

**SURGES AND VOLATILITY OF PRIVATE CAPITAL FLOWS  
TO ASIAN DEVELOPING COUNTRIES:  
IMPLICATIONS FOR MULTILATERAL DEVELOPMENT BANKS**

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## Foreword

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## Abstract

In the past decade or so, international financial markets have become increasingly integrated. As part of this process, private capital flows to Asian developing countries (ADCs) have surged. In 1997, there was a very sharp withdrawal of private capital from the five ADCs affected by the crisis. Medium-term prospects for private capital inflows in the affected ADCs are not very encouraging. As globalization of financial markets progresses on a longer term basis, however, it is expected that the surges will resume and cover a wider spectrum of countries. On the other hand, official flows have been sluggish and will probably continue to be so in the future.

Private capital inflows, although beneficial in net terms, pose important institutional and policy challenges. It is now well understood that were it not for the mismanagement of private capital flows, the East Asian financial crisis could perhaps have been avoided altogether or else would have been of a smaller magnitude. With the continuing surges of private capital expected in the region, the incidence of financial crises due mainly to structural factors including financial sector weaknesses and poor governance is expected to increase in the ADCs.

This paper outlines an expanded and more challenging role for multilateral development banks (MDBs) in the provision of longer term development finance. The traditional role has to be further refocused and expanded to cover mobilization of private sector resources, both external and internal. In the poorer countries and in sectors where private returns are lower than social returns, however, the traditional development finance role of MDBs will continue to remain important. MDBs, together with the International Monetary Fund (IMF), could also have a role in the management of financial crises especially those that are mainly structural in nature. In such cases, the MDBs would basically complement IMF efforts in various macroeconomic areas. These and other related issues need to be explored further under the ongoing discussions on the "new international financial architecture".

## I. Introduction

In the past decade or so, international financial markets have become increasingly integrated. As part of this process, private capital flows to Asian developing countries (ADCs) have surged. Their volatility has also increased. In 1997, there was a very sharp withdrawal of private capital from the five ADCs affected by the crisis (namely, Indonesia, Republic of Korea [Korea], Malaysia, Philippines, and Thailand). Although the affected ADCs are doing their part in restoring investor confidence, medium term prospects for private capital flows are not very encouraging. Longer-term fundamentals (e.g., high savings and investment rates, human resource development), are still sound in the affected countries and financial integration of the ADCs should broaden and deepen in the future. It is expected that after a few years, private capital flows to the ADCs will recover. Surges and volatility of private capital will resume and cover a wider spectrum of countries.<sup>1</sup> On the other hand, official flows have been sluggish and will probably continue to be so in the future.

The above trends have implications for the development finance role of multilateral development banks (MDBs) in the changed global context. Some commentators have concluded that the magnitude of private flows implies that MDBs are no longer needed except perhaps in the poorer countries, which will continue to experience difficulties in mobilizing private capital and in sectors where private returns are less than social returns. Others, including this author, believe that MDBs now perhaps have a more vital, and in many respects, an enhanced and more challenging role to play in the provision of longer term development finance. Strictly speaking, MDBs are providers of long-term development finance and are not designed to manage financial crises. MDBs, could, however, have a role in managing crises that are structural in nature. This is because structural issues are usually medium to long-term in nature. Further exploration of these issues is required.

Private capital inflows, although beneficial in net terms, pose two types of challenges. First, large surges lead to economic overheating and the associated problems of the appreciation of the real exchange rate. Second, sharp reversals and increased volatility in capital flows lead to uncertainty and can be potentially disruptive. Private capital inflows should therefore be managed properly with appropriate policy and institutional responses. Failure to do so in East Asia magnified the macroeconomic weaknesses and financial sector vulnerabilities and led to a vicious circle between the two types of vulnerabilities, which eventually precipitated the crisis. In other words, were it not for the mismanagement of private capital flows, the East Asian financial crisis could have perhaps been avoided altogether, or else would have been of a smaller magnitude (Asian Development Bank 1998, and Asian Development Bank and World Bank 1998).

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<sup>1</sup>Issues on how to manage private capital flows including the role of short-term capital controls are discussed in Rana (1998).

Section II of this paper analyzes the trends (size and composition) in (net) private capital flows to the ADCs from 1970 to 1996. Comparable data for 1997 are not available as yet. Using data available from the Institute of International Finance, Section III discusses the sharp withdrawal of private capital in 1997 from the five ADCs affected by the financial crises. Section IV argues that in the longer term, after recovery from the present crisis, globalization of financial markets will proceed and private capital will continue to surge in the ADCs and cover a wider range of countries. An implication is that the incidence of financial crises due mainly to structural factors, including financial sector weaknesses and poor governance, is expected to increase in the ADCs. Section V outlines a possible expanded and more challenging role for MDBs in the provision of longer term development finance, and possibly in the management of financial crises that are expected to be structural in nature. The MDBs are, to some extent, already involved in some aspects of this role. A more systematic effort is required to meet the challenges of globalization. These are issues to be explored further under the ongoing discussions on the "new international financial architecture".

## II. Trends Until 1996

### A. Overview

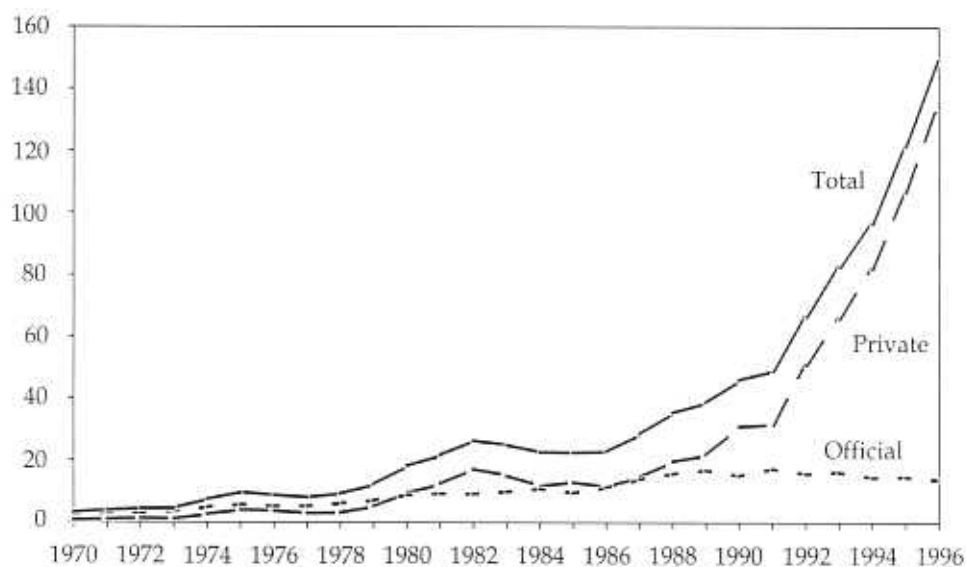
Capital flows to the ADCs is not a new phenomenon: Capital has long flowed between countries mainly (but not always) from the richer to the poorer countries. What has changed is its size and composition. Figures 1A and 1B show that net capital flows into the ADCs as a group have surged since 1987 in both absolute amounts and relative to GDP. In absolute terms, from a level of \$23 billion in 1986, net capital flows increased nearly sevenfold to \$150 billion (or 5.7 percent of GDP) in 1996 in a sustained manner. The surge was due entirely to sharp increases in net private capital. In 1987, the levels of both private and official flows stood at around \$14 billion, but by 1996 private flows had reached \$136 billion or 5.2 percent of GDP. Official flows stagnated at roughly the 1986 level and fell relative to GDP during the period (from 1.3 percent in 1986 to 0.5 percent in 1996), dwarfing official flows by 10 to 1.

The share of private capital flows to the ADCs increased compared to that of other developing subregions from about 40 percent in 1991 to 54 percent in 1996 (Figure 2). The composition of private flows to the ADCs changed as well. During 1980-1982, around 80 percent of private flows was debt-creating in the form of bank or trade-related credit (Figure 3). Foreign direct investment (FDI) by contrast accounted for only 16 percent, and portfolio bonds the remaining 3 percent. By 1994-1996 the share of bank and trade-related credits had declined sharply to 30 percent. FDI accounted for 43 percent of private flows followed by portfolio equity (16 percent) and portfolio bonds (12 percent). The driving forces behind portfolio flows in recent years are the institutional investors' (e.g., pension funds, mutual funds, insurance companies) increasing cross-border exposures.

