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Geographical Distribution and Pattern of International Capital Flows

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Abstract:
There have been sweeping changes in the global financial relations since the International Bank Credit boom of the 1970s. The changes have been all-pervasive, influencing the inter-relations between the State, industry and finance in a large part of the global economy. A significant aspect of this includes the wave of deregulation, which has integrated the major financial markets of the World. With finance crossing the boundaries of the Nation States, the advanced nations experienced a climate of interdependence as was never witnessed before. The steady rise in the cross-border financial flows has been combined by systemic risks with boom-bust cycles in private credit, and the amplitude also widened markedly over time. Thus in the present paper an attempt has been made to trace and examine the changing geographical distribution and pattern of international capital flows with time. The whole paper has been divided into five sections and various sub-sections. Apart from the introductory section, the changing pattern of capital movements during the decade of 1970s will be examined in Section-I. In Section- II country wise capital movements will be analyzed between the periods 1980 to 1990. An attempt will be made to highlight factors leading group wise differentials in the capital movement .The era of 1990s saw significant worldwide policy changes along with specific country wise changes especially in the developing countries which aim at unhindered movement of resources across the countries. As a result an attempt has been made to assess and analyze the changing pattern of different components of capital flows between various country groups during 1990 to 2000 and 2001 to 2010 in section III and IV respectively.

The period of 1945 to 1955 (after the World War II) was a period of limited capital mobility. Capital flows began to increase in the 1960s, and further expanded in the 1970s after the demise of the Bretton Woods system. Most of the flows were uni-directional and official either in the form of bank lending or external commercial borrowings from rich core to the periphery. Post 1970 however, gross flows (both inflows and outflows) increased tremendously. But net flows (inflows minus outflows) remained constant at relatively low levels for the last thirty years (1970-2000). The period 1973-81 witnessed massive capital flows to countries in many parts of the developing world, largely in the form of private syndicated bank loans directed to the public sector. Such lending effectively dried up for many (but not all) developing countries during the debt crisis period 1982-89. In recent years, however, a number of developing countries in various regions of the world have once again begun to receive substantial inflows of foreign capital. These flows have been notable not only for their magnitude, but also for the break that they represent from the period of the debt crisis for many of the countries now receiving the inflows. Though reduced access to foreign saving was previously perceived as a serious constraint on growth prospects for many such countries, the recent surge in capital inflows has not been taken as an unmitigated blessing.
Indeed, the surge of inflows has triggered a new literature investigating the appropriate policy response on the part of the recipient countries. The urgency of this issue has increased in the wake of the Mexican financial crisis at the end of 1994 and the East Asian crisis in 1997 and also more so because of the recent financial meltdown. In this chapter an attempt is being made to provide a summary of what is currently known about the various dimensions of the new capital inflow episode, and also the pattern and trends in the capital inflows and outflows both on geographical and economic basis. The analysis of capital flows is spread over a period of 1970 to the most recent year for which data is available. The entire period has been subdivided into two broad sub periods i.e. 1970-80 and 1980 till the present time. This demarcation has been deliberately made as prior to 1980s private portfolio flows formed only an insignificant proportion of total capital flows with a predominance of official capital flows. Disaggregative country groupwise data are available only after 1980s when the share of private direct, portfolio and other flows in total capital flows started to show an increasing tendency.

1. Pattern of Capital Flows for Different Country Groups: 1970 -1980

The decade of seventies saw a huge upsurge of inflows in the developing countries averaging about $ 163 bn per annum. The surge in capital flows during this phase was due to the recycling of oil revenue and earnings of petrodollars. The main types of capital flows received by developing and other emerging economies mainly are bank loans to governments, firms and other banks. These accounted for almost 57 percent of the total capital flows. Asia and Latin America received the maximum share. It is evident from the table 3.1 that net other private flow which includes bank lending shows the highest percentage share in total net private capital flows. The share of Latin America and Emerging Asia in this was highest.

2. Country Groupwise Capital Flows During 1980 - 90

The decade of Eighties witnessed stagnation in the capital flows to the developing economies. In the previous decade the problem of debt servicing created a hurdle in the momentum of capital flows to the new developing economies and other EMEs, other main reason being the defective economic policies of these countries such as restriction in convertibility of capital account in the first half of 1980s, unsound macro economic framework etc. As a result, the movement of capital was towards the newly developed country markets, such as Latin America, Japan etc. By the end of the decade, aggregate direct investment flows into developing countries were 1/8 of the flows to developed countries. Portfolio flows to the developing economies were limited in nature because of the non-existence of equity markets and underdeveloped nature of the financial system as a whole. As can be observed from the table 3, net private flow shows a consistently increasing trend in the Developing Asia. It was towards the end of the 80s that EMEs witness a spurt in the net private flows, out of these flows the net private direct investment is found to be having a highly significant increase in EMEs, developing Asia, & central and eastern Europe but it can be clearly observed that the quantum of these flows has been very less because of the reasons stated above. The newly developed countries were the important destination of capital inflows during this decade.

Among the selected economies except for developing Asia where net other private flows have a significant share, other developing country blocks are witnessing insignificant growth in these flows. In the Western hemisphere the inflows were negative. The data on official flows shows that in the decade of 80s official flows were more important for the selected economies in comparison to the private flows, but towards the end of this decade private flows started gaining momentum. The case of Western hemisphere was slightly different as the decade for this region started with a positive net private inflows i.e. 34 and 45 US bn $ in 1980 & 1981 but then from 1982 onwards because of the debt crisis it started falling sharply rather for the period 1984 to 1990 this region witnessed massive outflows of capital.

The net private direct investment was although declining but is comparatively stood positive. The share of FDI going to the developing countries declined from 25% during 1980-85 to 17% during 86-90, however the absolute amount of FDI to these countries increases. Further in 1990s the policy of economic liberalization in these countries has helped increase the FDI to them in 1990s.

2.1. Changing Domestic and International Economic Environment and Its Impact on Private Capital Flows

Since voluntary capital flows reflect endogenous responses of investors to the perception of profitable investment opportunities, they must arise in response to changes in the economic environment in the recipient country, the source country, or perhaps both.

The recent capital inflow trend has emerged in a very different international environment than that which characterized both the previous trends that started in the 1970s and the period 1982-89, with substantial changes in the economies both of the industrial source countries and the developing recipient countries. The scope of such changes covers the macroeconomic and regulatory environments in both sets of countries.

The period 1989-93 was a slow-growth period in the industrial world as a whole. The rate of growth of real GDP, which reached 4.4 percent for the G-7 countries as a group in 1988, averaged 2.8 percent in 1989-90 and 1.1 percent in 1991-93. Monetary policy has been used in countercyclical fashion in the United States during this period, and both nominal and real interest rates fell to extremely low levels in that country after 1988. This was also true of rates of return on other assets, such as real estate. Short-term nominal interest rates peaked at 9.1 percent in 1989, and had fallen to 3.2 percent by 1993. Long-term rates also fell dramatically, by roughly half. Regarding the international trading environment, during the six-year period 1988-93 developing countries as a group, as well as those in the regions of Asia and Latin America specifically, experienced adverse movements in their terms of trade. For developing countries as a group, the cumulative deterioration amounted to 5.5 percent over the period. In spite of slow industrial-country growth and poor terms of trade, however, exports from both Asia and Latin America grew rapidly at the outset of the current capital inflow episode.[2] Concerning the regulatory environment, continued financial liberalization in industrial countries has produced changes that have made these countries' capital markets more hospitable to developing-country borrowers.[3] For example, several industrial countries have relaxed regulations on foreign public issues in their capital markets. Rules and Regulations in the United States eliminated settlement delays, and also facilitated registration and the payment of dividends (El Erian (1992)). Market credit rating standards for public bond issues have been eased in Japan and minimum rating requirements have been eliminated in Switzerland (Jaspersen and Jinarte. (1993)). All of these changes have eased access of developing-country borrowers to capital markets in the industrial countries.

