RAPID RETURN OF PRIVATE FLOWS TO LATIN AMERICA; NEW TRENDS AND NEW POLICY ISSUES

Roy Culpeper*
The North-South Institute
Ottawa, Canada

and

Stephany Griffith-Jones
Institute of Development Studies
Sussex, United Kingdom

October 1992

* This paper was prepared for an IDRC-funded workshop, to be held in Santiago de Chile. We thank Alicia Rodriguez, Nicholas Georgiadis and Ana Marr for valuable research assistance. We are also grateful to Mohammed El-Erian and Ricardo Ffrench-Davis for their valuable comments, as well as to other participants in a FONDAD workshop (held in The Hague on 9-10 June 1992) for useful suggestions on a paper presented by one of the authors on a related subject.

Contents

1

Introduction

This paper discusses the massive and rather surprising return of private capital flows to Latin America. This is both a very new and a very old phenomenon. It is very new in that only three years ago, (when focus was mainly on the foreign exchange constraint and debt overhang of the region) such a massive return of private capital flows to Latin America would have seemed totally unlikely to most policy-makers, market actors and observers. It is a very old phenomenon in that private capital has flown in great abundance to the region on many previous occasions, since the early 19th century.

This paper will first (Section II) analyze the international context of changing international private flows, with some reference to flows to all developing countries. It will then examine in some detail what and how much is happening in private capital flows to Latin America. As this phenomenon is so recent, it seems essential to understand first as much as possible its magnitude and its features which is not easy given limitations of existing data and data collection. The next section (III) attempts an explanation of recent developments, focusing both on supply and demand factors. Section IV tries to develop an analytical framework for evaluating the effects of these flows in Latin American countries; some further empirical evidence is provided in that context. Section V presents conclusions, preliminary policy suggestions and some suggestions for further study.

2

The international context and private capital flows to Latin America

International trends

The return of private capital flows to Latin America needs to be understood in the context of major changes in international capital flows at a global level. During the 1980s, financial markets have been characterised by: 1) their growing integration amongst different countries, market segments, institutions and financial instruments, 2) liberalization and 3) spread of innovative financing instruments and techniques.

The factors explaining these trends are related firstly to the policy of deregulation of financial services in a number of areas, such as prices, interest rates, fees and commissions, a policy which began in earnest in the 1980s, and is now almost complete in industrial countries; furthermore the restrictions on the range of financial institutions' activities has also continued to erode, both through market practice and through legislative and regulatory action. Indeed, in the three major economies with traditionally segmented systems - Canada, Japan and the United States - there have been moves toward a relaxation of functional barriers. Movement towards geographic integration of financial markets has been particularly marked in recent years within the European Community, especially in the context of the 1992 Single Market programme. Indeed, as the IMF reports[1] many market participants in Europe (both EC member and non-member countries), view the overall process of European integration as the single most important influence on their activities and strategies for the 1990s. Within the EC, progress in integration of financial services has been accompanied by discussion of more integrated supervision and regulation, particularly in the field of banking. However, progress in the latter, in certain key sectors such as securities, has been relatively slow, which could perhaps be a cause for concern.

Finally, it should be stressed that other factors have also contributed to the globalisation of capital markets; these include important technological advances in telecommunications and computing, which accelerate and reduce costs both of operations and exchange of information at a global level. Also, the sharp current account imbalances in major industrial countries during the eighties led to large flows of funds from surplus to deficit countries, and especially to the US; this latter trend seems to be diminishing somewhat as Germany's current account surplus disappears and the US current account deficit declines somewhat.

Finally, there are two somewhat related trends, which seem important to highlight in this context. One is the far more rapid growth of securitized forms of lending (such as bonds) than of bank loans (see Table 1 below). The second is that institutional investors (such as pension funds, insurance and mutual funds), have played an increasingly dominant role in world capital markets; institutional investors have a greater ability to analyze in depth the changing conditions in different markets than individual investors; this has led many of them to a greater geographical diversification in their investments, with the aim of improving their profits, and diversifying their risks.

