domestic factors may be important in explaining the new wave of private capital flows. The abovementioned regions and countries have implemented structural reforms in recent years.

According to Folkerts - Landau *et al* (1995: 4) the level of *bank lending* to developing countries in the 1990s remained relatively unchanged and comprised a relatively small source of financing to these countries. The share of developing countries has also declined, falling from a high of 24,6 percent in 1991 to 12 percent in 1994, partly reflecting the cautious attitude of commercial banks towards lending to developing countries. Many developing countries suffered a massive reversal in bank credit flows because of various reasons of (Turner 1991: 21 - 22), such as debt conversion schemes, asset sales and write-offs. To some



extent, this declining pattern reflected the unwillingness of banks to increase their exposure to a number of countries whose creditworthiness was in doubt.

Nevertheless, the bulk of medium - and long-term bank commitments to developing countries have continued to be concentrated in Asian countries which had not experienced debt-serving difficulties.

The nature of *FDI* (Foreign Direct Investment) flows to developing countries has changed significantly. In the 1970s and early 1980s, the primary force or motive for FDI flows to developing countries was resource extraction and import substitution. The reasons for the increased pace of direct investment activity in the 1990s are many and diverse. The FDI flows to developing countries are motivated by efficiency in investment opportunities. Dadush *et al* (1994: 6) indicate that in recent years, developing countries have attracted a high share of FDI flows as industrial countries suffered recessionary conditions. The share of developing countries has risen from less than 15 percent in the second half of the 1980s to 31 percent in 1992, which is approximately equal to the proportion of World GNP accounted for by developing countries.

The view, expressed by Dadush, that capital flows to developing countries were governed by cyclical factors was opposed by the World Bank (1997:104-105) which stressed the fact that structural changes such as medium and long-term profitability considerations guided FDI flows. Hence, FDI flows are probably subject to a smaller degree of sudden reversals than portfolio flows, but likely to be least affected by a rise in international interest rates. A wave of cross border mergers and acquisitions also increased FDI flows during the late 1980s and early 1990s, though not all countries have been equally affected by the merger and acquisition boom (Turner 1991: 49).

Moreover, FDI have positive externalities for the recipient country in the form of increased access to foreign markets, increased scope for human capital development and introduction of technology. Thus, the investment flows have been directed mainly to the service sector, including infrastructure and banking, which has expanded significantly as a result of stronger economic growth and investment deregulation in developing countries. East Asia, with its strong economic growth, supporting infrastructure and a highly productive labour force, has been the primary recipient of FDI (World Bank 1997 104:105). Among these countries, FDI flows have been of the greatest importance - relative to total capital inflows - in Malaysia and Thailand (Khan & Reinhart 1995:17).

Although private capital flows to developing countries began to increase in 1986 after several years of decline, they accelerated when international interest rates began to fall. Hernández & Heinz (1995: 3) argue that the increase in private capital inflows since 1989, particularly *portfolio investment flows*, were largely due to a fall in interest rates in international financial markets. The fall in interest rates induced investors in industrial countries to look elsewhere for higher returns, and improved the creditworthiness of all developing countries.

International portfolio flows have been a major source of funds to developing countries as these portfolios have become more internationally diversified in many industrial countries giving greater exposure to these countries. These flows expanded noticeably in the early 1990s. By 1993 all the larger developing countries were able to tap both international bond and equity markets (Khan & Reinhart 1995:5).

Hernández & Rudolph (1995:4) maintain that this large share in current portfolio investment is evidence of a larger risk sharing component than in the late 1970s, possibly implying that the flows are more long-term than short-term.

The increase in portfolio flows also reflects investors' acknowledgement of the strength of developing countries' economic policies and growth prospects, exemplified by the normalization of relations with private creditors in Mexico and the Philippines following the completion of operations to reduce the two countries' debt and debt-servicing.

Another factor which has attracted more portfolio flows to developing countries is the decline in interest rates in industrial countries. In conjunction with strong macro-economic policy performance in the developing countries, improved market perceptions of creditworthiness of their securities, access to international financial markets has been facilitated. Chuhan (1994:1) also stresses this.

Although portfolio flows have been an important sources of finance to emerging markets, there has been marked regional differences in the composition of flows to these markets. On average, since 1990, 41 percent of capital flows to developing countries has been in the form of portfolio investment in tradeable bonds and equities and 37 percent in FDI, Folkerts-Landau *et al* (1995:2).

In Asia, portfolio investment share was 24 percent of inflows while 45 percent was FDI. These inflows were accompanied by a decline in interest rate spreads across comparable U.S. treasury securities to historically low levels. However, conditions in international financial markets changed significantly in the first half of 1994 because of the increase in U.S. interest rates. As a consequence, the volume of international portfolio flows to developing countries as a group fell significantly between February 1994 and April 1994 (Khan & Reinhart 1995:5).

Portfolio capital flows to developing countries do not consist of international placements of bonds and issues of equities in international markets only, but also of purchases by foreigners of stocks and financial market instruments in developing

countries' domestic markets.

Before discussing these other forms, it is necessary to look at the changing patterns in bonds and equities. During the period 1990-94 international *bond issues* were the main source of external funding for developing countries. For instance, international bonds issued by APEC (Asian Pacific Economic Cooperation - Council), to developing countries increased from \$4 billion in 1990 to \$31 billion in 1993, partly in response to the decline in the U.S. long-term interest rates and growing investor interest in these securities. In line with the experience of other developing countries, most APEC controls have been concentrated in the Eurobond market. The increase has been associated with greater sophistication and the diversification of borrowing instruments.

International *equity issues* have also been an important funding source, but to some extent they may have simply served to spark the interest of investors in developing country stock. Nonetheless, they have grown steadily from \$1.1 billion in 1990 to \$8.1 billion in 1993 (Khan & Reinhart 1995:11). Major equity issuers included Korea, Mexico, China and recently India, which accounted for 67 percent of the total international stock issues by APEC developing countries during the period 1990 through 1994. The increase is in part a result of the opening up of equity markets to foreigners, e.g. Korea and Mexico, which both relaxed restrictions on foreign ownership. In China, firms started to list stocks on the Hong Kong exchange market. Stock market liberalization in India is another example, resulting in a significant amount of private portfolio flows.

The fastest growing segment of the portfolio flows appears to be *direct purchase of securities* (mutual and pension funds) in domestic markets. This the importance of the institutional investor in the changing pattern of capital flows. This view is shared by Khan (1995:12), who stated that over the last years, direct purchases by international investors on local exchanges

have been an increasingly important source of portfolio flows to APEC developing countries.

The *mutual funds* have in general focused on equities, with the number of equity funds and their net assets growing significantly. Equity funds that were especially targeting APEC developing countries numbered 231 by the end of 1993 and their total net asset value amounted to \$17 billion (Khan & Reinhart 1995:12).

*Pension funds* also experienced a change in their holdings of developing country securities, in that they were moving beyond Asia to invest in Latin American assets. While these investors have significantly increased their holdings, they still place only a fraction of their portfolio in developing country securities. However, the 1993 - 1994 period witnessed a fairly rapid increase in the number of investors in developing country securities. Moreover, their risk-return preferences and method of operations tended to resemble those of the mutual funds.

Khan & Reinhart (1995:12) notice a different pattern in investor preferences for developing countries portfolio assets. For example, U.S. investors played a major role in the market, largely focusing their purchases on debt and equity issues in Latin America and Asia. This substantial increase in portfolio flows started in the 1980s when U.S. investors began to diversify investments in line with the relative weaknesses in major domestic asset markets. Moreover, declining interest rates boosted portfolio flows to developing countries. UK investors tended to buy assets in Asia and, to a lesser extent, in Latin America. German investors are reported to be principally interested in issues by Eastern European countries, probably because of their proximity to these markets but are now beginning to show more interest in Latin American securities. Japanese investors have invested only a small share of their assets in developing country portfolio issues and have mainly concentrated on Asian countries.

All in all, there were several positive developments in recipient countries as well, as outlined by Chuhan (1994:4). These included progress towards a North American Free Trade Agreement, comprehensive economic reforms, including the easing of regulations on foreign investment, the adoption of rapid privatisation programmes, and the recovery of Latin America from the sluggish growth of the 1980s.



### III CAUSES OF LONG-TERM CAPITAL INFLOWS

#### 1. CYCLICAL FACTORS VERSUS STRUCTURAL FACTORS

Private capital flows to developing countries began to surge in the early 1990s. There has been considerable debate as to whether the surge in private capital flows is essentially driven by cyclical factors in the international economy or by long-term structural changes in the international and domestic economy.

The recent surge in capital flows to many developing countries has also raised questions regarding the characteristics of these flows, the most important issue being whether these flows are temporary or permanent.

According to Folkerts-Landau *et al* (1995:13), cyclical developments in industrial economies, especially sluggishness in economic activity, the weak demand for funds and the decline in interest rates during the early 1990s stimulated the flow of capital into emerging markets.

Calvo, Leiderman and Reinhart (1993: 136-138) examine empirical evidence for 10 Latin American countries to see whether private flows were driven by cyclical factors in the international economy or by improvements in the economic fundamentals of developing countries during the 1988-91 period. International reserves and the real exchange rates were taken as proxies for private capital flows in order to analyse the degree of co-movement in these variables.

They observed that, for most countries, foreign factors accounted for a sizeable fraction of the monthly forecast error variance in the real exchange rate that occurred in countries that experienced no major changes in domestic

policies in the period 1988-91. Colombia, Chile and Bolivia implemented their stabilisation programmes well before the authors' sample started. This implies that there was a significant co-movement among the countries' foreign reserves and their real exchange rates, and that the degree of co-movement increased in 1990-91 compared to 1988-89 (World Bank 1997:81). They also found that the first principal component of both reserves and the real exchange rate exhibited a large bivariate correlation with several U.S. interest rates. This suggests that the main factor driving private flows to Latin America was the cyclical downturn in industrial countries and the associated decline in global interest rates.

International interest rates also were an important factor in driving other private capital flows to developing countries during 1990-93. While there has been a relative decline in the sensitivity of portfolio flows to interest rates, portfolio flows remain quite susceptible to cyclical or temporary factors.

Calvo, Leiderman and Reinhart (1993:108) conclude that the importance of external factors suggests that a reversal of those conditions might lead to future capital outflows, increasing the macro-economic vulnerability of Latin American economies. In sum, the cyclical factors could thus be regarded as a temporary or cyclical phenomenon.

Chuhan, Claessens and Mamingi (1993:3), on the other hand, also included the Asian countries in their analysis, which covers the period January 1988-92. They investigated the behaviour of capital flows by employing monthly data on capital flows instead of data on reserves and exchange rates. The aim of their study was to assess the importance of global factors in explaining portfolio



flows and to systematically explore the influence of country-specific factors in explaining these flows.

Their econometric results indicate the importance of global and country-specific factors in influencing capital flows. The result points out that about half of the explained increase in the flows to Latin America could be attributed to cyclical factors such as the drop in U.S. interest rates and the slowdown in the U.S. economy. Yet country developments were at least as important in determining those flows. Moreover, for Asian countries, country-specific factors were three or four times more important than global factors in motivating these flows. Chuhan (1994:34) emphasises that, over the past years, country-specific factors have posted substantial gains on the back of credible economic management, far-reaching economic reforms and reduced debt-service burdens in many developing countries. More recently, the relative importance of international interest rates as a factor has declined and country-specific factors have become important. The significance of country-specific factors, thus, suggests that private capital flows from industrial countries to developing countries might well be sustainable and permanent.

In support of the findings by Chuhan *et al*, the World Bank (1997:82) stated that the results of a panel regression run by Fernández and Rudolph in 1995 to assess the importance of international interest rates on private capital flows to developing countries during 1990-93 indicated that countries with strong economic fundamentals received the largest proportion of private flows relative to the size of their economies. This was in total contrast to the answers earlier by Calvo, Leiderman and Reinhart (1993:108), who stressed only the cyclical factors.

However, according to the World Bank (1997:81) Fernández-Arias (1994) argue that, since Chuhan, Claessens and Mamingi's study considered country creditworthiness as being solely determined by improvements in the domestic economy (whereas, in reality, global interest rates also affect country creditworthiness), the study might have overestimated the proportion that could be attributed to improvements in domestic fundamentals. By decomposing the improvements in creditworthiness into those arising from improvements in the domestic environment, Fernández-Arias found that global interest rates accounted for around 86 percent of the increase in portfolio flows for the average emerging market during the period 1989-93.

