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# Country and Political Risk: Supply of Capital Considerations

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# Outline

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- The Supply of Capital
- The Global Economy as a Complex System
  - Risk premia and lending maturities as a means to “take the temperature” of the system
- Transitions To Watch In The Next Decade
  - The US Fiscal Position
  - Spread of the Anglo-Saxon Model
- Practical Suggestions

# Supply and Country Risk

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- Risk assessment frameworks that focus exclusively on country issues will either overstate or understate risk
  - They will thus over-predict or under-predict crises
- The triggers for financial crises are usually supply side phenomena

# Recent Triggers

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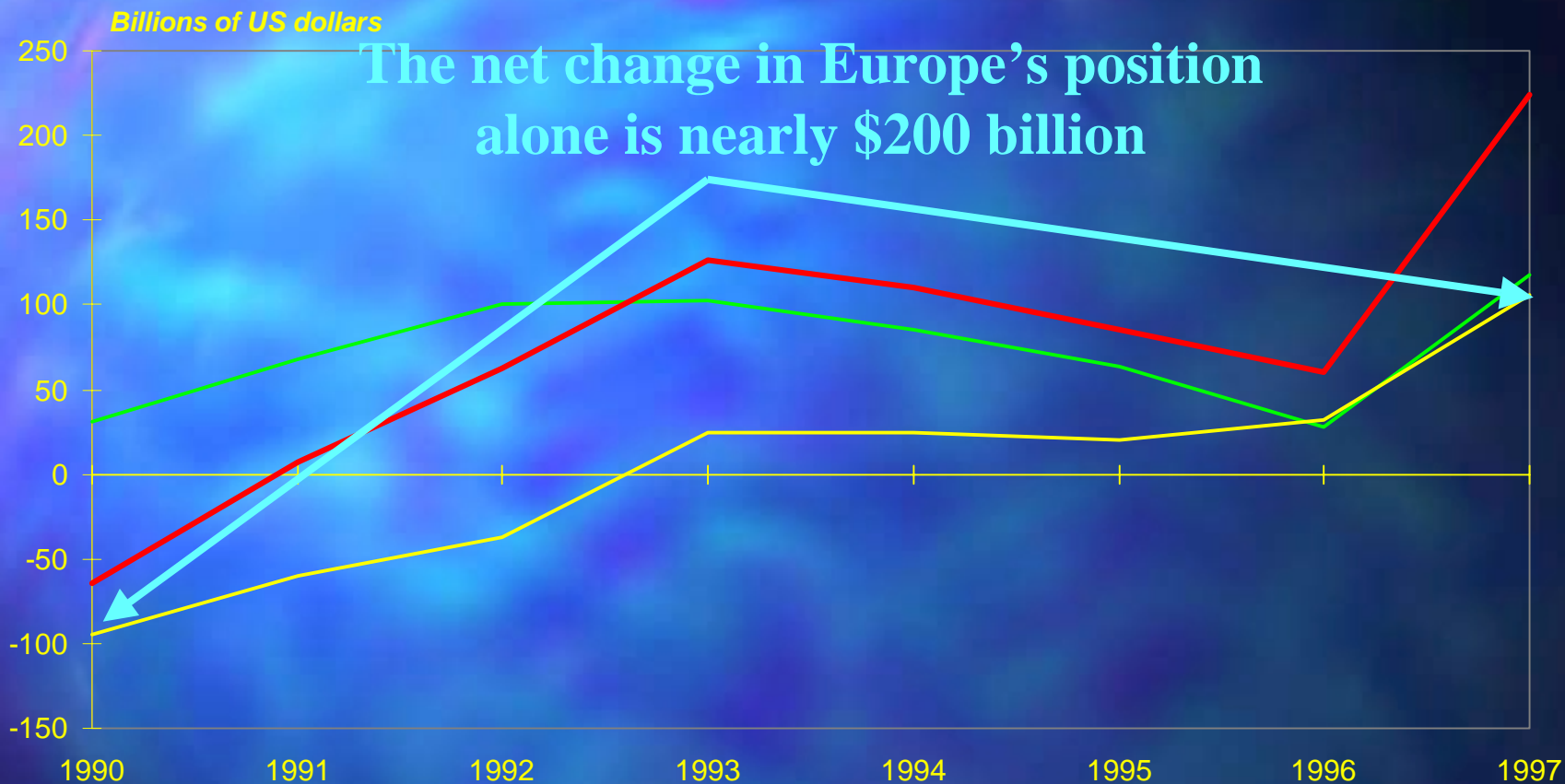
- In the 1994-95 Mexico crisis, the supply shock was a hike in the US Federal Funds rate
- In the 1997-98 Asian crisis, the supply shock was an increase in short-term yields in Europe and Japan and consolidation in Japan's banking system