Table 1 reflects the evolution of the international capital markets since 1982. A first trend to observe is the very rapid increase in total global borrowing, from $179 billion in 1982 to $439b in 1991. A particularly large increase (of almost 20 per cent) occurred in 1991, after a contraction in 1990, related to a significant reduction in some of the Japanese bonds. A second trend to observe is the increased importance of bonds in total borrowing; bonds which represented around 42 per cent in 1982, have increased

[1] IMF International Capital Markets, Developments and Prospects, World Economic and Financial Surveys, May 1991, Washington, D.C.

Table 1
International Capital Market Flows
$ billion

Instruments	1982	1984	1987	1988	1989	1990	1991
Bonds	75.5	111.5	180.8	227.1	255.7	229.9	297.6
Equities	n.a.	0.3	18.2	7.7	8.1	7.3	21.6
Syndicated loans	98.2	57.0	91.7	125.5	121.1	124.5	113.2
Note issuance facilities	5.4	28.8	29.0	14.4	5.5	4.3	1.8
Other back-up facilities			2.2	2.2	2.9	2.7	4.5
Total securities and committed facilities	179.1	197.6	321.9	376.9	393.3	368.7	438.7

Source: OECD Financial Market Trends, February 1992, and previous issues.

their share to around 67 per cent in 1991. This increase in the share of bonds in total borrowing has been accompanied by a decline in the share of syndicated loans, with their contracting in 1991; this is mainly caused by the attitude of leading international banks towards extending new loans other than to prime borrowers. This attitude reflects greater emphasis on containing asset growth within boundaries set by new capital adequacy requirements and on improving quality of loan portfolios. On the other hand, the past and the future situation of the international securities markets is clearly more favourable. Market observers point to the fact that the availability of funds remain ample on a global basis. According to the OECD[2] this positive underlying trend in international securities markets is strengthened by two factors; first, the process of asset diversification may intensify as several "emerging" segments of the euro-bond market have reached a critical size that justifies a heavier weighting in institutional investors' portfolios. Secondly, the maturing of the euro-bond market implies an increase in bond redemptions, which provides investors with an increasingly large source of liquidity that needs to be profitably re-invested.

If euro-commercial paper lending and other non-underwritten facilities are added, total borrowing on international capital markets increased from $392b in 1987 to $518b in 1991. The share of developing countries in this total borrowing, though still relatively low, increased significantly during the past three years, going up from 5.0 per cent of the total in 1988 to 8.1 per cent in 1991. Indeed, the overall recourse to private international markets by developing countries rose in 1991 by nearly 50 per cent (to $42b), the highest level in absolute nominal terms since the early 1980s.[3] Particularly noticeable in this expansion was the very strong growth in borrowing by a number of Latin American countries, which we will discuss in the next section.

Before doing so, it seems useful first to examine more general trends in flows to developing countries.

As can be seen in Table 2, since 1982 there was a significant increase both in total net resource flows and in private resource flows to Asian developing countries. Thus

[2] OECD, Financial Market Trends, No.51, February 1992.

[3] OECD, op. cit.

Table 2
Net Resource Flows to Developing Countries 1982-90
(US$ billions)

	1982	1983	1984	1985	1986	1987	1988	1989	1990
TNRF[1]	116.0	94.8	85.6	83.4	82.4	92.8	107.3	122.7	142.4
PNRF[2]	58.2	47.8	31.7	30.5	26.7	33.7	43.8	48.3	60.8
TNRF Africa[1]	23.2	17.5	18.6	21.6	24.6	25.1	29.2	29.6	32.0
TNRF Asia[1]	27.8	31.9	27.3	29.0	27.3	30.3	40.3	40.8	48.0
TNRF WH[1][3]	49.4	27.7	29.9	22.7	18.5	21.9	23.7	29.8	40.1
PNRF Africa[2]	5.7	1.9	1.4	2.8	5.3	2.9	5.7	2.0	3.0
PNRF Asia[2]	11.3	17.0	11.1	14.7	10.3	13.1	18.6	17.3	24.1
PNRF WH[2][3]	39.0	18.5	18.6	10.6	6.2	8.1	11.0	15.3	23.7
Percentage distribution									
TNRF Africa[1]	20.0%	18.5%	21.7%	25.9%	29.9%	27.0%	27.2%	24.1%	22.5%
TNRF Asia[1]	24.0%	33.6%	31.9%	34.8%	33.1%	32.7%	37.6%	33.3%	33.7%
TNRF WH[1][3]	42.6%	29.2%	34.9%	27.2%	22.5%	23.6%	22.1%	24.3%	28.2%
PNRF Africa[2]	9.8%	4.0%	4.4%	9.2%	19.9%	8.6%	13.0%	4.1%	4.9%
PNRF Asia[2]	19.4%	35.6%	35.0%	48.2%	38.6%	38.9%	42.5%	35.8%	39.6%
PNRF WH[2][3]	67.0%	38.7%	58.7%	34.8%	23.2%	24.0%	5.1%	31.7%	39.0%