Calvo *et al* (1993:109) argue that, although domestic reform is a necessary ingredient for reviving capital inflows, it only partially explains Latin American's forceful re-entry into international capital markets. The authors emphasize that domestic reforms alone cannot explain why capital sometimes flowed to countries that did not undertake reforms and conversely, why it sometimes did not flow, except until recently, to countries where reforms were introduced well before 1990. In order to explain the co-movement of capital inflows across countries in the region with reference to domestic reforms alone. The authors stress that, one would have to posit the existence of strong reputational externalities. They maintain that some of the renewed capital flows to Latin America resulted from external factors and should be considered an external shock common to the region.

Decomposing private capital flows, the study by Chuhan, Claessens and Mamingi (1993:4) also found that external variables explained about half of the portfolio flows from the U.S. to a panel of six Latin American countries. For Asian countries, however, they conclude that external

factors accounted for about one-third of the portfolio flows into the region. Decomposing portfolio flows into their cyclical components, they found that equity flows were more sensitive than bond flows to global factors, but that bond flows were generally more sensitive to a country's credit rating and to the secondary market price of debt.

A World Bank study (1997:82) which relied on Hernández and Rudolph took portfolio flows into account in their study and found that there was a high degree of co-movement in flows during 1990-93 for both Latin America and East Asia. The co-movement was related to movements in U.S. interest rates. This supported Calvo, Leiderman and Reinhart's findings that U.S. interest rates played an important role in driving portfolio flows during the 1990-93.

However, this study also found that since 1993, there has been a decline in the co-movement of portfolio flows to both regions. That implies that country-specific factors were becoming important, as emphasized by Chuhan, Claessens and Mamingi (1993:3-4). Another remarkable result was that the decline in the co-movement of flows after 1993 was especially marked for East Asia. The World Bank (1997:85) concludes that, on average, during 1990-95, 40 percent of portfolio bonds to Latin America and 16 percent to Asia were temporary or cyclical. Moreover, portfolio flows to Latin American showed a high degree of cyclicality. However, despite the relatively high degree of cyclicality, there was a clear upward structural trend in portfolio flows to both regions.

On balance, then, it has been stated that the prevailing view in the early 1990s was that cyclical factors in the international environment were the driving force of private flows to emerging markets, especially to Latin

America. However, more recent empirical evidence suggests that some structural forces were at work, especially in respect of East Asian countries.

If we apply the conclusions above to South Africa, the implication is that South Africa's long-term capital inflows were primarily cyclical and of a temporary nature during the 1990s.

## 2. STRUCTURAL FORCES BEHIND LONG-TERM CAPITAL INFLOWS

The World Bank (1997:85) states that two structural forces were behind private capital flows during the 1990s. The two structural forces outlined were, firstly: higher long term expected rates of return in developing countries, and secondly: the opportunity for risk diversification.

### 2.1 Higher Expected Rates of Return

Expected rates of return on available assets played an important role in investors' decisions about whether or not to move capital internationally. According to the World Bank (1997:85-86), "standard economic theory predicts that if the level of capital stock is relatively low, *ceteris paribus*, the marginal product of capital will be high. If not constrained by the availability of skilled labour, infrastructure and other factors that are complements to capital in the production process, therefore, the role of return to investment will be relatively high in countries with low levels of capital stock". As many developing countries displayed the characteristic of low levels of capital, industrial countries saw them as sources for high rates of return on their investments.

Another factor was that the economies of emerging markets were still in the early stages of modernisation and industrialisation and had been growing robustly. Hence, the earnings growth rate of companies in emerging markets has been higher than those of mature companies in developed markets, resulting in faster rising share prices for emerging companies. Furthermore, Mobius (1995:210) stipulates that, given the propensity of emerging markets to achieve very high earnings in positive years, the investor had a better chance of attaining higher overall returns by investing in emerging markets. The rises reflected the faster earnings growth and very low valuations at which individual shares could often be purchased. The opening up of new markets, liberalization, privatisation and high savings rates were all positive structural factors leading to higher returns in emerging markets.

## 2.2 Opportunities for Risk Diversification

The second force behind the structural trend in private capital flows was investors' desire to diversify portfolio risks because returns in emerging markets tended to exhibit low correlations with industrial country returns, with the result that investors were benefiting from holding emerging market equities. In holding assets of which the returns were not correlated with the returns of another asset, investors can raise the overall return on their portfolios without a commensurate increase in risk. Moreover, given that returns among emerging markets exhibited low correlations with others, greater diversification within them reduced portfolio risks even further (Park *et al* 1993:5). For example, Mobius (1995:215) states that there was a correlation coefficient of only 0.20 between Poland and the Phillipnes. Korea and Brazil actually had a negative correlation, as did South Africa and the Czech Republic.

However, correlations between some leading emerging markets and industrial country equity markets were likely to rise over time as developing countries became more financially integrated with the global economy and as their communications infrastructure improved. Nonetheless, quite a few other emerging markets showed little sign of following the ups and downs of mature markets. For example, Park *et al* (1993:8) states that most Latin American countries had followed a completely separate pattern in recent years, being more influenced by domestic, political and economic events than by world trends. Park *et al* (1993:5-6) also maintain that there were economic reasons for believing that correlation coefficients did not necessarily increase as emerging markets became a better known part of the global investment world.

Mobius (1995:281) concludes that higher returns and greater portfolio protection through diversification were the major reasons why virtually all investors had some portion of their investment funds in emerging equity markets. Nonetheless, there was a real potential for volatility within each of these emerging markets.

### 3. ENABLING ENVIRONMENT IN INDUSTRIAL COUNTRIES

Factors in the enabling environment in industrial countries are beyond the control of a given country and are thus unrelated to the policies followed in any particular country. For example, during the late 1980s, there was a steep acceleration in the integration, globalisation and international diversification of investments in North America and other financial centres.

Among the key cyclical factors behind the current episode of capital inflows were the unusually low interest rates that had prevailed in the U.S. and other industrial

countries, combined with persistent recessions in most industrial countries. In addition, regulatory changes in the U.S. made it easier for foreign private issuers of equity to offer issues that were more attractive to investors. All these underlying factors helped developing countries to re-establish themselves with foreign investors while providing the necessary conditions for attractive returns and opportunities for risk diversification.

The World Bank (1997:92) states that during the late 1980s, industrial countries saw great changes in their real sectors, which were characterized by increasing competition and rising costs at home, combined with falling transport and communication costs. These changes heightened firms' responsiveness to opportunities for increasing efficiency and reducing costs by placing investments abroad. That led to the progressive globalization of production and the acceleration of the growth in foreign direct investments which were motivated by efficiency. Production, sourcing and marketing decisions were increasingly made on a worldwide basis. The total sales of multinational firms were larger than world exports of goods and non-factor services.

While the rate and extent of globalisation has slowed down over the past five years after experiencing a spectacular rise in the 1980s, flows of foreign direct investment to developing countries have actually accelerated during the 1990s. The advantages these countries offer in terms of labour cost, rapidly growing domestic markets and increasingly hospitable trade and investment opportunities, have, apparently, been decisive for recent FDI flows (Goldstein 1995:13). Thus, these efficiency-seeking FDIs find higher returns in developing countries and offer opportunities for risk diversification.

*Financial markets* in industrial countries had transformed significantly during the 1980s and 1990s and were more globally integrated due to self-reinforcing processes of competition and financial innovation, coupled with deregulation and technological changes. The internationalisation of foreign exchange markets made it possible for prime issuers in industrial countries to raise funds at lower costs than in domestic markets, while investors often received higher rates of return than in their own regulated domestic markets.

*Financial innovations* during the 1980s and 1990s had made it more attractive for borrowers to raise capital in foreign markets and for investors to make cross-border investments. Again, financial innovations have been promoting the internationalisation of equity markets. Foreign investors used equity swaps, in which a domestic agent passed on the gains and losses from holding domestic equities to foreign investors for a fee. That process was enhanced by the deregulation of domestic financial markets which started during the mid-1980s. Deregulation enabled institutional investors, who during the 1980s concentrated on domestic equities and held the bulk of their international investments in bonds and currencies, to increase their holdings of foreign equities.

*Technological advances* reinforced the effects of deregulation and financial innovations in the internationalisation of markets by increasing efficiency in gathering and disseminating information and in processing transactions. Improved communications also encouraged financial institutions to keep on developing new instruments and to meet the needs of customers in prevailing isolated markets in developing countries.



Financial markets in developing countries had thus, since the 1990s, started to provide foreign investors with significant opportunities to diversify into investments that offered good prospective returns and low correlations with their investments in industrial country markets (World Bank 1997:93-96).

One of the most significant recent developments in international financial markets was that individual investors increasingly delegated the management of their portfolios to professional fund managers. That process was the result of competitive pressures, deregulation, technological advances and financial innovations. In addition, the international diversification of institutional portfolios had developed in tandem with the institutionalization of savings and portfolio management. The trend, increased the sensitivity of securities markets to the behaviour of a relatively small number of investors (Folkerts-Landau *et al* 1995:65).

Securitization is broadly defined as the process of matching savers and creditors through financial markets. It implies the creation of instruments that can be issued and traded directly in markets, that is, the replacement of flows through banks by the issue of securities (Turner 1991:33). Because securitized assets were more cost-effective than bank loans, institutional investors were encouraged to trade in those assets (World Bank 1997:96).

Institutional investors (such as mutual funds, pension funds and insurance companies) were both able and willing to invest abroad and had increased the magnitude of the response of private flows to long-term relative rates of return and new opportunities for portfolio diversification. The benefits were enhanced because those funds offered relatively low minimum investment costs, more liquidity and a relatively low cost method of

diversification across emerging markets.

The evidence on the diversification of portfolios by institutional investors confirms the international dispersal of assets during recent years. The share of foreign securities in portfolios have also increased for some institutional investors. The relative importance of foreign assets in the portfolios of pension funds followed a gradual upward path, at least since 1980 and in 1983. They ranged from a low of 45 percent for German pension funds to a high of almost 20 percent of UK pension funds (Folkerts-Landau *et al* 1995:167).

However, insurance companies were not as internationally diversified as pension funds, probably because they were generally more tightly regulated than pension funds, as there were ceilings on the amount of foreign assets in their portfolios. An exception was Japanese insurance companies, which, during the 1980s, set a trend in major diversification into foreign securities. The consequence of that was, that for several years, the heavy demand by Japanese investors for foreign financial assets exceeded Japan's large current account surplus, thus putting downward pressure on the yen. By 1990, that process of diversification had apparently run its course and in the 1990s, Japanese institutional investors were reducing their foreign exposure (BIS 1994:47).

Thus, the emergence of global institutional investors meant that capital flows to emerging markets were predominantly driven by liquidity and performance considerations, rather than by longer-term banking relationships.

Although industrial countries had liberalised capital movements, institutional investors in those countries still faced restrictions on their foreign investments.

The impediments were not only international, the most frequently cited impediments to investing in emerging markets being the perceived riskiness of limited information on those markets, and the illiquidity problems arising from the smallness of the markets. In addition, only a few stocks listed in emerging stock markets met the investment criteria that most industrial markets were used to (Chuhan 1994:28-29).

Large capital flows to developing countries could be induced through two channels. Firstly, through the asset substitution channel: lower interest rates in industrial countries made investing at home less attractive at the margin than investing abroad in emerging markets which yielded a high return. Secondly, through the creditworthiness channel: lower interest rates, combined with the persistent recession in most industrial countries improved the creditworthiness of debtor countries by reducing the present discount value of the contractual debt payments and/or by increasing the present discounted value of the resources available for external payments (Goldstein 1995:7). Lower interest rates and a continued recession could cause a decline in the terms of trade of a country, leading to more capital inflows to that country. Calvo *et al* (1993:126) emphasise the importance of this factor in Latin America, where current account deficits needed to be financed by increased capital inflows. In principle, a decline in a country's terms of trade can be expected to result in a larger current account deficit, and in the absence of major intervention by the state authorities, to a larger capital inflow to finance the deficit. However, the changes in the terms of trade in 1990-91 were too small to account for the sharp increase in capital inflows. Latin America's terms of trade only decreased by 1.2 percent in 1990 and by 5.2 percent in 1991.