# I. Chronic Suppliers

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- Chronic net suppliers of capital include Japan, the EU, Taiwan, Singapore, others
  - The following slide includes just Japan and Europe to make the point

## Net Capital Exports<sup>1</sup>



<sup>1</sup>Includes the European Union, excluding Greece and Portugal, and Norway and Switzerland.

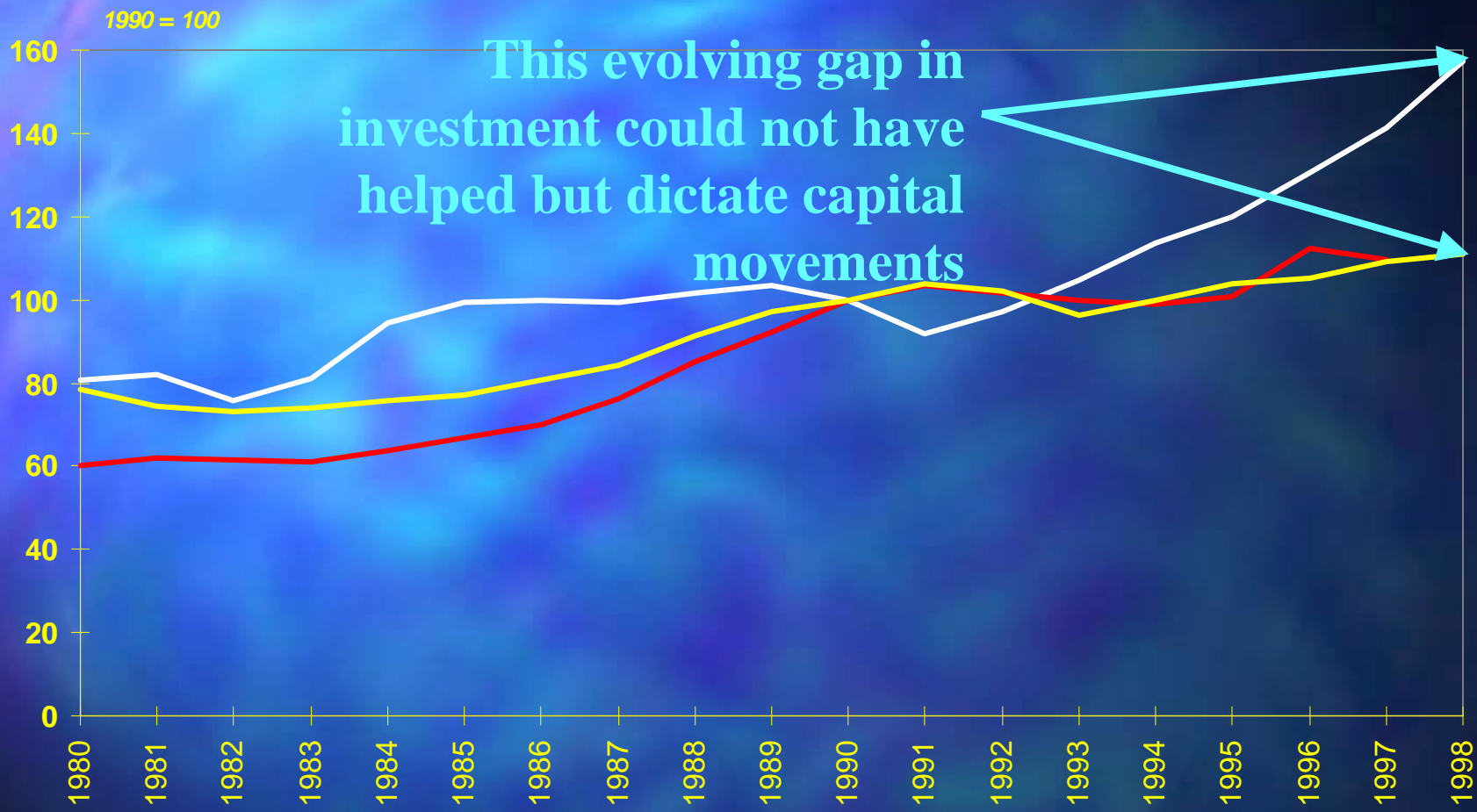


## II. The Structural Issue

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- The net flow of capital is a function of weak investment demand at home
  - While real investment in the US has about doubled since 1980, in Europe investment has risen by about one-fifth, as the next slide shows