[1]TNRF means Total Net Resource Flows.
[2]PNRF means Private Net Resource Flows.
[3]WH means Western Hemisphere.

Source: OECD Financing and External Debt of Developing Countries 1990 Survey. September 1991.

private net resource flows to Asia increased steadily from US$11 billion in 1982 to $24 billion in 1990. A very large share both of the private net resource flows and of their increase was via foreign direct investment from developed countries (source OECD). This gradual and steady increase of private net resource flows to Asia in the 1982-90 period was in contrast with the sharp fluctuations in flows to the Western Hemisphere evident in Table 2. Thus private net resource flows to the Western Hemisphere were at a peak of $39 billion in 1982, declined throughout the 1983-86 period, to a mere $6.2 billion in 1986, and then started to increase, first gradually (from 1986-88), reaching $11.0 billion in 1988 and then recovering much faster during the 1988-1990 period, when the net flows reached $24 billion in 1990, and increasing still further and even more dramatically in 1991, when they are reported to have increased to around $40 billion, as can be seen in Table 4 below.[4]

Therefore, it can be concluded that while Latin America and the Caribbean have seen a dramatic increase in net private flows to that region in the last three years, and especially in 1991, to recover the very high level in nominal terms it had in 1982, this is in sharp contrast with the Asian region which has seen a far more steady and gradual increase of private flows to it throughout the 1982-90 period, with flows more than doubling in nominal terms in that period. During this period, the performance of net private flows to the African region has been poor, with such flows reportedly declining from $5.7 billion in 1982 to $1.4 billion in 1984, increasing to $5.7 billion in 1988, but falling again to $3.0 billion in 1990.

As regards composition of the flows to Western Hemisphere, it is interesting that in the 1982-90 period (similarly as in the case of Asia), there is a rapidly growing share of foreign direct investment. Indeed, according to OECD data, foreign direct investment to Latin America and the Caribbean tripled its share of total private flows during 1982-90. Furthermore, this seems to be true also at the aggregate level for all developing countries, as according to the UN *World Investment Report 1992*, the share of FDI in total capital inflows to developing countries rose from 30 per cent in 1980-85 to 75 per

[4] There is some difference in the data, as the 1982-90 data (Table 2) are from the OECD and the 1991 data (Table 4) are from Salomon Brothers. These different sources used are due to limitations of data availability. However, the broad trends outlined above clearly remain, whatever source is used.

cent in 1986-90. It would seem, however, that as regards the massive increase in flows that occurred in 1991 to Latin America, the share of foreign direct investment in total private flows declined somewhat (see Table 6 and discussion below), though it would be premature to conclude whether this is a new trend, a one-off change or an effect of using a different statistical source.

New private flows to Latin America

Dramatic change of direction and increase

As is well known, in the eighties, net resource transfers to Latin America and the Caribbean (LAC) were strongly negative (see Table 3). One of the key reasons for this was the sharp fall in private flows to the region (described above), caused mainly by a large decline in private bank lending, that had reached such high levels till 1982. Indeed, according to El-Erian,[5] the total amount of voluntary loan and bond financing flows to Latin American countries during the whole 1983-88 period was considerably smaller than that for 1982 alone.

