2 Capital Flows to Developing Economies throughout the Twentieth Century  
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The recent surge in capital inflows to developing countries shares several features of the experiences of the late nineteenth and early twentieth centuries, but a number of new characteristics as well. This chapter begins with a survey of international finance at the beginning of this century followed by a review of capital inflows since the 1960s. The final section briefly addresses three issues. First, what has been the role of financial liberalization among the determinants of the recent upswing in capital inflows, and what are its implications for the recipient economies? Second, can we say something on the ‘quality’ of the new flows? Third, what are the long-run relationships between external finance, growth, and welfare in developing economies?

AN OVERVIEW OF HISTORICAL TRENDS IN EXTERNAL FINANCE TO DEVELOPING COUNTRIES

International lending and borrowing, as they are currently conceived, date back to the birth of the Western financial institutions. Italian bankers of the Renaissance period loaned to other countries, although an overall quantification of such operations is problematic (Kindleberger, 1984). The network of financial flows among different nations was historically centered on a few key trading cities: Amsterdam, Paris and London. Hence, the history of international finance to a large extent overlaps that of the rise and fall of these centres, which provided external finance for trade and investment projects in a large number of nations including western states, colonies and eastern empires. Wars, panics, and crashes often marked the decline of old financial centers, and the rise of new ones.

The history of foreign lending to developing countries is part of this wider picture, with some unique characteristics. First, developing countries (including colonies) have usually been net borrowers from the rest of the world. Second, the record of external finance in developing countries is a sequence
of periods of sustained borrowing, debt crises leading to an interruption or even a reversal of the flows, and eventual new surges in capital inflows (Eichengreen and Lindert, 1989; Marichal, 1989). Third, there seem to be complex causal links between the conditions of financial activity in the western centers and the solvency and liquidity position of developing countries. On the one hand, external variables such as international interest rates and commodity prices are often mentioned as crucial determinants of the swings in capital movements to the developing countries (Eichengreen, 1990; Calvo, Leiderman and Reinhart, 1993). At the same time, debt crises in developing countries may have a strong impact on western financial markets (see the description of the 1890 Baring crisis in De Cecco, 1984).

Capital inflows to developing economies during the nineteenth century were mainly associated with the functioning of London as the world financial center. Marichal (1989, pp. 27–8) reports that Latin American government issues accounted for the largest share of foreign government securities sold on the London Stock Exchange between 1822 and 1825, at the time of Latin American independence. As early as 1826 Peru suspended payments, followed by Chile, Argentina, Mexico and others. Nonetheless, a new surge in capital flows to Latin America occurred in the 1850s and 1860s, ending with the great depression of the late nineteenth century, 1873–96, when a number of developing country borrowers defaulted again. The securities floated on the London market mainly financed railways and public utilities, although some funds were used for rolling-over old debts or for speculative purposes (Marichal, 1989, pp. 243–255). The final years prior to World War I witnessed a new upturn in capital flows to developing countries, both in absolute and in relative terms, which led to the highest ever stock of gross foreign investment in developing countries, including colonies, as shown in Table 2.1. During this period, net capital outflows from Britain represented as much as 9 per cent of its GDP, while comparable figures for France, Germany and the Netherlands were almost as high (IMF, 1997, p. 113).

Table 2.2 shows that African and Asian countries became important destinations of foreign capital after 1890, while Argentina’s 1890 debt crisis may have had a negative effect on flows to Latin America. Note that North America (excluding Mexico) is still the principal destination of portfolio investment abroad. The 1914 financial crisis in London and the start of World War I changed the pattern of world capital movements once again. Net foreign lending to developing countries ended. However, some developing countries, particularly those that benefited from a rise in world commodity prices, became net capital exporters during the war years, as also happened during World War II (for instance, Argentina: see Veganzones and Winograd, 1997, pp. 208, 212–214). In the aftermath of World War I, the world financial community was engaged for a long time in the resolution of the joint problems of the German reparations and of the inter-allied loans