Another important external factor that engineered a surge in capital flows in the 1990s was the *regulatory changes* in many industrial countries. Those changes reduced transaction costs for investors accessing international capital markets from developing countries. They also reduced liquidity costs faced by developing countries in approaching capital markets (Calvo *et al* 1993:128), thus facilitating access to international markets, particularly portfolio flows.

#### 4. ENABLING ENVIRONMENT IN DEVELOPING COUNTRIES

Khan & Reinhart (1995:16) reiterate that, although some authors have emphasised the fact that foreign influences have played a significant role in stimulating bond and equity flows to several Asian countries, external developments were much less important than domestic ones in that region. They accounted for about one third of bond and equity flows to Asia. However, as the composition of capital flows to Asia shifted toward portfolio investment, proportionally less was accounted for by FDI, and the sensitivity of flows to external financial variables increased. However, the emphasis on external factors does not imply that domestic factors played a negligible role. It should however, be emphasised that domestic factors alone cannot explain why capital inflows occurred in countries that had not undertaken reforms or stabilisation policies.

According to Strydom (1995:9) an important element in the recovery of long-term capital flows to developing countries was increased investment in emerging equity markets. Major elements of the emerging markets included, *inter alia*, the integration of international capital markets due to liberalization of capital flows and financial markets; the extensive relaxation of trade controls and capital flow controls; the restructuring of

commercial bank debts; and the implementation of inflation stabilisation programmes.

Most important for long-term investment, is the fact that several developing countries adopted *sound monetary and fiscal policies* as well as market oriented structural reforms that facilitated their re-entry into international capital markets.

With the onset of the international debt crisis in the early 1980s, there was a dramatic decline in the macro-economic performance and creditworthiness of developing countries, due, in part, to external factors such as a sharp increase in international interest rates and the recession in industrial countries.

However, in the mid-1980s the creditworthiness and macro-economic performance of many developing countries began to improve. These countries applied policies to reduce and service their debts. That trend accelerated during the early 1990s as many developing countries experienced a decline in inflation, higher growth of output and exports and more efficient investment (World Bank 1997:86).

The *creditworthiness* of developing countries has been strengthened by low interest rates that prevailed in the industrial areas since the mid-1980s and the cyclical downturn in the early 1990s. As their creditworthiness and rates of return improved, developing countries started to offer attractive investment opportunities.

The forces behind the improvements in *economic performance* of developing countries have been the systematic adoption of macro-economic stabilization programmes and structural reforms. For example, Strydom (1995:10) states that many developing countries exercised

substantial discipline in respect of fiscal policy. Fiscal deficits came under control while public expenditure reforms were introduced. Moreover, important tax reforms coupled with privatisation were also introduced. Mobius (1995:67) states that the easing and abandoning of foreign exchange controls exemplified the new competitive spirit in the South African economy. He adds that there was potential for a major South African privatisation process including companies such as Telkom, Transnet, South African Airways, which would give a big boost to the local stock market, as happened with privatisation in Asian and Latin American countries.

El-Erian *et al* (1995:318) emphasise that the most important "pull factor" contributing to the enhanced profitability of investing in developing country securities was the impact of domestic adjustment and reform policies. Appropriate *macro-economic policies* have proved essential not only for the initial process of market opening and integration but also for minimising the potentially adverse implications of surges and changes in capital flows. Trade liberalization, investment deregulation and financial sector liberalization have promoted more private sector activity and outward oriented economies.

*Trade liberalisation* has thus provided an impetus to foreign direct investments which were driven by production efficiency i.e. the allocation of capital to activities that were more profitable, which provoked more interest on the part of institutional investors. In the light of reforms in South Africa (Mobius 1995:66), local companies were developing plans to exploit renewed international trade links and a more liberal trade regime. Thus, more long-term capital inflows would be attracted to South Africa.

The 1980s and 1990s have witnessed a progressive dismantling of barriers to capital account mobility in developing countries. By 1995, 35 developing countries had fully opened capital accounts (World Bank 1997:101). However, El-Erian *et al* (1995:320) maintain that with a more open capital account the economy became more vulnerable to abrupt shifts in investor sentiment. Hence, policy slippages were translated more quickly into capital outflows and currency substitution, as demonstrated by Mexico. Moreover, developing countries' capital markets became more sensitive to policy instability in other countries' markets. That phenomenon was regarded as "contagion effects", as exemplified by the spillover effects of the Mexican events of December 1994. Calvo (1996:207) termed it "the Tequilla effect".

Apart from macro-economic stability and liberalisation processes, developing countries attracted long-term capital because of their *growth performance*. The importance of growth performance is emphasised by Strydom (1995:11), who points out that several countries have reversed their poor growth history and that in many instances, developing countries have outperformed the major industrial countries in terms of real economic growth (see table 2). This is particularly true in respect of Latin America and Asia. The process was accompanied by a higher savings ratio which encouraged a sustainable inflow of long-term capital.

TABLE 2: INTERNATIONAL ECONOMIC GROWTH

	<u>1983 - 88</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>
Major Industrial Countries	3.4	4.0	4.0	2.8	1.3	-0.3
Developing Countries	4.1	3.9	3.6	3.3	4.6	4.3
Africa	2.8	3.6	2.3	1.5	1.0	0.6
Asia	7.7	5.7	5.6	5.3	7.0	7.2
Latin America	2.9	1.1	0.7	3.0	2.3	3.0
Eastern Europe	2.6	1.6	-4.9	-14.0	-15.0	-9.1
South Africa	1.4	2.4	-0.3	-1.0	-2.2	-1.1

Source: BIS (1994). *64<sup>TH</sup> Annual Report*, BASLE, and SARB, *Quarterly Bulletin* (March 1998)

Policy reforms such as stable domestic macro-economic investments have in turn, improved prospective rates of returns to investment in general, while the growth in earning capacity and reduction in stock of external liabilities in many heavily indebted countries has reduced country risk to the foreign investor.



**Table 3: MACRO-ECONOMIC PERFORMANCE DURING CAPITAL INFLOW EPISODES.**

*(Change from immediately preceding period of equal length)*

Country	Inflow episode	Average Annual GDP growth (%)	Average Annual inflation (%)
Argentina(1)	1991 - 1994	9.1	-801.1
Brazil	1992 - 1995	3.1	-93.5
Chile	1989 - 1995	5.7	-4.1
Colombia	1992 - 1995	1.6	-4.8
Hungary	1993 - 1995	7.5	-5.5
India	1992 - 1995	-0.7	0.1
Indonesia	1990 - 1995	2.2	1.3
Korea	1991 - 1995	-2.5	0.8
Malaysia	1989 - 1995	4.0	1.4
Mexico	1989 - 1994	2.9	-74.4
Morocco	1990 - 1995	-3.3	0.1
Pakistan	1992 - 1995	-2.3	1.7
Peru	1990 - 1995	3.3	-79.1
Phillipines	1989 - 1995	2.2	-3.1
Poland	1992 - 1995	8.5	-146.7
Sri Lanka	1991 - 1995	2.0	-2.2
Thailand	1988 - 1995	3.9	-1.1
Tunisia	1992 - 1995	0.5	-2.1
Turkey	1992 - 1993	1.4	5.0
Venezuela	1992 - 1993	-5.0	-2.7

Source: World Bank (1997).

According to the World Bank (1997:185), among the sharpest accelerations of growth in their sample were those registered by Argentina, Hungary, Peru, and Poland (see table 3). The World Bank emphasizes that both economic growth acceleration and capital inflows were responding to a third factor - the

change in policy regime.

According to de la Dehesa (1994:9), a few countries that did not introduce the necessary fiscal adjustments, but restrained internal credit or increased domestic interest rates, had also attracted large, albeit very speculative, capital inflows. However, he stresses that this could be possible under a regime of exchange rate stability.



#### IV. MACRO-ECONOMIC EFFECTS

##### 1. MACRO-ECONOMIC BENEFITS

Capital flows to developing countries provide them with substantial benefits, including a larger pool of capital to finance investments, the enhancement of their ability to use market based risk management techniques, improvements in the financial intermediation process, and a tendency for economic growth to increase (El-Erian *et al* 1995:320).

Increased capital inflows are beneficial to the recipient countries because they relax the severe financial constraints that these countries were facing during much of the 1980s. They also finance current account deficits associated with domestic investment in export-enhancing infrastructure and provide diversification opportunities to industrial country investors. By contrast to the 1980s, these resources are directed to the private sector and are predominantly in the form of equity rather than debt financing. In this way domestic savings may be supplemented and capital flows may be used more productively.

From a balance of payment adjustments perspective, large capital flows should emerge in response to capital account deficits which are normally related to an expansion in aggregate demand. Investment expenditure will generate export growth in the long term. However, in the short term, it will generate current account deficits which could go hand in hand with high consumption rates and falling savings ratios. Moreover, excess demand whether consumer or investment driven, will lead to inflationary pressures coupled with declines in savings ratios which inhibit long-term capital flows. If long-term capital inflows are experienced, there is an

enormous pressure on the domestic economy to perform in terms of macro-economic stabilization criteria. Failure to conform, could easily disrupt the inflow of long-term capital.

Foreign direct investment brings with it management know-how, technology transfers and access to international markets, thus enhancing global links. However, Hewin (1997: 4) emphasises the beneficial effects of these flows if they are stable in the sense of being repeatable and likely to remain, rather than likely to be rapidly reversed if market perceptions change. Of the different flows, foreign direct investment is the most stable.

The World Bank (1997:168) concludes that the benefits of capital inflows accrue on both the production and the consumption side. Financial integration, following capital flows, promises to boost growth rates, partly because better diversification allows a shift to riskier but more productive investments and partly because of spillovers in the financial sector via foreign direct investment. It also promises to reduce the volatility of consumption by allowing a better diversification of portfolios and by permitting international borrowing and lending to offset the effect of temporary swings in national fortunes. However, the World Bank cautions that the primary effects will not be realized through the first round of diversification effects, but rather through the more gradual change in new investments toward higher-return projects made possible by the scope for risk reduction and international equalization in returns.

## 2. MACRO-ECONOMIC PROBLEMS

The increase in capital flows to emerging markets since 1990 was a welcome global financial development. However, flows that are large relative to GDP carry with them certain risks and problems, including, *inter alia*, an appreciation of the real exchange rate, inflationary expansion of domestic money and credit, the accumulation of foreign exchange reserves, an unsustainable current account deficit and a more vulnerable banking system. The surge in capital flows can be accompanied by sharp increases in stock prices, and more generally, asset prices. Capital inflows could potentially be a problem if they are sudden and of a short-term nature, that is, highly volatile. Certain externalities are also associated with capital inflows.

### 2.1 Appreciation of Real Exchange Rate

In addition to their benefits, capital inflows have been associated with a marked real exchange rate appreciation. Many real exchange rate appreciations in developing countries from the 1990s to 1994 had detrimental effects in terms of export performance and were disruptive in terms of future capital flows.

Capital inflows are associated with an excessive expansion of aggregate demand - that is, macro-economic overheating. Thus, according to de la Dehesa (1994:10), the reason for the appreciation in the real exchange rate was that the increase in domestic absorption induced a larger spending in the non-traded goods sector; its relative price increases, the real exchange rate appreciates and resources shift towards that sector, resulting in a smaller traded sector and consequently a bigger trade deficit. In the case of Latin America, for example, (Calvo et al 1996:131) capital inflows were

primarily associated with a decline in private saving and higher consumption, particularly during the initial stages of the large inflows i.e. 1990 and 1991. Thus, investment is tilted toward imported capital goods and consumption has a higher domestic component. Other things being equal, this would work in the direction of generating a strong real exchange rate appreciation. The implication is that if strong capital inflows lead to a sharp real exchange rate appreciation, there is a subsequent risk of speculative currency attacks when the economy finally slows down (Hewin 1997:5). However, in the case of Mexico in 1994 and recently in Thailand, a key question is whether the capital inflow was used productively or not.

According to Goldstein (1995:5), the appreciation of the real exchange rate impacted on the appreciation of the nominal exchange rate and/or an increase in the host country's relative inflation rate owing to the monetary/spending effects following the capital inflows. That is, if the economy runs excess capacity, the short-term implication will be an increase in domestic economic activity without inflationary effects while the current account of the balance of payments deteriorates. Eventually, however, excess capacity will be absorbed and the expansion in demand will trigger an acceleration in domestic inflation (World Bank 1997:176).

