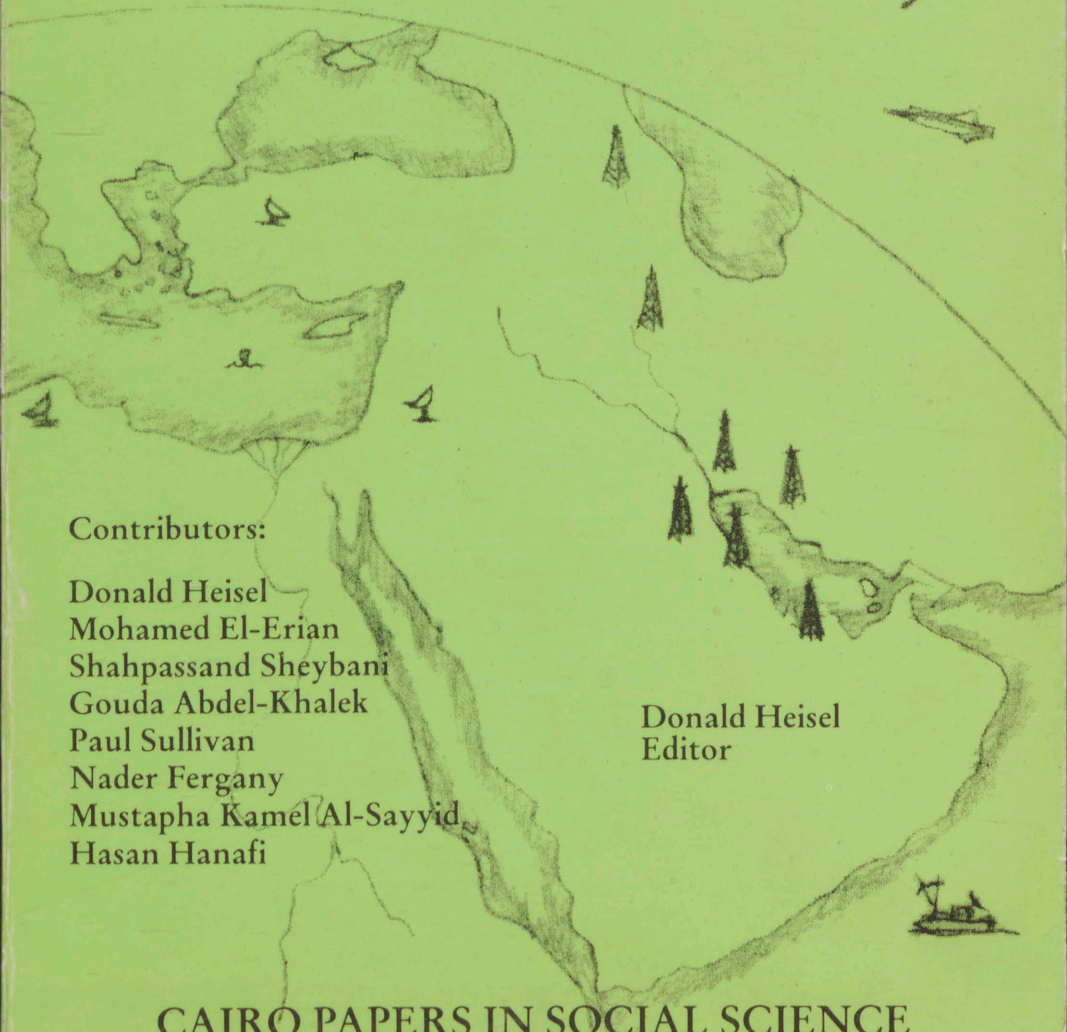
1998

Private Capital Flow in the Development of the Arab Countries

Mohamed A. El-Erian

Shahpassand Sheybani

The Middle East and Development in a Changing World



Contributors:

Donald Heisel
Mohamed El-Erian
Shahpassand Sheybani
Gouda Abdel-Khalek
Paul Sullivan
Nader Fergany
Mustapha Kamel Al-Sayyid
Hasan Hanafi

Donald Heisel
Editor

CAIRO PAPERS IN SOCIAL SCIENCE
Volume 20, Number 2

PRIVATE CAPITAL FLOW IN THE DEVELOPMENT OF THE ARAB COUNTRIES

MOHAMED A. EL-ERIAN AND SHAHPASSAND SHEYBANI[1]

The process of globalization and integration of the world economy has been accompanied by a dramatic change in the nature of capital flows to developing countries. Private flows now overwhelm official financing. Within private flows, foreign direct and portfolio investments dominate commercial bank lending. We have also witnessed important institutional changes including wide-ranging linkages between firms in industrial and developing countries and direct access to each other's equity and bond markets.

These developments have important implications for developing countries. They offer these countries a broader range of financing sources to help fund productive investments and enhance the development process. At the same time, they expose the countries to a set of risks, which, if improperly handled, can disrupt their economies. It is therefore essential to understand how best to realize fully the benefits of the evolution in capital flow while minimizing the risks.

These issues are of particular relevance to the Arab countries as they step up their efforts to take advantage of the changes in the world economy. Thus, while several developing countries experienced a large increase in private capital inflows in the first half of the 1990s, the process largely by-passed the Arab region. Indeed, this was one indication of the region's tendency to fall behind in the process of globalization and integration of the world economy.

More recently, some countries in the region have embarked on strengthened policies and are attracting larger amounts of private capital--from foreign sources as well as in the form of repatriation of resident capital held abroad. This capital supplements domestic savings in financing the

[1] The views expressed here are those of the authors and not necessarily those of the International Monetary Fund. The authors would like to thank Ilsa-Marie Fayad, Peter Kunzel, and Binta Terrier for their research assistance.

large investment needs. Other countries in the region are increasingly recognizing the risk of being marginalized in the process of globalization and are taking steps to formulate an appropriate policy response.

The purpose of this paper is to shed some light on the changing nature of the Arab countries' relations with the international capital markets. Accordingly, it documents recent developments and assesses in an international comparative framework the prospects for the region to benefit more from the changes in international capital markets while minimizing the risks.

The paper is organized as follows: The following section reviews the recent evolution of private capital flows. This provides the framework for the next section's analysis of the Arab countries' interaction with international capital markets. The last section presents concluding remarks.

The International Setting

Over time, the main sources of foreign capital available to developing countries have included commercial bank loans (voluntary and concerted), foreign direct and portfolio (bond and equity) investments, plus official bilateral and multilateral assistance. Notwithstanding the wide range of foreign sources of capital, certain types of flows have tended to dominate particular periods. For example, we have recently witnessed a marked increase in portfolio investment flows to developing countries.