In addition to these, the anticipated ratification of the North American Free trade Agreement (NAFTA), with the announced intention to incorporate in the near future other Latin American countries besides Mexico (such as Chile) is likely to have operated in the same direction.

On the part of the developing countries themselves, the last five years have seen substantial changes in policy regimes, as many countries have moved in the direction of improved macro-economic management and widespread liberalization. Prior to1982 capital inflow episode in Latin America, high fiscal deficits and inflation were widespread (Montiel 1993). However later on, inflation and fiscal deficits have both been reduced, and the rate of economic growth has increased. Export composition has become more diversified in many countries. For example, in Chile, Colombia, and Mexico, the primary export accounted for about half of total exports in the early eighties, but for only about a third by the end of the decade. Among the structural changes adopted by developing countries during the latter part of the eighties was the removal of restrictions on foreign ownership which had impeded inflows of foreign direct investment. Mexico and India removed many such impediments in 1991, while Chile had done so several years earlier. In addition, broader capital account liberalization has been undertaken in a number of countries.

3. Capital Flows for Different Country Groups during 1990-2000

As already indicated in the previous section the decade of 90s witnessed a growing importance of net private flows brought about by increased global integration across the country groups particularly in the developing countries. The free movement of resources and inching towards current and capital account convertibility made possible free flow of capital across nations which bring a new wave of openness in many parts of the world. Opening of the current and capital accounts with economic liberalization of the developing countries attracted private foreign capital in a greater quantum in these economies, particularly in Emerging Asia. Further the financial sector reforms and the comparative interest rate differentials attracted the higher return seeking capital to the emerging and developing economies. Private flows particularly FDI was higher for every year since 1993 than official flows. In 1980 the two were almost equal whereas in 2000 FDI was 10 times larger than official flows. Prior to the First World War developing countries received comparatively high levels of foreign capital but after that the scenario has changed.

It was only in 1990s that foreign capital inflows reached the pre- 1914 levels and in the new developing and EME regions. The percentage of foreign investment in developing countries to world total was 45% in 1914 whereas it was only 26% in 2003 and 36% in 2004.There was a dramatic upsurge in the capital inflows during 1990 to 1997 because of the reasons cited above. The flows increased from about 80 bn $ in the late 80s to $ 253 bn in 2000.

Country group wise picture reveals that Emerging economies and developing Asia have witnessed an increasing quantum of net private flows. The trend growth rate is found to be high and significant for these flows between the years 1991 to 1997.

In 1991-92 for the first time overall private capital flow exceeded official flows with their share rising from 43% in 1990 to 90% in 1996. However the period 1997-99 saw a decline in private capital flows due to the development of negative sentiments for the market and the weak macro-economic fundamentals of the East Asian economies which led to the huge outflows of the foreign capital from these economies. This caused the East Asian Crisis in which the share of private capital declined to 82% in 1999. The composition share of capital flows also saw a change in this period with equity (direct & portfolio) displacing the official lending of 1970s. This happened due to the opening of the capital account, development of the financial markets, growing securitization and increasing role of institutional investors, trade liberalization, financial deregulation, financial and technological innovation and strengthening of the economies. The share of FDI in GDP rose from 0.8% to 2.5% during 1991-1997. Other private flows remained volatile. Official flow started to decline and from 1993 onwards the share of official flows was less than private flows throughout. The private sector received more than 65% of the total flows which was a trend similar to 1870-1913. The maximum share was received by Asia & Latin America it was almost 70% of the total flows to emerging markets with Middle East and Sub-Saharan Africa getting a small share.FDI occupied the dominant position for Asia while Portfolio flows were more significant in Latin America.

The impact of the East Asian crisis can be seen clearly as there is a significant deceleration in these flows in case of EMEs, whereas in case of Developing Asia the figures are found to be negative indicating significant capital flight. This can be substantiated by negative portfolio flows and other net private flows in these two country groups during the same period. The impact of this crisis on the direct flows however was comparatively less. However the picture started to improve in the later half of 1999.

3.1. Changing pattern of External Financing for Developing Countries

As shown in table 3.1, the size, composition and distribution of external capital inflows to developing countries have all undergone fundamental shifts during the past three decades. Upto early 1970s the most important source of external financing for developing countries was official loans and aid, though from 1950s onwards FDI accounted for 20-30 per cent of their external financing, and, there was also an increase in the share of export credits.

This indicates that developing countries were not in a position to fill their resource gap through commercial borrowing on market terms. Official financing continued to increase rapidly in the 1970s, with private financial flows, primarily in the form of credits by banks in industrial countries also showing an increasing trend. This served to recycle the surpluses of major oil exporters that emerged after the sharp increases in oil prices during 1973–1974. This expansion came to an end in 1982 with a rapid withdrawal of bank lending, resulting in a generalized debt crisis in the third world and a lost decade for growth and development. During the rest of the 1980s capital inflows to developing countries remained virtually stagnant: while private financing fell sharply, official development assistance increased only moderately compared to the 1970s.Until 1997 the decade of the nineties witnessed a strong expansion in private capital inflows to developing countries. The increase was sufficiently rapid to more than offset the decline in official flows, and was greatly influenced by rapid liberalization of markets and privatization of economic activity in most developing world. An important portion of private capital took the form of non-debt creating flows, notably but not exclusively FDI. Net capital inflows to developing countries have risen by more than twenty-fold in nominal terms since 1970. In real terms the increase in total net inflows is

much less impressive. Measured in relation to the import price index of developing countries (i.e. in terms of its purchasing power over foreign goods) for example, the increase in net capital inflows during the same period is about five-fold. More importantly, measured in terms of the share of output of the recipient countries, the recent surge in capital flows represents only a recovery from the stagnant levels of the 1980s rather than an increase over the levels attained during the years preceding the debt crisis. Excluding China, on average the total inflow of capital to developing countries as a percentage of their combined GNP was indeed lower during 1990-1998 than during 1975-1982 table 3.2. Similar trends are also observed for net transfers, namely net capital inflows less net factor payments abroad including interest payments on external debt and profit remittances which are a broad measure of foreign resources available to finance trade deficits.

i) Definition of Different Types of Capital Flows: There is ambiguity in terminology for the different kinds of international capital flows. The same terms used by different institutions or writers often cover different categories of capital transactions, while the same categories are sometimes referred to in different terms. To avoid ambiguity the definitions which are being considered in the present study are briefly defined as follows:

Total Net Inflows	**1975-82**	**1983-89**	**1990-98**
0	**1**	**2**	**3**
Including China	4.91	2.87	5.00
Excluding China	5.45	2.97	4.22
Official inflows	1.58	1.57	1.03
ODA grants	0.53	0.62	0.56
Other official	1.05	0.96	0.47
Private inflows	3.33	1.29	3.97
Non-debt-creating inflows	0.42	0.55	2.21
FDI	0.42	0.53	1.67
Portfolio equity	0.00	0.02	0.54
Bonds	0.11	0.05	0.52
Bank credit	2.46	0.44	1.17
Short Term	1.10	0.10	0.72
Long-term	1.36	0.34	0.44
Memo item:			
Portfolio inflows	0.12	0.07	1.06
Interest payments	1.49	2.58	1.79
Profit remittances	0.93	0.54	0.56
Net capital transfers	2.48	-0.26	2.65

Table 3.2: Percentage Of Net Capital Inflows To GNP In Developing Countries: 1975-98
Sources: UNCTAD Secretariat Estimates, Based On World Bank, Global Development Finance, 1999 (CD-Rom, Washington.)