Folkerts-Landau *et al* (1995: 12) observes that in countries with a flexible exchange rate regime, an appreciation in the nominal exchange rate during periods of heavy capital inflows can insulate the money supply, domestic credit and the banking system from such flows. However, abrupt movements in the real exchange rate may impose substantial adjustment burdens on the economy if such an appreciation is reversed as capital exits. The problem is that even if the exchange rate is flexible the

appreciation of the currency finally results in real appreciation and foreign competitiveness is lost.

Contrary to what happened in Latin American countries, many high volume capital importing Asian countries recorded real exchange rate depreciations or accepted only small appreciations probably because they were generally in a better position to maintain a strong export performance during the surge period.

## 2.2 Inflationary Pressures

Surges in external capital inflows may complicate economic management not only through an appreciation in the real exchange rate, but also through increased inflationary pressures with potential adverse effects on international competitiveness, thus eroding the credibility of price stabilisation programmes in developing countries and affecting expectations regarding real rates of return adversely.

Excess demand, whether consumer or investment driven, will result in inflationary pressures coupled with declines in savings ratios which will inhibit long-term capital inflows. As a result of the drop in national savings, there would be a rise in private consumption spending. According to Calvo *et al* (1996:130), the consumption boom was heavily driven by rising imports of durables as exemplified in Latin American countries.

On the other hand, Goldstein (1995:5) observes that while the large majority of host countries experienced an increase in the growth of real money balances and a drop in real interest rates, there was little indication of a generalized sharp acceleration of inflation during the surge period in Chile and Mexico. The implementation of anti-inflationary monetary programmes either before or

during the surge period and heavy reliance on sterilized intervention, seem to have accounted for that outcome in these countries.

### 2.3 Increases in Foreign Currency Reserves

A significant share of the capital inflows was channelled into an increase in international reserves. For example, Fernandez-Arias and Montiel (1995:13) found that in half of the 12 countries included in their study which experienced the largest inflows relative to the size of their economies, reserve accumulation accounted for about 40 percent of the inflows. The larger amount of capital brought into the country would thus increase the volume of funds being intermediated through domestic capital markets. That would therefore exacerbate problems such as an expansion in the volume of domestic financial assets and liabilities. It would also result in a financial bubble that could eventually lead to a financial crisis especially in countries with a poor banking supervisory system.

Goldstein (1995:4) shows that usually and particularly at the beginning of the surge period, host country authorities were engaged in sterilized exchange market intervention. However, in the event where the capital inflow persisted, adjustment became harder to resist and some combination of appreciation of the real exchange rate, an increase in monetary expansion and an increase in domestic absorption with a decrease in domestic saving and a widening of the current account deficits were observed. It is difficult for emerging market governments to maintain sterilisation over a long period because the selling of government stock to achieve this objective adds to the government debt.

In principle, thus, there is a logical tendency for



capital inflows to raise current account deficits in order to facilitate the transfer of the goods and services that are the material counterpart of these flows. In reality, capital account surpluses, according to de la Dehesa (1994:10), more than compensated for the current account deficit, leading to an increase in foreign currency reserves.

Capital inflows which are of a speculative or destabilising nature, or those that overheat the economy, have led the monetary authorities (as noted above) to purchase part of the inflows, which resulted in an increase in reserves and the money stock. These highly speculative or reversible inflows can also have adverse effects on internal credit expansion and the domestic banking system. Those inflows not used directly to finance imports or investment are intermediated through bank deposits, usually one of the most attractive investments for short-term inflows because of their high nominal return. These new deposits might thus induce banks to expand their risk by increasing their short-term loans to the domestic private sector which leads to excess borrowing. Overdependence on short-term debt can be destabilising for the economy especially if short-term debt is high and reserves are low. This has been an important element in explaining the recent Asian crisis.

#### 2.4 Current Account Deficit

Calvo *et al* (1996:128) maintain that in most developing countries, capital inflows have been associated with widening current account deficits. That view is supported by a stylised fact emerging from the sample conducted by the World Bank (1997: 185-186), stating that the current account deficit fell during the inflow period and increases in current account deficits tended to be much larger than decreases.

The widening of the current account deficit has usually involved a fall in the national savings rate and an increase in national investment. Decreases in domestic savings more often than not accompanied increases in absorption, as experienced in Latin American countries. The consequence of these trends is that host countries experienced a deterioration in their current account positions, with the widening of current account deficits being more pronounced in Latin American host countries than in Asian ones.

The correlation between falling savings and investment is the result of a lack in international integration. In Feldstein and Horioka (1980), Calvo *et al* state that it was found that national savings and investment tended to be highly correlated. They interpret this as evidence confirming that global capital markets were not yet integrated enough to loosen the linkages between a country's savings and its investment. However, the recent behaviour of saving and investment in many of the developing countries would suggest that these capital markets have become increasingly integrated over the years. Not unexpectedly, high investment and consumption are reflected in higher growth rates for real GDP. Nevertheless, there exists the concern about maintaining a sustainable current deficit as a percentage of GDP in the long term. Sudden increases in this ratio, particularly because of a domestic consumption boom, could raise the country's risk premium and restrict its future access to international capital markets.

## 2.5 Volatility

Long-term steady capital flows are associated with extensive economic and financial benefits. However, a massive capital inflow can create economic imbalances and lead to an overvalued or excessively volatile exchange rate.

The World Bank (1997:124) outlines three contributory factors to the volatility of capital flows in the international economy. The first factor is the movements in international interest rates which strongly affect private capital flows. These movements have sizable effects on the macro-economic performance and creditworthiness of developing countries because many foreign investors, it is assumed, regard emerging markets as marginal investments i.e, foreign investors consider investments in emerging markets as a means of adding higher returns to their portfolios only when their mainstream investments are underperforming. Moreover, portfolio managers invest a relatively small portion of their funds in these markets in order to diversify their risk.

In a comparison of the different types of private capital flows, Dadush *et al* (1994) have discovered that portfolio equity, which account for only 10 percent of all private capital flows, is likely to display more volatility both across countries and in aggregate. The reason why portfolio flows are sensitive to changes in international interest rates is that a portfolio investor buys bonds or shares in expectation of a high rate of return. Therefore, should the rate of returns rise elsewhere, portfolio investors, unlike foreign direct investors, can divest their stock of equities or bonds relatively easily at the ruling market price. In addition, the fact that fluctuations in domestic equity prices are not closely correlated with fluctuations in industrial countries has made them appear ideal vehicles for diversification. Moreover, the development of country funds portfolios has made it easier to invest in a considerable number of completely different markets without housing detailed knowledge of the performance of individual companies (BIS 1994:152). FDI, on the other hand, less sensitive to changes in international interest rates because it is

driven by firms' considerations of long-term profitability. FDI investments are also much more costly to reverse than portfolio investments because of asymmetric information problems. Despite the worldwide integration of financial markets, the authority of regulators has remained mainly national in scope. In a global marketplace, it is difficult to assess the risk exposure of financial intermediaries, and such complex operations make risk evaluation even more uncertain.

It has been observed that despite further increases in interest rates in 1994 and 1996, portfolio flows to emerging markets recovered and in some cases continued this tendency because institutional investors were becoming more familiar with these markets and increasingly considered them to be mainstream investments (World Bank 1997:126). Moreover, large movements in international interest rates appear unlikely in the foreseeable future given that industrial countries are now operating in a low inflation environment, and are unlikely to require sharp corrections to their monetary stance.

The second factor is the presence of foreign investors that could increase stock price volatility by magnifying price fluctuations in the local market through herding. Dadush *et al* (1994) maintain that, although the fundamental reasons for investing in emerging markets are sound, many analysts believed that periods of extraordinary appreciation have induced a herd instinct among investors, i.e. investors follow each other in investment decisions irrespective of whether the particular investment decision is warranted by changes in economic fundamentals. If investors behave in a herdlike manner, changes in stock market prices in any particular period will tend to be accentuated. Therefore, prices will tend to exhibit periods of upward or downward

swings, which eventually reverse themselves, leading to excessive volatility.

However, since there are other reasons why stock prices and returns exhibit reversals and volatility, price swings could suggest investor herding only if they are accentuated when foreign investment become important in emerging markets. Therefore, as markets become more integrated and institutional investors become more familiar with emerging markets, these markets would become less susceptible to volatility related to herding (World Bank (1997:130-133)).

The third source of volatility for emerging markets is the contagion-spillover effects from one country to another. The Mexican crisis highlights this issue, in that it produced a more fundamental re-evaluation of risk in emerging markets, leading to a rebalancing of institutional portfolios which was the mechanism for transmitting the disturbance from Mexico to other emerging markets. The Mexican crisis led to spillover in other emerging markets because after the devaluation of the Mexican market, most of the developing countries experienced varying degrees of turbulence in their foreign exchange markets and registered marked declines in their equity markets (Landau-Folkerts *et al* 1995:6). Because investors were not sufficiently discriminating among emerging markets, portfolio flows to almost all emerging markets declined very sharply during the first quarter of 1995.

The initial contagion was reflected in equity prices in emerging markets as almost all emerging markets saw declines in domestic equity prices. The high volatility of equity prices in recipient countries led to concerns about the impact of capital inflows on equity price volatility in these countries. Moreover, many of these

emerging markets had not yet had the time to develop adequate financial structures, including exchanges, clearings and settlement systems.

As the attitude of investors towards emerging markets became more discriminatory, many investors had returned to international financial markets by the second quarter of 1995. Again, many countries whose macro-economic fundamentals were relatively strong, also saw a recovery in equity prices. In fact, according to the World Bank (1997:137), there is evidence that the magnitude and duration of the decline in stock market prices was clearly related to certain key macro-economic fundamentals before the onset of the crisis.

In sum, it has been observed that a shock in one emerging market may well lead to a degree of volatility in capital flows and asset prices in other emerging markets. Yet, experience teaches that such contagion is usually short-lived, lasting only until investors have re-evaluated the prospects in individual emerging markets.

## 2.6. Vulnerability

The World Bank (1997:192) explain that in the context of financial integration, vulnerability refers to the possibility that a country may find itself confronted with a sudden, large, and relatively long-lasting reduction in net capital inflows.

If capital flows are volatile and of a short-term nature, a reversal in flows may cause important economic costs and losses associated with the resource allocation process, bankruptcy, price rigidities or market imperfections. For countries with a more flexible exchange rate system, capital outflows could be a source of excessive volatility in the nominal and real exchange

rate.

The most outstanding feature of portfolio investments as opposed to other forms of capital inflows is that they present a potential risk of reversal in flows in the short-term, i.e., the possibility that foreign investors may suddenly decide to leave the country in which they have invested. The potential risk of flow reversal is comparable to the position with regard to short-term bank loans and may be harmful in terms of either greater exchange rate volatility or greater interest rate volatility or both. Moreover, if the central bank fails to respond or reacts too slowly and the stock of international reserves is at a low level, it may cause a balance of payment crisis (Corbo 1994:5).

According to de la Dehesa (1994:11), highly speculative or reversible capital inflows could also have adverse effects on internal credit expansion and the domestic banking system. The inflows not used directly to finance imports or investments are intermediated through bank deposits, usually one of the most attractive investments for short-term inflows because of their high nominal returns.

The World Bank (1997:171) emphasises the potential of vulnerability to large, abrupt reversals of capital flows because of changes in creditor perceptions, i.e. creditors would disinvest from a country when they think that a policy change could impair the value of their investment. Vulnerability will arise when the perception is created that a devaluation, non payment of public sector debt or the imposition of restrictions on capital outflows are about to occur.

In sum, the main risks of volatility and large reversals lie at the individual country level. While some of the

major recipients have relatively well established policy and performance track records, most developing countries lack a strong and stable banking sector with institutional underpinning and remain vulnerable to potential instability and reversals in capital inflows.





## v. POLICY RESPONSES

The BIS (1994:145) observes that major economic reforms in recipient countries had played a big part in attracting foreign capital.

Several possible consequences of capital inflows are of special concern to policymakers. For instance, if capital inflows are accompanied by increases in consumption rather than investment, they may not be sustainable for very long. The risk that capital flows may be reversed has increased vulnerability to macroeconomic shocks in some countries.

Capital inflow can lead to inflationary pressures especially when they are monetized. Since an inflow of capital also implies a higher demand for a nation's currency, it often means an appreciating exchange rate and increased exchange rate volatility, which may widen the trade deficit to uncomfortable levels. These may have a greatly negative effect on the competitiveness of the export sector. There has been substantial exchange market intervention to counter this pressure. This has caused foreign exchange reserves in developing countries to rise and the associated increases in domestic liquidity have created difficulties in a number of countries. If the banking system has difficulty handling capital flows, i.e, if they are not properly intermediated, there is some risk of financial destabilisation and of even banking crises (Calvo *et al* 1996: 133).