Several factors are responsible for the changing nature of private capital flows. They range from institutional factors to developments in the circumstances of industrial countries (Calvo, Liederman and Reinhart, 1993; El-Erian, 1992a; Khan and Mathieson, 1996). Policy changes in developing countries--particularly those that liberalized their financial markets, privatized public enterprises and, more generally, took measures to enhance the return to private investment--have also played an important role. The result has been an increased availability of capital to certain countries for expanding their productive base. Also, as vividly illustrated by the Mexican crisis of 1994, there has been an associated risk of disruptive capital movements, with adverse effects on employment and growth--including through contagion effects.

The Changing Nature of Private Flows to Overall flows

The surge in capital flows to developing countries in the first half of the 1990s, mainly in the form of private nondebt-creating capital (i.e., direct and portfolio investments), contrasts sharply with the experience of the 1970s and the early 1980s when flows were dominated by voluntary commercial banks loans. These loans declined sharply with the onset of the 1982 debt crisis triggered by Mexico's failure to meet scheduled debt service obligations. Net commercial bank loans to developing countries, which had averaged about US$40 billion a year between 1975 and 1982, dropped to US$7 billion in 1985, and averaged about US$18 billion a year over the 1983-1989 period.

With the drying up of new voluntary flows in the early 1980s, the emphasis of the international debt strategy focused initially on the need to relax liquidity pressures. For commercial bank indebtedness, this was achieved through the rescheduling of principal obligations and concerted new private loans to refinance interest payment (in some cases in conjunction with lending and some debt rescheduling by international financial institutions).[2] Later, the focus shifted toward addressing the more fundamental solvency issue through a major restructuring of contractual debt obligations involving debt reduction. The greater use of debt and debt service reduction instruments was facilitated by official support under the "Brady Plan".[3]

These operations alleviated concerns about debt overhang,[4] expanded the liquidity of the secondary market for debt claims, and played a critical role in defining the nature of subsequent private flows to developing countries. Total net flows to developing countries which had averaged about US$37

---

[2] Official bilateral creditors also provided debt reschedulings, principally under the auspices of the Paris Club.

[3] For details see El-Erian (1992b) and Griffith-Jones (1989).

[4] Under normal circumstances, borrowed funds are invested in projects that yield a rate of return at least as high as the interest rate charged on the loan, thereby increasing national income and the capacity to service the additional debt incurred. However, when the external borrowing is not put into productive uses and debt-servicing requirements end up absorbing most of the external resources generated by the country, then incentives to invest are weakened as the perception arises that benefits from improved policy, if realized, would accrue largely to creditors. It is this disincentive problem that is at the root of the debt overhang concerns. For more details, see Dooley et. al (1990).

billion a year in 1983-89 rose significantly to about US$150 billion a year in the 1990-95 period (Chart 1). The total includes exceptional financing. The notable difference between the 1970s and 1980s lies in the increasing share of exceptional financing from about US$ 6 billion a year during the 1970s to US$ 35 billion a year in the 1980s.

The Increasing Importance of Private Foreign Direct and Portfolio Investment Flows

The increase in capital flows in the first half of 1990 reflected mainly a sharp rise in private capital flows, comprising net direct investment, net portfolio investment, and other net private flows including short-term capital. Specifically, after registering net outflows throughout the 1970s and 1980s, annual private capital inflows to developing countries averaged some US$110 billion in the first half of the 1990s. By comparison, net borrowing from official creditors and commercial banks, which had constituted the bulk of capital inflows in the 1975-82 period (averaging about US$60 billion a year), declined to US$40 billion a year in the 1990s.

The increased private flows was accompanied by a marked increase in net foreign direct investment--from an annual average of about US$10 billion in 1975-1989 to about US$50 billion a year in the 1990-95, with a sharp increase in the latter years of the second period (Chart 2). The impact on developing countries went well beyond the financing contribution, involving also transfers of technology and managerial techniques. Indeed, foreign direct investment has been shown to be an important contributor to the process of capital stock upgrading and investment efficiency gains.

Another significant development in recent years has been the rapid growth of net portfolio (bond and equity) flows--from an annual average of US$3 billion in 1975-1989 to almost US$50 billion in the first half of the 1990s (Chart 3). Equity related flows to developing countries have taken a number of forms. These include direct investor flows to equity markets in developing countries, purchases of developing market equities through pooling vehicles (such as country, regional and sector-specific mutual funds), and placement of developing country equities on industrial country markets. Whereas in the late 1980s equity flows to developing countries were mainly through country-specific and multicountry funds, an important source of recent flows has been equity offerings by developing country corporations on industrial country stock markets or direct investment by institutional investors.[5] Other private flows (mainly short-term flows) turned from outflows in the 1970s and 1980s averaging about US$25 billion a year to inflows in the 1990s, averaging more than US$15 billion a year.

Geographical Distribution

The global numbers mask an important regional and intra-regional concentration of capital. The Asian and the Latin American countries have been the main recipients of the recent surge in private capital flows, accounting for about 70 per cent of total net private flows to developing countries in the 1990-95 period. In addition, capital flows to the countries in transition increased sharply in 1995 to US$ 30 billion, up from US$ 11 billion in 1994.

In Asia, notably China, private inflows predominantly took the form of foreign direct investment flows (averaging about US$40 billion a year in 1990-95). Intra-regional foreign direct investment, notably by residents of Hong Kong and Taiwan Province of China, has also grown significantly. In Latin America, in particular Mexico (prior to 1995), a large portion of private inflows were accounted for by portfolio investment (averaging more than US$20 billion a year in 1990-95).

Within the general framework discussed in the following subsection, the different patterns of capital flows to these two regions can be attributed to a number of factors. In the Asian countries these include relatively faster growth rates and more attractive investment climates (in particular, more flexible goods and labor markets).[6] In Latin America, more developed securities market and greater range of instruments through which foreign funds can be invested have been instrumental in attracting portfolio capital.

---

5 For more details, see El-Erian and Kumar (1994).

6 Annual growth rates in the Asian countries averaged about 81/2 percent in the 1990s as compared to 3 percent in Latin America.

Contributing Factors

Several factors have contributed to the changing pattern of capital flows. From a country perspective, they have included (i) an improved enabling environment because of strengthened macroeconomic policies and structural reforms; (ii) progress in reducing external debt burdens which inhibited access to international capital markets for many developing countries throughout much of the 1980s; and (iii) deregulation of financial markets, improvements in institutional and legal procedures, and privatization.

