This chapter describes the various types of international capital flows and discusses their benefits, as well as their risks. The key points in this chapter are:

- Capital flows have significant potential benefits for economies around the world.
- Countries with sound macroeconomic policies and well-functioning institutions are in the best position to reap the benefits of capital flows and minimize the risks.
- Countries that permit free capital flows must choose between the stability provided by fixed exchange rates and the flexibility afforded by an independent monetary policy.

Types of International Capital Flows

Not all capital flows are alike, and there is evidence that the motivation for capital flows and their impact vary by the type of investment. Capital flows can be grouped into three broad categories: foreign direct investment, portfolio investment, and bank and other investment (Chart 13-2).
Foreign Direct Investment

Foreign direct investment occurs when an investor, in many cases a firm rather than an individual, gains some control over the functioning of an enterprise in another country. This typically takes place through a direct purchase of a business enterprise or when the purchaser acquires more than 10 percent of the shares of the target asset.

A number of factors affect the flow of foreign direct investment. Trade links between investor and recipient countries tend to increase foreign direct investment, as demonstrated by the establishment of Japanese auto plants in the United States starting in the 1980s. Proximity to foreign markets also plays a role, as shown by the investment of U.S. companies in China to service Chinese consumers and firms. The political, economic, and legal stability of the recipient country also matters. Investors are reluctant to establish ownership of foreign companies or set up businesses abroad if corruption or political or social instability are likely to jeopardize operations.

In 2002, foreign direct investment made up roughly one quarter of world capital inflows. About 40 percent of these flows went to the major industrial countries—the United States, Canada, the United Kingdom, Japan, and countries in the euro zone. During much of the 1990s, the United States was the largest single recipient of foreign direct investment. Foreign direct investment flows to industrialized countries are driven largely by the desire for better distribution networks and market access. Another 30 percent of total foreign direct investment went to emerging markets. Relative to flows to industrial countries, these investments were driven more by the low production costs and growing markets of Asia, as well as the privatization of state-owned enterprises in many countries in Latin America and Eastern Europe.

Portfolio Investment

Portfolio investment occurs when investors purchase noncontrolling interests in foreign companies or buy foreign corporate or government bonds, short-term securities, or notes. This type of investment accounted for almost half of world capital inflows in 2002.

Economic and financial conditions in the recipient and investor countries are important influences on portfolio investment flows. The market for these assets is typically more liquid than that for direct investments; it is usually easier to sell a stock or bond than a factory. As a result, investors can quickly reshuffle portfolio investments if they lose confidence in their purchases. Not surprisingly, portfolio investment is far more volatile than foreign direct investment. Countries that receive large capital inflows in one year can see a quick reversal of these inflows if economic or political developments cause investors to reevaluate the expected return on their assets.
Sudden and destabilizing reversals of portfolio investment took place in countries such as Korea, Mexico, Russia, Brazil, and Argentina during the second half of the 1990s and early 2000s. These reversals partly reflected the concern that private-sector and government borrowers in emerging market economies might be unable to meet their financial obligations.

In the United States, portfolio investment in U.S. government securities has played an increasingly important role since 2001. Foreign purchases of U.S. government securities rose from 3 percent of total capital inflows in 2001 to 33 percent in the first three quarters of 2003. One of the most important factors explaining this change is a shift in the share of U.S. security purchases by foreign investors from equities into lower-risk assets, such as U.S. government obligations. Another important factor is increased purchases of U.S. government securities by foreign central banks. A decline in the number of mergers and acquisitions in the United States has also led to lower foreign purchases of private assets.

Bank Investment
Bank investment is the third major type of capital flow. Bank-related international investment includes deposit holdings by foreigners and loans to foreign individuals, businesses, and governments. These investments, grouped with a few other miscellaneous types of investments, accounted for over one quarter of total international capital inflows in 2002. For emerging markets, the importance of these bank-related and other investment flows has declined dramatically in the past decade. While these flows represented an average of 28 percent of capital inflows to emerging economies from 1992 to 1996, they represented an average of only 3 percent of inflows from 1997 to 2002. Economic crises in a number of Asian and Latin American countries since the mid-1990s have contributed to reduced bank lending to these regions since 1997, notably from banks in Japan and Europe.

Benefits of International Capital Flows
Capital flows can have a number of important benefits:

- International capital allows countries to finance more investment than can be supported by domestic saving, thereby increasing output and employment.
- Greater access to foreign markets can provide new opportunities for foreign and domestic investors to increase the return and reduce the risk of their portfolios.