- **Capital inflow**: This term refers to the acquisition of domestic assets by non-residents (plus grants). Sales of domestic assets are defined as a negative capital inflow. Thus the term net capital inflow denotes acquisition minus sales of domestic assets by Non-residents. The types of asset included in these flows vary according to the institution publishing the data. The term net resource flows used by the World Bank in its Global Development Finance, for example, refers to capital transactions by non-residents, but excludes assets that give rise to short-term debt. In the IMF Balance of Payment Statistics, capital inflows are the items included in the capital and financial accounts of the balance of payments, comprising mainly credit items (such as debt forgiveness and migrants' transfers) under the heading of “capital transfers”, “direct investments” in the country concerned, and the liability items under “portfolio investment” and “other investment” (which includes both short-term and long-term debt in such forms as bank loans, other types of trade credit, and borrowing from IMF).
- **Capital outflow**: This term refers to the acquisition of foreign assets by residents. Sales of foreign assets are defined as negative capital outflow. Thus the term net capital outflow denotes acquisitions minus sales of foreign assets by residents. In the IMF Balance of Payments Statistics, capital outflows consist of the debit items under the heading of “capital transfers”, “direct investment abroad”, and the asset items under “portfolio investment” and “other investment”.

- **Net capital flow:** This term refers to total net capital inflow less total net capital outflow as defined above. It is positive when net inflows exceed net outflows.
- **Net transfer:** This term refers to net capital inflows less net factor payments abroad; the latter include interest payments on external debt as well as profit remittances. Net transfer is thus a broad measure of a country's capacity to finance its trade deficits.

Types of flows	1975-82	1983-89	1990-98
0	1	2	3
FDI	9	8	34
Portfolio inflows	6	3	21
Bank loans	15	16	24
ODA Grants	8	21	11
Other pvt . credits	3	9	1
Other official flows	40	33	9

Table 3.3: Types of Net Capital Inflows in Developing Countrie
(Percentage of Aggregate Net Inflow) Source: Estimated From Table 3.1

Developing countries	1975-82	1983-89	1990-98
0	1	2	3
North Africa & Middle East	18	18	6
South Asia	6	14	6
Sub-Saharan Africa	13	23	10
East Asia & pacific	18	25	42
Europe	2	3	4
Latin America & Caribbean	43	17	32

Table 3.4: Region-Wise Net Capital Inflows to Developing Countries (1975-1998)
(Percentage of Aggregate Net Inflow) Source: Table 3.2

There has also been a series of major shifts in the composition of capital inflows since the mid-1970s. From 1975 until the early 1980s, private capital accounted for almost two thirds of total inflows, but after 1982 its share fell to less than 50 per cents. In the1990s the surge in private flows and the decline in official financing have meant that private capital has accounted for 80 per cent of total capital inflows to developing countries. In nominal terms official financing drifted around $40 billion, only a little above the levels attained during the years of debt crisis. These changes in the composition of capital inflows as between public and private sources have been accompanied by shifts in their distribution among developing countries and regions (table 3.4). In particular, since official flows tend to favour poorer developing countries and regions, their decline relative to that of private capital flows has been a major determinant of the changing share of different groups of developing countries. Thus, the shares of sub-Saharan Africa and South Asia, the major recipients of official finance, increased, while that of Latin America declined sharply after 1982 compared to the pre-debt crisis years owing to the drying-up of private flows.

However, during the 1990s the movement has been in the opposite direction. The share of East Asia saw a consistent rise of capital during the selected decades until a setback due to the financial crisis which began in 1997. This shift towards private capital has been concentrated in a small number of developing countries, mainly the so-called emerging markets. Seventeen while the twenty countries that constitute this group received, on average, 40 per cent of total net capital inflows during the whole period of the first two decades, with their share going up to over 90 per cent in the 1990s, leaving the remaining 10 per cent to be shared among the rest of the developing world.

There also has been a shift in the relative importance of different categories of private inflows. From mid-1970s till the debt crisis of the 1980s bank credits constituted three quarters of total private capital inflows to developing countries, while the rest was accounted for by FDI. This pattern significantly after the debt crisis when bank loans collapsed and FDI took the highest share in total private inflows.

In the 1990s the revival of bank lending has been concentrated mainly on the Asian emerging markets; FDI has accelerated rapidly and portfolio investment has emerged as a major form of private inflow. These changes have also been associated with the increased share of the private sector as borrower. Before the debt crisis, the share in total external borrowing of private flows not covered by an

official guarantee in the recipient country was only about 15 per cent. After 1982 this ratio fell even further before rising rapidly in the 1990s both in absolute terms and in relation to public and publicly guaranteed flows, exceeding the latter from 1995 onwards. However, this trend was (If unrecorded net capital outflows- errors and omissions), a substantial proportion of which generally consists of residents' purchases of foreign assets, are added to record flows, the proportions are even higher. Reversed after outbreak of the East Asian crisis: non-guaranteed borrowing almost disappeared, while public and publicly guaranteed debt shot up, largely as a result of socialization of private debt. Net capital inflows received by developing countries from non-residents do not necessarily give the amount available for financing current-account deficits and closing resource gaps. Account also needs to be taken of net capital outflows by residents. The importance of capital outflows through acquisition of assets abroad depends, inter alia, on the capital account regime adopted by the countries concerned. During the past 10 years, a growing number of developing countries have liberalized outward capital flows, enabling their residents to shift funds to foreign financial markets for short-term investment as well as for outward FDI and the purchase of long-term financial assets. However, such outflows can also occur under more restrictive capital-account regimes in the form of capital flight. Net capital outflows in fact constitute an increasing part of offsetting financial transactions, as can be seen from table 3.2.In the emerging markets, for each dollar of net inflow there was a net outflow of 14 cents in the 1980s and one of almost 24 cents in the 1990s, while for developing countries .as a whole this share has more than doubled since the beginning of the 1990s. The coexistence of capital inflows with outflows is a natural outcome of global financial integration. It is a widespread phenomenon in the developed world, reflecting in part the global reach, portfolio diversification and risk management of financial institutions.

