

## A global “capital shortage”?

*World capital markets will be tight in the years ahead. Some analysts fear a severe global capital squeeze, causing a sharp rise in real interest rates and pulling down growth rates. But this outcome is unlikely, provided that industrial countries continue fiscal consolidation*

Developing countries' need for capital is rising—to finance growth, infrastructure requirements, and environmental improvements. In the industrial world, investment is recovering, but private saving has been falling, and government deficits are large. If these trends continue, some argue, they could cause crowding out on a global scale, pushing real interest rates well above the already unprecedented levels of the past decade (figure 1), choking off investment demand, and driving the world economy into recession.

However, developing countries can meet most of the increase in their capital demand with their own resources—if their policies are right. The net claim of these countries on industrial countries' savings will likely remain small. What will determine long-term international interest rates is not so much the increased competition for capital from developing countries as the fiscal consolidation efforts of industrial countries.

### Capital requirements of developing countries

#### *Demand for capital*

The World Bank expects real gross domestic investment in developing countries to rise by an average of 6.0–6.5 percent a year during 1995–2004, boosting investment from the 24 percent of gross domestic product (GDP) that it averaged during 1985–94 to 27–28

percent in 1995–2004. Investment in developing countries could average \$1.7–\$1.8 trillion a year during 1995–2004 (in 1994 dollars), an increase of almost 50 percent from its estimated level in 1994 (figure 2).

Investment ratios are expected to rise in all developing regions, albeit by different margins. ■ The largest increase is expected in East Asia, where investment is already 34 percent of GDP. Annual gross domestic investment in the region could average as much as 39 percent of GDP over the next ten years, reaching \$800 billion a year (at 1994 prices) and accounting for nearly 45 percent of total investment in developing countries. Two factors account for the expected surge of investment in East Asia: infrastructure capacity is coming under severe strain, and the industrial structure of these economies is shifting from labor-intensive to capital-intensive industries.

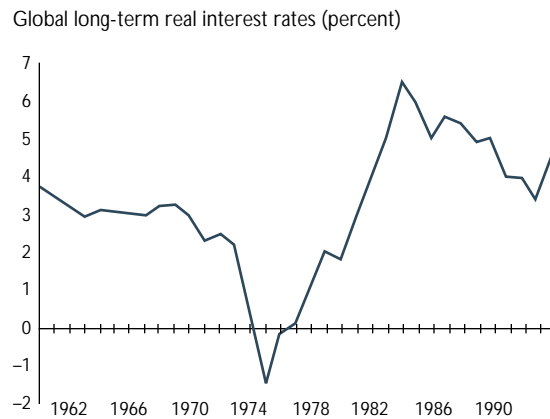
■ With the breakdown of central planning, investment collapsed in many of the transition countries of Eastern and Central Europe and the former Soviet Union, falling by an average of more than 15 percent a year (in real terms) during 1991–94. As these countries stabilize, investment will recover, and could rise by 5 percent or more a year over

*Note:* Because any “shortage” can be eliminated by a rise in the price of capital—the interest rate—the global demand for capital necessarily equals the supply. It is therefore more meaningful to pose the issue in terms of the possibility that global demand for capital will exert upward pressure on world real interest rates.

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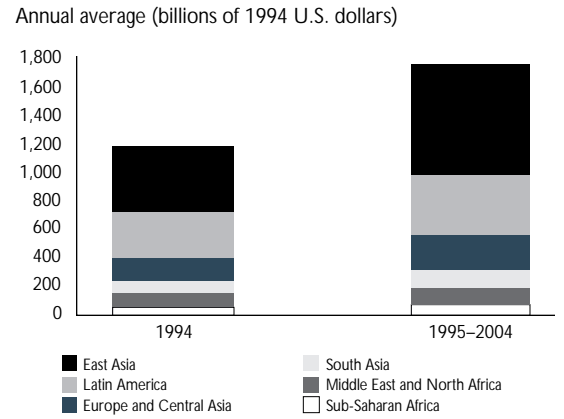
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Figure 1. Real interest rates have been unusually high since the early 1980s



Note: GDP weighted average of ten-year (or nearest maturity) government bond rates for Belgium, Canada, Germany, Japan, the Netherlands, Switzerland, the United Kingdom, and the United States minus long-memory inflation estimate.  
Source: IMF 1995.

Figure 2. Investment in developing countries will grow by about half in the next decade



Source: World Bank data; World Bank 1995.

...but will be met largely by the developing countries themselves, through higher domestic saving

the next ten years. Total investment in these countries could reach \$250 billion a year over the next ten years, measured in constant dollars.

■ Investment is expected to rise in Latin America as the region builds on the stabilization and structural gains of recent years, and in South Asia as that region makes a break from inward-looking policies and pervasive government controls on private activity. Over the next ten years investment in these two regions could average \$400 billion and \$125 billion a year, again in constant 1994 dollars. Total investment in the Middle East and North Africa will likely be roughly the same as in South Asia, starting from a higher base but growing more slowly.

