

Developing Countries and the Global Financial System



The 1990s saw a huge upsurge in flows of private capital from industrial to developing countries. At the beginning of the decade, private and official flows were about the same, but only five years later private flows dwarfed official flows. Not since the late 19th century have international capital flows assumed such prominence.¹ But there are marked differences between the movement of capital at the end of the 20th century and the movement of capital a century earlier. These differences have important policy implications for developing countries as they integrate into the global financial system.

At the end of the 19th century capital flows financed infrastructure projects such as railroads and direct investment in foreign companies. A hundred years later foreign direct investment is channeled primarily through multinational corporations that are establishing plants and service operations throughout the world. These investments bring with them more than money. They open access to markets, make new technologies available, and provide workers with training. But another type of capital has

appeared—a huge pool of highly mobile money channeled through mutual funds, pension funds, and wealthy individuals that is ready to move across borders at a moment's notice in search of the highest short-term returns.

Countries that open themselves up to these short-term capital flows are discovering that such investments have their costs. Rapid changes in investor sentiment can cause enormous instability, particularly in developing economies. This realization has led to a reexamination of the international economic architecture, raising some important questions: Are the benefits of liberalizing capital accounts worth the costs? Can developing countries find ways to capture the gains from financial globalization without running such enormous risks, which often jeopardize the poorest individuals? The policy response is to calibrate a sequential approach to financial reform that both ensures stability in developing countries and captures the benefits of integration into world capital markets.

This chapter emphasizes the four key components of that approach:

- Developing countries need to strengthen banking regulations and, where possible, build complementary and well-regulated securities markets, if the benefits of domestic financial liberalization are to materialize.
- While banking regulation is being strengthened, policies should be directed to reducing the demand for—and volatility of—short-term foreign borrowing.
- Further international cooperation in setting and implementing fiscal, monetary, and exchange rate policies should be considered.
- Long-term foreign investment should be attracted by cultivating a healthy economic environment—including investing in human capital, allowing domestic markets to work without unnecessary distortions, and committing to a strong regime of investors' rights and obligations—and not by offering subsidies or other inducements.

The chapter examines the mixed record to date of developing countries' integration into the international financial system. It draws from a variety of experiences to identify the principal benefits and risks of global financial integration. Even more important, it proposes national and global responses that can further development goals without jeopardizing financial stability.

The gathering pace of international financial integration

Rapid improvements in technologies for collecting, processing, and disseminating information, along with the opening of domestic financial markets, the liberalization of capital account transactions, and increased private saving for retirement, have stimulated financial innovation and created a multitrillion-dollar pool of internationally mobile capital. At the same time, consolidation in the global banking industry and competition from nonbank financial institutions (including hedge and mutual funds) have lured new players to the international financial arena. These trends accelerated in the 1990s, expanding investment opportunities for savers and offering borrowers a wide array of sources of capital.² The same trends can be expected to continue well into the 21st century.

The growing pool of international financial capital

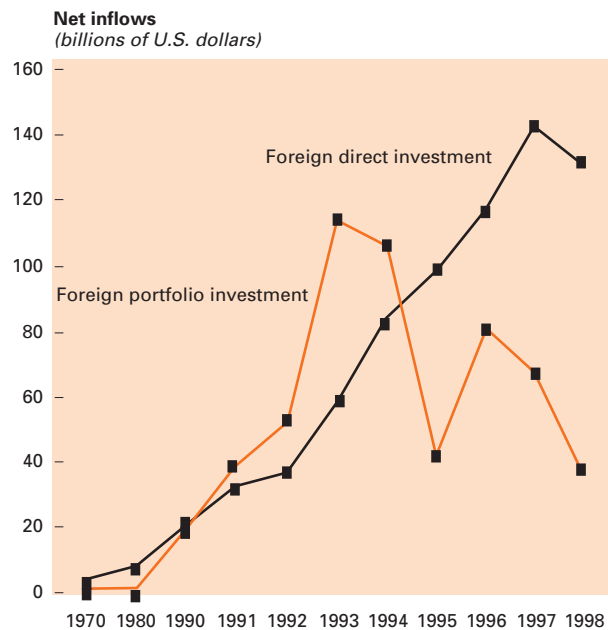
Over the last two decades, the financial markets of leading industrial countries have melded into a global financial system, permitting ever-larger amounts of capital to be allocated not only to their economies, but also to

developing and transition economies.³ Since 1980 the amount of net foreign direct investment in developing countries has climbed more than twelvefold (figure 3.1).⁴ In contrast, net portfolio investment flows have been far more volatile throughout the 1990s, exceeding \$100 billion in 1993 and 1994 and falling considerably since then.

Firms in developing and industrial countries alike are raising more funds from international securities markets. Multinational corporations are registering their equity on more than one country's stock exchange and are raising funds from financial markets in different economies. Since 1993 the amount of outstanding international debt issued by all firms has risen by 75 percent, reaching \$3.5 trillion in early 1998. Although financial and nonfinancial companies headquartered in industrial countries issue most of this debt, firms in countries such as Brazil, Mexico, and Thailand have also begun to tap the global market for capital—a path others will surely follow (figure 3.2).

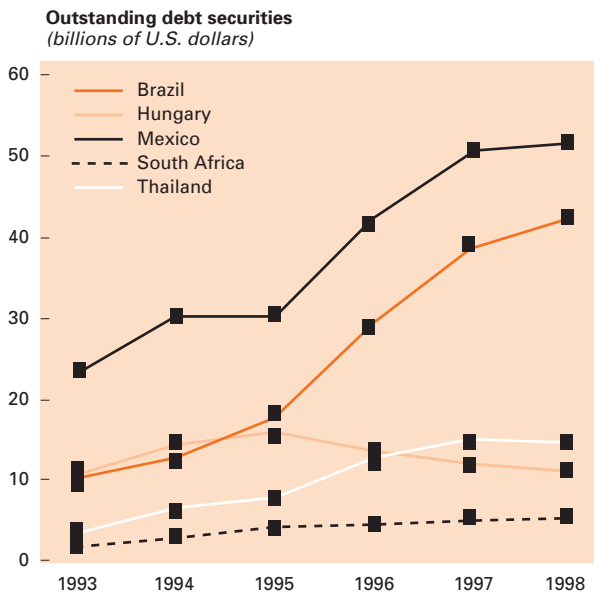
This rising number of international capital transactions, together with the substantial growth in interna-

Figure 3.1
Since 1980 net inflows of foreign direct and portfolio investment to developing economies have grown enormously



Source: IMF, *Balance of Payments Statistics Yearbook*, 1998.

Figure 3.2
Firms from developing countries are issuing more international debt than before

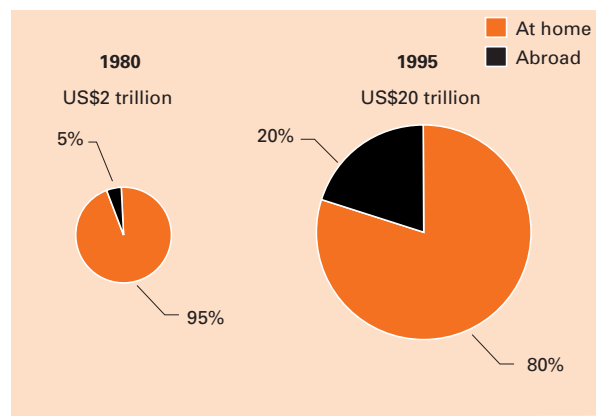


Source: IMF, *International Capital Markets*, 1998.

tional trade in goods and services, has increased turnover on foreign exchange markets eightfold. In 1998 the daily total stood at around \$1.5 trillion, an amount equal to around one-sixth of the annual output of the U.S. economy. Financial instruments with very similar risks pay similar returns no matter where they are issued, providing further evidence of the integration of national capital markets. The returns on these instruments varied widely across countries as recently as 10 or 20 years ago.