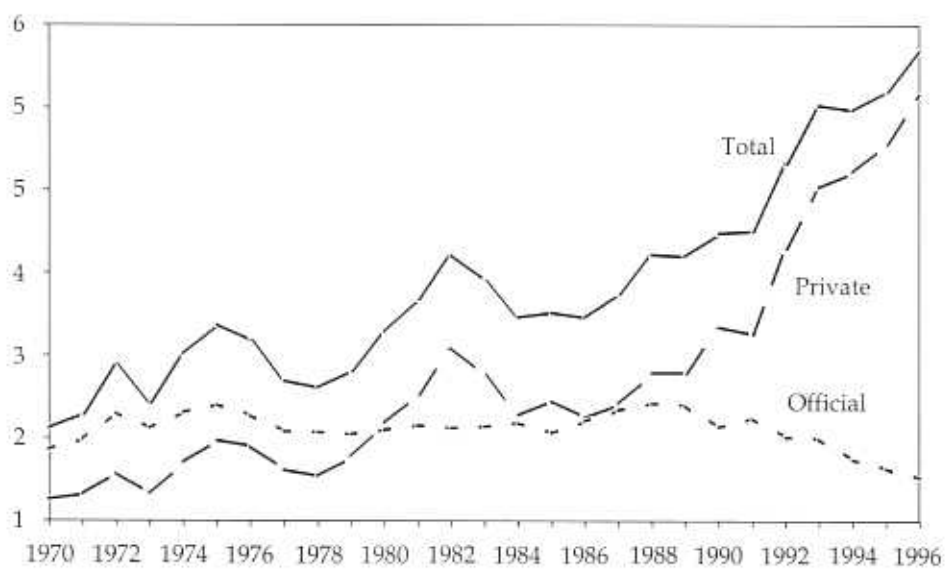
The rapid growth and changing composition of private capital flows reflected the increasing financial integration of the ADCs with international markets. Table 1 shows that in the 1980s, financial markets of all ADCs, with the exception of Bangladesh, Myanmar and Sri Lanka, became more integrated with global markets (World Bank 1997). Presently,

**FIGURE 1**  
**Net Capital Flows to ADCs<sup>1</sup>**

**A. Amount (in \$ billion)**

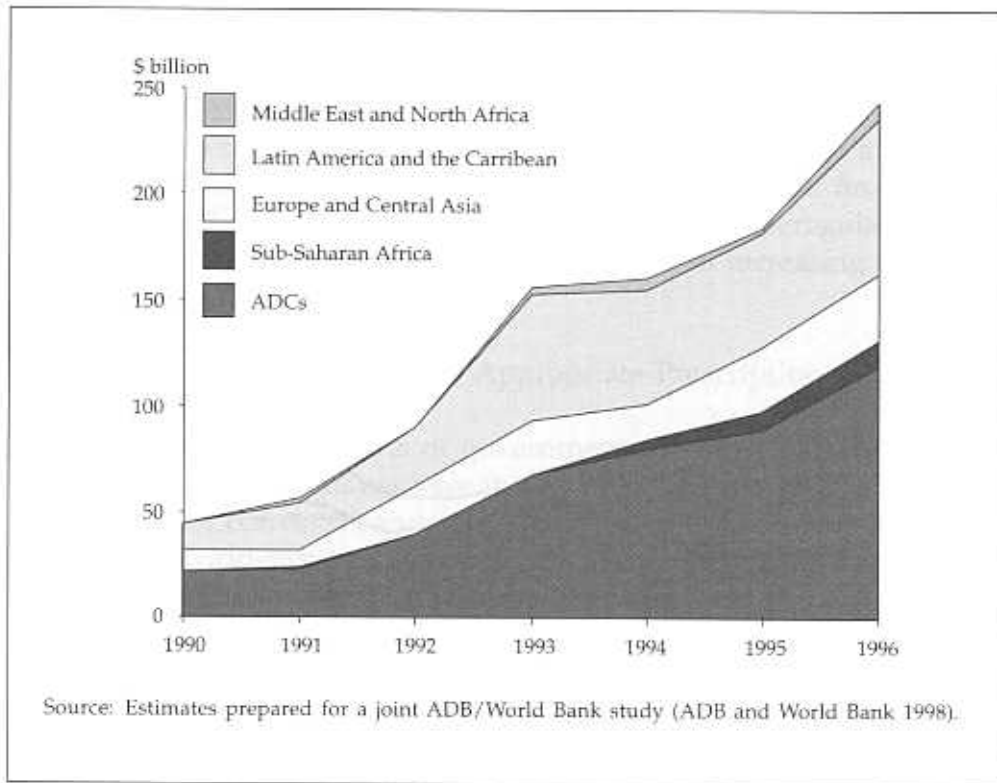


**B. Percent of GDP**

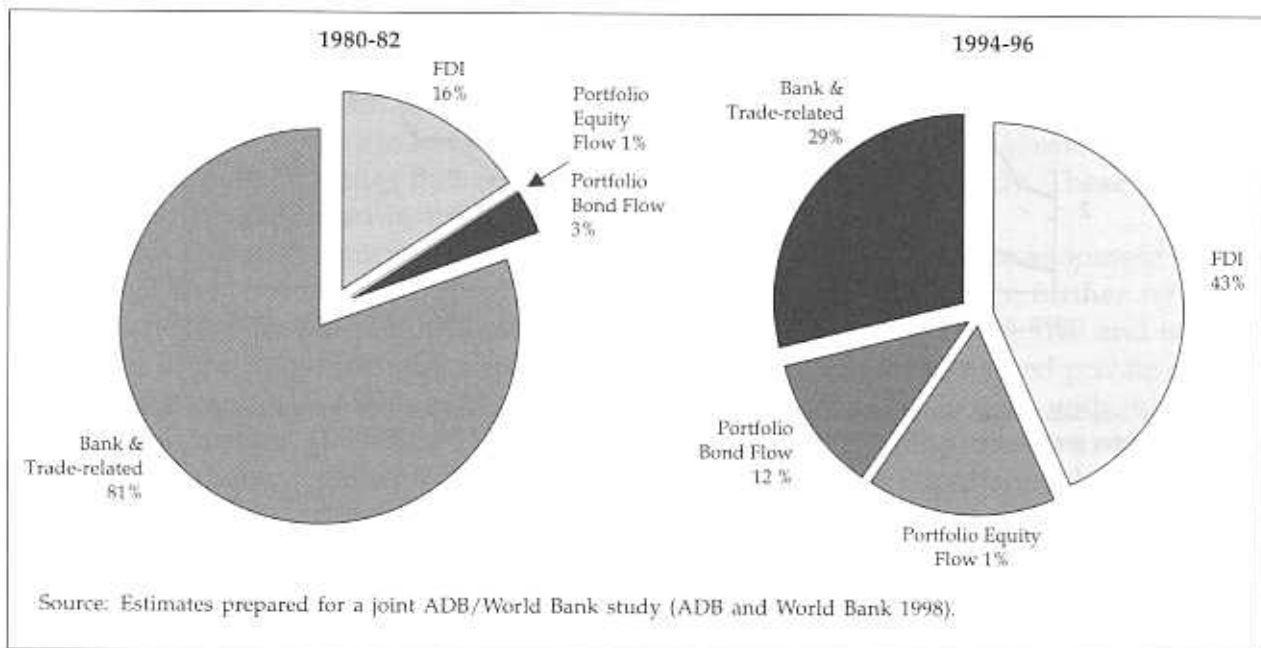


<sup>1</sup>Includes the Southeast Asian, South Asian, and selected Pacific island DMCs; data for 1997 are not available as yet. Source: Estimates prepared for a joint ADB/World Bank study (ADB and World Bank 1998).

**FIGURE 2**  
**Net Private Capital Flows to Developing Countries**



**FIGURE 3**  
**Changing Composition of Net Private Capital Flows to DMCs**



six ADCs are classified as having highly globally integrated financial markets—Indonesia, Korea, Malaysia, Pakistan, Philippines, and Thailand.