The recent experience with private capital flows to developing countries underscores the importance of improved macroeconomic and structural reform policies. In general, developing countries that have adhered to sound macroeconomic policies have been able to deepen considerably their access to international capital markets. Similarly, concerted efforts to implement economic adjustment programs in countries that have encountered difficulties have been rewarded by a resumption of market access in most cases--sometimes, much faster than anticipated but also in a more volatile manner.

Appropriate macroeconomic policies alone may not be sufficient to attract significant private capital flows. A broad range of structural reforms also needs to be implemented to create attractive investment opportunities. Equity flows, in particular, respond to developments in the corporate sector and in market infrastructure. As part of this climate, firms need assured access to foreign currency for imported inputs and the freedom to remit dividends and profits and to repatriate capital. Other important factors include a well-established and clear legal and regulatory framework; a transparent and nondistortionary taxation system; a stable and well supervised and regulated domestic financial system; and adequate infrastructure, including transportation and telecommunications.

Trade liberalization, particularly the ability to import both capital goods and intermediate inputs, has also influenced the willingness of foreign investors to engage in long-term investment. Trade liberalization has also increased the attractiveness of some developing countries as low-cost locations for labor-intensive products: Indonesia, Malaysian, Thailand and China have all benefited from the relocation of labor-intensive industries. Extensive deregulation and liberalization of domestic financial markets have improved the allocation of saving in many developing countries and have lowered both explicit and implicit taxation on investment and raised rates of return. These reforms have also supported the growth and development of stock markets, which has contributed to the mobilization of domestic saving and helped to provide investment capital at a relatively low cost.

A particularly important feature of recent structural reforms has been the privatization effort. In many developing countries, privatization has attracted large private capital inflows--both in the form of foreign direct investment (including initially through "anchor investors") and through the domestic stock market. In turn, the resulting broadening of the stock market and, more generally, the increased interest of foreign investors have facilitated the expansion of the privatization programs, including their extension to large scale utilities.

Finally, a number of developing countries have enhanced their access to foreign capital through judicious financial engineering. For example, several Latin American countries have been able to tailor their financial instruments to specific markets or investor segments. Keys aspects have included the placement of an appropriate "benchmark" instrument (on the basis of which subsequent issues were priced off) and incorporating features that address particular credit risk concerns.

The focus so far has been on changes in developing countries. It is also important to note that institutional changes in industrial countries have made an important contribution in allowing a broadening of the investor base to include large institutional investors--thereby supplementing venture capital and repatriation of flight capital.

Financial deregulation in industrial countries has resulted in increased international capital mobility by reducing (de-facto and de-jure) the cost of transacting in developing country instruments. Analytical work in this area has noted such changes as the approval in the United States of "Regulation S" and "Rule 144a," as well as changes in Japan. These developments lowered the cost of placing developing country instruments on industrial country markets, including through what has become an extensive use of equity-based ADRs and GDRs (American and Global Depository Receipts).

Better information flows have also facilitated the process. An increasing number of developing countries now have credit ratings issued by recognized and respected international agencies. Several of these countries have placed benchmark sovereign issues on the market, thus not only providing for continuous flow of information on market risk assessment but also establishing a basis for the pricing of issuance of instruments by their private sectors.

Finally, and as clearly demonstrated in the work by Calvo and his colleagues (1993a), cyclical factors in industrial countries have played an important role. The cyclical downturn in economic activity and the decline in interest rates in the large industrial countries contributed to the surge in capital flows to developing countries in the early 1990s. The impact of industrial country interest rates on the market conditions facing developing countries was vividly illustrated in February 1994 when an uptick in interest rates led to some, albeit temporary, redirection of capital.

Implications

Conventional wisdom maintains that greater international financial integration is beneficial to recipient countries. It eases the external financial constraints, pushes down domestic interest rates, and thereby supports higher investment and growth. Other potential externalities include improved financial intermediation resulting from the increased liquidity and efficiency of developing country financial markets, and a transfer of expertise and technology.

At the same time, large inflows of capital, if unmatched by appropriate policy responses, can become a cause for concern. Depending on the nature of the capital flows, they can place pressures on financial market infrastructure and induce inflationary pressures and appreciation of the real effective exchange rate. This is particularly the case for portfolio capital.[7]

Moreover, market turbulence triggered by the recent Mexican crisis illustrated that, with a more open capital account, policy slippages will translate more quickly into capital outflows and the economy becomes more vulnerable to shifts in investors' sentiment. These risks are most acute for the country experiencing the slippage but also, under certain circumstances, can impact other countries through unfavorable contagion effects. Of course, by the same token, by increasing the immediate cost of slippages, capital market integration should impose greater discipline on policy makers.

---

[7] For a detailed analysis of the impact of capital flows in a number of countries, see Schadler et al (1993).

Experience has shown that large capital inflows can lead to a widening of the current account deficit. If the larger deficit reflects higher consumption rather than investment, then such financing is ultimately unsustainable. However, under any circumstances, strong growth of domestic demand will place pressure on the real exchange rate to appreciate which, if not matched by productivity gains, reduces external competitiveness and exacerbates the deterioration of the current account. These risks are likely to be most serious where the capital inflows are of a relatively short-term and speculative nature. In contrast, when the inflows are of a longer-term nature, they can reinforce policies aimed at achieving a solid economic performance. Policy makers face a dilemma, however, for it is difficult for them to differentiate on a timely basis between these two types of capital, let alone discourage one type while encourage larger inflows of the other.

A common problem is the capacity of the financial markets, particularly of the banking system and the equity market, to effectively intermediate large volumes of capital inflows. Many developing countries have longstanding distortions in their financial sector. Intermediation of large capital inflows tends to exacerbate the costs of these distortions while placing a premium on strong prudential regulation and supervision. The challenge is particularly acute where deposit insurance schemes and inadequate capital requirements effectively shield banks from the true opportunity costs of their increased liabilities.[8] The banking crises experienced by a number of developing countries--while not all related to capital inflows--serve as an important reminder to policy makers of the importance of tackling this challenge.

Thus, to ensure the best use of sustained high capital inflows, a recipient country needs to maintain a healthy mix between risks and returns through responsive adaptations in the policy stance. This means: strengthening the capacity to monitor the nature and magnitude of the flows in a timely manner; improving the flow of information to the markets so as to minimize the risk of disruptive market responses; and implementing quickly the needed policy adaptations.