Mutual funds, hedge funds, pension funds, insurance companies, and other investment and asset managers now compete with banks for national savings. Although thus far this phenomenon has been confined primarily to industrial economies, the consequences for developing countries could be far-reaching. Institutional investors have taken advantage of the easing of restrictions in many industrial countries to diversify their portfolios internationally, enlarging the pool of financial capital potentially available to developing and transition economies. In 1995 these investors controlled \$20 trillion, 20 percent of it invested abroad. This figure represents a tenfold increase in the funds and a fortyfold increase in such investments since 1980 (figure 3.3).

Figure 3.3
A growing pool of institutionally managed funds is invested abroad



Source: IMF, *International Capital Markets*, 1998.

Liberalizing capital flows in developing and transition economies

The 1990s have seen a consistent trend toward more flexible exchange rate regimes and the liberalization of capital account transactions. The latter involves changes in policies toward different types of private capital flows, such as foreign direct investment, foreign bond and equity investment, and short-term borrowing from abroad. Developing countries in Asia and the Western Hemisphere, and the transition economies, have moved toward having a single exchange rate, rather than trying to have one rate for those who are exchanging their currency because of foreign trade and an alternative rate for those who exchange currency in order to invest.⁵ Old-style rules that used to require exporters to exchange their earnings of foreign currency with the nation's central bank have been relaxed by developing countries on every continent, particularly in the Western Hemisphere and Eastern Europe.

The speed and depth of capital account liberalization have varied across countries, however. Most countries have moved toward capital account convertibility as part of a wide-ranging, gradual economic reform program that includes measures to strengthen the financial sector. But Argentina, the Baltic countries, Costa Rica, El Salvador, Jamaica, the Kyrgyz Republic, Mauritius, Singapore, Trinidad and Tobago, and Venezuela have opened important parts of their capital accounts in one stroke.⁶

In addition to moves toward capital account convertibility, other policies have made many developing countries a more attractive destination for foreign investment: macroeconomic stabilization and structural reforms, privatization policies, relaxed rules on foreign direct investment, and lower interest rates in industrial countries. Rising confidence in the economic prospects of developing countries in the 1990s was reflected in the fact that foreign direct investment accounted for a greater proportion of capital inflows, which signals a commitment to invest over a longer time horizon than portfolio investments like equity holdings.⁷

By 1997 approximately half of all capital flows to developing countries was foreign direct investment.⁸ These investments fell slightly in 1998 in response to the East Asian crisis, a change that may prompt many countries to reevaluate their policies toward such investments—and the recommendations developed later in this chapter provide a framework for action. Developing countries are also becoming foreign investors themselves. In 1996 they invested \$51 billion abroad, raising their share of global foreign direct investment outflows to 15 percent. Like industrial countries, they invest predominantly in economies in the same region or continent.

Foreign direct investment in service industries accounts for close to two-thirds of such capital flows, while the share of such investment in manufacturing has been falling. Although these aggregate figures conceal differences across countries, the shift toward services is significant. Traditionally, service industries have been less exposed to international trade and so lacked this stimulus to control costs, develop products, and innovate. Foreign direct investment offsets this deficiency by enhancing the degree of competition in domestic service markets and by transferring best practices from abroad (see chapter 2). In addition, firms in developing countries have become more involved in cross-border partnerships with foreign firms—joint ventures with or without equity stakes, franchises, licensing, and subcontracting or marketing agreements. Since 1990 more than 4,000 such agreements have been signed, complementing the flows of foreign investment.⁹

The continuing liberalization of national regulatory frameworks for foreign investment has fostered these capital inflows and interfirm agreements. In 1997 at least 143 nations had frameworks for foreign direct investment in place. Some 94 percent of the regulatory changes since 1990 have actually helped create more favorable environments for foreign direct investment.¹⁰

A proliferation of bilateral investment treaties reinforced these domestic reforms. Between 1990 and 1997 developing countries were parties to 1,035 bilateral investment treaties, which protect the rights of foreign investors and engender a regulatory environment that promotes investment. Other treaties also reduce investor exposure to double taxation by authorities in the home country of the investor and in the destination of the investment.¹¹ Argentina, China, the Arab Republic of Egypt, the Republic of Korea, and Malaysia have signed the most treaties, followed by Central and East European countries. More recently, Latin American countries have also begun signing such treaties, starting, as is traditional, with their regional neighbors. By reinforcing commitments to stable national investment regimes, these treaties are encouraging greater international investment flows. In addition, these bilateral treaties are being reinforced by a growing set of regional and sectoral investment accords.¹²

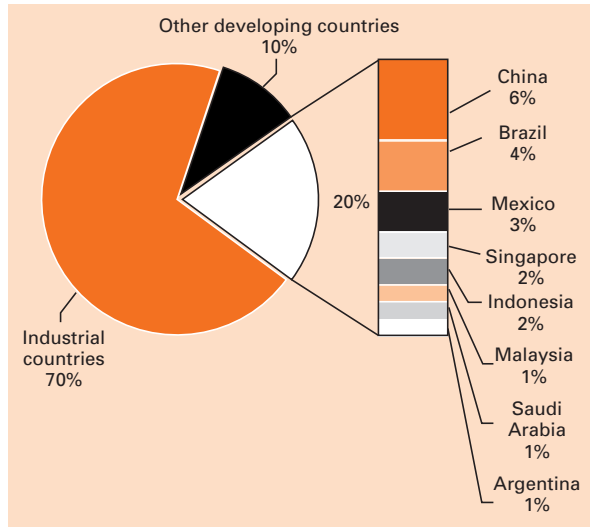
A small group of developing countries has consistently attracted most foreign investment (figure 3.4).¹³ Brazil, Indonesia, Malaysia, Mexico, and Thailand have been among the top 12 recipients in each of the past three decades. China (including Hong Kong) joined this group in 1990 and by 1998 had received \$265.7 billion in foreign direct investment, making it the most sought-after destination among developing countries. A few African and Middle Eastern countries have been very successful in attracting foreign investment as well, but as a group Africa and the Middle East have received less than 10 percent of foreign direct investment flows. In 1997 the stock of such investment in Africa was less than 2 percent of the world total. For this reason many Sub-Saharan countries will continue to rely on multilateral and bilateral aid to finance investment projects (box 3.1).

Although multinational corporations typically invest in foreign countries in order to sell in domestic markets or to create new bases for exporting, international firms have long shown an interest in exploiting developing countries' natural resources, including oil, minerals, and lumber. Investment in natural resources is often enclave investment. It brings needed capital into a country but offers few of the other benefits—new technologies, new markets, and increased human capital—that are usually associated with manufacturing investment. In many cases, the economic activities such investments entail are located in relatively remote areas, far from other areas of economic activity.

The benefits to developing countries of foreign investment in natural resource exploitation have been

Figure 3.4
A few developing countries received the lion's share of FDI invested outside industrial countries in 1997

Worldwide stock of FDI in 1997 (\$3,456 million)



Source: UNCTAD, *World Investment Report*, 1998.

ambiguous, for several reasons. First, the benefits to a developing country may be smaller than GDP indicators initially suggest, as these indicators do not take into account the wealth the country loses when resources are extracted. Second, the resulting economic growth may not be sustainable. In some cases the legacy may be more negative than in others. If gold extraction technologies lace the surrounding environment with cyanide, the costs of restoration can be enormous. In contrast, companies can replant hardwood forests that have been logged.

The kinds of foreign direct investment that are most likely to provide useful benefits and sustainable, long-term growth are associated with manufacturing producer services. Unfortunately even those African countries with a five-year record of good economic policies have found it difficult to attract this kind of investment, in spite of evidence showing that the overall returns in these economies may be just as good as elsewhere.