Starting in 1989, and continuing in 1990 and 1991, there has been a dramatic increase in voluntary new private flows to Latin America and the Caribbean. According to ECLAC, (see again Table 3), net total private flows to LAC increased since 1988 almost seven fold. As a result of this dramatic increase and to a lesser extent due to a decline in net payments of profits and interest, 1991 was the first year since 1981 that the net transfer of financial flows reversed direction and turned positive. Thus, the net outward flow of \$16b in 1990 was transformed into a new inflow of nearly US\$7b in 1991 (see again Table 3); this represented a turnaround of \$23b in the net transfer in one year, an amount equivalent to 15 per cent of the region's exports of goods and services.

---

[5] See M.A. El-Erian "Restoration of Access to Voluntary Capital Market Financing". IMF Staff Papers, Vol.39, No.1, (March 1992).

Table 3
Latin America and the Caribbean:
Net Capital Inflow and Transfer of Resources
(Billions of dollars and percentages)

	(1) Net capital inflow	(2) Net payment of profits and interest	(3) = (1) - (2) Transfer of resources	(4) Transfer of resources - (%) Exports of goods and services
1975	14.3	5.6	8.7	21.2
1980	32.0	18.9	13.1	12.5
1981	39.8	28.5	11.3	10.0
1982	20.1	38.8	-18.7	-18.2
1983	2.9	34.5	-31.6	-30.9
1984	10.4	37.3	-26.9	-23.7
1985	3.0	35.3	-32.3	-29.7
1986	9.9	32.6	-22.7	-24.0
1987	15.4	31.4	-16.0	-14.8
1988	5.5	34.3	-28.8	-23.4
1989	9.6	37.9	-28.3	-20.8
1990	18.4	34.4	-16.0	-10.6
1991	36.0	29.3	6.7	4.4

Source: UN ECLAC Preliminary Overview of the Economy of Latin America and the Caribbean 1991. December 1991, Santiago, Chile.

As can be seen in Table 4, Salomon Brothers[6] estimates even a somewhat more rapid increase than ECLAC, with private capital flows to Latin America calculated to have increased eight-fold between 1989 and 1991 and by almost 200 per cent in 1991 alone, reaching over $40b.

Table 4
Private Capital flows to Latin America and to selected Latin American countries
($ billion)

	1989	1990	1991
Argentina	1.4	0.5	5.1
Brazil	0.2	0.4	11.6
Chile	1.1	2.0	1.7
Mexico	0.7	8.4	16.1
Venezuela	1.0	1.8	4.8
Regional	0.6	0.2	0.8
Total	5.0	13.4	40.1

Source: Salomon Brothers, op. cit.

Country distribution

For 1991, according to Salomon Brothers, there was quite a large concentration of private flows in those going to the two largest countries in the region (Brazil and Mexico) which received almost 70 per cent of inflows (see Table 5). For Mexico (which accounted for 40 per cent of total flows to Latin America in 1991), this represented around 6 per cent of its GDP, while for Brazil it represented 2.7 per cent of its GDP.

[6] Salomon Brothers Private Capital Flows to Latin America: Volume Triples to US$ 40b in 1991, February 12, 1992, New York.

Table 5
Types of Private Capital Flows to Latin America (1991)
(% of type of flow)

	Total	Argentina	Brazil	Chile	Mexico	Venezuela	Regional
Borrowing							
Bonds, Private Placements & Medium-Term Notes	100.0	13.0	41.2	2.3	54.1	6.9	-17.4
Commercial Paper	100.0				24.1	4.9	71.0
CDs	100.0	27.2	69.1		3.7		
Trade Financing	100.0		65.8		34.2		
Term Bank Lending	100.0	4.2	70.0	13.7	10.6	1.4	
Sub Total	100.0	8.8	42.7	3.3	38.6	4.7	1.9
Total Portfolio Investment							
Funds	100.0	7.4	16.2	3.4	12.5		60.4
ADRs[1/]	100.0	12.9			87.1		-0.0
Sub Total	100.0	11.6	3.7	0.8	69.9		13.9
DFI[2/]							
Cash Inflows from Privatisation	100.0	39.1			60.9		
Other DFI	100.0	9.1	12.4	10.5	52.6		15.4
Sub Total	100.0	16.7	9.2	7.9	39.3	15.4	11.5
Other Flows	100.0	15.9	84.1				
Sub Total	100.0	15.9	84.1				
Grand Total	100.0	12.7	29.0	4.2	39.9	7.2	7.0
% of GDP		7.6	2.7	5.8	5.9	10.0	

Note: [1/]ADRs = American Depository Receipts
[2/]DFI = Direct Foreign Investment

Source: Table elaborated by Alicia Rodriguez on the basis of data in Salomon Brothers, 1992 Emerging Markets, op. cit.