■ Even Sub-Saharan Africa, which at an average of 16 percent of GDP has the developing world's lowest investment rate, can expect investment to grow, supported by the economic reforms of a number of countries in the region. But total investment will remain small relative to that in other developing regions, likely averaging \$75 billion a year over the next ten years (at 1994 prices) and accounting for less than 5 percent of total investment in developing countries.

### *Supply of capital*

Most developing countries will finance their increased investment from their own savings. Saving is projected to rise in these countries as

a result of stronger growth, favorable demographic developments, and further fiscal adjustments as government deficits fall. Average developing country central government deficits fell from 5–6 percent of GDP in the second half of the 1980s to 3–4 percent in the early 1990s. Further, in the past two decades investment and savings rates in developing countries have generally moved together (figure 3). Current World Bank projections are for average gross national saving in developing countries to rise from about 23 percent in the past decade to 26 percent in the next, roughly matching the projected rise in their investment rate (figure 4).

As with investment, the largest rise in saving is expected in East Asia. Over the past ten years gross national saving in the region averaged 33 percent of GDP, and in the next ten years is likely to reach 36–37 percent of GDP, supported by declining youth dependency ratios and the virtuous circle of high investment, high growth, and high saving. Savings rates are also expected to rise in other developing regions, although more moderately and from much lower levels. Savings rates in Latin America and Sub-Saharan Africa, at 17 and 15 percent of GDP, respectively, are among the lowest in the developing world, and have declined over the past decade. But if the macroeconomic and incentive-system reforms now under way remain on track, savings rates in these regions could recover some of the lost ground, averaging up to 2 percentage points of GDP higher than at present.

Saving will not rise automatically to support higher investment spending. Countries need to build a domestic economic environment—policies and institutions—that makes higher saving attractive. In addition to macroeconomic stability (to underpin strong and sustainable growth) and fiscal discipline, countries need reforms in pricing and tax and social security systems (to remove disincentives to saving) and well-functioning financial markets and institutions.

These are many of the same conditions that promote investment and attract foreign capital. Countries that are successful in raising investment and foreign capital on a sustained basis will likely also generate a complementary increase in domestic saving. Thus, the resources available to finance investment are not fixed. As East Asia's experience shows, higher investment can encourage higher saving. Foreign capital also tends to flow to countries with higher domestic investment and saving, and therefore with high rates of economic growth. So good policies both attract foreign capital and help keep it at sustainable levels.

### Financing the balance

Developing countries make a net claim on industrial countries' savings roughly equal to their current account deficit plus the net change in their external reserves. Experience shows that, in general, current account deficits in developing countries are unlikely to remain well above 2

percent of GDP for long because deficits of that size are incompatible with a sustainable external financial position. If large, persistent imbalances are not corrected by domestic adjustment, international financial markets could force the necessary adjustment by ceasing to finance the imbalances. The Mexican peso crisis of December 1994 is a case in point.

World Bank projections show an aggregate current account deficit for developing countries of some 1.6 percent of GDP over the next ten years, only slightly higher than in the past decade. Relative to industrial countries' total saving, the net capital flow to developing countries over the next ten years would remain small—on average around 3 percent.

As international capital markets integrate, developing countries' access to private foreign capital will improve further, but whether specific countries attract inflows will continue to depend on their economic prospects and policies. Even today, only a dozen or so countries receive the bulk of private capital flows to developing countries.

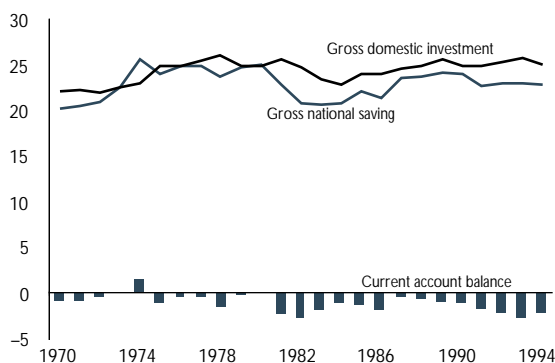
A large number of developing countries will continue to rely on official sources for most of their foreign capital requirements. But the tighter supply of official capital will force these countries to mobilize more domestic resources. And that will require accelerating economic reforms that in the longer term would begin to attract private investment.