Financial interruptions to development: banking and currency crises

Even though it is widely accepted that developing countries have substantially benefited from large inflows of foreign direct investment, the far more controversial aspect of capital account liberalization has concerned poli-

Box 3.1 **A continuing role for aid**

Among least-developed countries, the smallest and most resource poor are the least likely to receive substantial private capital flows. These countries still need official aid flows to finance investments in health, education, the environment, and basic infrastructure. In 1998 net official flows worldwide totaled approximately \$51.5 billion.

Aid can be highly effective in promoting growth and reducing poverty. But aid is also a scarce resource that needs to be used well, and using it well requires good decisions by governments and donors alike. Whether aid increases economic growth, for instance, depends on a country's policy and institutional environment. Good macroeconomic management, sound structural policies and public sector administration, and measures that increase equity are all important. They promote growth themselves, and they support the growth-enhancing effects of development assistance.

Development assistance, like so many other economic inputs, is subject to diminishing returns. Even countries with excellent policies are limited in their capacity to absorb such aid. Once official assistance reaches around 12 percent of GDP, its potential contribution to growth is usually exhausted. But few countries receive such high levels of aid, so that only a country's policy environment limits its capacity to absorb development assistance.

While the governments of developing countries determine the effectiveness of aid in the growth process, donors determine how effective aid is in global poverty reduction. For it is donors, not recipient governments, that decide which countries receive assistance. In making this decision, donors need to keep in mind two factors:

- The extent to which assistance will raise the growth rate, a factor that depends on the policy and institutional environment and thus differs considerably across countries
- The existing level and distribution of income in the recipient country, since income growth in a country like Chile, where poverty is low, tends to reduce poverty less than it would in a country with mass poverty, like India.

Three-quarters of the world's poor (those living on less than \$2 per day) now live in countries where the policy environments are such that additional aid would raise the growth rate. The challenge is to allocate the assistance available in order to take advantage of the favorable climate for growth.

Source: Collier and Dollar 1998; World Bank 1998a, 1999i.

cies (or lack thereof) toward foreign portfolio investment and short-term foreign borrowing.¹⁴ These kinds of flows have been closely linked with the financial and currency market volatility of the late 1990s. Countries with high levels of short-term debt are vulnerable to sudden changes in investor sentiment. The resulting mas-

sive shifts in the direction of flows are often too much for even strong financial systems and are certain to have disastrous consequences for weaker ones. The economic crises resulting from such vacillations have imposed enormous costs on the countries involved—costs that have affected not only borrowers but also huge numbers of innocent bystanders. In some cases workers have seen unemployment soar and wages fall by one-fourth or more.¹⁵ Small businesses with prudent levels of debt have found themselves either cut off from access to credit or facing astronomical interest rates few can afford. Bankruptcies have soared, contributing to the economic havoc and destroying information and organizational capital that will not be recovered for years.

In considering the risks inherent in the ebbs and flows of international capital, governments will want to differentiate between liberalizing domestic financial institutions and liberalizing the capital account. Although they involve different policy instruments and pose different risks, both types of liberalization can result in financial instability if they are poorly managed. The past two decades should leave no doubt about the heavy costs of global banking crises. Between 1977 and 1995, 69 countries faced banking crises so severe that most of their bank capital was exhausted.¹⁶ Recapitalizing these banks was extremely expensive, with budgetary costs reaching approximately 10 percent of GDP in Malaysia (1985–88) and 20 percent of GDP in Venezuela (1994–99). These crises can retard the progress of economic growth for years. As the Mexican crisis of 1994 and the East Asian crisis of 1997–98 made clear, banking and currency crises often come as a pair.¹⁷

Liberalizing the capital account also influences domestic financial stability because portfolio investment can be volatile.¹⁸ Latin America has seen its foreign capital flows rise and fall sharply. Net inflows were \$60 billion in 1993, but in the wake of the Mexican crisis in 1995, net outflows reached \$7.5 billion. Access to a growing pool of global capital can mean more volatility in emerging financial markets and greater exposure to changes in sentiment by institutional investors in industrial countries, too. Many empirical studies have demonstrated the sensitivity of portfolio flows of foreign capital to interest rates in industrial economies.

Increases in interest rates in industrial countries raise the probability of a banking crisis in developing and transition countries, for three reasons.¹⁹ First, to retain investments from industrial country investors who can now realize higher returns at home, banks in develop-

ing countries must raise their rates. The higher costs are passed on to domestic borrowers, increasing the likelihood of defaults. Second, many firms in developing countries borrow from overseas banks. When such borrowing is widespread, increases in interest rates in industrial countries create a common macroeconomic shock, leaving firms unable to repay their loans to domestic as well as to foreign banks.²⁰ Balance sheets deteriorate even further when a jump in industrial countries' interest rates leads to a depreciation in a developing country's exchange rate, so that domestic borrowers need more domestic currency to repay their foreign currency debts.

Third, speculative attacks can seriously jeopardize the stability of a developing economy's banking system.²¹ A speculative attack on a currency occurs when foreign and domestic depositors suddenly shift their funds out of domestic banks into foreign currency, often leaving the domestic banking system facing a bank run. These attacks take place because investors receive new information that affects the attractiveness of keeping money in a country. And financial contagion tends to occur when a country's economic characteristics resemble those of another country that is known to be in severe macroeconomic difficulties (box 3.2).²²

Fears of a banking or currency run may be self-fulfilling, creating a macroeconomic crisis that would not otherwise have occurred.²³ During the banking crisis in Argentina in 1995, deposits fell by one-sixth in the first quarter of the year, and the central bank lost \$5 billion in reserves. The crisis was attributed in part to the collapse in confidence in Latin American financial markets that followed the Mexican crisis in December 1994.²⁴ The two recent financial crises in East Asia and Latin America suggest that geographic proximity is an important determinant of financial contagion. "Institutional proximity," or similarities in legal and regulatory systems, and exposure to the same shocks may also be factors. Countries thus have an interest in ensuring that the financial systems and macroeconomic policies of neighboring countries do not increase the likelihood of a financial crisis and induce contagion. Potential spillovers across countries provide a compelling rationale for regional cooperation and coordination in macroeconomic policy, banking standards, and the enforcement of bank regulations—a proposal explored later in this chapter.²⁵

Recent cross-country studies find that imposing capital controls has little effect on economic growth.²⁶ One

Box 3.2**What causes financial contagion?**

During a financial crisis elsewhere, contagion is said to have occurred when a country succumbs to a financial crisis for reasons other than a change in its fundamentals. The crises that began in Mexico during 1994 and Thailand in 1997 spread rapidly around the world. These crises had a major effect on financial markets, labor markets, and output in a range of other countries in different regions—even half a world away.

What causes financial contagion?²⁷ The series of events could begin with a country that experiences a currency devaluation, perhaps as the result of a combined bank and currency run by foreign investors. That country's export goods become cheaper for foreign consumers to buy, and other countries that export the same goods find themselves at a competitive disadvantage. The latter countries then come under pressure to devalue their exchange rates. In 1997 and early 1998 many feared that East Asian countries, in an attempt to shore up export sectors against regional competition, would engage in rounds of "competitive devaluations" that would damage the economic prospects of every country involved.