Table 6
Types of Private Capital Flows to Latin America (1991)
(% of total flows)

	Total	Argentina	Brazil	Chile	Mexico	Venezuela	Regional
Borrowing							
Bonds, Private Placements & Medium-Term Notes	21.2	21.6	30.2	12.0	28.7	20.2	-53.1
Commercial Paper	6.3				3.8	4.3	63.7
CDs	1.6	3.4	3.8		0.1		
Trade Financing	4.2		9.4		3.6		
Term Bank Lending	5.9	1.9	14.1	19.3	1.6	1.2	
Sub Total	39.1	27.0	57.6	31.3	37.8	25.7	10.6
Total Portfolio Investment							
Funds	3.7	2.2	2.1	3.1	1.2		32.0
ADRs[1/]	12.3	12.5			26.8		
Sub Total	16.0	14.6	2.1	3.1	28.0		32.0
DFI[2/]							
Cash Inflows from Privatisation	8.8	27.0				74.3	
Other DFI	26.0	18.7	11.1	65.7	34.2		57.4
Sub Total	34.8	45.7	11.1	65.7	34.2	74.3	57.4
Other Flows[3/]							
Argentina	1.6	12.6					
Brazil	8.5		29.3				
Sub Total	10.1	12.6	29.3				
Grand Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: [1/]ADRs = American Depository Receipts
[2/]DFI = Direct Foreign Investment
[3/]Identified by the countries' Central Banks.
Source: Table elaborated by Alicia Rodriguez on the basis of data in Salomon Brothers, 1992 Emerging Markets, op. cit.

In 1991, inflows to Venezuela (at $4.8b) are estimated to have reached 10 per cent of the country's GDP, whilst inflows to Argentina reached 7.6 per cent of GDP and to Chile 5.8 per cent of GDP (see again Table 5). The country composition was somewhat different in 1990, when the largest flows went to Mexico and Chile, the two countries which, according to Salomon Brothers, received above 75 per cent of total inflows to Latin America. In 1990, inflows to Chile represented 7.4 per cent of the country's GDP and inflows to Mexico represented 3.6 per cent of that country's GDP.

It is very interesting that in 1991, not only Chile and Mexico (who had pursued prudent macro-economic policies and had reduced their debt over-hang significantly in the late 1980s) had access to private capital markets, but also countries like Brazil, where important macro-economic imbalances and a large debt overhang still persisted. However, the terms on which Brazilian borrowers have access to the capital markets are somewhat less attractive. We will return to this issue in Section III.

Types of flows

It is important to emphasize that the increase in net capital flows to Latin America and the Caribbean has not mainly been due to a return of bank lending, but due to the region's re-entry to capital markets, (especially bonds, private placements and medium-term notes), portfolio investments, and, as discussed above, to foreign direct investment. It is in this sense noteworthy that the process of the region's market re-entry is done via a wide range of financing instruments, and involves a wide range of markets, investors and lenders.

Table 6 offers a de-composition of private flows to Latin America in 1991. We can see that 39 per cent of the total flows ($15.7) took the form of borrowing, with most of this borrowing being in the form of bonds, private placements and medium-term notes. Borrowing was a particularly important source of funds in 1991 for Brazil (see again Table 6). Furthermore, as can be seen in Table 5, in 1991 a very high proportion of short term flows to Latin America (via for example CDs and trade financing) went to Brazil.