## Index of Real Fixed Investment: The United States, Japan, and Europe<sup>1</sup>



<sup>1</sup>Includes the European Union, excluding Greece and Portugal, and Norway and Switzerland.

— USA — Japan — Europe

## III. The US Factor

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- The United States is the dominant importer of capital
  - In 1997, the United States imported 68 percent more capital than the group of the 32 largest emerging markets taken together

## IV. Emerging Markets

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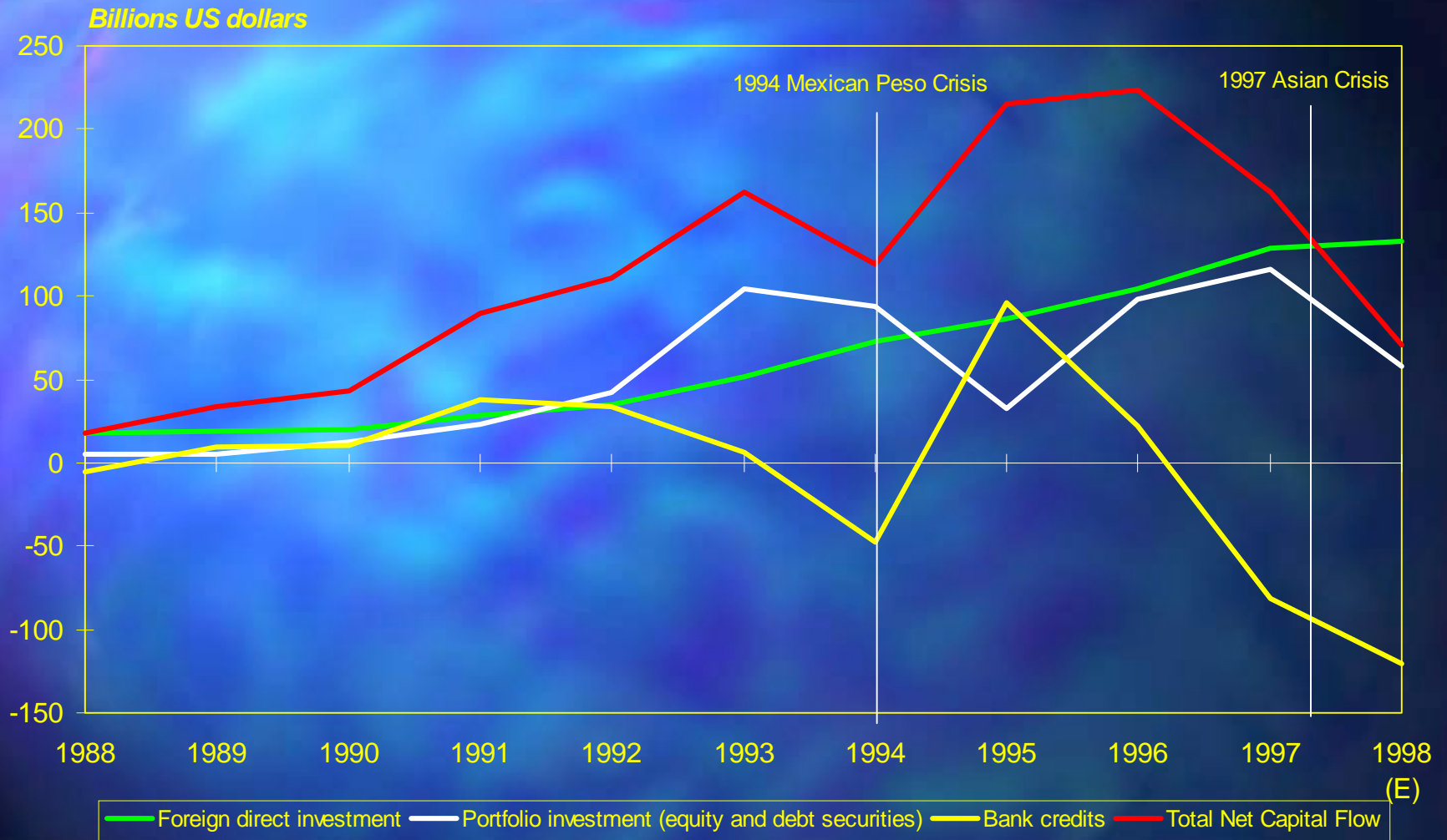
- The Emerging Market 32 has a shot at the residual
  - This amounts to a trickle; in 1997 the largest emerging market, China, attracted just two percent of global direct investment
  - The issue: how stable is this trickle?