The appropriate policy response depends on three elements. First, on the composition of inflows; second on the availability and flexibility of policy

---

[8] For a more detailed discussion see the 1995 edition of the International Monetary Fund *International Capital Markets Report*.

instruments; and third, on the robustness of the financial system including the regulatory and supervisory environment. In its simplest configuration, the policy response needs to consider: the appropriateness of the fiscal/monetary/exchange rate policy mix; the interaction between structural reforms and capital inflows; and the attractiveness of "sand in the wheels" instruments, including those aimed at slowing down capital inflows through implicit and explicit taxation such as the "Tobin Tax". Most recently, these instruments have been used in Thailand in the form of a tax on short-term bank deposits associated with capital inflows.[9]

As regards the policy mix, most analysts agree that a tighter fiscal policy--especially lower government expenditure--can limit the pressure on the real exchange rate. Not surprisingly, therefore, efforts to reduce fiscal deficits have constituted an important element of the policy arsenal of Asian countries that have experienced large capital inflows. The question arises as to what extent classic sterilization measures (entailing higher interest rates) and exchange rate appreciation should also be used extensively. Both Asian and Latin American countries engaged in sterilized intervention to mitigate the impact of capital inflows on money and credit. As both can ultimately act as a discouragement to growth, the decision depends not only on the assessment of the durability of the capital inflow but also on how far the economy is from full capacity. Finally, large capital inflows provide many countries an opportunity to increase the pace of structural reforms--in particular, privatization and liberalization of the trade and payments regimes.

The Arab Countries' Linkages with International Capital Markets

Until very recently, the Arab region's linkages with international capital markets were limited at the aggregate level and unevenly distributed within the region. As often noted in the literature, the region as a whole has attracted less than 1 per cent of equity capital flowing to developing countries from industrial country investors--a magnitude that is disproportionately low when account is taken of the region's importance in the world economy.

---

[9] For a discussion of various policy responses, see Schadler et al (1993) and Koenig (1996).

Historically in terms of aggregate flows, the Arab region witnessed net outflows of capital, averaging US$8 billion a year in the 1970s and early 1980s. This reflected the traditional balance of payments structure of the oil producing countries where large current account surpluses were associated with investments abroad--including a significant amount undertaken by the private sector (see Abiscourour, 1994 and Azzam, 1995). Indeed, during this period, external borrowing from official creditors and banks (mainly by the non-oil economies in the region and averaging about US$10 billion a year) was heavily out paced by the private capital outflows (averaging US$17 billion a year). Partial data also indicate that only a very small portion of the private capital outflow from certain countries in the region was invested in other countries in the region.

The trend of net capital outflows was reversed in the first half of the 1990s, with the region as a whole registering a net inflow of capital averaging about US$25 billion a year. This reflected mainly a marked increase in net private short-term inflows (averaging US$23 billion a year).

These global developments, however, conceal important intra-regional differences. Net capital flows to the non-oil economies in the region were historically dominated by borrowing from official creditors, averaging about US$6 billion a year in the 1975-89 period. In the first half of the 1990s, while net capital flows remained modest, a notable change in the composition of flows occurred, reflecting the marked increase in foreign capital interest in several countries in the region. Direct investment inflows (mainly to Egypt, Lebanon, Morocco, and Tunisia) almost doubled to US$2 billion a year, while net private short-term capital inflows compensated for a decline in net new external lending by official creditors.

The Arab oil economies experienced net outflows averaging more than US$13 billion a year during the 1970s and early 1980s. Recent inflows to the region, averaging more than US$20 billion a year in the first half of the 1990s, coincided with a period of low oil prices and external borrowing following the Gulf crisis (particularly two large syndication bank loans contracted by Kuwait and Saudi Arabia, the bulk of which have now been paid back according to schedule).

What distinguishes the recent experience of the Arab oil producers (and most Arab countries more generally) from that of the emerging market economies is that they have been largely bypassed by the process of globalization and integration of international capital markets. With about 25 per cent of global net private capital directed to the region in the first half of 1990s, the bulk of the inflows remained in the form of short-term capital.

The Arab region has attracted only a modest amount of foreign direct investment.[10] Since the mid-1980s, FDI has fluctuated between one-half and three-quarters of 1 per cent of GDP--well below the level of countries in Asia and Latin America (Chart 4). Moreover, the FDI directed to the Arab region has been concentrated in the energy sector.

The relatively disappointing experience with foreign direct and portfolio capital is part of the broader investment/growth picture--one that is slowly changing for the better. The Arab region's investment levels have been too low (Chart 5), too heavily tilted toward the public sector (Chart 6), and too highly dependent on external influences. Moreover, there are indications that the efficiency of the investment undertaken has been low. These developments have contributed to the disappointing growth performance. The Arab countries' real per capita income in 1995 was below the level of 1985 at a time when developing countries as a whole registered a 40 per cent increase (80 per cent for the countries of East Asian). Given the implications for employment and living standards, it is of no surprise that achieving sustained high growth is at the top of the policy agenda for the bulk of the Arab countries.

At present, there are growing indications that Arab countries' relations with international capital markets are undergoing a healthy change. Most importantly, countries that have strengthened their economic stabilization and structural reform policies are experiencing a deepening of their relations with international capital markets. Five examples illustrate this point:

- Tunisia has met significant success in placing international bond issues on the Euro- and Samurai markets--thereby diversifying its external financing approach in the context of a prudent debt management policy.
- Egypt has seen, as of October 1996, a successful GDR placement of private sector equities in industrial markets--that of the Commercial International Bank--with a second one in the offing. Its privatization program is attracting large capital inflows and the process will be consolidated by IFC's recent decision to include Egypt in its emerging

---

[10] Details are presented in Bisat, El-Erian, El-Gamel and Mongelli (1996) with a summary discussion in IMF (1996).

market index. An immediate implication of this for Egyptian equities and bonds is increased interest on the part of developing country index funds.

- Lebanon has also placed successively sovereign bond issues and GDRs. The process is facilitating foreign sector participation in the country's large reconstruction program, including through Solidere.
- The divestiture program implemented by the Kuwait Investment Authority is attracting considerable foreign capital interest as well as repatriation of domestic capital held abroad. There are indications that policy steps aimed at reducing barriers to foreign participation in domestic financial markets would be accompanied by growing flows from industrial country investors.
- Finally, there has been a dramatic increase in the setting up of equity mutual funds directed to the region--both of the country and the regional variety.

The activity of credit rating agencies is yet another indication of the growing interest in the region. As we argued, enhanced information to the markets, when associated with sound policies, can play an important role in improving the magnitude and nature of capital flows. Several countries have been rated in the last year; the most recent was Egypt in early October 1996 by Moody's and in January 1997 by Standard and Poor's. These ratings, along with comparator data for a set of other developing countries, are provided in Table 1. Several countries in the region compare well with those in Africa, central and eastern Europe and Latin America. Specifically, some Arab countries have obtained investment grade ratings (such as Egypt, Kuwait, Oman, Saudi Arabia, Tunisia, and the United Arab Emirates) while others are very near investment grade ratings (e.g., Bahrain, Jordan and Qatar).

