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Why capital flows in low-income countries are so low?

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Why capital flows in low-income countries are so low?

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Learned observations about less developed countries indicate that their capital markets are immature and commonly plagued by informational and other problems such as absence of international disclosure standards and regulatory forbearance in recognizing the extent of bad loans. As the economies develop over time, these problems can be mitigated in one way or another but they are still very much in presence to drive noticeable differences among the various means of investment financing. Indeed, although the major three types of net private capital flows into developing countries, viz., foreign direct investment (FDI), portfolio equity flows, and debt flows, co-move and are trending upward, their magnitudes differ substantially: FDI and debt flows occupy a more prominent position than equity flows. While debt and equity flows are mainly a source of finance for investment in the capital-importing countries, FDI has other distinguishable attributes: as a means of bypassing trade barriers and of technology transfer, a way for multinationals to be close to local consumer markets, etc.

One reason for what capital today not flow in much larger quantities from rich parts of the world to low-income countries is that capital is not the only thing which is lacking in most developing countries. Labour may be plentiful, but workers in poor countries are mostly less well educated and have less training in industrial skills than their rich-country counterparts. In many countries, property rights are insecure and the rule of law

is unreliable. The economic infrastructure necessary to get the most out of new investment may not be there. Political risk may be a problem. For these and other reasons, switching capital from countries where there is plenty to countries where there appears to be a shortage yields smaller profits than one would suppose. (America's overwhelming advantages in all these respects help to explain why it attracts so much new capital, despite seeming to have more than it needs.)

Second, most developing countries do not let capital come and go freely. Blanket restrictions on the movement of capital are much rarer than they used to be, but assorted official or unofficial obstacles are still often put in the way of foreign investors. Despite measures to liberalize the capital markets in recent years, they are still far less open to cross-border finance than the typical developed economy.

Two other things frustrate the efforts of the developing countries to receive capital flows. One is that the main effects of openness to capital can be expected to push in opposing directions: access to capital ought to spur investment and growth, but at the same time it will expose an economy to additional economic turbulence which may slow it down. The net result will be difficult to uncover among all the other factors contending for influence.

Also, “capital flows” is a broad term. It includes quite different kinds of financial transaction: bank lending, short- and long-term; investment in public or private bonds; investment in equities; direct investment in productive capacity. Each has different implications for growth on one hand and exposure to capital-market risk on the other.

The gains from capital inflows are going to depend on exactly what kind of capital is flowing.

In a perfect capital market, all forms of capital financing are indistinguishable and there is no unique debt-equity structure within a firm or in the economy as a whole. Similarly, there is no meaningful economic difference between international debt and equity flows. In the presence of information asymmetry between the firm's "insiders" and "outsiders", however, we can derive a well-defined debt-equity capital structure for the whole economy. Under asymmetric information, the equity market may be plagued by financial problems while the debt market by possibilities of default.