These sorts of trade and exchange rate effects emanated from the Thai devaluation in 1997 and helped spread the East Asian crisis. But they cannot explain the depth or breadth of financial contagion. An alternative cause, which is disseminated

through the attitudes of investors worldwide, is the response of mutual fund managers to country crises. Fund managers can spread financial volatility in several ways:

- Emerging market fund managers often allocate their portfolios across different countries according to percentages specified beforehand. When the value of investments in one country drops, one manager's response might be to sell stocks in other emerging markets to rebalance the portfolio, depressing stock prices and putting pressure on currencies in all the countries in which the manager invests.
- Fund managers facing losses from investments in one country may have liquidity problems, forcing the sale of investments in other markets.
- Investors, especially in emerging markets, find information on the prospects of a company or a country costly to collect. This difficulty encourages herd behavior: the disposal of stock by one investor is assumed to be based on news that is not yet widely known, so other investors interpret this action as a signal to sell their own holdings. The lack of information also encourages investors to take news of poor performance in one emerging market as a signal that bad news is imminent in similar markets.

plausible interpretation of this finding is that the benefits of having access to a global pool of capital—like the opportunity for adding to investment capital or diversifying risks—have been offset by the costs of the crises financial liberalization causes. While cross-country regressions are always open to scrutiny, they do underscore the difference between the evidence on the effects on economic growth of trade liberalization and capital account liberalization. A wealth of studies exists on trade liberalization, all of them suggesting that it has many benefits, but the evidence on capital account liberalization is much more mixed. The challenge is to devise policy and institutional responses attractive enough to lure investments that will have a significant positive impact on growth and, at the same time, to reduce the potential for costly financial crises. The rest of this chapter presents an integrated program to do just that.²⁸

Toward a more robust and diversified banking system

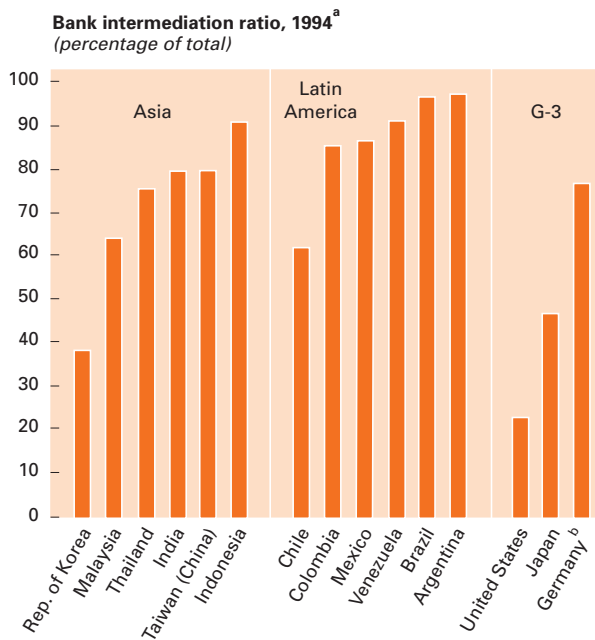
Banking systems are especially important for raising and allocating capital in developing countries, where the banking sector typically accounts for a larger share of total financial intermediation than it does in industrial economies (figure 3.5).²⁹ Cross-country studies point to the beneficial effects of a healthy banking sector on capi-

tal accumulation, productivity, and economic growth.³⁰ This evidence and the frequent banking crises developing countries experience suggest that a robust banking regulatory framework offers substantial payoffs. Such a framework would ensure that bank managers and owners balance the costs and benefits of risk-taking behavior.

Striking the appropriate balance in designing bank regulations is difficult, however. Lax regulation raises the risk that lending will move from the realm of measured risk-taking to foolhardiness. But excessive bank regulation is likely to send funds flowing to the more lightly regulated nonbank financial sector.³¹ This sector is less likely to be associated with systemic failures than banks, since severe bank failures lead to difficulties with the payment mechanism. Yet this sector can also breed financial instability, suggesting that at least some regulations may need to extend beyond the banking system to other financial entities.

The growing complexity and diversity of banking activities are straining bank regulatory resources everywhere, but especially in developing countries where these resources are scarce. Private monitoring of banks can complement formal regulations, and only a judicious combination of public and private oversight will allow developing economies to reap all the possible benefits of financial liberalization.

Figure 3.5
Bank intermediation typically accounts for a larger share of the financial sector in developing countries



a. Ratio of the banking sector's assets to the assets of all financial institutions.

b. The Universal banking system in Germany accounts for its very high bank intermediation ratio.

Source: World Bank 1997c.

In industrial countries an extensive legal and regulatory structure underpins banking operations. Laws protecting the rights of creditors permit banks to lend confidently and to collect deposits. Laws regulate bankruptcy and the recovery of assets and collateral, and judicial proceedings implement such laws quickly and impartially.³² Accounting and auditing standards help in comparing investment projects and are prerequisites for building efficient bond and stock markets. The rise of international bank lending increases the importance of global accounting standards.³³ And because these legal and professional institutions take years to build, it is important to begin constructing them now. In the meantime governments can develop regulatory frameworks that address some of the special problems of banking activities in developing countries.

Why are deposits insured?

Banks borrow money on a short-term basis from depositors and lend it out for longer periods. Depositors con-

cerned about the security of their money must try to gauge the quality of their bank's lending practices, which determine whether the bank is solvent enough to return deposits on demand. If many depositors—for good reasons or bad, based on good information or poor—demand their deposits back at the same time, banks face a liquidity problem. When banks lend large sums to each other, the resulting financial commitments can put pressure on a number of entities. If depositors cannot differentiate between them, a run on one bank may lead to runs on others, threatening the stability of the entire financial system. To limit this possibility, governments often insure deposits, guaranteeing depositors that they will get their money back and thereby reducing the incentive to start a bank run in the first place. Central banks may also act as lenders of last resort to help banks deal with short-term liquidity problems.

Deposit insurance has been criticized as contributing to the fragility of the banking system, and without the appropriate regulatory structure this can well be the case. With deposit insurance, depositors simply put their money in the bank offering the highest return. A variant of Gresham's law—with bad banks driving out good banks—can occur; a bank that is willing to take greater risks with higher expected returns can offer higher depositor rates; as funds flow to that bank, the profitability of more conservative banks that invest in low-risk, low-return activities declines.³⁴ Actually, the problem is not formal deposit insurance, as governments will bail out any large bank because the risks of systemic crisis are simply too great. Financial crises have afflicted countries with and without formal deposit insurance, as Sweden's recent crisis bears testimony. In short, the moral hazard problem arises whenever there are large banks, and in most developing and transition economies the concentration of banking activity is sufficiently high that it is implausible that government would not intervene.

Not all deposit insurance schemes are alike, however.³⁵ Some are more efficient than others, incorporating practices that could usefully be emulated elsewhere. Some governments limit deposit insurance coverage, setting a ceiling on the size of deposits or the number of accounts that can be insured. Some collect premiums from all banks on a regular basis, rather than imposing levies on surviving banks after a crisis. This last practice is particularly pervasive, since leaving the survivors to pick up the tab gives banks no incentive to avoid collapse in the first place. Theoretically, deposit

insurance premiums can be linked to the risk level of a bank's portfolio or to the proportion of nonperforming loans. But to date, no government has tried this idea.

Regulatory incentives to reduce risk-taking

A banking regulatory structure deals with many aspects of bank operations: the requirements for setting up a bank, the services banks can provide, the levels of capital they must hold, the reserves they need to protect themselves against nonperforming loans, and the liquidity levels they must have to handle withdrawals. The regulatory structure defines the terms for disclosing a nonperforming loan, governs the portfolio composition of banks, and specifies remedial measures in the event of deteriorating loan portfolios or bank runs. As the number and variety of services banks offer increase, regulators need to respond to the possibility that problems can occur simultaneously in many areas.

The reluctance of ever-hopeful regulators to control risk-taking or to preemptively close banks with deteriorating loan portfolios has made many banking crises worse.³⁶ For this reason, creating mechanisms that limit such "regulatory forbearance"—the term for putting off tough actions in the hope that the bank will recover on its own—is another important step governments must take to make bank regulations more effective.³⁷ Some governments have already begun to remedy this problem by insisting on independent audits of banks' balance sheets, punishing failures to disclose nonperforming debt in a timely fashion, and fining (or closing) banks that do not meet their capital adequacy requirements. After its banking crisis in 1982, Chile introduced reforms specifically intended to reduce regulatory forbearance by increasing regulators' autonomy and mandating public disclosure of the activities of both regulators and banks. Chilean law also proscribes links between insured banks and business conglomerates.³⁸

The growing number of banking crises calls into question the merits of certain other government policies. For example, governments have tried to encourage lending to targeted industries either by guaranteeing loans or by simply directing banks to make loans.³⁹ Some commentators on the East Asian crisis argue that these initiatives have created implicit or explicit government guarantees.⁴⁰ In these situations banks have little incentive to carefully screen loan applications for favored projects, a lapse that often results in widespread default.