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The call by developing countries on international capital markets is relatively small

Figure 3. National savings and investment rates follow similar paths in developing countries

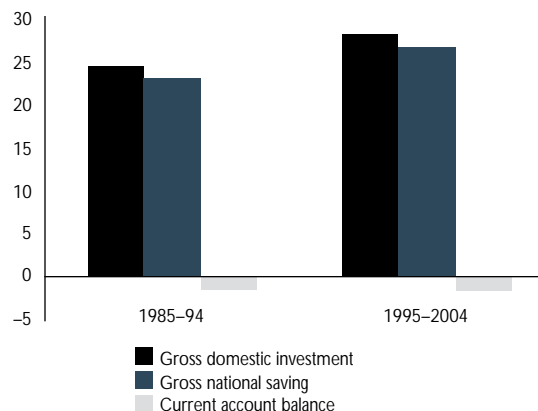
Developing countries' saving, investment, and current account balance, 1970–94 (percentage of GDP)



Note: Excludes transition countries.  
Source: World Bank data.

Figure 4. Saving will likely keep pace with investment

Outlook for developing countries' saving, investment, and current account balance, 1985–2004 (percentage of GDP)



Note: Includes transition economies.  
Source: World Bank data; World Bank 1995.

## Savings and fiscal consolidation in industrial countries

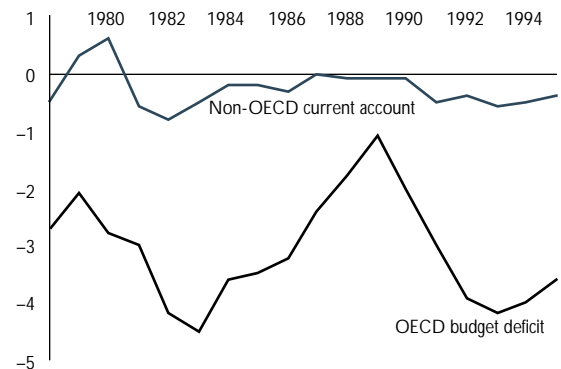
The greatest influence on world capital markets will be the supply of savings relative to demand in industrial countries, which account for about three-quarters of the world's total annual savings. Unfortunately, industrial countries' savings rates have been falling. The average gross savings rate in OECD countries is about 5 percentage points of GDP lower than in the early 1970s, with the drop concentrated in the public sector.

But this picture is likely to change, at least for a while, as the baby boom generation enters middle age, the prime saving years. That demographic shift is likely to boost private savings rates in industrial countries over the next 15 or so years. Then, around 2010, the baby boomers will begin to swell the ranks of the over-65 population, while the 40–64 age bracket shrinks, depressing private savings rates once again. This underscores the importance of investing the temporary increase in savings over the next decade as profitably as possible (including in developing countries) to support future pensioners. A major area of reform is social security systems: the present value of unfunded public pension liabilities in several major industrial countries already exceeds 150 percent of GDP. Generous, unfunded pension schemes are fiscally unsustainable, and depress private incentives to save.

The critical factor in alleviating pressure on global interest rates will be progress in industrial countries' efforts to consolidate public finances—to reduce fiscal deficits and place social security systems on a more sustainable footing (figure 5). Despite the surge in private capital flows to developing countries in the 1990s, the total net capital flow remains small compared with industrial countries' budget deficits. For example, in 1994 a lowering of industrial countries' aggregate budget deficit by about 20 percent would have been enough to finance the whole of the net capital flow to developing countries.

Figure 5. Net capital flows to developing countries are small compared with the budget deficits in industrial countries

Comparison of claims on resources, 1978–94 (percent of OECD GDP)



Source: OECD 1995; World Bank data.

Governments of industrial countries have begun to address the major fiscal challenges they face. Their fiscal consolidation efforts, if sustained, should help avoid a global crowding out of capital. The OECD expects the average general government budget deficit in industrial countries to fall from 3.9 percent in 1994 to 1.9 percent in 2000. Still, these adjustments will be difficult. If industrial countries falter, the world economy could suffer. If they succeed, the world economy would move toward strong investment and saving, efficient global capital allocation, and sustained economic growth.

—by Zia Qureshi and Leilynn Lau

## Further reading

IMF (International Monetary Fund). 1995. *World Economic Outlook*. Washington, D.C.

OECD (Organization for Economic Cooperation and Development). 1995. *Future Global Capital Shortages: Fact or Fiction?* Proceedings of the OECD Forum for the Future Conference, April 3–4, Paris.

Qureshi, Zia. 1995. "Do We Face a Global 'Capital Shortage'?" World Bank, Policy Research Working Paper 1526. Washington, D.C.

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This *DECnote* has been prepared by Zia Qureshi and Leilynn Lau in the International Economics Department of the World Bank. *DECnotes* transmit key development trends to Bank operations managers and staff. They are drawn from the work of individual Bank researchers and do not necessarily represent the views of the World Bank and its member countries—and should not therefore be attributed to the World Bank or its affiliates. *DECnotes* are produced by the Research Advisory Staff. We welcome your questions and comments; please e-mail them to the authors or to Evelyn Alfaro, RAD.

Industrial country savings rates are likely to recover, at least for a time, but fiscal consolidation is crucial to avoiding a global capital squeeze