It can also reflect the desperate behavior of different categories of financial flows. Cross-border financial activities have increasingly become a feature of financial institutions in emerging markets. Around 300 banking entities from 10 leading developing countries were operating in OECD countries in 1996 (Corn ford and Brandon, 1999: tables 1 and 2). Thus opening of the capital account in emerging markets presents profitable opportunities for portfolio diversification not only for lenders and investors in industrial countries but also for asset holders in these markets themselves. It also allows businesses to take positions abroad in order to hedge against exchange-rate risks. Furthermore, some developing countries have become significant providers of FDI in recent years, with the cumulative outward flow reaching $52 billion during 1991–1996, or 21 per cent of total net capital outflows from developing countries (World Bank, 1998: table 1.11). However, an important part of outflows, as of inflows, also consists of liquid capital driven by short-term arbitrage opportunities; another important category of offsetting financial transactions is reserve accumulation. During the 1990s more than 20% of total net capital inflows were absorbed by additions to reserves in both developing countries as a whole and in the emerging markets. For the latter there has been a large increase in such additions from a level of only 3 per cent in the 1980s to one similar to the developing country average. So long as private capital flows are subject to the control of recipient countries, such flows can be expected to be closely related to imports and current-account financing.

	1990–94	1995–98	1990–98	1980–89b	1990–97
Billions of dollars					
Net capital inflow	825.8	1064.9	1890.6	355.3	1083.8
Net capital outflow	-142	-435.3	-577.2	-49.6	-256.2
Net capital flow	683.8	629.6	1313.4	305.7	827.6
Bop errors and omissions	-49.9	-106.3	-156.2	-39.5	-53.2
Change in reserves	-221.2	-216.5	-437.7	-10.6	-231.6
Current-account balance[d]	-412.7	-306.8	-719.5	255.6	-542.7
Percentage of net inflow					
Net outflow	17.2	40.9	30.5	14.0	23.6
Bop errors and omissions	6.0	10.0	8.3	11.1	4.9
Change in reserves	26.8	20.3	23.2	3.0	21.4
Current-account balance[d]	50.0	28.8	38.0	71.9	50.1
Percentage of net flow					
Bop errors and omissions	7.3	16.9	11.9	12.9	6.4
Change in reserves	32.3	34.4	33.3	3.5	28.0
Current-account balance[d]	60.4	48.7	54.8	83.6	65.6

Table 3.4: Net Capital Inflow, Current-Account and Offsettings Financial Transaction in Developing Countries and Sixteen EMEs
Sources: World Bank, Global Development Finance, 1999 (CD-Rom); IMF, World Economic Outlook, October 1998;
IMF, Balance Of Payments Statistics, Various Issues

- (Argentina, Brazil, Chile, Colombia, Egypt, India, Indonesia, Malaysia, Mexico, Pakistan, Peru, Philippines, Republic of Korea, South Africa, Thailand, Turkey.)
- Excluding 1987 and 1988, which were years with current-account surpluses.
- A minus sign indicates an increase in reserves.
- The sum of net capital flow, Balance of Payments Statistics errors and omissions and change in reserves.

The need to maintain a certain level of reserves would then arise from time lags between payments for imports and receipts from exports and from miscellaneous temporary disequilibria in the current balance of payments.

Traditionally, reserves covering on average three or four months' imports are considered as adequate for such purposes, and even smaller reserves would be needed to the extent that governments are more willing to respond to current-account disturbances by exchange-rate adjustments. The trend in developing countries has, however, been to accumulate reserves, leading to levels well above the traditional norm. Indeed, despite policy reforms designed to ensure greater flexibility in the adjustment of exchange rates to market conditions, their reserve holdings have tended to rise in both absolute and relative terms during the past two decades, a policy involving significant costs. For the developing countries as a whole, the increase in reserves from 1990 to 1998 amounted to 60% of the total increase in their import bill during the same period. These increases would appear to be a response to the instability of private capital flows, especially short-term bank loans and much portfolio investment. The instability is exemplified by major constituents of these two categories of external financing for developing countries which displayed much sharper fluctuations during the 1990s than total net capital inflows, increasing more than 2.5 times more rapidly during 1988-1995 but decreasing no less than 83% in 1995-1998, while the total net inflow declined only 12 %. Such fluctuations reflect the boom-bust cycle of external financing in the 1990s and the impact of the associated financial crises.

3.2. Financial Instability and Crises

Since the collapse of the Bretton Woods system increased global capital mobility has been accompanied by greater frequency of financial crises in both developed and developing countries alike. The episodes of financial instability and crisis in industrial countries include the banking and real estate crises in the United States lasting more than a decade from the late 1970s, the major slumps in the global stock market in 1987 and 1989, several episodes of extreme instability in the currency markets of industrial countries of which an outstanding instance was the currency crisis of the European Monetary System (EMS) in 1992, and the ongoing instability in Japanese financial markets that started with the bursting of the bubble in the early 1990s. In developing countries the notable crisis period are Southern Cone crisis of the late 1970s and early 1980s, the debt crisis of the 1980s, the Mexican crisis of 1994-1995, the East Asian crisis beginning in 1997, the Russian crisis of 1998, and a number of other more limited currency and banking crises. There are, however, important differences between industrial and developing countries in the nature and effects of financial instability and crises. Experience shows that in developing countries reversal of external capital flows and sharp depreciation in the currency often threaten domestic financial stability. Similarly, a domestic financial crisis usually tends to translate into currency turmoil, payments difficulties and even external debt crises. By contrast, currency turmoil in industrial countries since the advent of more flexible exchange rates in the 1970s has frequently involved large movements of rates concentrated into short periods.

These movements, which result from buying and selling decisions by economic actors in currency markets often taken with little regard for indicators of country's fundamentals (such as relative price levels, microeconomic performance, and the stance of macroeconomic policies), generally impose costs on the real economy and can lead to significant misalignments, that is to say levels of the exchange rate which are inconsistent with a sustainable external payments position. But such turmoil does not usually spill over into domestic financial markets, nor do domestic financial disruptions necessarily lead to currency and payments crises. These differences between developing and developed countries stem from a number of factors. First, the size of developing-country financial markets is small, so that entry or exit of even medium-size investors from industrial countries is capable of causing considerable price fluctuations, even though their placements in these markets account for a small percentage of their total portfolios. Furthermore, differences in the net foreign asset position and the currency denomination of external debt play a crucial role. Here the vulnerability of developing countries is greater because of their typically higher net external indebtedness and higher shares of their external debt denominated in foreign currencies. The vulnerability of the domestic financial system is increased further when external debt is owed by the private sector rather than by sovereign governments. A number of common features have marked the history of the post-Bretton Woods crises. First, many of them have been preceded by liberalization of the economy, notably the financial sector. Second, all episodes of currency instability have been started by a sharp increase in capital inflows followed by an equally sharp reversal. Such swings in flows are related to internal or external policy changes that produce divergences in domestic financial conditions relative to those of the rest of the world, often initially reflected in interest-rate differentials and prospects of capital gains. Reversals of capital flows are frequently, but not always, associated with deterioration in the macroeconomic conditions of the recipient country. This deterioration often results from the effects of capital inflows themselves such as overvaluation of the exchange rate, excessively rapid credit expansion, and speculative bubbles in asset prices. But the deterioration is also generally influenced by external developments affecting interest rates and exchange rates in international markets as much as by shifts in domestic macroeconomic policies. Finally, financial crises tend to be associated more closely with certain types of financial flow and with certain classes of lenders and borrowers than others.