Banks are also sometimes restricted in the types of loans they can make. Often these restrictions permit

lending only to certain industries or regions. To the extent that they prevent a bank from maintaining a well-diversified loan portfolio that balances risks in one industry or region against risks in others, such restrictions should be avoided. This concern is particularly important for banks that lend in only one geographic region and where most borrowers are in the same industry. In such situations a collapse in prices that threatens the industry's solvency will also affect the solvency of the banks.

Two other challenges faced in designing appropriate bank regulation are worth noting: competing jurisdictions over banks, and close links between provincial banks and subnational governments.⁴¹ To avoid duplication of subnational and national regulatory resources, subnational pressure for regulatory forbearance, and the offer of implicit guarantees by subnational governments, there is a strong case for executing bank regulation at the national level.

Establishing private incentives to reduce risk-taking

Private incentives that complement the framework of government regulation can help align the costs and benefits of the risks banks take. Banks can, for instance, periodically issue a special category of subordinated debt that is not guaranteed by the government. Since those holding subordinated debt lose their capital if a bank defaults, they have a powerful incentive to monitor the riskiness of bank lending practices.⁴² But unlike holders of bank equity, holders of subordinated debt do not see higher returns if a bank increases its revenues by making high-risk loans, since the market sets the initial rate of return on subordinated debt.⁴³

Banks wanting to reduce high interest payments to those holding subordinated debt (especially because high interest rates send a signal to depositors and government regulators) have an incentive to establish monitoring and disclosure practices that regularly report on the quality of the bank's lending portfolio. Chile and Argentina have adopted some of these practices.⁴⁴

Credible banking reform

A new bank regulatory system may well face credibility problems, especially in countries with histories of directed government lending, regulatory corruption, and recurrent banking crises. Arm's-length relationships between regulators and regulated may well be a novel idea, along with the notion that strong interventions occur automatically and without regulatory discretion

when a bank fails to meet its legal obligations. Developing countries can improve the credibility of new bank reforms by adopting and enforcing international banking standards. The various accords of the Banking Regulations and Supervisory Practices Committee of the Bank for International Settlements, more widely known as the “Basle Accords” or “Basle Standards,” can provide such standards.

Many argue that the current Basle Accords do not go far enough and in fact are now being revised.⁴⁵ Critics say they do not do enough to discourage directed lending, promote transparency (through the publication of regulatory standards), or minimize the risks of regulatory discretion. The standards have also been criticized for recommending relatively low capital standards for developing countries that may face significant external shocks.⁴⁶ But developing countries can draw up a memorandum of understanding with international financial bodies like the World Bank and the International Monetary Fund (IMF) adopting standards stronger than those in the Basle Accords. Or, given the risks of regional contagion, neighboring countries can create stronger voluntary banking standards for the region.

Adopting internationally recognized banking standards does more than just stabilize the banking system. There are other payoffs, such as reduced borrowing costs for domestic banks, which will be considered safe risks. Realizing the payoffs is likely to require some external monitoring of the country’s compliance with the new standards. For example, if a group of neighboring countries agrees to a set of voluntary standards, the agreement can include a mechanism for periodically investigating compliance. This mechanism may be similar to the Trade Policy Review Mechanism of the World Trade Organization (WTO). An impartial body conducts an investigation and, after a nonconfrontational discussion among the countries involved, publishes a report on its findings. The country under investigation can produce a rejoinder that includes commitments for further reforms. These reports are available to investors, enabling them to better differentiate among countries. Ultimately, such a system reduces the likelihood of banking crises and financial contagion by inducing countries to conform to higher banking standards.

A role for foreign banks

Allowing foreign banks to enter a country can disrupt the domestic banking sector in the short term. But the presence of foreign banks also offers long-term benefits

in the form of additional pressure for appropriate risk-taking by domestic banks. Admitting foreign banks is no panacea, but if it is carefully timed and the economy can withstand the short-term disruptions, the benefits can be considerable.

Governments can foster the transfer of skills and best practices to their countries by allowing high-quality international banks with impeccable reputations to supply domestic markets with financial services.⁴⁷ This step requires governments to give foreign banks the right to establish themselves and to permit the immigration of skilled banking personnel. These international banks inevitably recognize that local bankers have a better knowledge of the domestic economy, business practices, and customs—and so offer them employment. Over time, local bankers will learn from the practices of the international banks and acquire skills that they retain when they move back to domestic banks.

The benefits of admitting foreign banks are not limited to the transfer of skills and technology. Foreign banks can stimulate competition, encouraging all banks to lower margins and overhead costs. A recent study of the effects of foreign banks on the banking systems of 80 countries found that in economies with relatively large numbers of foreign banks, domestic banks have lower expenses. However, domestic banks also have lower profitability.⁴⁸ The findings suggest that the timing of foreign bank entry should be considered carefully. It would be highly undesirable if a rise in foreign competition caused domestic banks to expand their portfolio of high-risk loans in a desperate attempt to stave off default.⁴⁹

Foreign banks are generally more diversified than domestic banks and can better withstand the effects of internal shocks. A severe macroeconomic downturn can push a domestic bank into default. But if a foreign bank has assets in healthy economies, a macroeconomic shock in the host country is likely to be less damaging. Of course, this benefit works only if the business cycles of the various countries differ. Economic shocks can be region-specific, continent-specific, or industry-specific. In such cases developing economies can expect little benefit from diversification if their foreign banks are from the same region or continent or from countries with similar production structures. Another warning concerning the admission of foreign banks: events abroad will affect the banks’ willingness to lend in the new host country. For example, lower real estate and stock prices in Japan in the 1990s led to reduced lend-

ing by Japanese banking subsidiaries in the United States.⁵⁰ In general, however, the risks posed by an undiversified banking system overshadow this possibility.

A final benefit of admitting foreign banks is that the presence of these banks conserves on scarce administrative and bank regulatory resources in developing countries. Foreign banks are traditionally regulated by authorities in their home country. If foreign banks are allowed to take over domestic banks—or to buy domestic banks in privatization sales—regulatory responsibilities are transferred abroad, and domestic regulators can concentrate their resources on the remaining domestic banks. This scenario highlights the need for a clear allocation of regulatory responsibilities across international borders.

The orderly sequencing of capital account liberalization

Improving bank regulation would be an important policy step even if world financial markets were not becoming increasingly interconnected. However, the safety and security of a developing country's banking system matters even more in light of the volatility of international capital flows. The question then becomes one of finding a way to fit bank regulation into national strategies to liberalize the capital account. The macroeconomic crises in Mexico and East Asia following the liquidation of short-term capital holdings by foreign investors has rekindled interest in proposals for a measured, sequential approach to capital account liberalization.⁵¹

This discussion identifies a number of pitfalls developing countries face as they consider liberalizing their capital accounts. Each of these pitfalls must be sidestepped in order to minimize the risk of a financial crisis. Of course, developing countries differ substantially in the nature of their legal institutions, corporate governance practices, banking regulations, capital market development, and macroeconomic conditions.⁵² A unique recipe for sequencing capital account liberalization is therefore unlikely to exist. Instead, the formula will vary across countries, dictated in part by how quickly countries can correct macroeconomic imbalances and enforce credible financial regulations.