## V. Choices of Bankers

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- All investors are in a real sense at the mercy of the portfolio choices of bankers
  - Net bank lending is the least stable category of capital flows, as the next slide shows

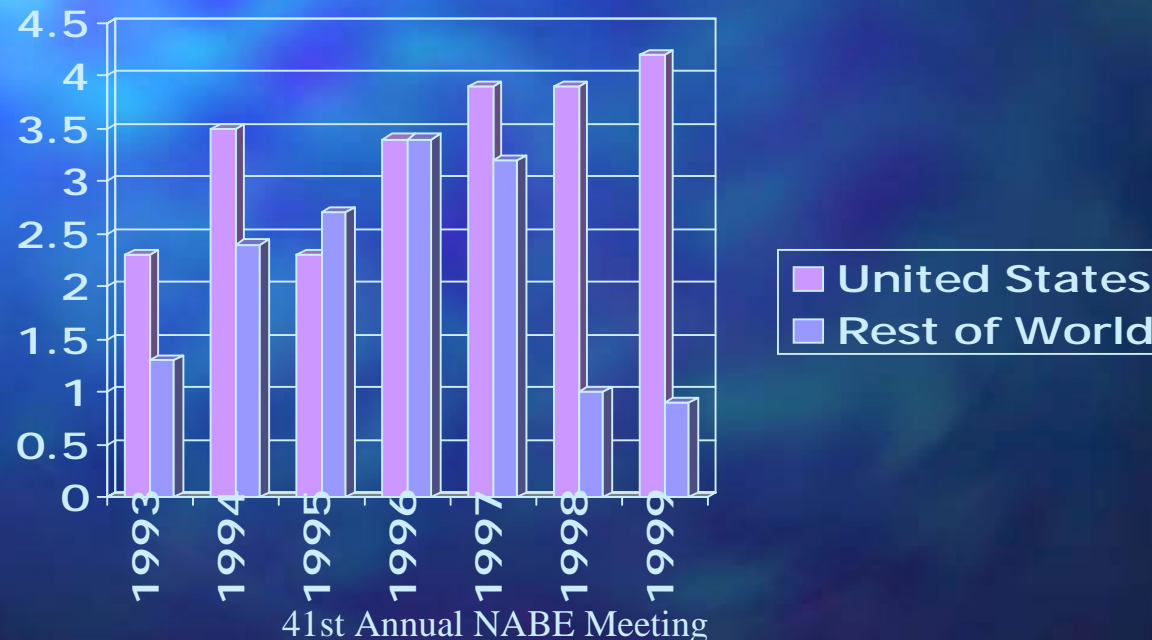
# Net Capital Flows to Emerging Market Countries by Type of Investment



Note: 1998 figures are estimates based on IIE projections for their group of 33 emerging market countries.

## VI. A Complication

- Conflicted central banks: in a world of financial crises, can central banks focus exclusively on the domestic economy?