## B. Subregional and Individual Country Trends

The data in Annexes 1 and 2 show that all ADC subregions experienced surges in private capital flows. The surges, however, were strongest in the middle-income countries and the People's Republic of China (PRC), and weakest in South Asia where private capital flows increased from only \$7 billion in 1988 to \$12 billion in 1996. In 1996, South Asia received about 8 percent of private capital flowing into the ADCs. South Asia is relatively more dependent on official capital relative to other subregions. In 1996, official flows accounted for a quarter of total capital flows to the subregion. The corresponding figures were around 3 percent in Southeast Asia and PRC.

Data on the composition of private capital show that, although rising (\$2.6 billion in 1996), FDI flows were relatively less significant in South Asia where portfolio equity and bank and trade-related flows dominate. The PRC received the largest amount of FDI in the region (\$42.3 billion or roughly two thirds of FDI inflows to the region) followed by Southeast Asia.

It is difficult to precisely identify the year when surges in private capital began in the ADCs partly because of the reversals in the flows such as those experienced by Indonesia (1993) and Malaysia (1994). In general, data show that all ADCs experienced surges in private capital sometime in the late 1980s or the early 1990s (Figure 4). The surges appear to have begun the earliest in the PRC (in 1987), followed by the Southeast Asian countries and Korea in 1988-89, and finally the South Asian countries where the surges began in the early 1990s coinciding with the implementation of economic reforms. Private capital flows

TABLE 1  
Changes in Degree of Global Financial Integration<sup>1</sup>

1985-87		1992-94	
Republic of Korea	High	Thailand	High
Malaysia	High	Republic of Korea	High
		Indonesia	High
Thailand	Medium +	Malaysia	High
India	Medium	Pakistan	High
Indonesia	Medium	Philippines	High
Sri Lanka	Medium -		
Philippines	Medium -	India	Medium +
Pakistan	Medium -	People's Republic of China	Medium +
Myanmar	Low	Sri Lanka	Medium -
People's Republic of China	Low		
Bangladesh	Low	Myanmar	Low
		Bangladesh	Low

<sup>1</sup>Based on an overall index of integration, which takes into account a country's access to international financial markets, ratio of private capital to GDP, and diversification of financing based on the composition of flows.  
Source: World Bank (1997).

were nearly 12 percent of GDP per annum on average in Malaysia, followed by 7.4 percent in Thailand (Table 2). It was about 5 percent in the PRC and Indonesia and 3 to 4 percent in Philippines and Korea. Volatility of capital inflows also increased significantly during the surge period in all the ADCs as compared to the pre-surge period (last two columns of the top panel of Table 2).

On a cumulative basis, PRC received about \$260 billion of private funds followed by Korea with \$80 billion, Thailand with about \$75 billion, Indonesia and Malaysia with around \$68-69 billion each, and India around \$23 billion (Table 2). Volatile flows (defined as short-term debt, portfolio equity, and bonds) comprised nearly three quarters of the flows in Korea, while it comprised nearly one half of the flows in the other countries. The exceptions are Malaysia where volatile flows comprised about one quarter and the PRC about one sixth. Relative to GDP, the cumulative surges were largest in Malaysia (68 percent), followed by Thailand (41 percent), PRC (32 percent), Indonesia (30 percent), and Philippines (27 percent).

The surges had been uneven among countries and therefore led to its concentration. During 1990-1996, five countries (PRC, Indonesia, Korea, Malaysia, and Thailand) accounted for about 90 percent of private flows to the ADCs; nine countries received less than 5 percent (Figure 5). Comparison of data in Figures 6A and 6B shows that private flows to the ADCs had become more broad-based and covered a wider spectrum of countries. In 1989, four countries (PRC, India, Indonesia, and Thailand) accounted for 90 percent of private flows, which increased to six in 1996 (PRC, India, Indonesia, Korea, Malaysia, and Thailand).

### C. Reasons for the Surges in Private Capital Flows

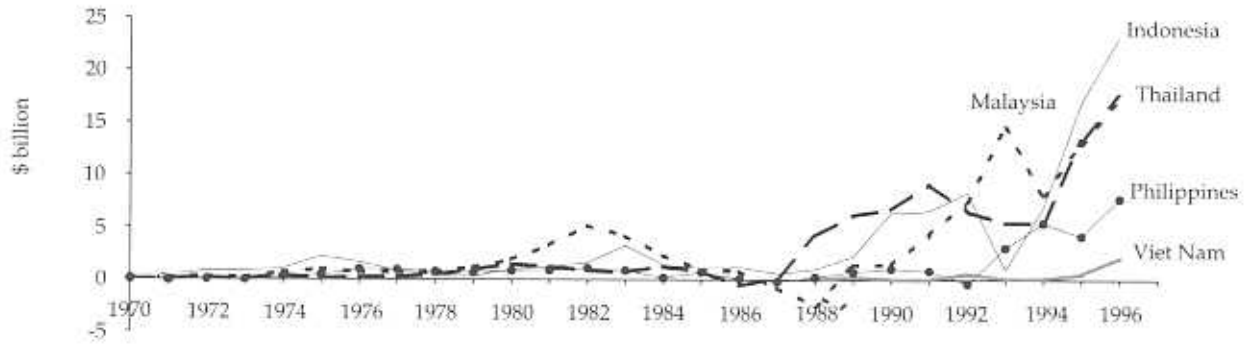
The initial impetus for the surges was the cyclical downturn in global interest rates in the early 1990s while relatively high returns were available in emerging financial markets. The fact that the surges had persisted even after the upturn in interest rates suggests, however, that these flows entered a new phase reflecting mainly structural forces that have led to the progressive integration of the ADCs into the world financial markets (World Bank 1997).

Three structural factors are responsible. First, in the industrial countries, competition and rising labor costs in domestic markets, along with falling transport and communication costs, have encouraged firms to look for opportunities to increase efficiency and returns by producing abroad. This led to the progressive globalization of production and to the growth of "efficiency-seeking" FDI flows.

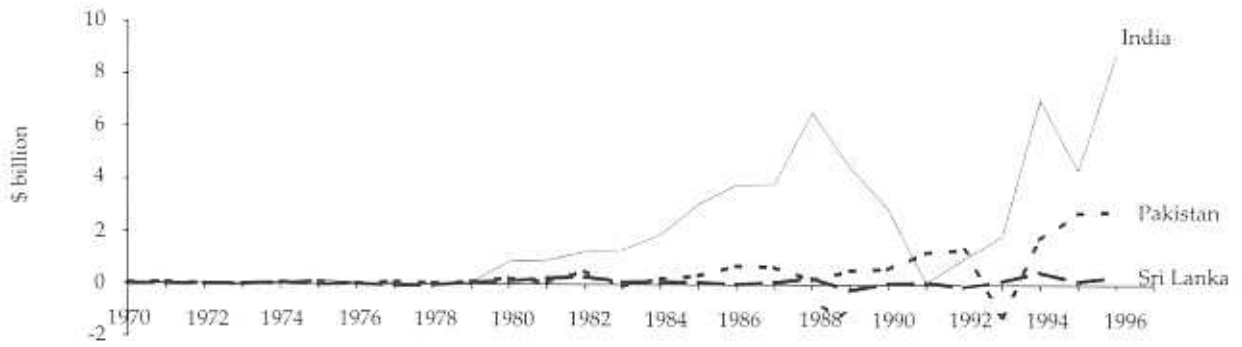
Second, financial markets have been transformed over a span of two decades from relatively insulated and regulated national markets into a more global integrated market. This was brought about by a mutually reinforcing process of advances in communication, computer-based technologies, and information and financial instruments; and by progressive internal and external deregulation of financial markets. The new technologies and the emergence of more diversified financial instruments have strengthened the interdependence between markets both within and beyond national boundaries. An important facet of this globalization of capital markets has been the growing importance of institutional investors in the industrialized countries who were both willing and able to invest internationally.