For the future, the change in the Arab countries' relations with the international capital markets needs to be consolidated and expanded as it holds the promise of larger inflows of foreign direct and portfolio investments--thereby supplementing domestic savings in financing productive investments. The region's development process would thereby benefit--not only from the additionality of resources but also as a result of the associated transfer of technology and managerial know-how adapted to the requirements of the region.

It is clear from our argumentation that policy makers in the region must exploit and build on the opportunities offered by the evolving relations with international capital markets while minimizing associated risks. Given the heterogeneity of the countries in the region, specific policy priorities vary from country to country. Nevertheless, some general remarks are warranted--remarks that have a broader relevance in the context of countries' attempts to exploit fully their considerable economic potential.

First, countries in the region must ensure the maintenance of a strong enabling environment to allow first, for high sustained capital inflows, and second, their channeling into larger investment in physical and human resources. After all, it is such investment that holds the key to sustained high economic growth, lower unemployment and improved living standards. As previously noted, this implies the maintenance of sound macroeconomic policies and the deepening and widening of reforms.[11] Several countries in the region are already well advanced in the policy formulation and implementation process; others are at an earlier stage of formulation of a comprehensive policy approach.

Second, the policy stance must not only aim to secure high and sustainable capital inflows but also to manage the challenges of such success. Again as noted before, this involves close monitoring of the nature and magnitude of the capital inflows and related impact on the financial market structure. It also entails timely policy responses to minimize excessive aggregate demand pressures that can ultimately erode a country's competitiveness. The first line of defense involves adaptation in the mix of fiscal/monetary/exchange rate policies and the intensification of structural reforms.

Third, for the process to be sustainable, it must be supported by strengthened institutions and information flows. Institutions play a critical role in defining the nature and effectiveness of the economic development process. International experience confirms the importance of an institutional base that is transparent, predictable, responsive and, to the extent possible, insulated from the vagaries of the political process. At the same time, a sound and timely flow of accurate information between economic management agencies, as well as to the markets, can enhance the effectiveness of economic and financial policies. Such a flow can help minimize the information failures that many countries suffer from, allows

---

[11] Specific policy measures are discussed in El-Erian, Eken, Fennel and Chauffour (1996).

for effective policy coordination, and reduces the risk of ill-informed and ultimately destabilizing market behavior.

Concluding Remarks

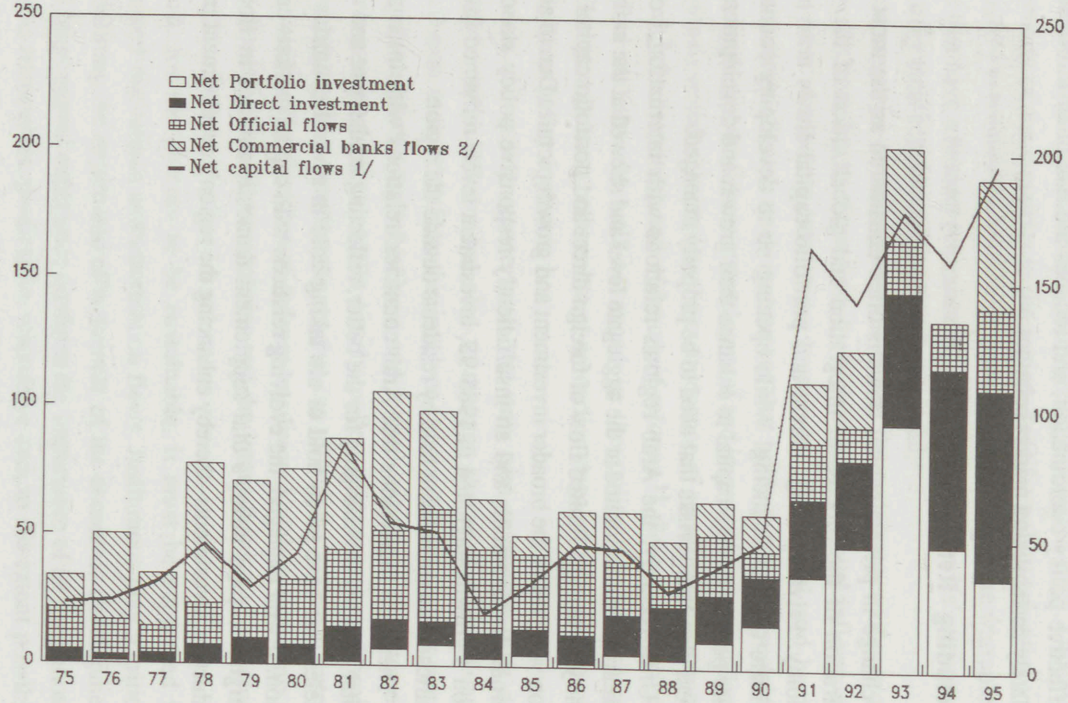
The change in private capital flows is often considered as the most vivid illustration of the process of integration and globalization of the world economy. Private foreign direct and portfolio capital flows now totally dominate official financing. While opening up to developing countries a greater pool of foreign capital to enhance their growth and development, this process also entails risks that need to be properly managed.

Until recently, the Arab region's relations with international capital markets have been limited at the aggregate level and skewed at the individual country level. The limited flow of foreign direct and portfolio capital to the region was part of the broader investment and growth picture. Due to adverse external developments and an insufficiently responsive policy stance, the region's growth stagnated in 1985-95, investment levels remained low, and significant resources were held by residents outside the region.

There are indications that Arab countries' relations with international capital markets are changing for the better, reflecting adjustment and reform policies that have taken hold or are taking hold in several countries in the region. If well managed, the evolving relations with capital markets can lead to higher capital inflows that supplement domestic savings in financing productive investments--thereby enhancing the region's development process.

