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Economic Viewpoint

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Where oh Where Can that Capital Be?

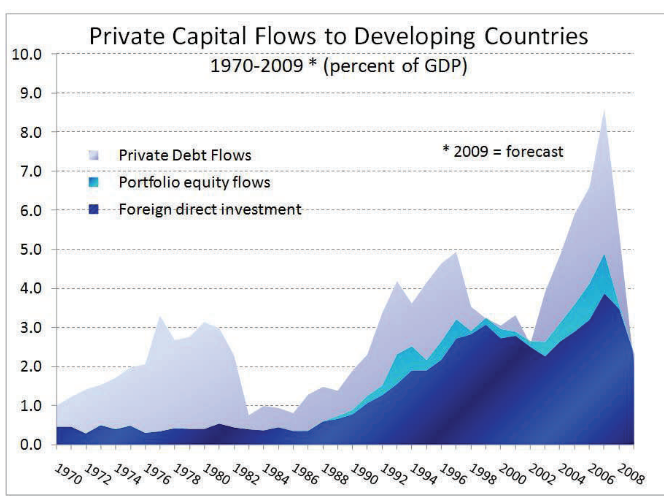
The unfortunate reality associated with the current crisis is that it will hit some capital importers very hard, not the massive reserve accumulators, but rather those countries whose corporate sectors have borrowed extensively in the flush capital markets of recent years. Estimates from the IMF indicate that non-sovereign external refinancing needs will reach close to $700 billion for Asia, $200 billion for Latin America and perhaps $400 billion for Emerging Europe in 2010—a total of at least $1.3 trillion. If unfinanced, we can expect a major debt crisis, which will not only damage debtors, but also the creditors who will be emerging from the disaster year 2009 and can ill afford to shoulder additional losses or write-downs.

The massive injection into the IMF's coffers can help, although official borrowing will undo much of the successful recovery of sovereign debt in emerging markets. Governments will be faced with the choice of either allowing their corporate sectors to sink or once again allowing themselves to become over-indebted. The only other alternative would be a massive new intermediation scheme to channel refinancing from the surplus countries and sovereign wealth fund holders to the corporates in other parts of the world.

But since the global banking community is too weak to undertake this intermediation, and international institutions too small (viz., the IFC, the World Bank's private sector arm, has a book of $33 billion), we might have to rely on bilateral arrangements. This is normally undesirable because it can take on political implications, as we have seen with Venezuela, for example. Moreover, given the fact that these rollovers will start coming due this year, the global community doesn't have time, even if it could coalesce around a new idea, to swing into action. So we are stuck with existing institutions, mostly some flush central banks like China, and others like the Fed who can issue currency globally, the condition of its own balance sheet notwithstanding.

The corollary dilemma is what advice to offer developing countries for the future. Should they rely less on foreign capital? Certainly the history of capital flow cycles as shown in the attached figure is one of boom and busts. Progressively over the cycles that led to collapses in 1981, 1997 and 2008, the size of flows to GDP has risen from 3% to 5% to 8%, only to have these flows collapse. Indeed, the only relatively more stable portion of capital flows is FDI. Should advice to developing countries be to promote FDI at the expense of other more volatile forms of capital? Isn't this the very policy that Chile pursued in the late 1980s and 1990s that helped it weather the Tequila and Russia financial crises? Isn't this the policy that was pilloried by the powers that be at the time and ultimately abandoned? Yes it was. The additional reserve requirement on short-term flows was a smart idea then and now.

Finally, it must be noted that given the risks associated with external finance, countries may wish to put more effort into domestic tax collection, and also into domestic capital market development. The latter requires greater certainty for investors. It is not irrational for Latin Americans to save in Miami or East Asians to save in Singapore. Governance concerns abound and frequent confiscations of savings or pensions don't inspire trust. Domestic capital markets may be part of the longer term solution, but first we must manage the next few years and finds ways to recycle capital.



*The views expressed here are personal and do not represent necessarily the position of either the World Bank Group or its Board of Executive Directors. Comments can be sent to *Dannyleipziger@gmail.com.*