However, currency and financial crises in emerging markets have occurred under varying macro economic conditions. They have occurred when current-account deficits were large and unsustainable (Mexico and Thailand), but also when such deficits were relatively small (Indonesia and Russia). Although significant overvaluation has often been characteristic of countries experiencing currency turmoil (Mexico, Russia and Brazil, all of the three used exchange rate as a nominal anchor to bring down inflation), this has not always been the case: for instance, in most East Asian countries the appreciation of the currency was moderate or negligible. Similarly, while in some cases crises were associated with large budget deficits (Russia and Brazil), in others the budget was balanced or in surplus (Mexico and East Asia). Finally, crises occurred when external debt was owed primarily by the public sector (Brazil and

Russia) or primarily by the private sector (East Asia). Financial crises in developing countries are all characterized by a rush of investors and creditors to exit and a consequent financial panic.

Indeed, whatever the proximate causes of financial crises or the events that trigger attacks on currencies, international investors and creditors of developing countries tend to manifest herd-like behaviour in exiting as well as in investing or lending. The debt crisis of the 1980s witnessed a drastic cutback in lending by international banks to sovereign debtors, while during the 1995 Mexican crisis the rush for the exits by international creditors took the form of rapid liquidation of government paper and conversion of the proceeds into dollars. Again, in the more recent turmoil in East Asia, the refusal to roll over short-term loans together with the attempt of unhedged debtors to avoid exchange-rate losses was the principal factors deepening the crisis. Creditor overreaction to debtors' financial difficulties is often explained in terms of a collective-action problem. Even though the creditors as a group are better off if they continue to roll over their maturing claims on a debtor, an individual lender or investor has an incentive to exit. Without access to liquidity a debtor entity is then forced to curtail operations or to resort to distress sales of assets, which in turn lower its income and wealth, thereby further constraining its ability to service debt and hence damaging the interests of creditors as a group. A generalized debt run by international creditors triggered by a loss of confidence can easily turn a liquidity problem into widespread insolvencies and defaults by altering key asset prices, interest rates and exchange rates. In the absence of a large stock of reserves or access to international liquidity, the ability of a debtor developing country to repay its entire stock of short-term external debt on demand is no greater than the ability of a bank to meet a run by its depositors. In the case of bank lending, withdrawal of loans by foreign creditors is likely to trigger a rush by unhedged private debtors into foreign currency as they seek to pay debt or cover their open positions, and may also lead to speculative selling of the currency by residents. This in turn drives down the foreign-exchange value of the domestic currency and raises interest rates, making it more difficult for debtors to service their debt, forcing them to liquidate assets and thereby deepening the debt-deflation process. Debt runs by foreign creditors are often also associated with a flight from non-debt instruments held by both residents and non-residents notably from the equity market. Since such investors face a decline in prices when they attempt to liquidate their holdings, the selling pressure in the currency market may be weakened. Moreover, since they would also suffer from depreciations, they may have less inducement to exit. However, investor over reaction can nonetheless still amplify destabilizing feedbacks between equity and currency movements.

3.3. East Asian Financial Crisis: Causes, Evolution, and Prospects

The financial crisis began in Thailand, leading to a 20% devaluation of the baht on July 2, quickly spreading to other countries in South East Asia and eventually to the Republic of Korea, with severe global repercussions. Between June 1997 and the end of the year the median currency devaluation in twelve of the largest emerging markets was 39 percent whereas in the five East Asian countries hardest hit by the crisis- Indonesia, Korea, Malaysia, the Philippines and the Thailand this worked out to 80 percent. The international finance corporation's (IFC) emerging stock market index dropped 25 percent between June and December, and its Asian index fell by 53 percent. Among the group of twelve countries the median rise in short term interest rates (from July 1 to each country's peak rate) was more than 600 basis points.

The crisis management included interventions, increase in interest rates and restrictions on foreign speculators, ultimately failed because by mid-1997 domestic companies sought to protect themselves from foreign exchange risks to their balance sheets by repaying foreign debt and hedging their foreign exchange exposure. After spending $ 8.7 billion in reserves to defend the currency and undertaking $ 23 billion in forward contracts maturing over the next twelve months, Thailand's central bank let the exchange rate float on July 2. By the end of the year the baht had depreciated 93 percent and the stock market had fallen 34 percent (in dollar terms) relative to June 1997. The devaluation of the baht triggered a collapse of market confidence in Indonesia, Malaysia, and the Philippines, causing their exchange rates to plummet in July and August 1997. Further declines in currencies and equity markets followed. During the second half of 1997 equity prices in the region fell by 50-75 percent (in dollar terms).

The crisis began to affect other economies in October 1997, when speculative pressures intensified against the Hong Kong dollar, the Korean Won, the Taiwan (china) dollar, accompanied by sharp falls in stock markets in these economies. A severe plunge in Hong Kong's equity market precipitated a global drop in equity prices. Although the picture somewhat was improved in the second half of 1998.

Total outward FDI per annum – the value of financial flows per year from home countries to foreign affiliates in host countries – and the inward FDI corresponding to it (which should, in principle, equal outward FDI) have grown steadily in recent years. In 1998, world FDI outflows reached a record level of $649 billion and inflows, $644 billion, and making it the single most important component of private capital flows to developing countries. These levels were reached against the backdrop of numerous unfavourable conditions in the world economy which could have slowed down FDI in 1998 – but, at least in 1998, it did not: Recession in Asia, including Japan; instability in financial markets in Asia, the Russian Federation and Latin America; reduced bank lending; declining world trade; decreases in commodity prices, especially oil prices; reduced privatization activity; and excess capacity (e.g. in automobiles) contributed to a slow-down in world economic growth in1998 to an estimated two per cent, compared to a growth rate of 3.4 per cent in 1997.

Indeed, estimates of FDI flows for 1998 and 1999 made by various organizations all reflected expectation of a substantial slow-down in FDI flows. Contrary to expectation, FDI flows grew in 1998 by 39 per cent in the case of inflows and 37 per cent in the case of outflows, the highest growth rate attained since 1987. Indications are that FDI flows could increase further in 1999, even though the world economic scenario continues to be difficult and a further decrease of world GDP growth to 0.9 per cent is expected (World Bank, 1999a).For example, the value of cross-border M&As of these estimates are for the world as a whole, announced in the first half

of 1999 which reached a new record level ($574 billion), already close to the value of all cross-border M&As announced in the whole 1998.The reasons for an apparent paradox of FDI growth under adverse global circumstances becomes clear taking a closer look at FDI trends region wise.

FPI on an average, virtually all of the increase in FDI in 1998 was concentrated in developed countries, where, the rate of economic growth remained more or less stable (with growth rates of 2.5 percent in 1996, 2.7 per cent in 1997 and 2.3 per cent in 1998), mainly because the effects of the recession in Japan were compensated for by increases in production in the United States and the European Union. FDI inflows to and outflows from developed countries reached new heights of $460 billion and $595 billion, respectively.

The developing countries, which grew at a rate of only 1.5 per cent in 1998, nearly on account of China, the first time in ten years they recorded a lower rate of economic growth than the developed countries. Inward FDI flows decreased slightly, from $173 billion in 1997 to $166 billion in 1998, a decline of about four per cent. The extent of the decline was moderated by factors such as currency depreciation, FDI policy liberalization and more hospitable attitudes towards M&As.*

•Flows to the economies in transition of Central and Eastern Europe remained almost stable, at close to $19 billion, although the Russian Federation saw a sharp decline.