CHART 1

COMPOSITION OF NET CAPITAL FLOWS TO DEVELOPING COUNTRIES
(In Billions of US Dollars)



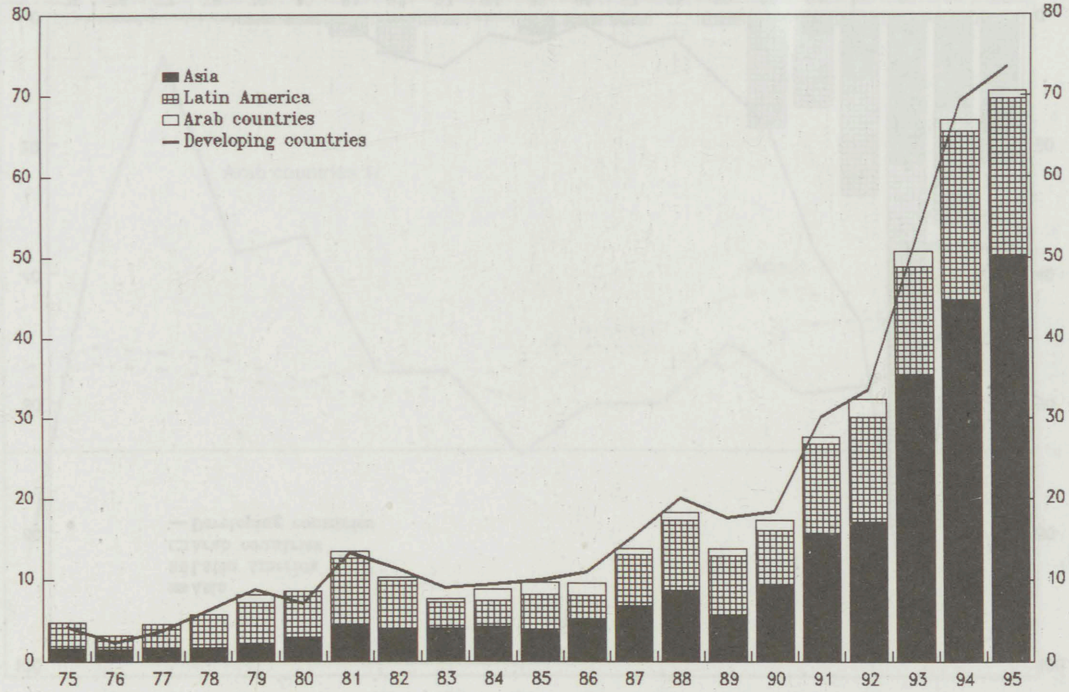
Source: World Economic Outlook.

1/ Excludes net official reserves. But includes exceptional financing and other, mainly short-term, net investments.

CHART 2

NET DIRECT INVESTMENT FLOWS TO DEVELOPING COUNTRIES

(In Billions of US Dollars)

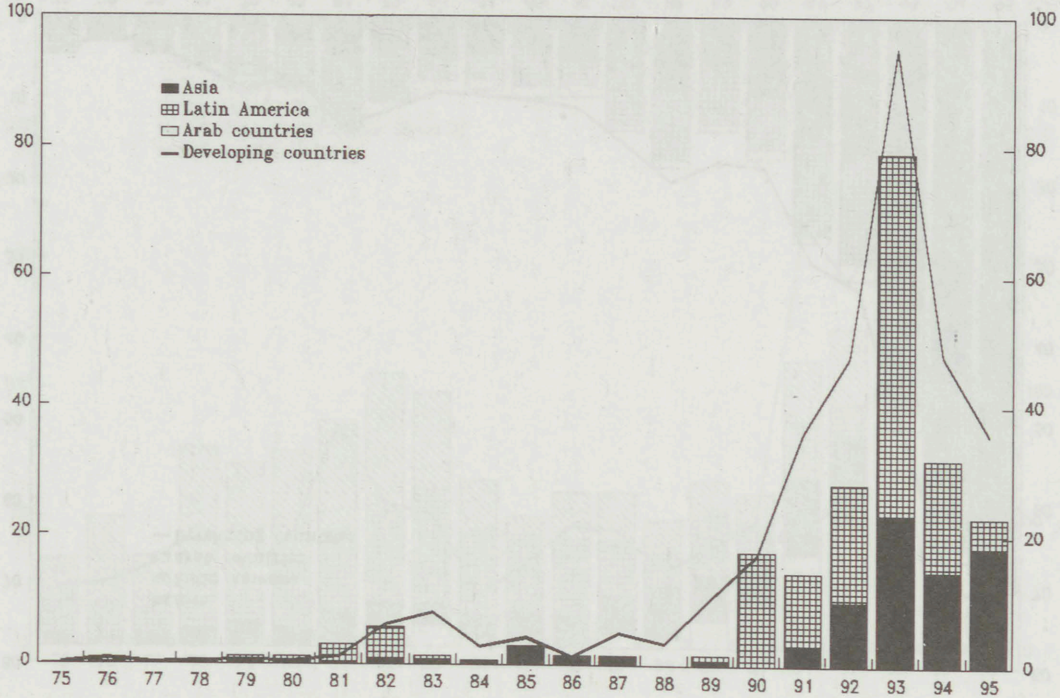


Source: World Economic Outlook.

CHART 3

NET PORFOLIO INVESTMENT FLOWS TO DEVELOPING COUNTRIES

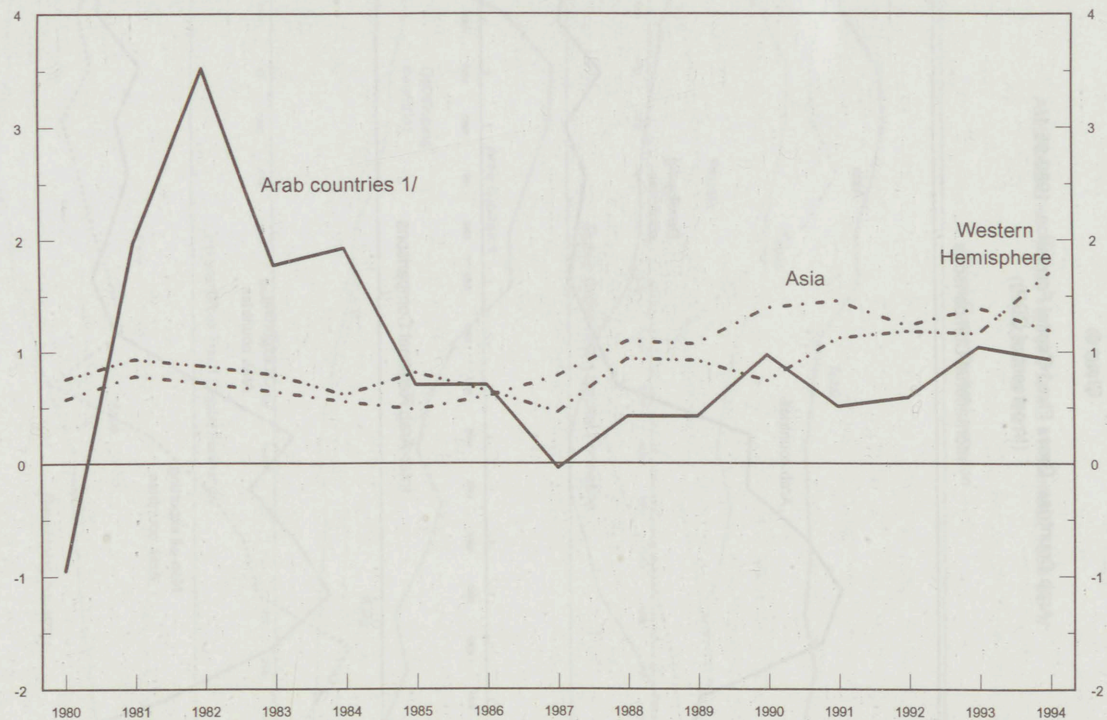
(In Billions of US Dollars)



Source: World Economic Outlook.
1/ Net portfolio flows to Arab countries have been negative throughout most of the period.