On the whole, in a world of high capital mobility, the abovementioned concerns can lead to severe macroeconomic instability. Calvo *et al* (1996) cite the experience of Mexico in the aftermath of December 1994 as a vivid illustration of these potential problems and especially

of the sharp contraction in economic activity that can follow a sudden reversal in capital flows.

Thus, such concerns have led the monetary authorities to react to these inflows by implementing a variety of policy measures, including, inter alia, exchange rate policy, monetary policy, fiscal policy, trade policy capital controls and regulation and supervision of banks.

The BIS (1994: 145) cautions that the authorities should always bear in mind that the appropriate policy response to capital inflows is dependent on the compositions of the inflows, the availability and flexibility of various policy instruments and the nature of the financial markets.

The World Bank (1997: 173) highlights the fact that the two macroeconomic challenges to overheating and vulnerability are likely to be particularly important during the transition to financial integration, when international investors are adjusting their portfolios and when policy credibility is not yet well established in the capital-importing countries. Moreover, new macroeconomic challenges will continue to arise when the process of integration is well advanced. In particular, the World Bank stressed that financially integrated developing countries would find themselves operating in a different macroeconomic environment, one in which capital movements are highly sensitive to changes in prospective foreign and domestic rates of return. This new environment may be characterised by enhanced volatility, which poses an ongoing challenge to macroeconomic management.

Sound macroeconomic policies are therefore necessary not just to attract capital inflows *per se*, but also to help avoid their undesirable side-effects, and to ensure that

they are put to the most productive use.

## 1. EXCHANGE RATE POLICY

According to Goldstein (1995:20), exchange rate policy in the face of extensive capital inflows, depends in large part on the choice of the exchange rate regime. Many developing countries maintained a managed floating regime. Goldstein (1995) cites Malaysia as an example of a country that had maintained a policy of managed floating before and during the surge in capital inflows.

If a country moves closer to a floating exchange rate regime, it allows the nominal exchange rate to appreciate to the extent that market fundamentals call for a real exchange rate appreciation. The latter can thus be effected at once through nominal appreciation of the exchange rate rather than gradually through increases in domestic inflation. This policy option insulates the money supply, domestic credit and the banking system from inflows, especially if the flows are perceived to be reversible. Thus, increased exchange rate flexibility grants the monetary authorities a greater degree of autonomy in the conduct of domestic monetary policy and permits them to exercise more control over the monetary aggregates.

Calvo *et al* (1996:136) and Corbo (1994:14) reiterate that greater exchange rate flexibility could discourage some of the speculative short-term cross-border flows. A flexible exchange rate regime would also strengthen the degree of autonomy of domestic policy precisely when the central bank's function as "lender of last resort" might be needed during a temporary subsequent reversal of capital inflows. However, it may be associated with excess volatility in the real exchange rates. Massive capital inflows may induce a steep nominal and real

appreciation in the domestic currency which may, in turn, damage the competitiveness of strategic sectors for export-led growth (Khan and Reinhart 1995: 26) and the damage would be inevitable if the real appreciations were to persist.

In the case of Malaysia (Goldstein 1995:22), however, it did not mean that managed floating could provide complete independence for monetary policy, since the process of large capital inflows was seldom complete. Again, fiscal policy was less effective in a pure floating system. Thus countries that have adopted flexible managed exchange rate systems faced major difficulties in maintaining a flexible enough fiscal policy and build cushions – such as a large stock of international reserves – to improve the resilience of the economy to shocks (World Bank 1997:203). All these problems call for the authorities to intervene in the foreign exchange market.

## 2. MONETARY POLICY



Once the decision has been made to intervene in the foreign exchange market, the next question is whether intervention should be sterilized or non-sterilised.

### 2.1 Sterilised intervention

Sterilized intervention has been the most popular policy response to the present episode of capital inflows in Latin America. Chile (1990–91) and Colombia (1991) are leading examples of this policy (Calvo 1993:146).

The open market operation takes the form of sales of government bonds by the central bank. The objective of the central bank in carrying out open market operations is to mop up the liquidity created by the initial

purchase of the domestic currency.

If effective, sterilization tends to increase domestic nominal and real interest rates, lower aggregate demand and mitigate the appreciation of the real exchange rate. Thus, if carried out successfully, it insulates the stock of domestic money supply from variations associated with capital mobility, and avoids loss of control over the domestic money stock (Calvo *et al* 1996:133).

Even if sterilization remains a possibility for financially integrating developing countries, its effectiveness in insulating domestic demand from external financial shocks is questionable. According to the World Bank (1997:208), sterilization is most effective when domestic interest-bearing assets are close substitutes for foreign interest - bearing assets. Under these circumstances, sterilized intervention can insulate domestic monetary aggregate demand from transitory portfolio shocks.

However, as some economic analysts have observed, (Calvo 1993:146; Calvo *et al* 1996:133; Dadush 1994:25; and de la Dehesa 1994:12), sterilized intervention is associated with certain difficulties. Sterilization leads to an increase in the differential between interest rates on domestic government debt and international rates. Moreover, it contributes towards fiscal deficits.

Another danger of sterilizing is that, by placing treasury debt instruments, massive open market operations tend to increase domestic interest rates, which in turn induce further short-term capital inflows, thus setting off a vicious circle: the more sterilization, the more capital inflows and the more need for sterilization (de la Dehesa 1994: 12).

Sterilization can take other forms, for example, instead of reducing the money supply by selling bonds, the central bank could raise bank reserve requirements. It is a viable policy option that limits the expansion of money and credit associated with the surge in capital inflows. Increasing marginal reserve requirements clearly lowers banks' capacity to lend, thus diminishing some of the risks associated with non-sterilized intervention without incurring quasi-fiscal costs (Khan & Reinhart 1995: 27).

However, the World Bank (1997:208) maintain that because bank borrowers may not have access to securities markets, sterilizing by raising reserve requirements on banks is likely to be less effective in insulating the domestic economy from portfolio disturbances than sterilizing through open-market bond sales.

Calvo *et al* (1996: 219) argued that another major difficulty is that, in practice, it has not been easy to determine when the demand for money had experienced a sufficiently permanent shift to warrant a change in reserve requirements. Furthermore, while lowering reserve requirements is likely to be welcomed by both banks and the private sectors, increasing them may provoke political resistance. Thus, this policy may have a bias toward low reserve requirements which could unduly increase financial vulnerability.

Khan & Reinhart (1995:27) conclude that reserve requirement policy is a one-off measure which could ultimately promote disintermediation, as new lending procedures may develop which would make it possible to by-pass the regulations. Therefore, increasing marginal reserve requirements is unlikely to be effective. Moreover, increasing bank reserve requirements amounts to a reversal of the underlying trend towards financial

liberalization which has become a notable characteristic of developing countries, given that reserve requirements are part and parcel of direct as opposed to indirect market oriented policies.

## 2.2 Non-Sterilised Intervention

Alternatively, the central bank could opt for non-sterilized intervention, whereby the central bank purchases the foreign exchange brought in by capital inflow in exchange for domestic money.

Non-sterilized intervention may be desirable if the demand for money is perceived to increase owing to, for example, a successful inflation stabilisation programme that the authorities wish to accommodate. Under such circumstances, rapid monetary growth is not necessarily inflationary and no quasi-fiscal burdens are generated (Khan & Reinhart 1995:27). The policy can therefore help to avoid nominal exchange rate appreciation and is likely to narrow the domestic foreign interest rate differential.

It is, however, likely to generate an increase in the domestic monetary base beyond the central bank's target. The latter development could in turn fuel inflationary pressures and contribute to real exchange rate appreciation. It is at this point that credibility regarding a fixed nominal exchange rate comes into play.

As mentioned above, non-sterilized intervention runs the risk of leading to high inflation, which, apart from resulting in an eventual loss of competitiveness, can also increase the vulnerability of the banking system, especially if there is a system of deposit insurance and the banking system is poorly developed. From an overall macroeconomic perspective, non-sterilized intervention is

a more attractive option for a banking system with less capacity or willingness to increase loans to the private sector, especially for consumer purposes.

### 3. FISCAL POLICY

A viable policy reaction to increased capital inflows is to tighten fiscal policy through higher taxes or through lower government expenditure. Though not likely to stop the capital inflows, this policy could lower aggregate demand, curb the inflationary impact of capital inflows, limit the appreciation in the real exchange rate, reduce the deterioration in the current account and discourage further inflows (Goldstein 1995: 29).

#### 3.1 Fiscal Tightening

A restrictive fiscal policy is intended to have a macroeconomic effect which attempts to counterbalance the increase in aggregate demand created by capital inflows. Fiscal policy could also help to contain a real exchange rate appreciation, as government consumption is most likely more intensive in nontradable goods than private expenditures. A deflationary impulse will thus offset the expansionary impact of the unsterilized portion of foreign exchange intervention, which may put downward pressure on interest rates, especially if government's borrowing requirement is perceived to be declining. Folkerts-Landau *et al* (1995:120) cite Thailand as an example of fiscal tightening at its most effective: the use of a contractionary fiscal response to capital inflows turned a modest fiscal deficit into a surplus of 5% of GDP in Thailand over the period 1988-96.

Fiscal restraint has also been used by such countries as Mexico and Chile in order to dampen inflationary pressures, and thus to minimize real exchange rate



appreciation (de la Dehesa 1994: 12). When capital inflows are large and persistent, this is probably the most efficient response, especially if it is limited to cutting expenditures, since increasing taxes reduces the absorption capacity of the private sector.

However, a contraction in government expenditure is always sensitive to political pressures. On the whole, it will be hard to put a strong case for adjusting fiscal policy in response to short-term fluctuations in international capital flows. Fiscal policy is therefore viewed as too inflexible to be of assistance in a situation where the duration of the capital inflow itself is undeterminate.

Moreover, fiscal policy is usually set on the basis of medium or long-term considerations, rather than in response to what may turn out to be excessively volatile fluctuations in international capital flows.

### 3.2 Taxing Short-term Capital Inflows

Khan & Reinhart (1995:28) emphasize that taxes on short-term borrowing conveys the powerful message that the authorities are concerned with short-term, potentially speculative inflows. Such taxes attack the problem at the source and can co-exist with policies that encourage a different type of inflow, especially foreign direct investment. Taxes on short-term borrowing abroad have been used in countries such as Israel (1978) and Chile (1991) (Calvo *et al* 1993:145).

However, higher taxes may be less effective than lower government expenditure. Often, when credit is fully available, individuals' expenditures can be largely independent of their tax liability, especially when higher taxes are expected to be transitory.

Although taxes on short-term capital inflows can be effective within the immediate horizon experience shows that the private sector is quick to find ways to evade these taxes through over - or under-invoicing of imports and exports.

#### 4. TRADE POLICY

Calvo *et al* (1993:45-46) state that trade policy measures can help to insulate the export sector from real exchange rate appreciation.

Authorities could increase export subsidies or import tariffs, or both. However, in the case of export subsidies, such a policy distorts resource allocation between exportable and importable goods, and a fiscal cost could be incurred. The authors state, for example, that " to offset a 20 percent overvaluation of the real exchange rate through export subsidies would increase fiscal expenditure by about 40 percent of GDP, given that the average export - to - GDP ratio hovers around 20 percent."(Calvo *et al* 1993: 46).

Alternatively, the authorities could equally increase export subsidies and import tariffs to avoid creating further relative discrepancies between internal and external terms of trade. They should indicate that these subsidies and tariffs will be phased out in the future. This alternative is effective, because if the private sector perceives these measures as only transitory, economic agents are likely to substitute future expenditures for present expenditure, thus cooling off the economy and attenuating the real exchange rate appreciation.

The effectiveness of this policy depends on whether the private sector could be convinced that those subsidies and tariffs are transitory and will be phased out; otherwise individuals will make little effort to lower present expenditure. Therefore, the effectiveness of this policy depends heavily on credibility. Again, the policy is contrary to the rules of the World Trade Organisation (WTO), and thus tends to provoke retaliation.