•The 48 least developed countries (LDCs) continued to attract less than $3 billion, accounting for 1.8 per cent of flows to all developing countries and 0.5 per cent of world FDI flows.

The dramatic growth of FDI in 1998 was fuelled to a large extent by a boom in cross-border M&As. Their value, at $544 billion, was $202 billion higher than in 1997. Some of these –e.g. the takeover of Amoco by BP for $55 billion and the acquisition of Chrysler by Daimler-Benz for $44.5billion – involve record amounts.

*Terms that they are usually not geared towards short-term profits (but rather long-term returns) and are not prone to herd behaviour (UNCTAD, 1998a).Total net resource flows to developing countries reached $275 billion in 1998. Private capital flows have increased until 1997, while official flows have been declining in absolute terms compared to the beginning of the1990s.Within private capital flows, the relative payments shares of both bank loans and portfolio investment etc have declined over the past few years while the share of FDI has increased over the past few years. In 1998, bank lending and portfolio investment declined in absolute terms as, which could affect FDI flows as well. In contrast to other types of private capital flows, FDI flows to developing countries have demonstrated remarkable resilience in the face of the financial and economic crises of the past two years divestments or repayments of principal on loans. They are not net of dividends, interests, lending and portfolio investment declined in royalty payments etc. absolute terms as well, which could affect FDI Bonds and portfolio equity flows. The adverse effect of the East Asian Crisis continues till the year 1999 resulting in the reduction of FDI &FII inflow percentages in all the developing countries, but the picture starts improving from the second half of the year 2000.

4. Recent Trends in Capital Flows in Developing Countries (2001-2009)

Table 3.6 reveals that in the mid-1990s inflows to Asia were larger in both nominal and real terms, than the recycled petrodollar inflows to Latin America in the late 1970s whereas, those of the United States (Greenville 1998). In the 1990s, foreign direct investment (FDI) to emerging markets remained the most stable source of capital inflows, even at the peak of the financial crisis, while bank loans were the most volatile and underwent the most violent reversal (Arellano and Mendoza, 2002).

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Net private capital flows (a+b+c)	74.8	79.5	89.8	169	242	252	232	605	331	442
Net private direct investment (a)	171	186	157	166	189	260	250	310	307	322
Net private portfolio investment (b)	15.9	-78.7	-92.2	-13.2	16.4	-19.4	-104	48.5	-72.2	31
Net other private capital flows (c)	-112	-27.1	25.1	17.1	38.5	13.3	87.5	249	98	90
Net official flows	-33.9	0.9	-0.6	-50	-70.7	-110	-160	-149	-162	-150

Source: World Economic Outlook, April 2007 and 2008; World Economic Outlook Update, July 2008, IMF, 2009

Table 3.6: Net Private Capital Flows to Emerging Markets
(Annual Average, Us $ Billion)

	1977–82	1983–89	1990–94	1995	1996	1997	1998-99
Total private capital flows	30.8	8.8	125.1	193.3	212.1	149.2	64.3
By type:							
-Net FDI	11.2	13.3	44.9	96.7	115.0	114.0	131.0
-Net portfolio investment	-10.5	6.5	64.9	41.2	80.8	66.8	36.7
-Bank loans and other	29.8	-11.0	15.2	55.4	16.3	-57.6	-103.5
By region:							
-Asia	15.8	16.7	39.1	95.1	100.5	3.2	-55.1
-Latin America	26.3	-16.6	40.8	38.3	82.0	87.3	69.0
-Other	-11.6	8.7	45.2	59.9	29.7	58.7	50.4

Source: IMF Various Issues; IMF 1995 for 1977–89 data; IMF 1999 for 1990s data, World Development Outlook

Table 4.1 indicates that net capital flows to the developing countries have increased tremendously between 2000-2007. Net private direct investment has also registered rapid growth, whereas net private portfolio investment has remained highly volatile during the same periods. Net other private capital flows registered positive growth starting from 2002 but again remained highly volatile. The capital inflows into Asia through purchases of equities have become larger and more volatile over the years. The scale of the pullback by foreign investors from Asian equities in episodes of global volatility in equity markets has increased over the years. The bouts of disinvestment due to reversal in capital flows that have occurred since the summer of 2007 have been unprecedented. In the face of losses on mortgage securities, liquidity blockages in major money markets and prospects for decelerating growth, foreign investors liquidated over US$ 12 billion in August and November in six Asian markets as per daily transaction reporting.

These liquidations have reached to such levels notwithstanding the fact that global volatility (as measured by the VIX index of option prices on the Standard and Poor's index of US equities) has not climbed to the levels reached earlier in the decade or at the time of the long term capital movements (LTCM) and Russian defaults.

Even before this most recent episode, these flows have drawn much market commentary and such interest led a number of stock exchanges to release daily data on non-resident flows. This has resulted in a number of careful studies that illuminated the relationship between capital flows and equity prices.

The effects of East Asian Crisis were evident till the year 2000. As most of the developing countries were either facing negative inflows (outflows) or were receiving a very small quantum of private capital inflows. The picture starts changing in the year 2001, as the overall quantum of private inflows which includes FPIs as well starts improving. In 2001, thefive largest recipients attracted more than 60 percent of the total inflows to the developing countries, important of them were Emerging and developing economies with net private inflows of 78.207 US bn $, Western Hemisphere with 38.522 bn 4, Developing Asia with 30.5 bn $ and less important was Central & Eastern Europe with 16.13 bn $. Middle east and Africa were at a worse end as the Net private inflows in middle east was (-) 8.055 and for Africa it was only 1.919 bn$.

The quantum of inflow starts increasing in 2003 at a higher rate and the momentum continues till the second half of the year 2007. The inflows in EMEs & Developing economies increases from 177.52 TO 696.53, for Africa 3.803 bn$ to 30.03 bn $, for Central; & Eastern Europe it was 16.47 bn4 to 185.5 bn$, for Developing Asia from 50.96 bn $ to 200.6 bn $ for Middle East it was 19.701 to 43.303 bn$ and finally for Western Hemisphere it increases from 6.367 bn$ to 112.169 bn$. However the financial crisis of late 2006 starts affecting the economies adversely and as a result the inflows start declining for example the Net private inflows in 2009 turned negative to -52.49 bn $ in EMEs and for Africa and western hemisphere it came down to 21.04 & 6.396 bn$ respectively. For Developing Asia it was (-) 54.3 and for Middle East and Western Hemisphere it was 48.015 & 24.844 bn $ only. Turmoil in financial markets slower growth in high-income countries, and rising inflation have all adversely affected growth prospects for developing countries. Most countries have shown impressive resilience in this turbulent environment and growth for developing countries as a group expected to moderate from 7.8 percent in 2007 a still strong 6.5 percent in 2008. Vulnerable countries that depend on foreign capital flows are likely to experience a sharper slowdown. Moreover, despite strong production growth at the aggregate level, higher food and energy prices, have caused real income to decline, significantly increasing the hardships faced by the very poor, particularly in urban centers. In 2008, not all of the news is gloomy. In some respects, the slowing of the global economy is welcome, coming as it does on the heels of several years of very fast growth and increasing signs of overheating, as illustrated by a dramatic increase in international commodity prices and by excessive inflationary pressures in a number of countries and the slowdown in U.S. domestic demand along with the depreciation of the dollar.