# Putting The Pieces Together

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- The global economy increasingly must be thought of as an integrated complex system
- Shocks are a fact of life; what matters is how the system is configured
  - The sand pile metaphor: identical shocks can have wildly different impacts

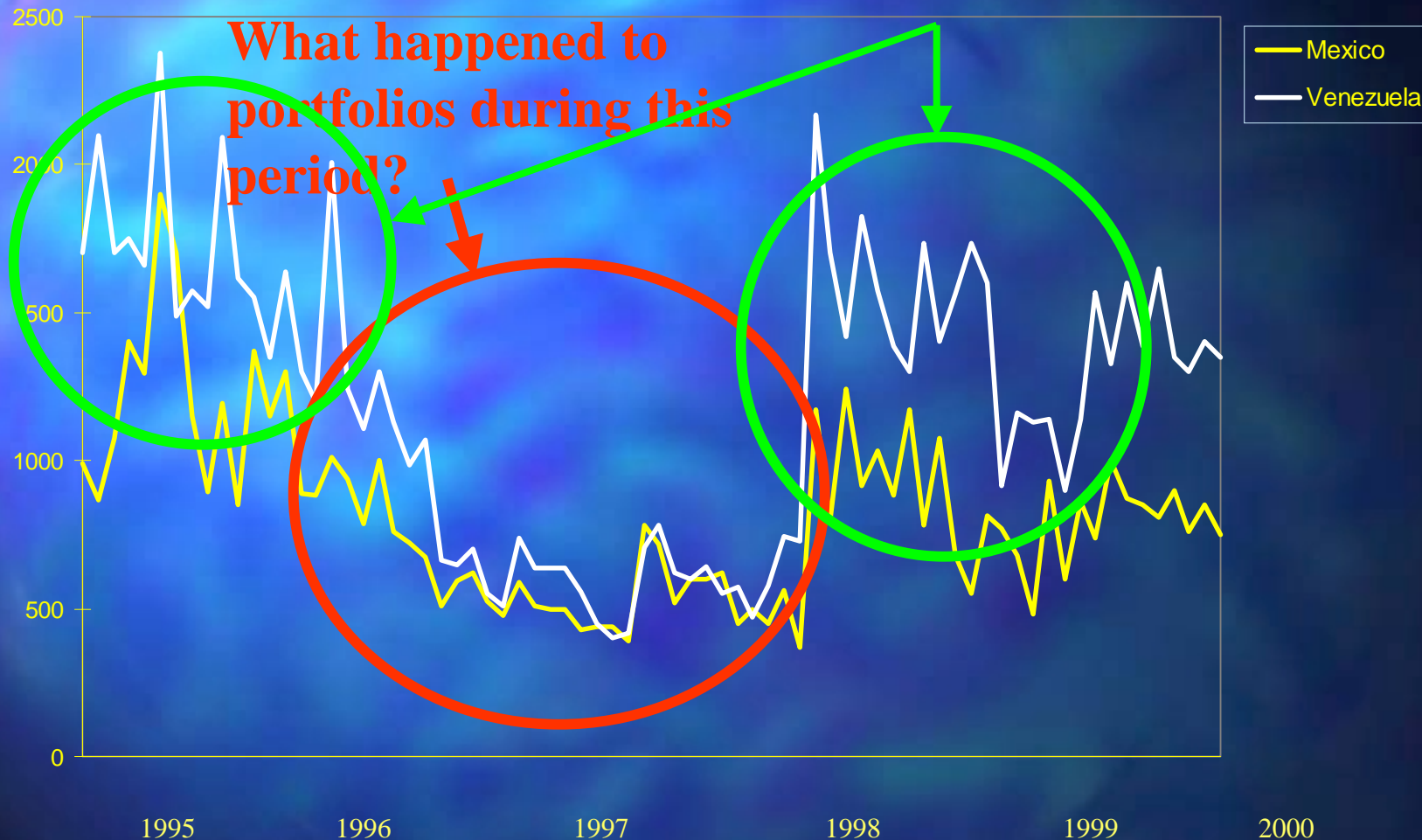
# Risk Premia

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- Spreads provide a means of taking the temperature of the system--if you do it right
  - What does it mean when suppliers of capital, for several years, have “under-priced” risk? That the eventual avalanche will be a big one?

Emerging Markets Debt\*  
(basis points)

We know what happened  
during these periods



\*Brady Par Bond stripped yield minus US 10-year government yield.