FIGURE 4  
Net Private Capital Flows

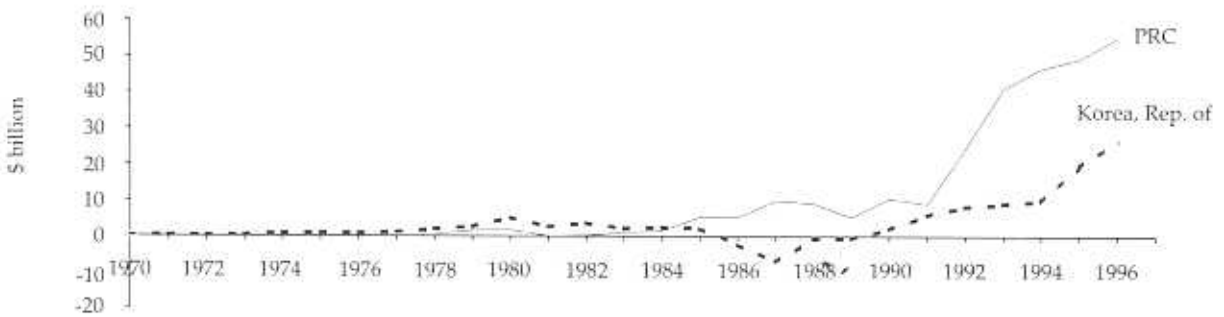
A. Southeast Asia



B. South Asia



C. PRC and Korea



Source: Estimates prepared for a joint ADB/World Bank study (ADB and World Bank 1998).

**TABLE 2**  
**Net Private Capital Flows to the ADCs<sup>1</sup>, 1987-1996**  
 \$ million

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	Surge Period		Standard Deviation	
											Cumulative Flows	Percent in Volatile Forms	Pre-Surge <sup>2</sup>	Surge Period
Southeast Asia														
Cambodia (1992-96)						33	54	67	146	204	523	...	0	71.8
Indonesia (1990-96)				6395	6552	8320	980	6870	16890	23167	69174	55.4	837.2	7523.2
Laos (1993-96)							119	69	87	86	360	2.5	3.7	20.8
Malaysia (1989-96)			1417	1433	4326	7572	14581	8131	13009	17132	67601	28.5	2551.0	5980.2
Philippines (1989-96)			729	1064	857	-348	3057	5428	4168	7763	22718	59.0	461.8	2789.0
Thailand (1988-96)		4184	6151	6708	9202	6538	5459	5434	13418	17610	74705	50.1	662.7	4432.4
Viet Nam (1992-1996)						607	89	118	554	2146	3514	45.3	109.7	841.6
South Asia														
Bangladesh (1990-96)				158	99	30	-76	67	9	71	358	71.2	41.5	73.7
India (1992-96)						988	1849	7065	4377	8808	23087	45.7	2373.2	3333.4
Pakistan (1991-96)					1226	1354	-1208	1756	2740	2824	8692	46.5	208.3	1467.4
Sri Lanka (1993-1996)							132	494	134	319	1079	...	134.8	173.3
PRC (1987-96)	9921	9204	5259	10517	8975	24284	41081	46579	49182	55040	260042	16.6	2053.8	19818.7
Korea (1990-96)				2056	5933	8219	9026	9822	19617	26659	81332	76.9	3385.5	8519.2

**Percent of GDP**

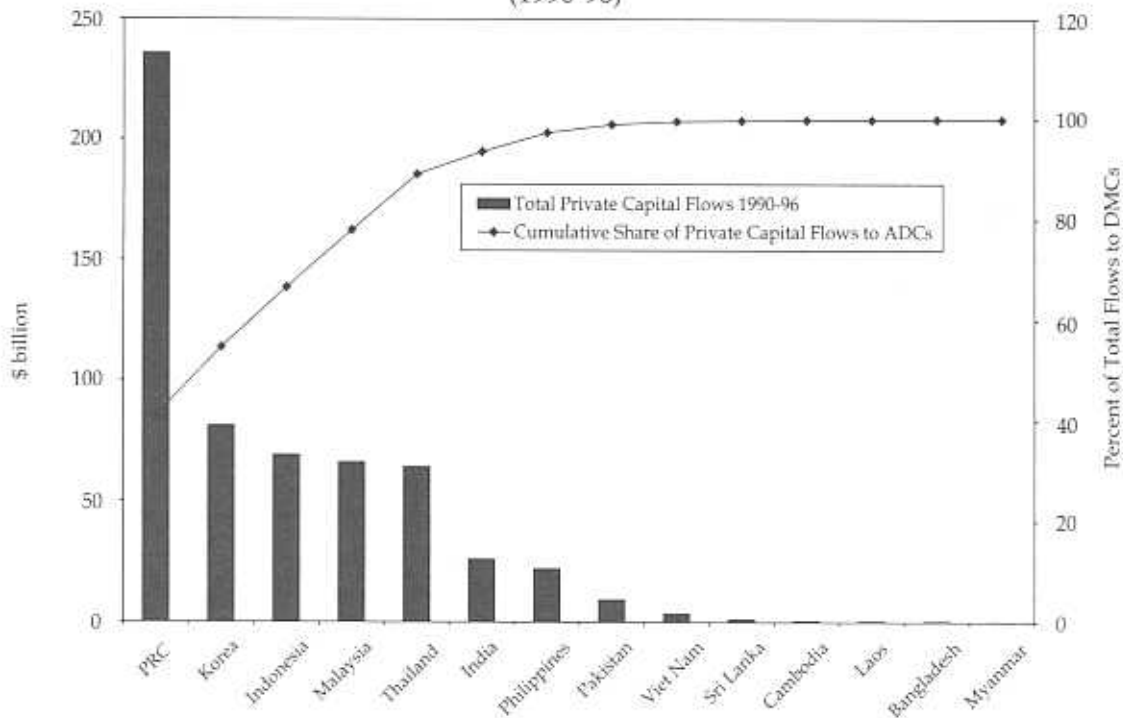
	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	Surge Period	
											Cumulative/ 1996 GDP	Mean Ratio
Southeast Asia												
Cambodia (1992-96)						1.1	0.8	0.9	1.7	2.0	5.2	1.3
Indonesia (1990-96)				5.6	5.1	6.0	0.6	3.9	8.4	10.2	30.5	5.7
Laos (1993-96)							8.9	4.4	5.7	4.6	19.4	5.9
Malaysia (1989-96)			3.7	3.3	9.0	13.0	22.7	11.2	14.9	17.3	68.1	11.9
Philippines (1989-96)			1.7	2.4	1.9	-0.7	5.6	8.5	5.6	9.3	27.1	4.3
Thailand (1988-96)		6.8	8.5	7.9	10.3	6.0	5.2	3.9	8.2	9.7	41.3	7.4
Viet Nam (1992-1996)						6.1	0.7	0.8	2.7	8.9	14.6	3.8
South Asia												
Bangladesh (1990-96)				0.7	0.4	0.1	-0.3	0.2	0.0	0.2	1.0	0.2
India (1992-96)						0.4	0.7	2.4	1.4	2.5	6.7	1.5
Pakistan (1991-96)					2.7	2.7	-2.5	3.4	4.5	4.3	13.4	2.5
Sri Lanka (1993-1996)							1.3	4.2	1.0	2.3	7.8	2.2
PRC (1987-96)	3.1	3.0	1.5	3.0	2.4	5.8	9.5	8.6	7.0	6.7	31.8	5.1
Korea (1990-96)				0.8	2.0	2.7	2.7	2.6	4.3	5.9	16.8	1.4

<sup>1</sup>Years in parentheses define the surge period; volatile flows are defined as the ratio of short-term debt, portfolio equity, and bonds to net private capital flows.

<sup>2</sup>Of equal length as the surge period.

Source: Estimates prepared for a joint ADB/World Bank study (ADB and World Bank 1998).