A key element of the sequential approach involves devising policies that control the demand for short-term foreign debt.⁵³ This type of foreign capital is the most likely to flee, destabilizing the banking sector and the entire economy. Policies affecting short-term debt are best implemented before the inflows occur. In part,

restraint in short-term foreign borrowing is a matter of government will. In the Mexican crisis, for example, state entities were heavy foreign borrowers.⁵⁴ Private demand for short-term foreign debt should not be encouraged with preferential tax treatment, as happened in Thailand with borrowing through the Bangkok International Banking Facility.

A more aggressive way to limit short-term foreign borrowing is to directly influence capital inflows.⁵⁵ This discussion focuses on controls on inflows because controls on outflows are typically ineffective.⁵⁶ One method of circumventing outflow controls has multinational firms selling goods to overseas parent companies at very low bookkeeping prices, transferring value out of the country. Foreign investors wanting to circumvent the controls also sometimes swap their funds for the overseas assets of a domestic resident.

A scheme that provides disincentives for short-term capital inflows has been in place in Chile since 1991.⁵⁷ This scheme imposes a one-year unremunerated reserve requirement on all foreign inflows that do not increase the stock of physical capital, such as foreign loans, fixed income securities, and equity investments. A portion of any such inflows must be held in a non-interest-bearing account for one year. The amount was initially set at 30 percent, but it was lowered to 10 percent in June 1998 and subsequently to zero. The requirement remains on the statute book and can be reinstated, however. This experience demonstrates that such a requirement can be varied in order to stabilize the level of capital inflows. Rather than targeting specific types of capital inflows—a measure investors can easily circumvent by relabeling—this scheme provides a sharp disincentive to investing for less than one year.⁵⁸ Empirical studies suggest that the effect of this tax has been to alter the composition of capital inflows toward less “footloose” foreign direct investment, although evidence on the overall impact on the level of capital inflows is mixed.⁵⁹ Countries may be able to reduce their exposure to changes in the sentiments of foreign portfolio investors without banning such investment outright. Then, as governments strengthen their bank regulation systems, they can gradually lower the nonremunerated deposit requirement. This approach reduces an economy's vulnerability to capital outflows by limiting certain of the original inflows.

In addition to modulating short-term foreign borrowing, governments must decide how to treat foreign currency deposits in their domestic financial systems.

Such deposits often account for a substantial percentage of the broad money supply in developing countries and in fact exceeded 30 percent in 18 countries in 1995.⁶⁰ While so-called dollarization undoubtedly has many implications for macroeconomic management, the focus here is on its effects on financial stability and the implications for capital account liberalization.⁶¹

In a fractional reserve banking system, a rapid expansion of foreign currency deposits increases the liabilities of domestic banks' loan portfolios. The risk involved stems from the fact that the amount of net foreign currency in the economy is much lower than the total volume of foreign currency-denominated assets and liabilities. Faced with a run on foreign currency deposits in the domestic banking system, the central bank may come under pressure to act as lender of last resort and provide substantial loans in foreign currency to domestic banks.⁶² But these loans require the central bank to hold a relatively high level of costly foreign currency reserves. In addition, the liquidation of foreign currency deposits may affect the exchange rate and the solvency of domestic firms that have borrowed in foreign currency. These factors argue for discouraging holdings of foreign currency deposits in banking systems with rudimentary regulatory oversight, by means of taxation or higher bank capital-adequacy requirements.

Developing countries can also reduce the risk of financial and economic crises from capital outflows by maintaining high levels of foreign currency reserves.⁶³ The necessary level of reserves will depend on the country's level of international trade and on the amount of footloose capital invested in the economy. Countries with enough reserves send a signal to investors, who know they can convert their assets into foreign currencies at the prevailing exchange rates. This knowledge reduces the risk that investors will all stampede for the exits at the same time because they fear a currency crash.⁶⁴ But accumulating reserves comes at a price. Usually, domestic consumption and investment must be limited so that exports exceed imports and the net receipts are retained. Alternatively, reserves can be borrowed by issuing long-term bonds, in which case the cost equals the difference between short-term and long-term interest rates.

The choice of exchange rate regime is another important element affecting the sequencing of liberalization. Of course, which exchange rate regime best serves a country's interests depends on many considerations other than the regime's compatibility with capital account liberalization. However, different types of ex-

change rate regimes do provide different incentives to potential borrowers of foreign short-term capital. In particular, a fixed exchange rate regime offers what some interpret as an implicit guarantee to borrowers that they can ignore the risk of changes in the exchange rate. Coupling fixed exchange rate regimes with deposit insurance is tantamount to relieving foreign depositors of much of their credit risk.⁶⁵ Such guarantees encourage capital inflows, potentially exacerbating an economy's dependence on short-term foreign debt. More troublesome still, when investors call these guarantees into question, substantial capital outflows are likely. The exchange rate regime is then in jeopardy unless the country has enough foreign reserves to cover the outflows. Apparently, the preconditions for successfully maintaining a fixed exchange rate are more stringent than was previously thought.

In contrast, flexible exchange rate regimes provide incentives for investors to take exchange rate risk into account and offer no protection against a fall in the exchange rate. As the experiences of Mexico in 1995, Thailand in 1997, and Indonesia in 1998 show, the viability of a national banking system can be threatened when corporate borrowers face insolvency because a devaluation of the national currency substantially increases their foreign currency exposure. Financial crises are certainly possible in flexible exchange rate regimes, but these regimes create more incentives for investors to take account of exchange rate movements than fixed exchange rate regimes. Exchange rate regimes also differ in the options available to policymakers when facing a surge of capital inflows—an issue discussed in the World Bank's *Global Economic Prospects 1998/99*.

The extent of macroeconomic instability and imbalances suggests that other considerations are important in determining the appropriate pace of capital account liberalization. Although the consequences of liberalization may depend on the exchange rate regime, removing barriers to capital flows at a time when a massive inflow or outflow of funds seems likely is imprudent. For example, an outflow can be precipitated if capital account liberalization occurs during a period of high inflation, when domestic investors prefer stable returns overseas.

The objective of a measured policy of sequential capital account liberalization is to gradually increase a national financial system's tolerance for external disruptions. While governments are building domestic capital market institutions (like bank regulation), they can also focus on ways of reducing exposure to changes in

the sentiments of holders of foreign debt instruments—so long as the methods chosen do not scare off too much long-term foreign investment.

Attracting foreign investment

Long-term foreign investment will continue to provide developing countries with important benefits. Public sector infrastructure projects will be in ever-greater demand in expanding cities, and governments and domestic savers need not be the sole sources of financing. In the private sphere the benefits of long-term foreign investment begin with the expansion of the host country's capital stock. However, since multinational corporations are responsible for most foreign direct investment, there are other benefits as well. This investment enhances competition in domestic markets, so resources are allocated more efficiently and domestic firms invest more. Foreign direct investment that involves joint ventures or licensing arrangements between local and foreign firms often transfers technology⁶⁶ and best practices to the host nation, stimulating productivity growth.⁶⁷ (The importance of foreign direct investment to Egypt and Tanzania is taken up in two case studies in chapter 8.)

How can countries attract foreign investment? This discussion presents several of the most effective methods: adopting complementary human capital policies, liberalizing the trade policy regime, avoiding inducements for foreign investors, creating a stable set of rights and responsibilities for those investors, and developing stock markets as alternative funding sources.

Adopting complementary human capital policies

One recent study found that countries with low levels of education and low rates of foreign direct investment grow much more slowly than countries with high education rates and levels of inflow.⁶⁸ Countries whose working populations have less than an average of five months of secondary schooling and whose levels of foreign investment are less than 0.1 percent of GDP have annual growth rates of less than 1 percent. But countries whose workers have an average of more than one year of secondary schooling and inflows worth more than 0.2 percent of GDP enjoy, on average, annual growth rates of 4.3 percent. Countries with high educational levels but low foreign direct investment, or with low educational levels but high foreign investment, do little better than countries that score low on both measures. These results may in part reflect the fact that if labor is to facilitate continuous transfers of in-

vestment and technology, workers must be sufficiently well educated—often with industry-specific skills—and able to continue to learn.⁶⁹ And as foreign investors increasingly discriminate between regions and cities within countries, the payoff to subnational governments of improving local systems of education and training increases still further.