Chart 4

Foreign Direct Investment, 1980-94
(In percent of GDP)

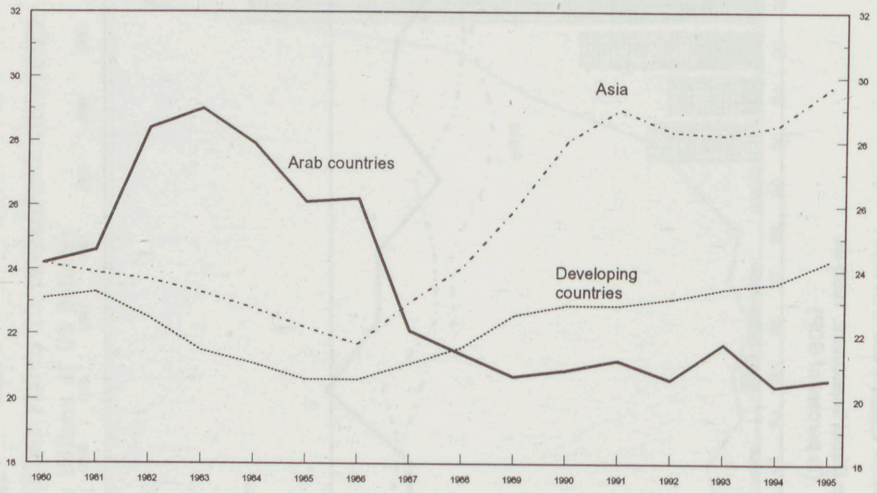


Source: World Economic Outlook.
1/ Excludes Djibouti, Lebanon, Qatar, and U.A.E., as data was not available.

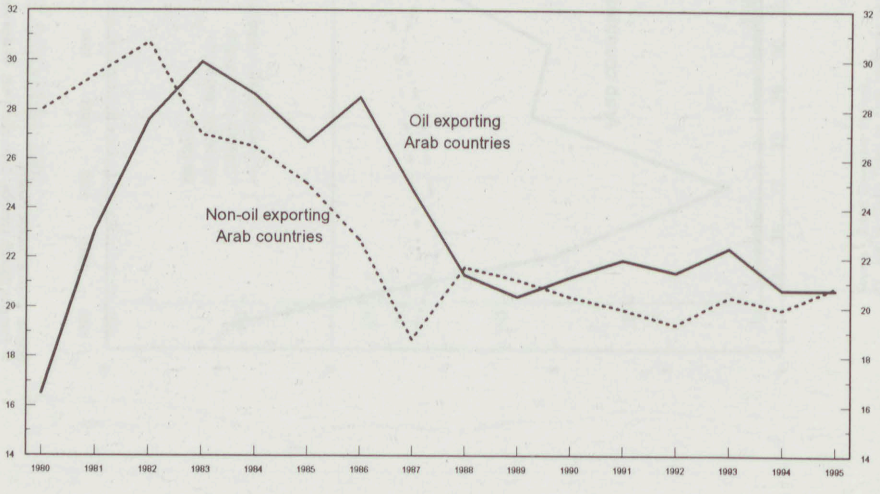
Chart 5

Arab Countries. Gross Fixed Capital Formation, 1980-95 1/
(In percent of GDP)

International Comparisons



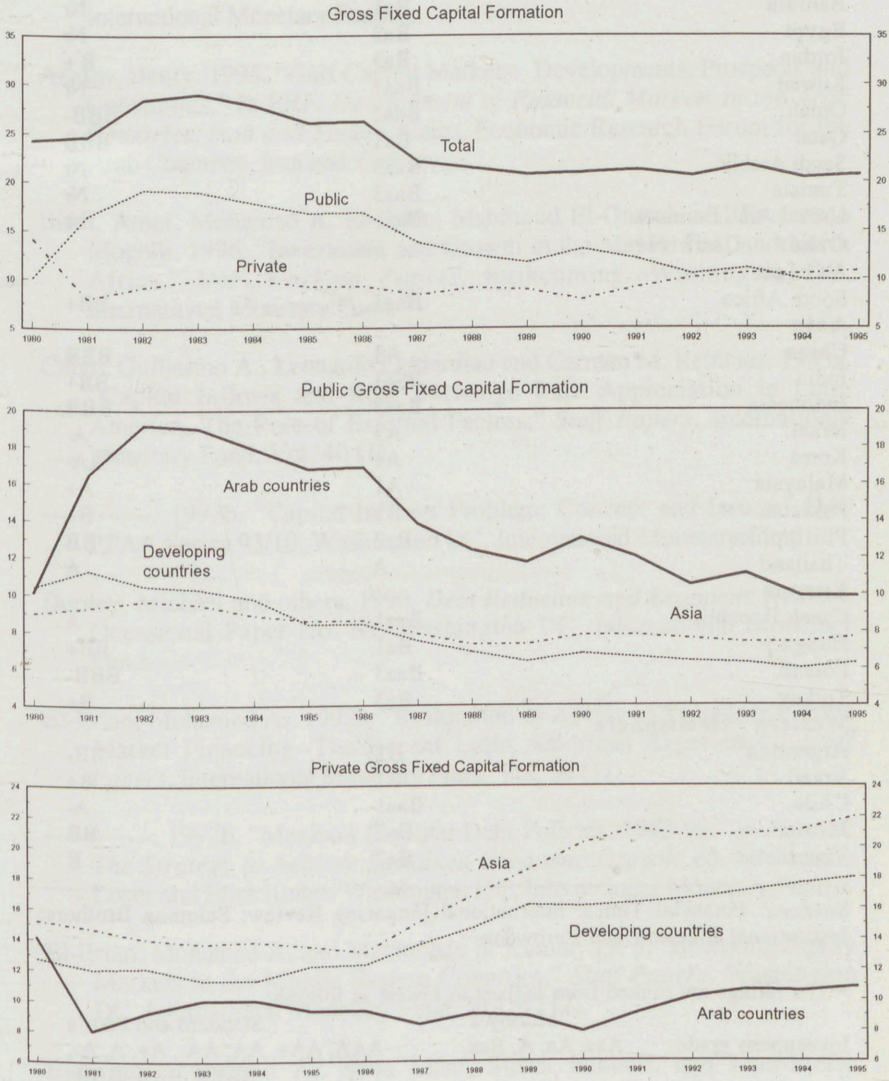
Inter-Arab Regional Comparisons



Source: World Economic Outlook.
1/ Excludes Bahrain, Djibouti, Lebanon, Libya, Qatar, Sudan and Yemen, as data was not available.