Another important category in 1991 was foreign direct investment, which at $14b represented almost 35 per cent of total flows into the region. Direct foreign investment is reported to have been a particularly high proportion in Venezuela (where it went mainly for privatisation), Chile (for new investments) and to a lesser extent in Argentina, mostly for privatisation, but also in a smaller proportion for new investment (see again Table 6). In this context, it should be stressed that foreign direct investment going to privatisation does not necessarily imply an increase in total capital stock in the economy, but more often a transfer of ownership from the domestic public sector to the foreign private sector. However, privatisation may lead to important efficiency gains. Portfolio investment flows represented a smaller share - 16 per cent - of private flows in 1991, with fairly significant proportions in Mexico and in other Latin American countries. In previous years, 1989 and 1990, Mexico and Chile were the Latin American countries that obtained a particularly large share of portfolio investment in Latin America.[7] Indeed, it was a Chilean firm, CTC (Chilean Telephone Company) which was the first Latin American company since 1963 to sell shares on the New York Stock Exchange, via ADRs.

Also of interest in this context is the Telmex (Mexican Telephone Company) privatisation, which involved the issuance of some $2.3b on several equity markets. This equity offering is reported[8] to be the sixth largest placement of shares in the world (in nominal values).

An important cause (as well as partially an effect) of rapidly increasing foreign portfolio investment in Latin America is the rapid increase in the US dollar stock prices of the main Latin American markets in 1991. According to emerging markets data from IFC, investments in Latin American securities yielded total returns of 134 per cent in dollar terms in 1991. Similar rises have occurred in the prices of country and regional market funds traded in the US and Europe.

Length of period and cost

As regards the length of time for which these capitals are entering, it is encouraging that for some countries, such as Mexico and Chile, and to a lesser extent Venezuela, 1991 was characterised by increased levels of longer term capital flows.

---

[7] P. West "El regreso de los países latinoamericanos al mercado internacional de capitales privados." Revista de la CEPAL September 1991, Santiago de Chile.

[8] See El-Erian, op. cit.

Thus, for Chile, over 65 per cent of the private flows entering in 1991 via were direct investment, all of which was for new investment; for Mexico, almost 35 per cent of private flows entering in 1991, were via direct investment, again all for new investment. Furthermore, Mexico established a new benchmark and reportedly broke a psychological barrier with a ten-year, US$150 million Euro-bond issue for NAFINSA (the national development bank). However, on average, Mexican international bond issues have not improved their maturities that much. According to the IMF,[9] for secured issues average maturities went up only from a 5 year average in 1989 to a 5.5 year average for 1991 (see Table 7); for unsecured issues in the private sector, there has been a more important lengthening of maturities, (from 2 to 4.4 years), but still to fairly short periods.

Table 7
Average Terms on International Bonds (Mexico)

	1989		1990		1991	
	Spread[(1)]	Maturity (Years)	Spread[(1)]	Maturity (Years)	Spread[(1)]	Maturity (Years)
Secured issues	165	5	304	4.4	150	5.5
Unsecured issues						
Public sector	820	5	379	4.9	246	4.2
Private sector	800	2	613	3.6	542	4.4

[(1)]Spread = premium in basic points, defined as the difference between the bond yield at issue and the prevailing yield for industrial country government bonds in the same currency and of comparable maturity. As most of the bonds are issued in US$, the spread in those cases is over LIBOR.

Source: IMF

[9] World Economic and Financial Survey, 1991, op. cit.

On the other hand, public sector unsecured issues saw their average maturity decline slightly. (It is noteworthy, however, how significantly spreads have come down in Mexico, especially for unsecured public issues - (see again Table 7).

Aside from direct investment, some bonds and possibly some portfolio investment, the majority of private capital flows to the region has been short-term, especially in short-term money market instruments, where local short-term Latin American interest rates tend to be significantly higher than in the US. Thus, many American, Latin American and European investors and lenders have been attracted to CDs, Treasury bills, bonds and commercial paper that offer yields at <u>two to four times LIBOR</u> for short-term investments. Table 8 shows estimated bench mark real domestic interest rates and compares them to US$ LIBOR.

Table 8
Benchmark Real (Short-Term) Domestic Interest Rates, 1990-1991

	1990	1991
Argentina (Intercompany lending rate)	47.4%	22.0%
Brazil (Monthly rate - LTN/BBC)	25.4%	32.4%
Chile (90-365 day real annual deposit rate)	9.5%	5.5%
Mexico (28 day CETES rate)	34.7%	15.9%
Venezuela (91 day zero coupon rate)	33.8%	35.5%
US$ LIBOR (6-month average)	8.4%	4.4%

Source: Salomon Brothers, based on national and international sources.