Liberalizing the trade policy regime

Foreign direct investment has a more profound impact on growth in countries that pursue policies promoting exports than it does in countries that follow import-substitution policies.⁷⁰ The reason may be that foreign-owned companies aiming for global competitiveness and international markets have a greater incentive to bring in technology and training—with the accompanying spillover benefits. In East Asian countries, foreign direct investment has played an important role in bolstering advanced manufacturing exports and output. In Korea, for example, foreign affiliates accounted for between 65 and 73 percent of output in the electrical and electronics sector.⁷¹

An open trade policy is also important for attracting foreign direct investment. Surveys of Japanese firms which had decided to invest abroad found that a positive perception of policies governing such investments was a strong determinant of plans to invest in a country and that low trade barriers made it more likely that multinational companies would enter a country.⁷² When first-rate information technology systems reinforce liberal market access, a country is further integrated into the world economy and becomes still more attractive as a destination for investment. A survey of international firms in Hong Kong (China), Singapore, and Taiwan (China) found that the presence of advanced infrastructure was the most important consideration in choosing to locate regional headquarters and service and sourcing operations in a country, and the second most important factor in siting production. Foreign direct investment is increasingly connected more with trading opportunities than with local market exploitation.⁷³ For example, the huge increase in foreign direct investment in Mexico after the North American Free Trade Agreement (NAFTA) came into force is evidence that the country is seen as a desirable base for supplying the U.S. market.

Export-oriented development means that investment decisions depend less on the scale of home markets, since firms are looking to sell in the global marketplace. Because multinational corporations are no longer tied to domestic markets, they have more flexi-

bility in choosing locations. Both points suggest that stable and attractive economic policies have become much more important. In fact, foreign direct investment seems to be responding faster to economic factors than it has in the past.⁷⁴

Avoiding inducements for foreign investors

Not all measures to attract foreign direct investment have enhanced national welfare. In an assessment of 183 foreign direct investment projects in 30 countries over the past 15 years, one recent study found that between 25 and 45 percent of projects had a negative net impact on national welfare.⁷⁵ This unwelcome and unexpected finding reflects the fact that foreign direct investment is often accompanied by distortive policies. Such policies include requirements that producers use a specified number of domestic inputs; trade protection against imports that compete with the goods produced by foreign investors; financial inducements, subsidies, or tax holidays; and mandated joint ventures and technology licensing arrangements. At least some of these policies may encourage investment, but for society as a whole the losses all too often outweigh the gains. Yet another problem arises when urban centers and other subnational entities compete for investment, often engaging in inefficient beggar-thy-neighbor competition to provide public subsidies and incentives. National governments can play a role here in restricting the types of inducements that subnational governments can offer foreign investors.

Creating a stable set of rights and responsibilities for foreign investors

National policies and regulatory institutions help foster a climate conducive to foreign direct investment by multinational corporations. Taking steps to clearly define the rights and obligations of multinational investors is a start. Many developing countries are taking steps to create such legal frameworks and to simplify bureaucratic procedures. This sort of institutional reform is especially attractive to investors considering investing in countries plagued by political risk and corruption, since these practices are negatively associated with foreign direct investment.⁷⁶ Countries that reduce red tape and bureaucratic delays not only make themselves more attractive to investment but help their own producers as well.⁷⁷

Two other types of domestic regulations and commitments have particularly important ramifications for foreign direct investment. The first is privatization pol-

icy, which can be designed to induce foreign investment. Chapter 8 describes Hungary's successful efforts to attract foreign buyers for its formerly state-owned banks. The second involves a country's obligations under the WTO's General Agreement on Trade in Services. These obligations may include commitments to allow foreign firms access to certain domestic service markets, as chapter 2 notes.

Even if a nation implements sound macroeconomic policy, market liberalization measures, and clear legal rules, it is not always possible to ensure that successor governments, including subnational governments and their agencies, will honor the commitments of their predecessors over the long term. This risk can limit the attractiveness of investments with high set-up costs and long payback periods, such as urban infrastructure projects. The growing activities of subnational governments may exacerbate this problem (box 3.3).

A dispute settlement mechanism can help resolve the issue of commitment. International arbitration is often the preferred option. Arbitration clauses can be included in investment agreements with subnational entities. In certain situations arbitration under the auspices of the International Centre for Settlement of Investment Disputes (ICSID) can be made available to subnational governments that contract with foreign investors. Almost 1,000 bilateral investment treaties and 4 multilateral investment treaties contain clauses providing for binding arbitration under the ICSID. Some of the bilateral treaties explicitly state that their provisions cover acts and omissions of local governments in states signing the agreements.

In the end, long-term investment agreements that are balanced and mutually beneficial may be the most lasting safeguards. Providing specialized training to increase local governments' capacity to negotiate fair agreements in the first place can advance this objective. The International Development Law Institute in Rome trains developing country lawyers to deal effectively with foreign investors and lenders, and a number of World Bank initiatives also work to ameliorate this commitment problem (box 3.4).

The collapse of negotiations on a multilateral investment agreement in 1998 suggests that a global treaty on investment rules is still some way off. However, the number of bilateral and regional investment agreements and treaties has increased. Signatories to these agreements realize that extending protections to foreign investors provides an incentive to cosignatories not to renege on long-term deals with their own foreign investors. Since most

Box 3.3**Subnational governments face commitment problems, too**

A U.S. company agreed to build the Dabhol Power Project, which would supply the Indian state of Maharashtra with 2,000 megawatts of power over a 20-year period.⁷⁸ After the agreement was signed in 1993, the foreign investor began to incur heavy expenses for the construction of the power station. The state government officials who signed this contract lost the 1995 election, in which the investment project had become a contentious political issue. The new state government canceled the project, and only after 10 months of negotiations and several concessions by the foreign investor was a new agreement signed. Many argued that the original agreement was too generous to the investor, and the fact that the company did not abandon the project but instead chose to renegotiate offers some evidence for this view. With renegotiation, the formal cost of construction fell from \$1.3 million per megawatt to \$0.9 million per megawatt.⁷⁹ Canceling a project the previous administration had agreed to was clearly not the best way of attracting further foreign investment to the sector. The investor reported that the delay cost approximately \$250,000 a day, and the international financial press gave the crisis extensive coverage.

This case shows how the proliferation of assertive subnational entities, which this report identifies as one of the chief political reactions to localization, can complicate the efforts of national governments to make binding commitments. If foreign investors cannot discriminate among subnational entities in a given nation, the actions of one entity may be seen as reflecting the behavior of all others. This kind of spillover is a serious concern for national governments keen on attracting foreign direct investment.

foreign direct investment is intraregional—with developing countries now investing substantial amounts abroad and so recognizing the need to protect their investments—an even greater role for regional investment agreements is likely to emerge.

When these investment accords include commitments to maintain domestic reforms, the reforms are more credible. Reversing the reforms once the accords are signed would do more than wreak domestic havoc; it would also invite retaliation by foreign governments. NAFTA's investment provisions in effect “locked in” Mexico's domestic regulatory and institutional reforms. Similarly, the Mercado Común del Sur (MERCOSUR) preferential trade agreement reinforced reforms in Brazil and Argentina and stimulated foreign direct investment from other countries, principally the United States.⁸⁰

Regional foreign investment agreements can also include constraints on the use of subsidies, tax inducements, and regulatory competition. The initial agreement can identify accepted forms of favoritism, quan-

Box 3.4**Mitigating the commitment problem: the role of the World Bank**

The World Bank has provided loans to host governments to fund their obligations under political risk guarantees that are in turn issued to foreign investors. The Bank also offers lenders a guarantee that covers the risks of debt service defaults resulting from the failure of host governments to perform specified obligations in respect of the project. When issuing this guarantee, the Bank requires that host governments sign a counterguarantee to reimburse the Bank for any compensation the Bank pays the foreign investor(s). Unless the host government plans to default on its obligations to the Bank (jeopardizing its entire relationship with the World Bank Group), this counterguarantee diminishes the government's incentive to break its contractual obligations.