# Another Means

- By December 1996 East Asian borrowers owed the following share of their debts to BIS banks short-term:
  - Indonesia 62 percent
  - Malaysia 50 percent
  - South Korea 68 percent
  - Thailand 65 percent
  - Philippines 58 percent
- This says something telling about the creditor banks in Japan and Europe

# The US Fiscal Position

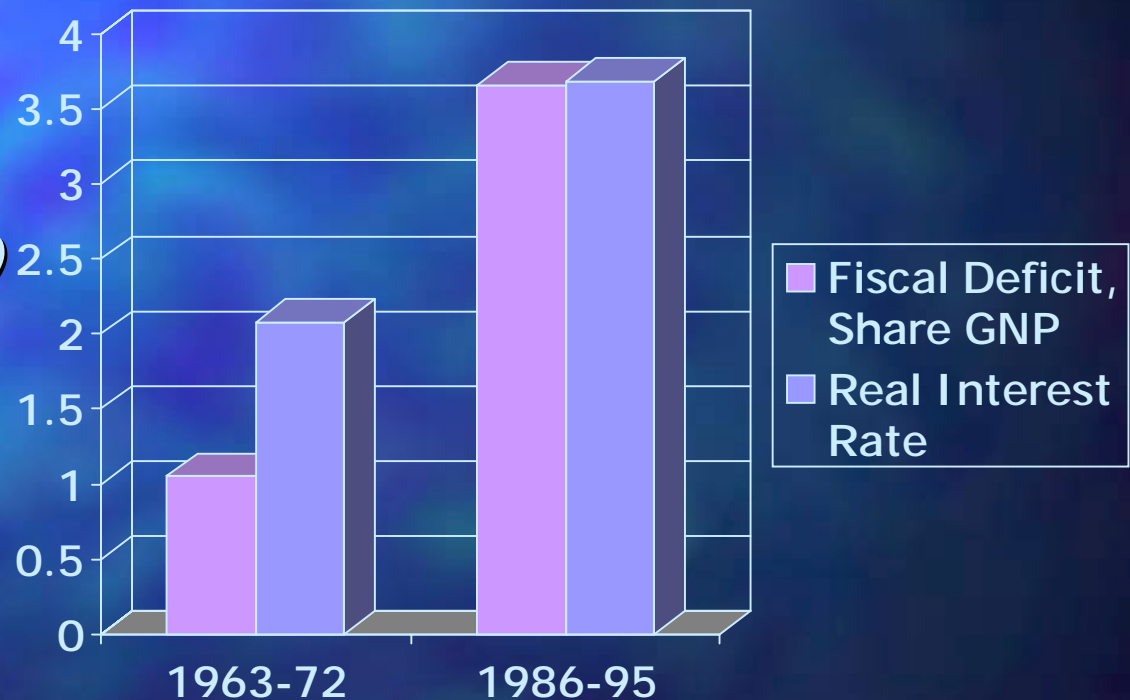
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- The US fiscal position may change so radically in the next decade that the environment for capital flows will be very different for all
  - CBO projections peg the accumulated nominal surplus at \$ 3 trillion through 2009
  - This sum compares to \$3.6 trillion in debt now held by the public

# The US Fiscal Position

- Both real interest rates and the supply of the benchmark asset may fall substantially

– Will 2000-2009 resemble 1963-72?



# US Fiscal Position Impact

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- Impact on emerging markets would be mixed
  - Lower benchmark cost of capital
  - But fewer no-risk benchmark assets to balance riskier assets in portfolios, which may mean far less appetite for emerging market assets

# Spread of the Anglo-Saxon Model

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- The spread of the Anglo-Saxon model would reinvigorate investment in the EU and Japan
  - Recent indications: financial deregulation in Japan, talk of fiscal reform in Germany, deepening of the European bond market, cross border M&A in the EU

# Plausible Outcomes

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- If we are to be surprised in a big way, it will be because policy developments in *industrial countries* fundamentally alter the supply of capital to emerging markets
  - Could we see a return to the period prior to the first oil shock, when the emerging markets literally got no private capital?

# Tools To Use

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- Maturity of lending by BIS banks to blocks of emerging market countries
- Structural reform and deregulation among the capital suppliers
- Spreads, foreign and domestic
- Later, spreads not linked to Treasuries
- The musings of globalists
- Systems dynamics, biological metaphors

# References

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