## 5. CAPITAL CONTROLS

In recent years, developing countries have imposed a variety of legal restrictions and taxes on international capital movements in an effort to directly limit or modify the composition of capital inflows (Dooley 1996:198). Capital control measures range from prudential controls on the banking systems to market based measures, running the gamut to quantitative controls on inflows and outflows.

According to the World Bank (1997:172), capital controls were used by those countries that received the largest inflows of capital relative to the size of their economies in order to reduce the potential for overheating. A related objective has been to subsidize credits favoured by the government. Controls on capital have also been commonly used to limit foreign control over domestic firms or politically sensitive industries. However, such controls generally did not attempt to restrain aggregate capital inflows. The exposition by Dooley (1996:1997:72-73) suggests that capital controls and financial repression have been successful in reducing government debt service costs, but there is little evidence that it has achieved other objectives.

It has been observed that no host country has made

controls or taxes on capital inflows the centrepiece of its economic policy during the surge. There are a few exceptions to this general observation, such as Chile, Colombia and Mexico, which have employed such instruments as part of their policy arsenal (Goldstein 1995:33).

### 5.1 Restricting capital outflows

The aim of this policy option is to deal with volatility and to reduce the risk of a flow reversal by limiting the amount of capital that foreign investors are allowed to take out of the country within a certain period of time (Corbo & Hernández 1994:8).

However, this policy is also likely to reduce the amount of portfolio investment in the first place, limiting the economic benefits of having access to foreign financing. Dealing with the risk of potential flow reversal of portfolio investment is not a matter of restricting capital outflows, but of building mechanisms which would restrain the effects of a negative shock to the economy.

### 5.2 Liberalising capital outflows

In view of the above, one alternative policy would be to liberalize capital outflows by allowing domestic residents unrestricted investment in all kinds of foreign assets. This may partially compensate for the effects of capital inflows.

However, as foreign investors perceive the host country to be less risky, they may increase the amount of capital inflows, and if domestic assets are well diversified internationally, the effects of a negative shock will be less severe in the first place. On the whole, this policy may reduce the probability of a flow reversal.

Control programmes that attempted to support inconsistent monetary and exchange rate policies seem to have had little success. Capital controls have been able to influence the structure of the capital account, but have been much less effective in controlling total private capital flows or the exchange rate. The available evidence (World Bank 1997:172) indicates that capital controls have been effective in the short term in reducing the overall magnitude and influencing the composition of capital inflows. The effectiveness of controls is likely to decrease as developing countries become internationally more integrated, and as market participants discover opportunities of evasion. Under- or over-invoicing of trade are well-known methods of evasion. Thus, the greater the incentive to evade the controls, the more difficult it will be to enforce them. In addition, controls have not been able to prevent large capital outflows and inflows in response to large prospective arbitrage profits. Moreover, controls have been inefficient in effecting capital flows on a sustainable basis.

In sum, experience suggests that capital markets are very difficult to control and economic policy in emerging markets will have to adapt to changes in international interest rates. Capital control programmes will become less efficient over time, and eventually, emerging markets will have to choose in favour of more flexible exchange rates and domestic interest rates. Moreover, domestic capital and money markets cannot be isolated from events in the international capital markets.

## **6. REGULATORY AND SUPERVISORY POLICY**

Banks play an important role in the intermediation of capital inflows, as well as being direct importers of foreign funds. This role is most evident when capital

inflows lead to an increase in the foreign liabilities of domestic banks which could be used to increase bank lending. Therefore, net capital inflows have typically been accompanied by increases in domestic credit in host countries. Thus, a major concern regarding the intermediation of international capital flows through the domestic banking system is whether individual banks are subject to free or subsidized deposit insurance. Free implicit deposit insurance induces banks to increase their risk exposure because the risk management systems of banks in developing countries is not well developed and the regulatory and supervisory frameworks are weak (Goldstein 1995:30). Khan & Reinhart (1995:28) verified a sharp expansion of non-performing loans to finance private consumption expenditure in Latin American countries. In addition, they state that banks paid little attention to matching maturities of deposits against those loans. All these factors increase the vulnerability of the financial system to reversals in capital flows. Such reversals have the potential to ignite a financial crisis. Large and volatile capital flows will therefore magnify the consequences of these weaknesses in the host country's banking system.

To deal with the problem of moral hazard in banking, the regulation and supervision of banks encompass the whole set of prudential rules and practices associated with official supervision over the operation of financial institutions and the functioning of financial markets.

Bank regulators and supervisors have to set up entry hurdles into the banking system, for example, through strict licensing requirements, high capital requirements, stringent exposure rules, tight systems of loan quality classifications and provisioning, regular on-site inspections, and consolidated reporting, including up-to-date information about off-balance sheet positions to

assess the actual market risk position of institutions.

As a follow up, the host country could strengthen the regulatory and supervisory framework before the surge in capital inflows take place or to match the pace of capital market liberalization to the capacity of the regulatory and supervisory structure. Such improvements would also enhance the host country's long-term attractiveness to foreign investors (Goldstein 1995:30-31).

Regardless of how rigid the rules are or how close the supervision is, it has been found that certain banks are likely to fail. The failure may occur within a single bank or simultaneously throughout the banking system. Again, it may be difficult to muster political support for significant regulatory reform. The practical problem of forecasting the timing and scale of private capital inflows also needs to be addressed.

Calvo *et al* (1996:137) supply empirical evidence regarding the appropriateness of the policy responses. They maintain that, judged in terms of their economic performance and ability to withstand the adverse side effects of the Mexican crisis, the countries that have been most successful in managing capital flows, Chile and Malaysia have implemented a comprehensive policy package and did not rely on a single instrument. At the outset of the surge in inflows, these countries reacted by treating the inflows as temporary and resisted nominal exchange rate appreciation. As the flow persisted, sterilization efforts were scaled back and the domestic currency was allowed to appreciate. To moderate the extent of a real appreciation while preventing the economy from overheating, fiscal policy was tightened. To moderate the volume of the inflows while lengthening their maturities, exchange rate flexibility was increased

and measures to curb inflows were implemented.

The macroeconomic lesson is that a developing country experiencing a surge in capital flows should not rely on a single, independent policy in response to the surge but should select an interdependent package of policies as an appropriate response.





## VI. SUSTAINABILITY OF CAPITAL INFLOWS

As a large number of developing countries with a wide spectrum of domestic economic conditions have experienced a significant surge in capital flows, the notion has been put forward that these flows may be driven by a common set of favourable global factors which could in the future be reversed. Thus, many economists (e.g. Chuhan *et al* 1993: 1) have been concerned with the fact that the recent surge in capital flows in many developing countries has raised questions regarding the sustainability of these flows. Strydom (1995:11), for example, states that a critical question in most of the countries that experienced a surge in capital flows is: to what extent will external and internal developments combine to make the flows endure? The answer partly depends on the consistence of the underlying trends in the international financial system, and partly on the continuation of favourable policies and structural reforms in developing countries.

The World Bank (1997:2) argues that the process of financial integration is still unfolding in developing countries and is expected to deepen and broaden over the coming decade against a background of increasing global financial integration. As part of this process, gross private capital flows can be expected to rise substantially, with capital flowing not only from industrial countries but also increasingly among developing countries themselves and from developing to industrial countries. Therefore, the sustained increase in private capital flows reflects the fact that these flows have reached a new phase, which is driven by increased financial integration.

The World Bank has warned that basic factors such as domestic politics, the availability of resources and the

level of development that has been attained are bound to affect the flow of capital. In fact, it stresses that countries with weak economic policy fundamentals might initially experience a growing financial integration with international markets via a net outflow of private capital.

Strydom (1995: 11) emphasises the diversification of investment portfolios as the underlying trend determining the sustainability of capital inflows. He states that the growing interest of institutional investors, for example in Asia and other emerging markets, could continue to manifest itself throughout the rest of the 1990s in the form of portfolio shifts. The movement of international capital into emerging markets has been based not only on a high expected rate of return, but on the idea that diversification can reduce overall risk in portfolios. Given the continuing decline in investment risks, the higher expected rates of return in developing countries and the underweighting of emerging markets in institutional portfolios, net private capital flows to developing countries in aggregate are likely to be sustained.

De la Dehesa (1994: 17) points out that the recent demand for developing country securities might have reflected the growing conviction of investors that the overall risk of a portfolio can be reduced by adding developing country securities even if these assets are riskier than those of industrial countries. The reason for this is that returns on developing country securities have been found to have very low or negative correlations with returns in the industrial country markets. In addition, returns among different developing countries tend to be relatively uncorrelated.

Strydom (1995: 14) states that new competitors are likely to emerge as economic and political conditions in other parts of the world improve. Such developments could raise the possibility of reversals, especially in markets characterised by speculative bubbles and in countries where the inflows were mostly short-term. In the face of heavy sales of domestic securities by foreign investors, the liquidity of financial markets in various countries would be put to the test. Gooptu's study (1994: 1 - 2) refutes the above by emphasising a negative relationship between debt portfolio flows and equity portfolio flows. This implies that developing country policy makers are really competing to send the right signals to international markets in terms of economic and domestic institutional reforms which would attract portfolio investment abroad. They compete against other developing countries for private voluntary capital available to be allocated by portfolio managers to emerging market countries. In the long term, portfolio flows into well-performing countries can only be sustained by enticing institutional investors to allocate a share of their large investible portfolio to these markets.

Dadush *et al* (1994: 2) observe that, while private flows to developing countries will not continue to grow at the rates seen in recent (1990s) years, a generalized reversal in capital flows is unlikely, because the major portion of private flows is accounted for by foreign direct investment, which is driven by efficiency and long-term rates of return.

The World Bank (1997: 131) states that the reason for the sustainability of these flows is the fact that FDI (Foreign Direct Investment) has shown resilience and is less susceptible to cyclical and other short-term shocks than other types of capital flows. The conditions necessary for the continued growth of FDI are that they

be profitable and that dividend payments and capital could be repatriated in foreign currency. Again, FDI is likely to be least affected by a rise in international short-term interest rates. It is more likely to be affected by long-term rather than short-term considerations.

Nevertheless, de la Dehesa (1994: 15) states that in the first half of 1994, external conditions had become drastically less favourable for capital inflows, particularly in view of the prevailing global environment of low interest rates and weak economic activity in industrial countries. Most industrial countries are recovering from the recession and some, such as the U.S. are growing faster than expected. As the global economy recovers, international interest rates may increase and capital market conditions may tighten. As a consequence, the rate of return on financial assets is increasing in the OECD countries, and some investors are shifting their portfolios back to domestic markets. According to Goldstein (1995: 15), asset substitution and creditworthiness effects have switched signs. The implication is that interest rate effects should reduce the demand for developing country assets over the medium term relative to what it has been on average during the past years.

The impact of these developments on the sustainability of capital flows seems to have been small, because an increase in real interest rates is likely to be modest, since inflationary pressures are muted. Dadush *et al* (1994:2-4) state that the rise in interest rates will largely reflect rising credit demand resulting from higher economic activity which will benefit the exports of developing countries. The World Bank (1997: 140) has also emphasized that private capital flows to developing countries have continued to grow despite the increase in

U.S. interest rates in 1994 and the Mexican crisis in 1994-95, albeit at a slower rate. The Mexico crisis dampened enthusiasm for a while, but, as observed by Hewin (1997: 2), investment activities had receded by 1996. In general, it seems that concerns about unjustified contagion may be exaggerated. The trends which are driving investors to look at emerging countries seem to continue, particularly in view of a continued liberalisation of financial markets. In this respect, the liberalisation of investment procedures by pension funds could be important.

Though external conditions have become drastically less favourable for capital inflows, Strydom (1995: 12) stresses that sustainability and durability also depend on internal conditions. For example, sound macroeconomic policies, a strong commitment to market-oriented reforms, and outward oriented trade strategies are likely to enhance the credibility of a country's policymakers to international investors.

Economically, countries make the most efficient use of capital inflows if the investment return on these resources is higher than their cost. Policies that promote high domestic saving and adequate returns on domestic investment would be beneficial, and would enhance the sustainability of capital inflows. Both the BIS (1994: 49) and de la Dehesa (1994: 17) support the idea that domestic savings had played a far more important role in the financing of investment and the sustainability of capital inflows. The ratio of aggregate saving to GDP had been significantly higher in certain developing countries than in industrial countries, reflecting very high saving propensities. Therefore, the coincidence of strong inflows of foreign capital with increased domestic savings in developing countries means that the recent restoration of the

developing world as a major capital importer is more likely to be sustainable.