**FIGURE 5**  
**A. Concentration of Private Capital Flows**  
 (1990-96)



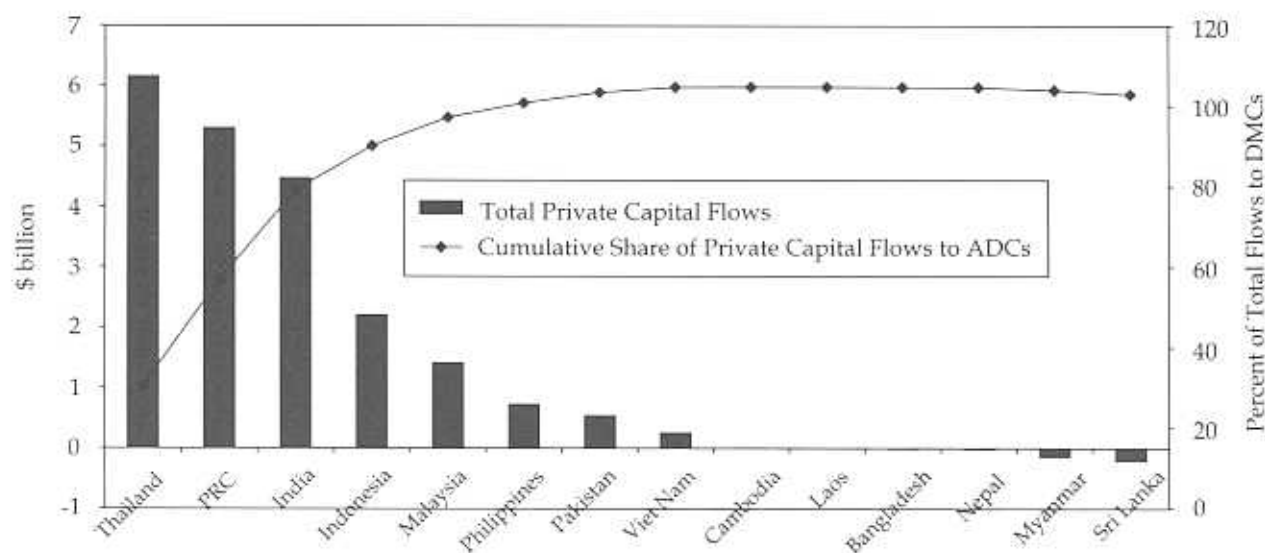
Source: Estimates prepared for a joint ADB/World Bank study (ADB and World Bank 1998).

Third is the shift in policy orientation in the ADCs. Since the mid-1970s, the ADCs have embarked on structural reforms that have made East and Southeast Asian countries among the most open of all developing regions in the world. Following an initial stage of modest import substitution, most of the fast growing ADCs lowered their import tariffs and export taxes, removed quantity restrictions on trade, and reduced barriers to international flows of capital. The PRC also transformed from one of the most closed economies in the world in the mid-1970s to a moderately open one in the mid-1990s. South Asian countries generally isolated themselves from the global economy by maintaining high tariff rates and a plethora of controls on imports to protect their domestic industries. But since the early 1990s these countries, led by India, have begun to open themselves to the global economy with favorable impacts.

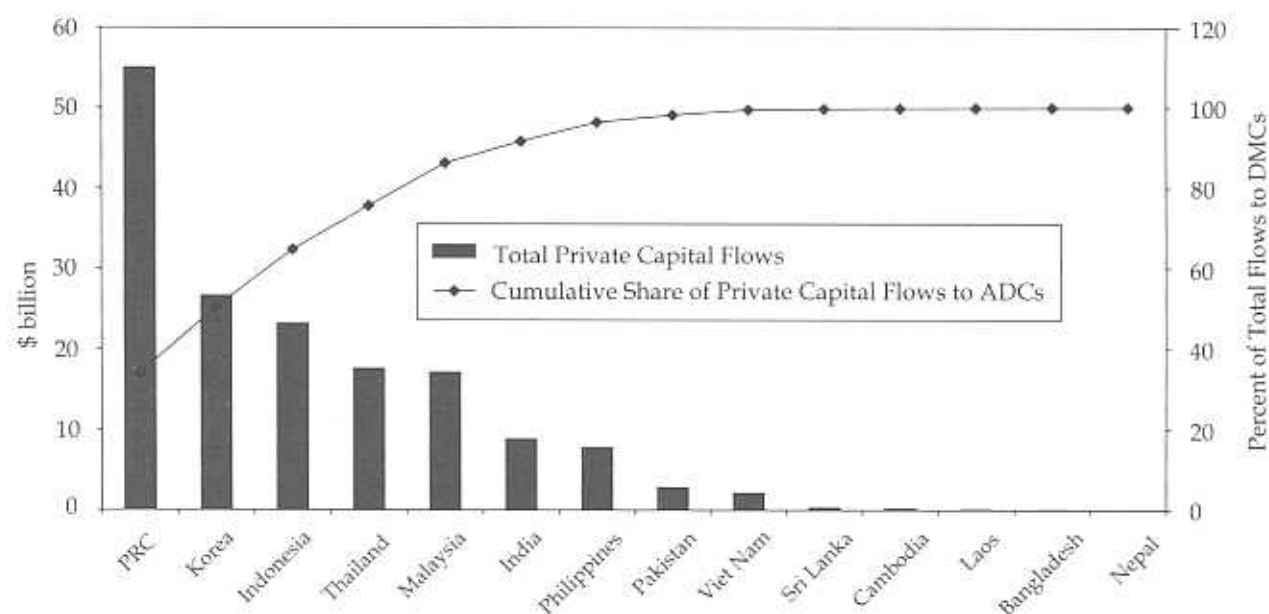
Although the perceived risks of investing in emerging markets remain high, the ongoing structural reforms have led to improvements in country creditworthiness, declines in investment risks, and, until recently, increases in expected rates of return. As security markets in the ADCs have broadened and deepened, and as their market accessibility has increased, these countries have also begun to offer investors significant opportunities for risk diversification, which arise from the low correlation of rates of return in emerging markets as compared to industrial countries. As a result, foreign investors, who initially turned to emerging markets largely because of the cyclical downturn in interest rates and stock market returns in industrial countries in 1990, have begun to consider these markets on a more long-term basis. The de facto dollar pegs of the Southeast Asian countries have also eliminated exchange rate risks for foreign investors and led to further capital inflows.

**FIGURE 6**  
**Concentration of Private Capital Flows**

**A. 1989**



**B. 1996**



Source: Estimates prepared for a joint ADB/World Bank study (ADB and World Bank 1998).

### III. Sharp Reversal in 1997

The East Asian financial crisis shows that financial institutions in the affected ADCs were ill-equipped to deal with globalization's sudden surges in capital flows. Poorly regulated banks channeled funds from savers to investors in an inefficient manner encouraged by rising asset prices. The quality of investment portfolios of financial institutions deteriorated as they embarked on less productive and more risky investments. Standards of loan appraisal and portfolio management were generally inadequate. Weak or poorly enforced disclosure requirements limited the amount of accurate information that was necessary for proper decision making. With resulting disturbances in their financial markets, these countries lost the confidence of both domestic and international investors (Asian Development Bank and World Bank 1998). There was, therefore, a sudden withdrawal of foreign capital from the affected ADCs in 1997.

According to the estimates by the Institute of International Finance, the five affected ADCs suffered net private outflows of \$6 billion in 1997 compared to net inflows of \$94 billion in 1996 (Table 3). This sharp \$100 billion reversal was about 10 percent of their combined GDP, perhaps the largest such reversal in recent economic history. While the level of FDI did not change very much and stood around \$7 billion, the sharpest decline occurred in the case of lending from commercial banks followed by portfolio equity investments. As investor confidence was shattered toward the middle of 1997, maturing short-term debts were not rolled over. This resulted in an estimated outflow through commercial banks of \$29 billion as compared to inflows of about \$58 billion in 1996. Portfolio equity investment suffered an outflow of \$7 billion in 1997, in contrast with an inflow of about \$12 billion in 1996. The level of international reserves fell sharply in these countries despite official assistance and narrowing of their current account deficits as imports declined sharply.

### IV. Prospects for Private Capital Flows to the ADCs

In the medium term, the prospects are not very encouraging. The affected countries are doing their part to restore investor confidence. They are undertaking the difficult structural reforms including restructuring banks and companies, and improving the governance system. However, the foreign investors that have abandoned East Asia are still waiting for some signs of economic revival. Some sort of a vicious circle between the economic prospects for the region and investor confidence seems to be at play. Improved investor confidence requires good economic performance of which foreign capital, at least long-term, is an important determinant. What appears to be required is a concerted partnership between international financial institutions, government, and private banks. As governments restructure their banks, the international financial institutions should work with the commercial banks to make them part of the solution.