The Multilateral Investment Guarantee Agency (MIGA) provides foreign investors with insurance against losses from war and civil disturbances, expropriations, and currency inconvertibility. When a foreign investor cannot enforce a contract with a host government in that country's courts, MIGA can insure it against losses caused by the breach of contract. Between 1991 and March 1996, MIGA issued 30 contracts involving approximately \$3.5 billion in infrastructure projects. These contracts are in addition to those supplied by private insurers, which now offer contracts for “breach of undertaking.”

In 1992, at the request of the Development Committee, the World Bank Group issued a set of guidelines embodying commendable approaches to the legal framework for the treatment of foreign investment. The guidelines cover the main areas dealt with in investment protection treaties: the admission, treatment, and expropriation of foreign investments and the settlement of disputes between governments and foreign investors. By their terms the guidelines are not binding and are intended to complement applicable international agreements. Moreover, by their terms they are intended to apply to both states and any of their constituent subdivisions.

tify them, and negotiate common guidelines for their use. Signatories can then negotiate additional constraints later on, in much the same way as signatories to international trade agreements have renegotiated tariff levels. These agreements also reduce incentives to engage in beggar-thy-neighbor policies to attract capital. They allay fears that countries may be tempted to reduce environmental and other important protections in return for the promise of an investment project (the so-called “race to the bottom” syndrome).

Developing stock markets as alternative funding sources

Although foreign portfolio investment does not offer the same opportunities for technology transfer and in-

creased competition as foreign direct investment, it can also be very useful to developing countries. Opening stock markets to foreign participation increases liquidity by deepening the pool of buyers and sellers. Price-earnings ratios rise as liquidity increases, making the market a far more attractive source of equity financing.⁸¹ As the stock market develops and strengthens, it benefits other parts of the financial sector as well as the wider economy—foreign direct investment accompanies stock market purchases, for instance. Stock market development and banking development have a strong positive relationship, as do stock market liquidity and economic growth.⁸²

The potential volatility of a stock market is an ongoing concern. Many policies for reducing volatility in the banking sector can help reduce the volatility of bourses, however, and approaches to sequencing capital account liberalization can be applied to portfolio equity flows as well. But as with other parts of the financial sector, the cause of stock market volatility is often a lack of reliable, up-to-date information. Accurate information from independent sources makes an emerging market attractive to foreign equity investors and increases the stability of capital flows. Rules mandating the regular public reporting of financial positions in key areas such as investment, property and equipment, foreign currency operations, and long-term contracts reduce uncertainty.⁸³ Financial markets develop best in the presence of legal codes that stress the rights of shareholders (especially minority holders) and regulatory systems that encourage the disclosure of corporate information.⁸⁴

During the next 25 years the flow of foreign investment to and from developing economies will increase substantially. Developing countries will have a growing interest in establishing secure and stable regimes that protect their overseas investors—and that clearly delineate their responsibilities. As the supply of capital grows, subnational and central government entities will increase their demands for capital to fund urban infrastructure projects. Developing economies can take action to attract and maximize the benefits of long-term foreign investment by participating in regional agreements that enhance investor security and by maintaining stable macroeconomic, trade, and regulatory policies.

Revitalizing international macroeconomic cooperation

This sketch of international financial integration has deliberately avoided placing the entire burden of reform

on individual countries. The contributions of regional and global agreements to foreign direct investment and financial supervision have already been discussed. But a corollary to the growing trend toward a globalized economy exists. As economies become increasingly interdependent, the effects of national policy decisions spread, with ramifications—including potentially disruptive ones—for other countries.⁸⁵ Although the interdependencies are typically strongest among neighboring countries, macroeconomic conditions in industrial economies have distinct consequences for the rest of the world.

Fluctuations in interest rate differentials between industrial countries alter the flow of capital to and from developing countries, potentially destabilizing their financial systems. A variety of vehicles for international cooperation could be considered that would enable industrial countries to meet their own goals without buffeting the outside world.

The growing links among countries in the same region also suggest a motivation for regional networks to prevent and fight financial crises.⁸⁶ Because of the growing trade and financial links among regional economies, one economy's poor performance can profoundly affect its neighbors. This fact argues for close monitoring and mutual support among countries in the same region. However, the growing strength of regional linkages will cause national economic cycles within a region to move more closely in phase. In this case the IMF's function as an extraregional crisis management body will take on added importance, as countries in the same region are likely to enter downturns together, reducing the resources they have available to help their regional partners.

One promising approach builds on the steps some countries are already taking toward regional economic monitoring. The Association of Southeast Asian Nations (ASEAN) agreed to implement an economic monitoring mechanism in November 1997. The mechanism aims to monitor policies in "vulnerable" sectors, to improve economic policy coordination among members, and to assist members during a crisis.⁸⁷ But doubts have been raised about this mechanism, with skeptics questioning not only whether enough resources have been devoted to it, but whether governments will actually be willing to release timely information or to criticize each other's domestic policies.⁸⁸ This points to the difficulty of sustaining cooperation in regional initiatives such as this and the Manila Framework.

When a regional grouping does establish a credible monitoring scheme to certify that members have im-

plemented commendable regulatory and macroeconomic practices, members can extend cooperation to include pooling funds to deter speculative currency attacks. This “seal of approval” helps investors differentiate among member states. This pool of regional funds can be used to augment the national reserves of what might otherwise become the “trigger economy” for a regional crisis. If these additional reserves reduce the likelihood of a future devaluation of a country’s currency, foreign and domestic investors will be less inclined to liquidate their portfolio investment in that country, possibly preventing a currency run altogether.

Countries can also explore opportunities for cooperation with regional partners during a financial crisis. Crisis management accords can be signed in advance, providing investors with the expectation of a coordinated response to shocks and helping allay the most pessimistic expectations. These accords can then serve as a framework for a coordinated fiscal policy of tax cuts and spending increases that provides a safety net for those most affected by shocks and stimulates the regional economy.⁸⁹ The accords can also lay the groundwork for commitments not to engage in competitive devaluations or impair market access by raising existing tariff and nontariff barriers.

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Internationally mobile capital is here to stay. Growing trade links, new communications technologies, and increasingly sophisticated financial products are making national borders more porous to financial flows. The challenge facing policymakers in developing countries is how to navigate through this financially integrating

world. Since 1997, when the East Asian crisis began, the world has learned that poorly managed financial liberalization can lead to a protracted economic downturn and a renewed cycle of poverty. But the potential upside of international capital flows is enormous, as the positive contribution of foreign direct investment to boosting productivity in recipient countries demonstrates.

The discussion in this chapter has highlighted four essential and related measures for developing economies wishing to integrate into global financial markets. First, even if an economy is completely isolated from foreign financial flows, the benefits of domestic financial liberalization cannot be assured without strong banking regulation. Second, strengthening those regulations takes years, and in the interim governments must develop policies that reduce the volatility of short-term foreign inflows. Third, developing countries will want to increase their attractiveness to long-term foreign investment. The rise of global production networks (discussed in chapter 2) shows that multinational firms are slicing up production processes, distributing them across economies. Large domestic markets are likely to become less important to multinationals looking for new locations, creating opportunities for smaller developing countries with suitable infrastructure and education. Finally, efforts to coordinate aspects of financial and regulatory policies can be advantageous to developing economies. Financial crises in developing countries are not always homegrown. Fluctuating interest rate differentials between industrial countries have increased the volatility of global capital flows, which can be ameliorated by policy coordination among industrial countries.