In a number of major developing countries internal conditions have deteriorated because of certain unfavourable economic conditions. Private investors responded with alacrity to a worsening of economic prospects and the threat of political instability, as exemplified in South Africa during the 1980s. The political crises in South Africa in 1976 and 1985 (Khan in Black and Dollery 1984: 248) restricted South Africa's access to international capital markets. The crises not only resulted in capital flight, but made it difficult for South African borrowers to raise new loans to offset the effects of capital outflows.

Dadush *et al* (1994: 2 & 27) conclude by pointing out that the question of sustainability does not easily lend itself to generalisation because the prospects for sustainability vary enormously from country to country, and considerably by type of capital flow.—A reversal of capital flows across the board is now more likely to be caused by a country-specific deterioration in creditworthiness, rather than by international developments over which the country concerned has no control. Sustaining private capital flows in the long-term requires an economic policy which is conducive to export growth in developing countries. This should be supplemented by a stable environment, which would ensure that FDI in developing countries would be more profitable than in industrial countries to compensate for risk.

## VII FOREIGN CAPITAL FLOWS INTO SOUTH AFRICA

### 1. FOREIGN LIABILITIES

The total foreign liabilities of South Africa include all domestic assets owned by non-residents. They consist of long-term and short-term foreign liabilities. An inflow of capital is indicated by a positive sign which indicates an increase in foreign liabilities and a decrease in assets. An outflow of capital, on the other hand, is indicated by a negative amount which indicates a decrease in foreign liabilities and a net increase in foreign assets.



Table 4: Non-monetary private sector liabilities to total foreign liabilities, 1990-1996. (R million)

	1990	1991	1992	1993	1994	1995	1996
Non-monetary Private sector	40 809	45 901	54 795	62 250	74 003	89 875	100 657
LONG TERM	33 923	40 002	46 857	49 229	60 546	72 641	80 739
-Ordinary and other shares, nominal value	2 691	2 742	2 669	3 101	3 263	3 841	4 578
Shares premium, reserves and undistributed profit	24 629	28 914	35 049	35 003	42 683	50 954	56 936
-Branch and partnership balances	104	103	109	117	291	385	378
-Debentures, loan-stock and similar securities	532	691	707	626	1 928	2 069	2 184
-Mortgages and long-term loans	5 064	6 548	7 213	9 168	11 028	13 666	14 764
-Other	903	1 004	1 110	1 214	1 353	1 726	1 899
SHORT-TERM	6 886	5 899	7 938	13 021	13 457	17 234	19 918
<b>TOTAL FOREIGN LIABILITIES</b>	<b>89 584</b>	<b>98 514</b>	<b>121129</b>	<b>138606</b>	<b>169653</b>	<b>200804</b>	<b>240 998</b>

Source: SARB, *Quarterly Bulletin* (March 1998).

Table 4: Shows that South African foreign liabilities amounted to R240,9 billion at the end of 1996 compared with R169,6 billion at the end of 1994 and R89,5 billion at the end of 1990. On average, the amount of foreign liabilities has increased more than two and half times since 1990 up to 1996.



The non-monetary private sector activities are considered as an indicator of the flow of capital into South Africa. As indicated by the above table, foreign investment in the non-monetary private sector amounted to R100,6 billion at the end of 1996 compared to only R40,8 billion at the end of 1990. However, its percentage share in total foreign liabilities points a different picture.

Table 5: Percentage share of the non-monetary private sector liabilities to total foreign liabilities.

YEAR	NON-MONETARY SECTOR LIABILITIES (%)
1990	45,6
1991	46,6
1992	47,7
1993	44,9
1994	43,6
1995	44,7
1996	41,8

Source: *SARB, Quarterly Bulletin* (March 1998).

The share of the non-monetary private sector in terms of the total foreign liabilities increased from 45,6 per cent in 1990

to 47,7 per cent at the end of 1992. Since then, the share has declined, reaching its lowest level of 41,8 per cent at the end of 1996.

**Table 6: Percentage share of long-term and short-term liabilities relative to total foreign liabilities in the non-monetary private sector**

YEAR END	LONG-TERM (%)	SHORT-TERM (%)
1990	37,9	7,7
1991	40,6	6,0
1992	38,7	6,6
1993	35,5	9,4
1994	35,7	7,9
1995	36,1	8,6
1996	33,5	8,3

Source: SARB, *Quarterly Bulletin* (March 1998).

South Africa's foreign liabilities in the non-monetary private sector consist mainly of long-term liabilities. These liabilities have been increasing between 1990 and 1991 in absolute terms but in relative terms they have been declining in recent years, as is evident from table 6. The conclusion implied by the table is that South Africa has been unsuccessful in attracting long-term capital on a sustainable basis. On the other hand, the share of short-term foreign liabilities in the non-monetary private sector, which amounted

to 7,7 and 6,6 per cent of total foreign liabilities at the end of 1990 and 1992 respectively rose to 9,4 per cent at the end of 1993, as is evident from table 6. The uncertainties surrounding the political transition of that period possibly contributed to that rise. However, the relative share of short-term foreign liabilities subsequently declined to 8,3 per cent at the end of 1996.

**Table 7: Percentage share of portfolio flows to total foreign liabilities.**

YEAR END	EQUITY CAPITAL (%)	MORTGAGE AND LONG-TERM LOANS (%)	SECURITIES (%)
1990	30,5	5,7	0,6
1991	32,1	6,6	0,7
1992	31,1	6,0	0,6
1993	27,5	6,6	0,5
1994	27,1	6,5	1,1
1995	27,3	6,8	1,0
1996	25,5	6,1	0,9

Source: SARB, *Quartely Bulletin* (March 1998).

Table 7 shows that the proportion of direct investment by foreigners remained almost constant over the years 1990–1996.

However, since 1990 portfolio flows into the non-monetary private sector consisted mainly of equity capital. As a share of total investment, equity capital held by direct investors increased from 30,5 per cent at the end of 1990 to 32,1 per cent at the end of 1991. It has, nevertheless, declined from 32,1 per cent to 25,5 per cent at the end of 1996.

The share of mortgage and long-term loans increased at a very small rate from 5,7 per cent at the end of 1990 to 6,8 per cent at the end of 1995. However, their contribution declined to 6,1 per cent at the end of 1996.

The contribution by securities has also been very small, increasing from 0,6 per cent at the end of 1990 to 1,1 per cent in 1994. However, this share declined to 0,9 per cent at the end of 1996.

In regard to portfolio flows, South Africa has been unsuccessful in securing sustainable inflows in terms of total long-term capital, which was an important factor in the escalation of short-term foreign liabilities.

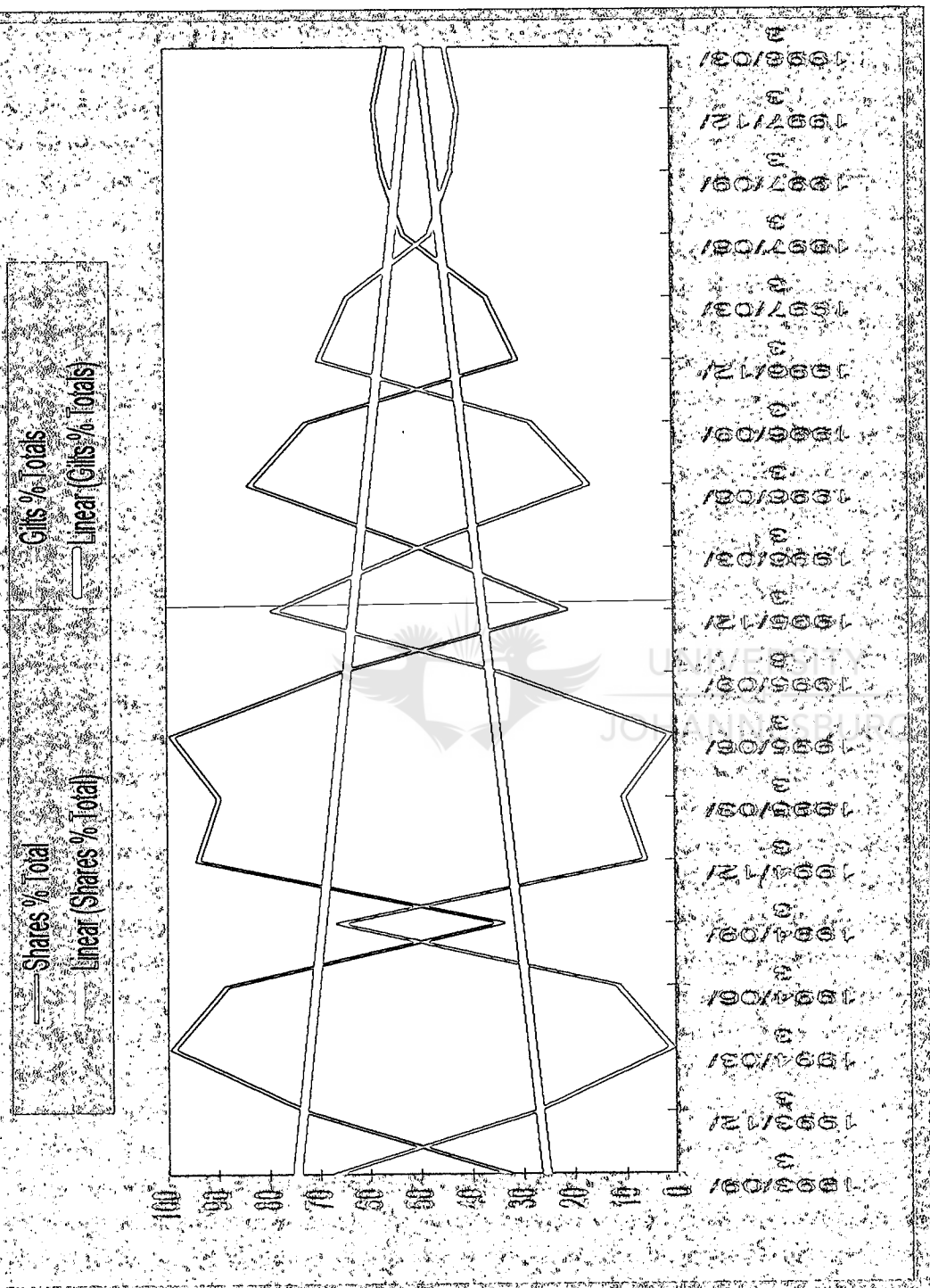
Another approach to capital inflows is to compare the net purchases of shares and gilts by non-residents.

**Table 8: NON-RESIDENTS' NET PURCHASES OF SHARES AND GILTS (R million)**

Period	Shares	Gilts	Total abs	Shares % total	Gilts % total
93/09/30	-138.338	-284.849	423.19	32.69	67.31
93/12/31	929.632	347.8895	1277.52	72.77	27.23
94/03/31	2147.017	24.8436	2171.86	98.86	1.14
94/06/30	-1165.87	-153.324	1319.20	88.36	11.62
94/09/30	-261.042	511.572	772.61	33.79	66.21
94/12/31	-534.849	35.3346	570.18	93.80	6.20
95/03/31	833.056	-95.8463	928.90	89.68	10.32
95/06/30	2043.335	-23.167	2066.50	98.88	1.12
95/09/30	1174.504	-592.725	1767.23	66.46	33.54
95/12/31	760.711	2846.332	3607.04	21.09	78.91
96/03/31	2350.278	2355.474	4705.75	49.94	50.06
96/06/30	1975.998	394.769	2370.77	83.35	16.65
96/09/30	1450.647	-560.918	2011.56	72.12	27.88
96/12/31	-523.039	1193.843	1716.88	30.46	69.54
97/03/31	3470.388	6085.184	9555.57	36.32	63.68
97/06/30	8238.041	7407.603	15645.64	52.65	47.35
97/09/30	7887.475	5986.716	13874.19	56.85	43.15
97/12/31	6605.057	-4701.06	11306.11	58.42	41.58
98/03/31	12818.37	10097.62	22915.99	55.94	44.06

Source: Data supplied by the South African Reserve Bank.

Figure 4: NET FOREIGN SHARES AND GLTS TRANSACTIONS



Although foreign investments in shares and gilts could be primarily of a short-term nature, it could be asserted that investment in shares follow a more long-term profile. The net foreign shares and gilts transactions indicate that non-residents display an interchangeable preference for bonds and equities as indicated in figure 1. This substitution effect shows that there is no commitment to long-term investment. The trend line in figure 1 shows that investments in shares (i.e. long term) is following a declining trend while investment in gilts follows the opposite pattern. South Africa is probably entering a changing pattern, yet the momentum of this changing pattern appears to be slow.