The dramatic drop in short-term US real interest rates since 1989, and especially during 1991 and early 1992, to a level which (by 1980s standards) was very low, drastically increased the attractiveness of short-term Latin American investment instruments, with far higher yields. It is interesting (and worthy of further research) that US investors, faced with lower interest rates at home, increase so much their investments in Latin America, even though European interest rates are far higher than US ones.

As Kuczynski[10] correctly suggests, the fact that in 1991 short-term private capital inflows took place even into countries such as Peru, that were suffering from significant financial and other problems, suggests that the external causes explained the flow of short-term funds, driven by sharply lower short-term interest rates in the US markets, and a far higher short-term interest in countries like Peru, were a very powerful explanation of such short-term flows. As we will discuss in more depth in the next section, other factors (including not just high Latin American interest rates but also better economic prospects in the region) have also played a major role.

The fact that long-term US interest rates (e.g. for 10 year maturities) are high and far above US short-term rates may be an important factor in explaining why a relatively high proportion of recent financial flows to Latin America have been at the short-term end.

Sources of funds

It is also encouraging that the investor base of flows going to Latin America has broadened significantly, particularly in 1991, to include money managers, pension funds, mutual funds, insurance companies, finance companies, as well as Latin American investors, the latter either returning capital home or investing in other countries in that region. Furthermore, multinational companies are increasing their direct investments in the region. According to the World Bank, Mexico and Brazil were among the top three destinations for investment in developing countries, in the period 1981 to 1991 with

[10] P.P. Kuczynski "International Capital Flows into Latin America: What is the Promise?" World Bank Annual Conference on Development Economics, 1992.

China being the first major destination.[11] The prospect of trade integration between Latin American countries, the US and Canada, is further encouraging the formation of strategic alliances between US and Latin American companies, particularly but not only in the case of Mexico, linked to the likely and imminent approval of NAFTA.

An interesting issue is whether a large proportion of the capital flowing into Latin America is from Latin American investors returning home their assets previously held abroad. As can be seen in Table 9, estimated repatriation of capital flight in 1990 reached $7b (for 5 major countries in the region); this would be around 40 per cent of total capital inflows into the whole region during that year (see again Table 3). For 1989, the proportion would be similar. This would seem to give some credibility to the perception of those observers who believe that more than 50 per cent of the capital entering Latin America is from Latin American investors. However, it would seem[12] that a growing proportion of capital flowing into the region originates in investors from outside the region, as the potential and profitability of such flows becomes more broadly known. On the other hand, the fact that so little of the Latin American paper originally bought has come back on the market (for short-term gain) would seem to indicate, according to market participants, that it was largely purchased by Latin investors returning home rather than by developed countries' institutional investors, who tend to sell before maturity expires if gains can be made.[13]

---

[11] Source World Bank. World Bank Debt Tables 1991-92. Vol.I, Washington, D.C., 1991.

[12] Interview material.

[13] Interview material.

Table 9
Estimated Capital Flight (-) Repatriation (+), 1983-90
(US$ billion)

	Argentina	Brazil	Chile	Mexico	Venezuela	Total
83	-1.7	-4.3	+0.2	-1.8	-4.5	-12.1
84	+0.9	-6.4	+1.2	-3.1	-1.6	-9.0
85	+0.4	-1.3	+1.0	-4.1	+0.4	-3.6
86	+1.6	-0.4	+0.6	-2.1	+1.2	+1.0
87	-1.8	-1.0	+0.2	-1.6	+0.9	-3.2
88	+0.8	-1.5	-0.6	-5.3	+1.8	-4.7
89	-1.3	-1.7	0.0	+5.2	+1.2	+3.4
90	+0.3	-1.0	+1.4	+5.5	+0.7	+7.0
1983-90	-0.7	-17.6	+4.1	-7.3	+0.2	-21.3

Source: Chatered West LB, op. cit., Developing Country Investment Review, London, March 1991.