In contrast with the high-income countries where investment in sound macroeconomic policies and GDP growth eased from 3 percent in 2006 to 2.6 percent in 2007, gains for developing countries as a group picked up modestly to 7.8 percent from 7.6 percent in the year. Improved macro-economic fundamentals, diminished sovereign exposures to international financial markets, largely favorable terms-of-trade developments, and buildup of Foreign exchange reserves are at all-time highs, large international reserve positions helped to insulate many countries from financial spillovers. And as figure 2 shows, robust momentum in domestic demand, driven in many

countries by investment outlays, was sufficient to buffer the initial shocks stemming from the financial turmoil in mature markets. Indeed, growth stepped up across all developing regions during 2007, with the exceptions of Europe and Central Asia and South Asia.

Net capital inflows to developing countries surged to another record level in 2007, marking the fifth consecutive year of strong gains. Economic expansion in developing countries and ample liquidity in the first half of the year supported a $269 billion increase in net private flows, mainly reflecting continued rapid expansion in equity inflows and net bank lending, which both reached record levels. But developing countries' easy access to global capital markets deteriorated in late 2007 and 2008 in the wake of the U.S. sub prime mortgage crisis. Uncertainty both about the identity of financial institutions with large exposures and about the potential magnitude of losses gave rise to a volatile financial environment, sparking a sell off across the entire spectrum of risky assets in major financial institutions that have taken sizable write-downs have curbed their lending to restore balance sheets, and further losses are expected over the balance of 2008. Besides reducing capital flows to developing countries, the turmoil has increased borrowing costs, although less so than in previous episodes, when emerging markets themselves were the primary source of difficulty. This section reviews financial flows to developing countries, analyzing recent developments and assessing short-term prospects. The key indications are as follows.

- Net private flows to developing countries reached a record level for the year 2007 as a whole, even though economic and financial conditions deteriorated appreciably over the latter part of the year. Turmoil in international financial markets has curbed private debt and equity flows in late 2007 and into early 2008.
- Because of the decline in global growth, credit conditions have tightened and private flows have experienced a sharp decline in the short run.
- The financial turmoil that began midyear 2007 had a marked impact on emerging debt and equity markets, although to a lesser degree than in previous crises.

Global financial markets entered into an episode of heightened volatility from the midway of 2007 when the crisis in the U.S. sub-prime mortgage market spilled over into equity, currency and bond markets worldwide. Because of this turbulence in the financial markets, the risk bearing capacity of the investors declines which results in the sell-off of risky assets in mature and emerging markets. Although the sell-off has had little impact on the cost of sovereign borrowing from abroad, it has increased the cost of corporate borrowing significantly, particularly for less-credit worthy borrowers. The effect of this financial crisis and turmoil can be traced from the increasing volatility in global equity prices, which perked in 2007 and have since undergone a sharp correction, although because of the good performance of the financial markets in the first half of 2007, the markets manages to post impressive gains for 2007 as a whole which resulted in on an average a comparatively better growth of capital inflows to the major emerging and developing economies.

Current account balances for developing countries have worsened in most of the developing countries. The external financial position of many development countries has deteriorated, leaving many of them more vulnerable to subsequent adverse shocks. Although for the BRIC countries the picture was somewhat different as for the case of china, which accounted $426 billion current account surplus, as a result the pace of foreign reserve accumulation for these countries improved significantly. Although private capital flows to developing counties have surged over the past few years in 2007. Most of the countries have surged over the past few years. Most of the flows have gone to just a few large countries.

Net debt and equity inflows to developing countries increased by $ 269 bn in 2007, reaching a record $1.03 trillion. This marks five consecutive years of strong gains in net private flows, which averaged over 44 percent a year. However much of the increase in dollar terms reflects the depreciation of the U.S $ against most other currencies. The group wise analysis of recent trend and pattern of capital flows are as follows

i) East Asia and Pacific: In 2007 the economies of East Asia and pacific recorded robust growth of 10.5 percent up from 9.5 percent in 2006s. This pace was highest in over decade and came despite growing concerns about the potential impact of the slowdown in the U.S. economy, rising volatility in global financial markets and soaring food & fuel prices. the key driving force for growth in many east Asian countries for this period 2001-07 was domestic demand, export to markets other than united states, capital flows also recorded a huge upsurge in these economies during this period was mainly attributed to net put debt flows ($18 bn), which was amplified by a moderate increase in net equity stood at $ 117 bn up from $ 105 bn in 2006. But the regions share of FDI among developing countries in aggregate fell from 29 percent in 2006 to 26 percent in 2007; china was continuing to be a top FDI destination among developing countries.But its relative share to other countries started to decline because of the increasing importance of other important players such s India. It is also notable that FDI outflows from this region also increases for ex for china outflows increase was $ 14 bn, mainly through cross-border acquisition and investments in newly established overseas trade and economic zones. The global economic slowdown starts affecting the second half of 2007 which resulted in a sharp slowdown in global demand and sudden stop in capital inflows , growth in developing and east Asia and pacific slowed to 8 percent in 2008 from a record high of 11.4 percent in 2007 . The steep drop occurred despite policy easing and measures taken by the authorities in most countries to support the economy. with exports sharply down , companies moved to cut production and investment , the pace of economic expansion slumped further during the first quarter of 2009 & as a result capital inflows diminishes in 2008-09. After peaking in 2007, net capital inflows to East Asia and pacific began slowing in early 2008 before shifting to outflows during the second quarter in Malaysia and the NIEs and in the later part of the year in china & Indonesia. For the region as a whole, a notable decline in portfolio equity flows, bond issuance and bank borrowing was evident in 2008, while FDI retained a relatively firm tone on average, increasing by $ 10 bn in the year to $185bn. Excluding official flows, income from resident living abroad , and errors and omissions items, private capital flows to the region declines from about $280 bn in 2007 to $203bn in 2008.