Some encouraging signs of investor confidence emerged in the region during the first four or five months of 1998 following the agreements to roll over and restructure Korea's and Indonesia's short-term bank debt. The stock markets and currencies of the affected countries stabilized and reversed somewhat during the same period. In April, the first signs that international capital markets were again accessible to the affected countries appeared. The Philippines launched a \$500 million Yankee bond and Korea followed with a \$4 billion issue

**TABLE 3**  
**Five Asian Economies<sup>1</sup>: External Financing**  
(\$ billion)

	1993	1994	1995	1996	1997 <sup>e</sup>	1998 <sup>f</sup>	1999 <sup>f</sup>
Current account balance	-14.6	-24.5	-41.0	-54.5	-26.3	59.9	58.6
External financing, net	50.2	45.2	86.3	91.2	25.0	3.7	-10.0
Private flows, net	44.8	37.9	83.8	93.8	-6.0	-24.6	-15.1
Equity investment	21.1	12.1	15.9	17.4	-0.3	8.0	6.5
Direct equity	4.5	4.7	4.9	5.8	6.5	6.9	7.4
Portfolio equity	16.6	7.4	11.0	11.6	-6.8	1.1	-0.9
Private creditors	23.8	25.8	67.9	76.4	-5.7	-32.6	-21.6
Commercial banks	7.5	23.4	58.0	58.3	-29.0	-30.5	-17.8
Nonbank private creditors	16.3	2.4	9.9	18.1	23.3	-2.1	-3.8
Official flows, net	5.3	7.3	2.6	-2.6	31.0	28.3	5.1
International financial institutions	1.1	-0.4	-0.3	-2.0	22.6	22.4	2.5
Bilateral creditors	4.2	7.7	2.9	-0.6	8.4	5.9	2.6
Resident lending/other, net <sup>2</sup>	-15.8	-15.2	-31.3	-17.4	-29.4	-23.2	-18.7
Reserves excluding gold <sup>3</sup>	-19.8	-5.4	-14.0	-19.3	30.7	-40.4	-29.9
Memo: short-term credits, net	...	7.3	45.1	36.0	-36.6	-49.9	-13.5

e= estimate; f= forecast

<sup>1</sup>Indonesia, Malaysia, Philippines, Thailand, and Korea.

<sup>2</sup>Including resident net lending, monetary gold, and errors and omissions.

<sup>3</sup>Minus (-) means increase.

Source: Institute of International Finance (1998).

that was three times oversubscribed. Portfolio flows into the Philippines in the first quarter of the year were higher than the corresponding figure in the previous year.

Since then, however, with the weaker yen and the uncertainty in the PRC, foreign investors appear to have become a bit more apprehensive. Resurgence of antimarket sentiments in Hong Kong, China (where the government has been intervening in stock markets); Malaysia (where, in early September, an alternative recovery strategy comprising sweeping capital controls and fixed exchange rates was adopted); and the PRC (where the government is further tightening capital control measures), will certainly scare away foreign investors. Initial responses to the introduction of capital controls in Malaysia were actually encouraging with stock markets improving and reserves increasing. But these events may reverse given the ongoing political tussle.

Reflecting these adverse trends, the Institute of International Finance has recently revised its forecasts downward. While in April 1998, it had expected net private capital flows to the affected countries to stabilize this year (that is, be close to zero as compared to the sharp fall in 1997), it is now expecting a new outflow of \$25 billion from the affected countries (considerably more than the outflow of \$6 billion in 1997). The situation is expected to improve next year, but the affected countries will still experience an outflow of \$15 billion. Stability and recovery of international private capital flows to the affected countries is still in the distant future.

Longer term fundamentals are still strong in the affected ADCs, and financial integration of the ADCs should broaden and deepen over the coming decades. East Asia and the affected economies have had relatively high saving rates averaging more than 30 percent in the last two decades and investment rates of between 30-40 percent of GDP. The Institute of International Finance forecasts, therefore, that private capital flows will basically stabilize in 1998 from the sharp decline in 1997. Philippines and Korea are expected to receive about \$4 billion of private flows each in 1998 (still low compared to levels in 1995 and 1996) followed by Thailand and Malaysia. Indonesia may continue to see an outflow of capital in 1998. Beyond that, and as the economies recover, they should continue an upward path as investor confidence is further restored and strengthened and the ongoing reforms start to bear fruit.

In the longer term, private flows are expected to rise significantly, with capital flowing not only from industrial countries to the ADCs, but, increasingly, among the ADCs themselves, and from ADCs to industrial countries. These flows are also expected to cover a wider spectrum of countries. There are a number of reasons for this thinking.

First, many ADCs are still in the early stages of policy reforms. The policy reforms that are being embarked upon—which focus on macroeconomic stability and the promotion of more deregulated, outward-oriented, and market-based economies—are likely to increase the productivity of investments in these countries. On the expectation that ADCs will continue to strengthen and deepen their policy reforms, and that the external environment will remain broadly favorable, the ADCs are likely to grow at a faster rate than the industrial countries, providing significant opportunities for productive investments. The income gap between the ADCs and the US is also expected to narrow.

Second, although it is difficult to speculate on the nature of future innovation and technological change, competitive pressures and increasing integration have been stimulating investments in technology that are likely to continue to reduce transaction costs and make distant markets more accessible to small as well as large investors. Such innovations will make policy-induced barriers less effective, spurring even more deregulation and competition.

Third, an important new factor that will provide further impetus to these underlying trends is the demographic shift under way in industrial countries. Industrial countries now have a pronounced bulge in their demographic structure, reflecting the aging of the baby boom generation and declining birth rates. This will lead to a steady rise in the proportion of elderly to active population in all industrial countries, mainly Japan. This is in sharp contrast to the ADCs, whose clearly pyramidal structure reflects a much younger population.

There are three broad implications of this difference in demographic patterns. First, the aging of populations in industrial countries could lead to an increase in savings as they reach closer to retirement age in the short to medium term. Second, aging and the associated slowing of labor force growth is likely to exert downward pressure on the rate of return to capital relative to that of labor in industrial countries. Given the demographic structure in developing countries, the reverse can be expected there. Thus, differences in demographics are likely to reinforce the differentials in the expected rates of return to capital between industrial countries and the ADCs. Both of these factors should stimulate the flow of capital to emerging markets. Third, the aging of populations in industrial countries is leading to pressures for pension reform. These reforms are likely to result in greater responsiveness on the part of pension funds to investment opportunities in the ADCs.

## V. Changed Global Context and Implications for the Development Finance Role of MDBs

As discussed above, since the early 1990s, the global context in which MDBs operate has changed in several important ways. First, mainly because of globalization of financial markets, many ADCs have experienced surges and increased volatility in private capital inflows. In 1997, there was sharp withdrawal of private capital from the five ADCs affected by the crisis. On a longer term basis, however, there are indications that private capital inflows are expected to continue and cover a wider spectrum of countries. Second, net official flows to the ADCs, while stagnating in absolute terms, have declined relative to GDP. This is mainly because of aid fatigue in the industrial countries. Third, there is now a strong understanding among developing countries (and also industrial ones) that to achieve market-oriented growth, they must create the conditions in which a strong private sector can flourish. All of these factors combine to generate private capital flows, both domestic and foreign.

The above trends have two implications for the development finance role of MDBs. First, traditionally, the MDBs have promoted their objectives by working primarily with governments and government agencies by mobilizing public and private sector resources in the donor countries. This reflected the ideas and capital structures that prevailed at the time of creation of the MDBs. The instruments used were mainly loans for public sector projects or programs, technical assistance, and policy-based lending. Through such operations, the MDBs have played an important role. However, in the changed global context, the traditional development finance role of MDBs has to be refocused and expanded in a more systematic manner. In the poorer countries that will continue to have difficulty in mobilizing private capital and in sectors where private returns are less than social returns, the traditional role of MDBs will continue to be important. Second, with integration of financial markets, the incidence of financial crises in the ADCs due mainly to structural factors including financial sector weaknesses and poor governance, will probably increase.<sup>2</sup> Therefore, together with the IMF, MDBs could have an important role to play in the management of financial crises if a new international financial architecture is not developed.

### A. The Refocused and Expanded Development Finance Role<sup>3</sup>

There is a need to further refocus and expand the traditional development finance role of the MDBs to cover mobilization of private sector resources, both external and internal. There are two ways in which MDBs can help:

- (i) Facilitate and enable private capital flows by helping governments create favorable conditions through reorientation of their development finance operations, and
- (ii) Become participant investors working with the private sector to expand and improve private capital flows.

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<sup>2</sup>Since the Latin American debt crisis of the early 1980s, the incidence of financial crises around the world has tended to increase. Costs of crisis have also increased (Wyplosz 1998, IMF 1998).