## **2. MACRO-ECONOMIC PERFORMANCE OF SOUTH AFRICA**

It has been reiterated throughout this study that domestic economic factors are important in encouraging long-term investments. These factors are associated with the performance of the economy as measured by the GDP growth rate, inflation, the level of foreign reserves and the savings ratio.

The purpose of this analysis is to investigate the performance of South Africa in terms of these performance criteria compared to other emerging markets.

**Table 9: GDP Growth in emerging markets.**  
(annual average; %)

	1993 - 97	1998 - 2002
<b>Asia &amp; Australasia</b>	<b>6.4</b>	<b>3.9</b>
Japan	1.4	0.2
China	11.0	7.3
South Korea	7.2	0.6
Australia	3.7	2.0
India	6.0	5.6
Taiwan	6.7	5.2
Indonesia	7.0	-3.1
Hong Kong	5.1	1.3
Thailand	6.1	1.4
Malaysia	8.7	0.2
Singapore	8.8	2.6
<b>Latin America</b>	<b>3.4</b>	<b>3.1</b>
Brazil	3.7	3.0
Mexico	2.4	4.0
Argentina	4.5	4.4
Colombia	2.5	3.1
Venezuela	0.8	2.7
Chile	7.5	4.7
Peru	7.2	3.5
Ecuador	2.8	3.4
<b>Africa</b>	<b>2.7</b>	<b>3.0</b>
South Africa	2.5	2.4

Source: Economist Intelligence Unit (4<sup>th</sup> quarter 1998).

One reason why countries in Latin America and Asia have attracted long-term capital since the 1990's is that they showed a higher economic growth rate than the industrial countries (Tables 2 and 3). Table 9 shows that South Africa's economic growth rate is



still far below that of major competing countries for long-term capital. The difference between South Africa's growth rates and that for other emerging markets is expected to decline to the year 2002 as indicated in table 9.

Table 10: Inflation in emerging markets.

	NON-OIL DEVELOPING COUNTRIES - %: CHANGE IN CONSUMER PRICES	WESTERN HEMISPHERE - % CHANGE IN CONSUMER PRICES	ASIA - % CHANGE IN CONSUMER PRICES	SOUTH AFRICA % CHANGE IN CONSUMER PRICES
90/12/31	89	503.52	6.49	14.4
91/12/31	46.3	147.47	8.17	15.28
92/12/31	48.87	166.51	7.71	13.92
93/12/31	54.42	226.73	9.33	9.66
94/12/31	67.72	265.57	13.69	9.01
95/12/31	24.4	44.22	11.26	8.59
96/12/31	14.91	22.85	7.68	7.42
97/12/31	11.17	13.68	5.02	8.42

Source: WEFA GROUP

Table 10 indicates that, although South Africa's inflationary rate has been reduced to single digits since 1993, it is still high compared to that of Asia, which has reached the very low level of 5.02. If inflation is high, the real returns on investment tend to be low, discouraging international investors to diversify their portfolios to such countries. Countries in Asia successfully implemented anti-inflationary monetary policies which reduced their macro-economic risks and stimulated capital inflows (Calvo *et al* 1996: 127).

Table 11: Foreign reserves in emerging markets. (\$ bn)

	1997	Year ago
<b>Asia</b>		
China	127.8 (Jul)	91.7
Hong Kong	85.3 (Aug)	55.4
India	26.8 (Aug)	18.3
Indonesia	19.3 (Aug)	15.5
Malaysia	26.1 (Feb)	23.1
Phillipines	10.0 (May)	8.0
Singapore	80.7 (Jun)	72.2
South Korea	34.4 (Aug)	33.5
Taiwan	87.8 (Aug)	86.1
Thailand	25.0 (Aug)	38.3
<b>Latin America</b>		
Argentina	19.8 (Aug)	14.6
Brazil	58.8 (Jul)	57.4
Chile	17.4 (Aug)	14.5
Colombia	10.0 (Jul)	7.8
Mexico	25.8 (Aug)	17.5
Venezuela	15.2 (Aug)	8.7
<b>Africa</b>		
South Africa	4.8 (Aug)	0.9

Source: London economist (25<sup>th</sup> October 1997).

China has by far the biggest stock of reserves amongst emerging countries. At the end of July 1997, the country held some \$ 128

billion in foreign reserve. Taiwan was in second place, with reserves of \$ 88 billion at the end of August 1997. In Latin America, Brazil was ranked top with \$ 59 billion at the end of July 1997. South Africa occupies the worst position with reserves worth \$ 4,8 billion.

Table 12: South African savings ratio.

	GDS% of GDP	Personal saving % of Pers disp Income	GDP	Government saving	Govsaving % of GDP
88/12/31	22.7	3.9	200448	-2151	-1.07
89/12/31	22.6	3.4	240639	-1995	-0.83
90/12/31	19.5	1.1	276060	-1805	-0.65
91/12/31	18.9	1.9	310074	-4799	-1.55
92/12/31	17	4.3	341765	-18555	-5.43
93/12/31	17.2	5.3	382199	-23652	-6.19
94/12/31	17.1	4.1	431088	-20537	-4.76
95/12/31	16.9	1.9	484614	-17594	-3.63
96/12/31	16.9	2.1	542741	-17746	-3.27
97/12/31	15.2	0.9	594858	-22050	-3.71

Source: SARB, *Quarterly Bulletin* (March 1998).

Asian markets have been recipients of long-term capital because in

the Far East, savings ratios have been very high. In South Africa, gross domestic savings as a percentage of gross domestic product (GDP) has been falling from 22,7 per cent in 1988 to 15,2 percent in 1997. The main contributing factor to this situation has been the low economic growth rate. Throughout this period, government has also been dissaving. Although personal savings as a percentage of personal disposable income are following a downward trend, (see table 12) the falling gross domestic savings rate is largely explained by government dissaving. Moreover, the large dissaving ratio has been accompanied by a rise in private consumption spending; these factors point to difficulties in maintaining a tight fiscal policy.

Thus, the macroeconomic variables support the conclusion that in comparison with other emerging markets, South Africa's GDP growth rate is too low; the inflation rate is too high; reserves are too low; and the savings rate is too low.

### 3. POLICY IMPLICATIONS FOR SOUTH AFRICA

Challenges facing South Africa include, *inter alia*, to improve the GDP growth rate; to reduce inflation; to build reserves; and to encourage savings (Strydom 1995: 11).

The GEAR (Growth, Employment and Redistribution) macro-economic strategy of the government is aiming at macroeconomic stability as well as growth but in practice the programme has been more

successful in achieving stability as opposed to growth. The evidence shows that countries in Latin America where the emphasis is more on stabilisation rather than growth are attracting short-term capital as opposed to FDI. The challenge to South Africa is to achieve a better balance between growth and stability and to generate a real GDP growth rate of between 3 and 6 percent *per annum* in order to be competitive in the international capital markets (see table 9).

The monetary authorities of South Africa should implement a tight monetary policy in order to reduce the high inflation level and enhance competitiveness. Restraining credit expansion in relation to the growth of money demand, in order to achieve a persistent reduction of the inflation level, could lead to the inflow of long-term capital becoming sustainable. For foreign investors, the relatively low value of South Africa's reserves is an indication of the vulnerability of its balance of payments situation. This of course implies that the value of the rand could follow a volatile pattern. A more important implication is that the rand will probably remain a weak currency. A weak currency has negative inflationary associations which discourage long-term investments. Moreover, it does not bode well for the dividend payments on foreign investments. The rate of return on foreign investment is therefore adversely affected.

South Africa's reserves should be built up through a continuation of the present outward looking policies in order to secure a more stable balance of payments situation.

Since the savings ratio is already low and still falling the government faces the major challenge of reversing its dissaving pattern in order to stimulate a recovery in the savings ratio through adequate fiscal discipline.

South Africa has introduced highly segmented and inflexible labour markets which are discouraging foreign investment. It is instructive to note that Germany, for example, experienced high unemployment levels when it had a similarly rigid labour market.

The liberalisation of the foreign exchange market should gain momentum. South Africa will not be fully integrated into global markets as long as it maintains exchange controls on residents.

Privatisation has attracted substantial long-term capital flows to Poland and other East European countries. South Africa is missing many opportunities by dragging its feet in the privatisation of state assets. Specific investment opportunities associated with the implementation of privatisation programmes would create a favourable macroeconomic climate. This could assure investors that their capital is safe from large swings in inflation, taxes and exchange rate volatility (Landsbury *et al* 1996: 106).

As indicated above, South African foreign capital flows mostly come from short-term funds. On the basis of the evidence related to Latin America, it can be concluded that this is a direct result of South Africa's obsession with macro-economic stabilisation as opposed to growth. In order to attract FDI on a sustainable basis

it is imperative that South Africa will rely on a more growth oriented macro-economic approach. Privatisation of state assets and the reform of the South African labour market in favour of greater flexibility should be key elements of such a growth strategy.



## VIII CONCLUSION

International capital flows have followed various dissimilar patterns. In many developing countries, including South Africa, inflows were initially based on short-term capital, especially during the 70s and early 80s. Short-term capital inflows resulted in the accumulation of debt in many developing countries, especially in Latin America. Although South Africa attracted long-term capital inflows until the early 1970s, there was a shift in favour of short-term debt-oriented capital flows during which the importance of foreign macroeconomic performance and the domestic investment process became more domestically driven. During the 1980s South Africa was characterised by overspending and a fiscal deficit. It imported more short-term capital, while its foreign debt as a percentage of GDP increased markedly.

With the marked improvement in the foreign debt situation and the implementation of sound macro-economic policies towards the end of the 80s and during the early 90s, medium and long-term capital inflows began to rebound strongly and have since then risen rapidly, with their composition shifting substantially over the period 1990-1993.

However, since the 1990s South Africa has failed to attract long-term capital on a sustainable basis because of the economic and political crises facing the country. It is, however attracting short-term capital at a higher rate. This is exacerbated by the lethargic real growth rate, low and falling savings rate, low and

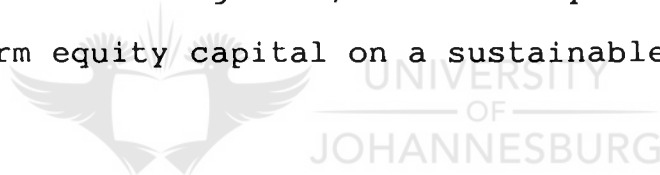


falling gross domestic fixed investment, a relatively high (though decreasing) inflation rate, and a low level of foreign reserves. To attract long-term capital flows on a sustainable basis, South Africa has to generate real GDP growth at a higher rate than most developed countries vying for international long-term capital. However, South Africa would only be able to achieve the high growth rate if it implements sound macro-economic policies. A sound macro-economic policy framework will enable the country to follow stringent fiscal and monetary policies. The deficit on the current account could be reduced by increased exporting. The deficit on the current account of the balance of payments may become a problem area in South Africa unless it is offset by sufficient foreign capital inflows. The slowdown in private consumption, which started in 1996 and continued throughout 1997 could be sustained if savings rates by both the private and the public sectors could be increased. A high level of domestic savings is required to finance the fixed investment levels necessary to secure a higher sustainable economic growth rate.

The structural reforms that South Africa should implement include privatisation programmes, a liberalisation process and integration in the capital markets. These would become the driving force in attracting long-term capital flows into South Africa.

The durability and sustainability of capital inflows depend on the internal policies of the developing countries themselves. According to the World Bank (1997: 86 - 88), the improvements in

economic performance of developing countries were underpinned by the systematic adoption of macro-economic stabilisation programmes and structural reforms by a growing number of these countries. A key element of the stabilisation programme was sustained fiscal adjustment, with fiscal deficits declining substantially from high levels. Trade liberalisation, deregulation and financial sector liberalisation promoted more private sector activity and outward oriented economies. The challenge which South Africa faces is to strike a balance between economic growth and stabilisation. The present macro-economic strategy is intended to stimulate growth, yet appears to be primarily concerned with short-term stabilisation. Economic growth is lagging behind. As long as South Africa follows economic policies which favour economic stabilisation rather than growth, the country is unlikely to attract long-term equity capital on a sustainable basis.



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