Chart 6

Arab Countries. Public versus Private Investment, 1980-95 1/
(In percent of GDP)



Source: World Economic Outlook.
1/ Excludes Bahrain, Djibouti, Lebanon, Libya, Qatar, Sudan and Yemen, as data was not available.

Table 1. Sovereign Credit Ratings*

	Moody's	Standard and Poor's
Arab Countries		
Bahrain	Ba1	Nr
Egypt	Ba2	Nr
Jordan	Ba3	B+
Kuwait	Baa1	Nr
Oman	Baa2	BBB-
Qatar	Ba1	BBB
Saudi Arabia	Baa3	Nr
Tunisia	Baa3	Nr
United Arab Emirates	Baa1	Nr
Other Countries		
Africa		
South Africa	Baa3	BB+
Asia		
China	A3	BBB
India	Baa3	BB+
Indonesia	Baa3	BBB
Israel	A3	A-
Korea	A1	AA-
Malaysia	A1	A+
Pakistan	B1	B+
Philippines	Ba2	BB
Thailand	A	A
Europe		
Czech Republic	Baa1	A
Hungary	Ba1	BB+
Poland	Baa3	BBB-
Turkey	Ba3	B+
Western Hemisphere		
Argentina	B1	BB-
Brazil	B1	B+
Chile	Baa1	A-
Mexico	Ba2	BB
Venezuela	Ba2	B

Sources: Financial Times; International Financing Review; Salomon Brothers; Institutional Investor; and Euroweek.

* The ratings are ranked from highest to lowest as follows:

	Moody's	Standard and Poor's
Investment grade	Aaa, Aa, A, Baa	AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-
Noninvestment grade	Ba, B	BB+, BB, BB-, B, B-
Default grade	Caa, Ca, C, D	CCC+, CCC, CCC-, CC, C

In addition, numbers from 1 (highest) to 3 are often attached to differentiate borrowers within a given grade.

Bibliography

Abisourour, Ahmed. 1994."The Emerging Arab Capital Markets: Status, Role and Development Prospects," in *Financial Policies and Capital Markets in Arab Countries*, ed. by Said El-Naggar. Washington DC, International Monetary Fund.

Azzam, Henry. 1995. "Gulf Capital Markets: Developments, Prospects and Constraints," in ERF, *Development of Financial Markets in the Arab Countries, Iran and Turkey*. Cairo, Economic Research Forum for the Arab Countries, Iran and Turkey.

Bisat, Amer, Mohamed A. El-Erian, Mahmoud El-Gamal, and Francesco Mogelli. 1996. "Investment and Growth in the Middle East and North Africa," *IMF Working Papers*, forthcoming. Washington DC, International Monetary Fund.

Calvo, Guillermo A., Leonardo Leiderman and Carmen M. Reinhart. 1993a. "Capital Inflows and Real Exchange Rate Appreciation in Latin America--The Role of External Factors," *Staff Papers*, International Monetary Fund, Vol. 40 (1).

------------. 1993b. "Capital Inflows Problem: Concept and Issues," IMF PPAA Series 93/10. Washington DC, International Monetary Fund.

Dooley, Michael and others. 1990. *Debt Reduction and Economic Activity*, Occasional Paper No. 68. Washington DC, International Monetary Fund.

El-Erian, Mohamed A. 1992a. "Restoration of Access to Voluntary Capital Market Financing--The Recent Latin American Experience," *Staff Papers*, International Monetary Fund, Vol. 39 (1).

------------. 1992b. "Mexico's External Debt Policies, 1982-90," in *Mexico: The Strategy to Achieve Sustained Economic Growth*, ed. by Claudio Loser and Eliot Kalter. Washington DC, International Monetary Fund.

El-Erian, Mohamed A. and Manmohan S. Kumar. 1995. "Emerging Equity Markets in the Middle Eastern Countries," *Staff Papers*, Washington DC, International Monetary Fund, Vol. 42 (2).

El-Erian, Mohamed A., Sena Eken, Susan Fennell, and Jean-Pierre Chauffour. 1996. *Growth and Stability in the Middle East and North Africa*. Washington DC, International Monetary Fund.

Frankel, Jeffrey. 1994. “Sterilization of Money Inflows: Difficult (Calvo) or Easy (Reisen)?” *IMF Working Papers* 94/159. Washington DC, International Monetary Fund.

Griffith-Jones, Stephany. 1989. *Third World Debt: Managing the Consequences*. London, IF Publishing Limited.

International Monetary Fund, *World Economic Outlook* (various issues), Washington DC, International Monetary Fund.

-----------, *International Capital Markets* (various issues), Washington DC, International Monetary Fund.

------------. 1996. *Building on Progress--Reform and Growth in the Middle East and North Africa*. Washington DC, International Monetary Fund.

Khalil, Nehro. 1996. “The Five-Year Prospects for Four Arab Countries,” *Arab Banker*, Volume XII, No. 4.

Khan Mohsin S. and C. M. Reinhart. 1995. *Capital Flows in the APEC Region*, Occasional Paper No. 122, Washington DC, International Monetary Fund.

Khan, Mohsin S. And D. Mathieson. 1996. “International Capital Flows,” *International Journal of Finance and Economics*, Volume 1 (July).

Koenig, Linda M. 1996. “Capital Inflows and Policy Responses in the ASEAN Region,” *IMF Working Papers* 96/25, Washington DC, International Monetary Fund.

Schadler S., M. Carkovic, A. Bennett A., and R. Khan R. 1993. *Recent Experiences with Surges in Capital Inflows*, Occasional Paper No. 108, Washington DC, International Monetary Fund.

World Bank. 1995. *Claiming the Future*. Washington, DC, The World Bank.