<sup>3</sup>See also Larosiére (1996).

A new focus on private sector resource mobilization for the MDBs does not mean abandoning their traditional role. There are significant complementarities between the two roles especially in low-income countries that do not have the preconditions (namely, policies and institutions) to attract private capital, and in sectors where payback periods are long and social returns are higher than private. In both cases, MDBs can facilitate private flows by fostering systemic change to raise private returns through policy reforms, and sound public investment to help countries address two major impediments to such flows: high risks and limited information.

The principles that govern the new role of MDBs apply as well to developing countries that are already attracting substantial amounts of private capital. Despite significant progress, as the East Asian financial crisis has indicated, most of the middle-income ADCs do not yet have robust banking systems; suffer from deficiencies in infrastructure and human resource development; and more generally, lack the institutional structures needed for integrated financial markets. In these countries, the traditional role of MDBs can play an important role for private capital. The "participant investor" role of the MDBs is, however, to some extent a relatively new territory and needs systematic actions.

#### (1) Facilitator/Enabler Role of the MDBs

MDBs can assist ADCs mobilize private capital in the following manner:

- (i) MDBs can help sustain improvements in the policy and institutional framework of the ADCs especially in the area of banking and capital markets. Financial markets that are not performing their functions efficiently are likely to misallocate resources and contribute to increased vulnerability in the face of growing financial integration. The standard supervision and monitoring tools become less effective with financial integration as the speed and magnitude of market reactions increase. The strengthening of the financial sector, however, is a complex and long-term process, and the differences in initial conditions mean that no unique formula can work. MDBs can be a source of knowledge of what has worked and what has failed, and why, and can also help countries with institutional development and expertise in effective reform programs.
- (ii) "First generation" reform, is not, by itself, enough either to accelerate social progress sufficiently, or to allow ADCs to compete more successfully in globalized markets. "Second generation" reforms are indispensable. In addition to the strengthening of the financial sector, these include the quality of fiscal adjustment, bolder structural reforms, and improved governance. Reducing the budget deficit is the key, but improving the composition of fiscal adjustment is also important. In particular, human resource development should not suffer. Bolder and deeper reforms notably in the civil service, labor market, and trade and regulatory systems are required. While many ADCs have eliminated the negative aspects of state intervention, they have not taken the complementary steps to make public institutions a positive force for economic growth and development. By increasing the speed and magnitude of market

reaction, globalization of financial markets has maximized the benefits of good policies and the costs of based policies.

- (iii) MDBs can finance and help improve the quality of investments in human resources and infrastructure, and support adequate social and environmental protection. These are all areas where private returns will often be less than the social returns, and where public investments play a vital role in enhancing the productivity of private investment. MDBs can promote increased private participation in the infrastructure and human resources sectors, by supporting improvements in the policy and institutional framework and by assisting with privatization programs. In addition, support for poverty reduction and better social safety nets will promote human development—an important determinant of long-term growth—and reduce risks of social and political instability as well.
- (iv) MDBs can catalyze private investment by providing selective guarantees for risks that they may be better able to mitigate—such as political risks and risks arising from shifts in the regulatory regime—or for promoting pioneering investments with large potential spillover benefits. Although third-party guarantees complicate negotiations on the cost of financing, guarantees by MDBs can play a useful role in reducing the uncertainties surrounding the future policy regime. Such guarantees may be extended to cover risks at the subnational (e.g., state and local level) and subregional level.

## (2) Participant Investor Role of the MDBs

Many of the MDBs are already involved in this role albeit in an ad hoc manner. A more systematic and expanded effort is required to meet the challenges of global financial integration.

- (i) MDBs can develop new financial instruments and products to work directly with the private sector. They can help set up joint ventures and funds for activities such as leasing, venture capital, infrastructure financing, and banking. This not only brings in benefits in terms of loan and equity financing but also spillover benefits in terms of transferred know-how, financial innovation, and improved management systems.
- (ii) MDBs can mainstream and enhance cofinancing operations with the private sector. To the international investor this would provide an umbrella of political comfort derived from long-term relationships with governments and their preferred creditor status. To the local partner, MDBs would provide the much-needed medium-term capital, and could assist in institutional development.

As noted above, there is ample scope for MDBs to promote private sector investment. But why should MDBs undertake this task—what is it that they have that the private sector could not offer? In other words, what is the comparative advantage of MDBs in

mobilizing private sector resources? First, MDBs have a unique and long-term relationship with governments in the ADCs, allowing them to reduce political risk in a way that private institutions cannot. This provides the latter with an element of comfort. Governments will often have more confidence in a project if the MDB—which has a duty to protect its members' interest—is acting with a private partner. Second, the MDBs' experience in project appraisal techniques and technical assistance means that they can mitigate the risks in project development. Without the project development support of MDBs, many projects would never get off the ground. Third, the preferred creditor status of the MDBs, together with their conservative gearing ratio and their strong shareholder support, allows them to take the risks associated with taking a lead in joint ventures with the private sector.

Investment flows to developing countries are hampered by perceptions of country risk, lack of familiarity with ADC markets, inadequate knowledge of country and sectoral conditions, uncertainty over legal and tax regimes, etc. This is particularly true for many institutional investors, such as pension funds and investment companies that are generally more conservative in outlook than commercial banks and merchant banks. Foreign investors who are prepared to accept the commercial risk will often hesitate on account of political uncertainties and risks. Local investors face similar problems. It is through sharing roles and responsibilities that MDBs and the private sector can cooperate and move forward.

## B. The Possible Medium-Term Financial Crisis Management Role

The first and most obvious need is to reduce the risk of financial crises occurring in the future. The reasons are obvious. Financial crises disrupt people's lives and economic and social development. Despite preventive measures, however, a certain number of crises will be unavoidable in an integrating world. The second need is, therefore, crisis intervention and getting the diagnosis and prescription right.

### (1) Crisis Prevention: Reducing the Risk of Future Crises

MDBs can assist in the following manner.

- (i) Assist in improving transparency and disclosure in international financial markets. It is impossible to assess and manage risk without access to accurate and timely information. An important lesson emerging from the East Asian financial crisis is that, all parties would have benefited from more frequent and more timely data on private capital flows, maturity and currency composition of external debt, and net international reserves (gross international reserves less reserve related liabilities, including commitments in the forward exchange markets).
- (ii) Intensify their surveillance/monitoring activities of financial sector issues and capital flows and provide increasingly strong warnings to countries that are believed to be seriously off course in their policies. While intensification of surveillance could help in identification of a crisis at an earlier stage, it does not deal with the issue of how to get countries to accept the diagnosis and prescriptions more seriously. The contemplated regional effort under the

Manila Framework should help to make surveillance more effective through peer pressure.

- (iii) Play an important role in providing policy advice on sequencing financial and capital account reforms to their member countries. An important lesson from the East Asian financial crisis is that having the reform process of the financial sector taking place too late in the development process is a bad idea (Goldstein 1998). At the same time, evidence from several recent financial crises around the world strongly suggests that financial sector deregulation and capital account liberalization play an important role in increasing the vulnerability of countries to a crisis.

## (2) Crisis Management: Applying the Appropriate Prescription

- (i) Despite the best efforts of governments, the private sector, and MDBs, currency crises are unavoidable in an integrating world. It is crucially important to get the correct diagnosis of the problem before prescribing policies. There is some evidence to suggest that the recent interventions in Indonesia, Korea, and Thailand were based on a faulty diagnosis of the underlying problems and resulted in policy prescriptions that worsened the crisis (Culpepper 1998, Goldstein 1998).
- (ii) Because financial turbulence will inevitably undermine long-term development efforts, it is important for regional MDBs, bilateral aid agencies, private creditor agencies, and domestic authorities to work together in resolving the crisis.

## VI. Conclusions

As the global environment in which MDBs operates change, so must the role of MDBs. Since the early 1990s the global environment has changed enormously in three ways—global financial integration is increasingly leading to surges and volatility in foreign private capital to the ADCs; there is a scarcity of official funding; and, there is a greater understanding in developing countries themselves of what the private sector can do. These trends are expected to be reinforced in the future.