ii) Europe and Central Asia: Among developing countries, Europe and central Asia has been hit hardest by the global economic and financial crisis. After years of growth over 6 percent real GDP growth in the region slowed to 4 percent in 2008 and is expected to drop to 4.7 percent in 2009, driven be a collapse in capital inflows, a sharp deterioration in terms of trade, and contraction in both domestic & external demand. The most vulnerable group of countries within the broader region, (CEE) Central & Eastern Europe, received greater shocks. In the capital markets, external financing control to decline with total gross capital flows (syndicated bank lending, bond issuance and equity initial public offerings) declines from $ 5.66 bn in the second quarter of 2008 to a merge $3.9 bn in the first quarter of 2009. Unlike Latin America and the Caribbean, East Asia and pacific, Europe and central Asia entered the global financial crisis highly dependent on foreign capital inflows. Net private inflows which stood high to $ 471.4 bn in 2007 declines to $ 250.5 bn in 2008 (as per the estimated projected)**.**
iii) Middle East: In comparison to the other developing country groups the middle east was less affected but then also in 2008-09 the growth rate of for the developing countries of the middle east declines because of the adverse external environment, such as reduced external demand from not only the US but also from Europe and Japan resulting in a drop of the growth rate from a peak of 5.7 percent in 2007 to 5.1 percent by 2010. Within this region Egypt continues to receive the largest FDI flows although the quantum declines as it was $ 10 bn in 2006 but it came down to $ 7.5 bn only in 2007.
v) Latin America and the Caribbean: Net debt flows to the region rebounded to $ 59.1 bn in 2007 after plummeting in 2006. Though gross bank lending increased only slightly to $27 bn from $19 bn in 2006, the proportion of bank lending to the region denominated in domestic currency increased dramatically, led by Brazil and Mexico. Net other private flows especially bond flows recovered from negative levels in 2006 to $ 8 bn in 2007. Similarly the net equity flows (FDI and portfolio equity) surged to $ 135 bn in2007 from $ 81.9 bn in 2006, particularly reversing a long term trend. Net FDI inflows to the region in particular, increased by $ 37 bn in 2007, raising the region`s share of FDI flows to developing countries from 19 percent in 2006 to 24 percent, strong gains came in Brazil ($16mn), Chile ($6bn), and Mexico ($ 5 bn). But despite this increase the total percentage share of this region in the total FDI inflows in developing countries was half of what it was in 1990 because of the strengthening of the EMEs & other developing Asia. In 2008-09 again the picture reverted back because of the adverse impact of the US sub-prime crisis. This region also faces a decline in net private flows especially portfolio flows. Although the strength of many countries in Latin America and the Caribbean to bear the external shocks has improved because of the improving current account positions, marked terms of trade gains, decline in public external debt, to output ratio, expansion in international reserves and more specifically the financial sector reforms, but then also the region has not been immune to the global shocks resulting in the decline in growth of capital flows in virtually all the countries in this region. Inflows of external capital from private sources dropped sharply during 2008 and countries experienced massive capital outflows in the last quarter of the year (for example Brazil recorded portfolio outflows by $30 bn and Mexico by almost $ 11 bn from 2007).

5. Framework Required to Manage International Capital Flows

Industrial and emerging market economies alike share a common interest in building a strong and safe system for global flows of capital to the extent that they take place in well-functioning, competitive markets and respond to proper price signals, capital flows contribute to an efficient, cross-country allocation of resources and risk. However, these benefits do not come without risks and potential costs, especially in the case of short-term flows. If the risk exposures associated with capital flows are not properly managed, the consequences for creditors and debtors and for global financial stability more generally can be severe. Realizing the full benefits of capital flows will require adopting policies that control the risks associated with them. In particular, abrupt portfolio adjustments can involve sudden stop or reversals of flows and sharp changes in asset prices. Recent history provides ample evidence that countries with fixed exchange rates and large amounts of short-term debt are prone to disruptive volatility of this sort, which can have systemic consequences. Indeed, one of the central lessons of the crises in emerging market economies over the past few years is the importance of prudent management of liquidity and other risks. However, efforts of this kind to reduce volatility need to be complemented by a prudential, risk management framework for the analysis of capital flows.

5.1. Risk Monitoring At the National Level

National authorities should have, as a clear goal, a risk management strategy that involves a system for monitoring and assessing the risks and liquidity of the economy as a whole, including at a sectoral level. Risk monitoring at the national level could be assisted by compiling a balance sheet, for the economy as a whole and for key sectors, designed to identify significant exposures to liquidity, exchange rates, and other risks. Further if controls on inflows are an option under consideration, authorities should examine the objectives of such controls and assess their costs and benefits relative to alternative means of achieving the same objective. If inflow controls are to be implemented, experience suggests that there are certain conditions for their use that can help to increase the likelihood of success:

- Controls can only serve as support for a solid macroeconomic program committed to stability. The regulations cannot avoid the over-appreciation of the currency driven by excesses in spending, or in general keep the real exchange rate permanently away from its equilibrium value. The country should have a strong external payments and reserve position.
- Controls with a prudential element are likely to work best when they are temporary and apply broadly, that is, when they do not try to make subtle distinctions amongst particular instruments.
- Implementation requires an effective and enforceable system of foreign exchange regulations. Authorities should impose rules in a transparent and nondiscriminatory way, without privileged sectors, groups or institutions.

- A fundamental requirement for capital controls to work is an adequate system of information on the universe of foreign exchange transactions, including both those subject to regulation and those that can be undertaken outside them.

5.2. Risk Management by the Public Sector

Recent experience has highlighted the need for governments to limit the build-up of liquidity exposures and other risks that make their economies especially vulnerable to external shocks. To this end, sound risk management by the public sector warrants high priority. Effective Policy on official reserves and foreign currency liability management is also important for the position of the non-bank private sector, but the primary mechanism for effective risk control in this area should be improved transparency, also there is a need to develop domestic bond markets. The international institutions should help countries to identify elements of public sector risk management that deserve attention and to monitor and encourage progress in implementing those elements. Technical assistance should be provided, where warranted, by international institutions and national authorities.

5.3. Risk Management by the Banking Sector

Banks in countries receiving capital inflows - in particular, in the emerging market economies - and the international banks that extend cross-border credit, both have a responsibility to avoid any build-up of exposures that generates systemic vulnerabilities. The Basel Committee's revised guidelines on managing liquidity risk and in particular the distinction made between domestic and foreign currencies; their application to emerging market economies should be given a high profile and made a high priority by national authorities. Further guidance from the Basel Committee on how to measure and manage foreign exchange exposures is desirable, as well.

5.4. Risk Management by Non-Bank Financial Institutions and Non-Financial Institutions

National authorities should promote good corporate governance practices on the part of individual firms. Government agencies should avoid policies that distort corporate sector liability choices and, in particular, that bias corporations to engage in short-term borrowing.

5.5. Transparency

Good information is fundamental to risk management. Disclosure by participants in financial markets is, in turn, a key element in making good information available. National authorities should adopt a high level of transparency about their own risk and liquidity management strategies and operations, and about official, including regulatory, policies governing private sector risk and liquidity management. Further National authorities should promote, if necessary via corporate law, the adoption and implementation of accounting standards that require companies to disclose, in their audited report and accounts, the composition of their liabilities and financial assets, including by maturity and currency.

5.6. Data Requirements

In addition to better disclosure of the financial positions and risk management policies of market participants, better data on aggregate external financial positions are needed if investors and borrowers are to understand more fully and take better account of the risks inherent in international capital flows.

6. Conclusion

Domestic lending rates to the private sector have increased sharply in nearly all the economies after 1980s. By the end of eighties and in the beginning of nineties most of the countries of the world had liberalized their internal policies and were moving towards increased integration. In wake of WTO the movement of resources across the countries was made free and the economies were moving towards the full capital account convertibility. This increased openness resulted in a spurt of capital movement across nations and the private foreign capital flows, mainly to developing countries saw a significant increase. Strengthening macroeconomic indicators, financial sector reforms and interest rate differentials resulted in private flows, particularly FDI to surpass the official flows. The scenario exactly replicated the pre protection era of early twentieth century.

The geographical capital flows have also witnessed a movement away from Latin America to the newly emerging Asian economies. With increased capital account convertibility, the profit seeking portfolio capital flows also started to get attracted to the newly emerging Asian economies in wake of interest rate differentials.

Experience shows that any reversal of external private capital flows and depreciation in the currency tends to threaten the domestic financial stability, which translates into payment difficulties, currency turmoil and even to external debt crises. For example, the East Asian crisis of 1997 destabilized many south East Asian countries which after having a continuous trend of capital inflows witnessed huge capital outflows.

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