This changed context has two important implications for the development finance role of MDBs. First, the traditional development finance role has to be further refocused and expanded to cover mobilization of private sector resources, both external and internal. However, in the poorer countries and in sectors whose social returns exceed private returns, the traditional role of MDBs will continue to remain important. Second, with integration of financial markets globally, the incidence of currency crises will probably increase in the future. The MDBs, together with the IMF, could also have an important role in the management of financial crises especially those that are mainly structural in nature. In such cases, the MDBs would basically complement IMF efforts in various macroeconomic areas. These and other related issues need to be explored further under the ongoing discussions on the “new international financial architecture”.

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**ANNEX 1**  
**Net Capital Flows to the ADCs**  
(**\$ billion**)

	1988	1989	1990	1991	1992	1993	1994	1995	1996
<b>DEVELOPING MEMBER COUNTRIES<sup>a</sup></b>									
Net Private Capital Flows	19.21	20.70	29.86	31.43	49.25	66.16	82.17	104.75	135.16
Net FDI	6.87	8.58	10.37	12.89	21.14	38.60	44.66	51.72	63.42
Net Portfolio Equity	0.54	2.24	1.16	0.73	2.42	16.64	16.31	16.61	18.10
Net Portfolio Bond	0.66	0.70	0.22	1.97	-0.70	5.31	9.94	8.10	0.47
Bank and Trade Related	11.14	9.17	18.11	15.84	26.39	5.60	11.27	28.33	53.18
Net Official Capital Flows	12.54	14.50	13.47	15.39	14.71	15.01	12.72	12.75	8.21
Net Total Capital Flows	31.75	35.19	43.33	46.82	63.95	81.17	94.89	117.50	143.38
<b>SOUTHEAST ASIA<sup>b</sup></b>									
Net Private Capital Flows	2.99	10.63	15.65	20.98	22.70	24.37	26.17	48.35	68.10
Net FDI	3.35	4.70	6.43	8.08	9.37	10.26	9.65	14.09	18.50
Net Portfolio Equity	0.49	2.07	1.05	0.05	0.84	10.80	6.17	11.46	9.80
Net Portfolio Bond	-0.78	-0.39	0.12	0.57	-0.49	2.62	6.88	7.57	1.04
Bank and Trade Related	-0.06	4.24	8.04	12.28	12.98	0.70	3.48	15.23	38.77
Net Official Capital Flows	3.96	4.90	4.93	5.49	5.58	4.88	4.14	2.78	2.61
Net Total Capital Flows	6.95	15.52	20.58	26.47	28.27	29.25	30.31	51.14	70.71
<b>SOUTH ASIA<sup>c</sup></b>									
Net Private Capital Flows	7.01	4.78	3.69	1.48	2.27	0.71	9.42	7.22	12.02
Net FDI	0.33	0.48	0.46	0.45	0.62	0.83	1.22	1.78	2.62
Net Portfolio Equity	0.06	0.17	0.11	0.02	0.38	2.03	6.22	2.34	5.40
Net Portfolio Bond	0.67	0.68	0.15	1.38	-0.21	0.46	0.18	0.21	-1.39
Bank and Trade Related	5.97	3.45	2.98	-0.37	1.48	-2.61	1.79	2.89	5.39
Net Official Capital Flows	6.92	7.08	6.56	7.61	6.46	5.24	5.13	2.43	3.80
Net Total Capital Flows	13.94	11.86	10.26	9.09	8.73	5.95	14.55	9.65	15.82
<b>CHINA, PEOPLE'S REPUBLIC OF</b>									
Net Private Capital Flows	9.20	5.30	10.52	8.97	24.28	41.08	46.58	49.18	55.04
Net FDI	3.19	3.39	3.49	4.37	11.16	27.52	33.79	35.85	42.30
Net Portfolio Equity	0.00	0.00	0.00	0.65	1.19	3.82	3.91	2.81	2.90
Net Portfolio Bond	0.77	0.42	-0.05	0.02	0.00	2.24	2.88	0.32	0.82
Bank and Trade Related	5.24	1.49	7.08	3.93	11.94	7.51	6.00	10.21	9.02
Net Official Capital Flows	1.66	2.52	1.98	2.29	2.67	4.89	3.45	7.53	1.81
Net Total Capital Flows	10.86	7.82	12.49	11.26	26.95	45.97	50.03	56.71	56.85

<sup>a</sup>DMCs include the countries listed below.

<sup>b</sup>Includes Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand and Vietnam.

<sup>c</sup>Includes Bangladesh, India, Nepal, Pakistan and Sri Lanka.

Source: Estimates prepared for a joint ADB/World Bank study (ADB and World Bank 1998).

**ANNEX 2**  
**Net Capital Flows to the ADCs**  
(percent)

	1988	1989	1990	1991	1992	1993	1994	1995	1996
<b>DEVELOPING MEMBER COUNTRIES<sup>a</sup></b>									
<b>Net Private Capital Flows</b>	60.5	58.8	68.9	67.1	77.0	81.5	86.6	89.2	94.3
Net FDI	35.7	41.5	34.7	41.0	42.9	58.3	54.3	49.4	46.9
Net Portfolio Equity	2.8	10.8	3.9	2.3	4.9	25.2	19.8	15.9	13.4
Net Portfolio Bond	3.4	3.4	0.7	6.3	-1.4	8.0	12.1	7.7	0.3
Bank and Trade Related	58.0	44.3	60.6	50.4	53.6	8.5	13.7	27.0	39.3
<b>Net Official Capital Flows</b>	39.5	41.2	31.1	32.9	23.0	18.5	13.4	10.8	5.7
<b>Net Total Capital Flows</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<b>SOUTHEAST ASIA<sup>b</sup></b>									
<b>Net Private Capital Flows</b>	43.1	68.5	76.0	79.2	80.3	83.3	86.3	94.6	96.3
Net FDI	111.8	44.3	41.1	38.5	41.3	42.1	36.9	29.1	27.2
Net Portfolio Equity	16.3	19.5	6.7	0.2	3.7	44.3	23.6	23.7	14.4
Net Portfolio Bond	-25.9	-3.7	0.8	2.7	-2.2	10.7	26.3	15.7	1.5
Bank and Trade Related	-2.1	39.9	51.4	58.5	57.2	2.9	13.3	31.5	56.9
<b>Net Official Capital Flows</b>	56.9	31.5	24.0	20.8	19.7	16.7	13.7	5.4	3.7
<b>Net Total Capital Flows</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<b>SOUTH ASIA<sup>c</sup></b>									
<b>Net Private Capital Flows</b>	50.3	40.3	36.0	16.3	26.0	11.9	64.8	74.8	76.0
Net FDI	4.6	10.1	12.4	30.4	27.2	117.6	13.0	24.7	21.8
Net Portfolio Equity	0.8	3.5	2.8	1.5	16.7	285.7	66.1	32.4	44.9
Net Portfolio Bond	9.5	14.2	4.0	93.3	-9.1	64.4	1.9	2.9	-11.5
Bank and Trade Related	85.1	72.2	80.8	-25.2	65.1	-367.7	19.0	40.0	44.8
<b>Net Official Capital Flows</b>	49.7	59.7	64.0	83.7	74.0	88.1	35.2	25.2	24.0
<b>Net Total Capital Flows</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<b>CHINA, PEOPLE'S REPUBLIC OF</b>									
<b>Net Private Capital Flows</b>	84.7	67.7	84.2	79.7	90.1	89.4	93.1	86.7	96.8
Net FDI	34.7	64.1	33.2	48.6	45.9	67.0	72.5	72.9	76.9
Net Portfolio Equity	0.0	0.0	0.0	7.3	4.9	9.3	8.4	5.7	5.3
Net Portfolio Bond	8.4	7.9	-0.5	0.3	0.0	5.4	6.2	0.6	1.5
Bank and Trade Related	56.9	28.1	67.3	43.8	49.2	18.3	12.9	20.8	16.4
<b>Net Official Capital Flows</b>	15.3	32.3	15.8	20.3	9.9	10.6	6.9	13.3	3.2
<b>Net Total Capital Flows</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

<sup>a</sup>DMCs include the countries listed below.

<sup>b</sup>Includes Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand and Vietnam.

<sup>c</sup>Includes Bangladesh, India, Nepal, Pakistan and Sri Lanka.

Source: Estimates prepared for a joint ADB/World Bank study (ADB and World Bank 1998).