In any case, the return of capital previously fled is an important and positive trend emerging since 1989. According to Chartered West LB estimates for five major Latin American countries (Mexico, Chile, Venezuela, Brazil and Argentina), there was a total net capital repatriation for 1989-90, of $10.5b, which is in sharp contrast with the 1987-88 period, when there was a capital flight of -$8.0b, implying a turnaround of $18.5b in a short period.

As can be seen in Table 9, the situation was quite heterogeneous across these five countries, in 1989-1990. Some countries (Mexico, Venezuela and Chile) saw important levels of repatriation, while other (Brazil and Argentina) saw capital flight; indeed, Brazil - once held as an example of a country to have avoided capital flight - was consistently losing capital between 1983 and 1990. On the contrary, Mexico - a country which traditionally had large capital flight - has had a massive return (estimated at $10b) in the 1989-90 period; the Mexican government estimates that a further $5.5b returned in 1991. Of the five, the only country that has had a significant net repatriation of capital for the whole 1983-90 period is Chile. This seems to have been due both to so-called economic fundamental factors (strength of macro-economic policy, good relations with external creditors, private sector orientation, low inflation, positive real interest rates and a welcoming attitude to foreign direct investment) and institutional factors (debt conversions and dollar-swap mechanism). It is noteworthy that the apparently more sustainable stability given by a successful democratic government (in 1990) implied in that year the highest capital repatriation of the period for Chile (see again Table 9). It is important to stress that, at least in the Chilean case, a return to democracy has had a favourable effect on capital repatriation.

3

Causes of large private inflows into Latin America

It is important to understand the causes of large private inflows into Latin America, not only because it is of interest in itself, but also because such an understanding throws light on two relevant policy issues; one is whether levels of net private flows are likely to be sustained to the countries in Latin America where they are now flowing in such a great scale. The other is to throw some light on what other countries (in the rest of Latin America, in the rest of the developing world and in Eastern Europe) should be equally or at least partly as successful as some Latin American countries have been in attracting new flows.

One set of factors relates to overall supply conditions. We have already mentioned above two key supply factors that have encouraged flows to Latin America; these are the rapid growth and globalisation of world capital markets (especially of bonds and equities) and the dramatic decline in US dollar short-term interest rates. Continued recession or slow growth in the US and Europe further discourage investment there, as do serious debt problems in important sectors, e.g. real estate, in those countries. Indeed, problems in sectors such as real estate in countries like the US and the UK also imply very low (if not negative) yields in such investments. The decline in budget deficits in certain countries (e.g. in the UK) in the 1980s also implied smaller demand from traditional alternative investment sources e.g. gilts;[14] a reduction in the US budget deficit could have a similar effect.

Linked to the previous discussion, it is noteworthy that in 1990-91 there was a sharp swing in the private capital account of the US balance of payments towards increased outflows and reduced inflows. Calvo, Leidermann and Reinhart[15] show that about 60 per cent of the increased capital inflows into Latin America are directly associated with increased private capital outflows from the US to that region, as recorded in the US balance of payments. It is interesting (though perhaps not surprising) that the large capital inflows in 1978-81 to Latin America were matched by increased private capital outflows from the US and the increased capital outflows from Latin America in 1983 were matched by US capital inflows. This link gives quite strong empirical basis to the conclusion reached by Calvo, Leidermann and Reinhart that savings in private capital outflows from the United States play a key role as external impulses affecting the size of capital inflows into Latin America.

Naturally, similar changes in Europe and Japan would also tend to have a similar effect, though the link may be less direct.

More generally, it should be stressed that net private capital flows to the Latin American region do not and will not just depend on conditions and policies in those countries, but also on the savings and investment balances in the rest of the world, interest rate differentials, and on the efficiency and stability of international financial and capital markets.

More broadly, analysis of availability in the medium-term of private external finance to developing countries in general and the LAC region in particular needs to examine the issue whether there is likely to be "a global capital shortage". These concerns were particularly strong in 1990 and 1991, when fears that the capital needs of

---

[14] Financial Times Pension Fund Investment, May 7, 1992.

[15] G.A. Calvo, L. Leidermann and C. Reinhart Capital Inflows and Real Exchange Rate Appreciation in Latin America: the Role of External Factors. June 1992, International Monetary Fund Research Department.

the transition from socialist to market based economies in Eastern Europe and the former Soviet Union, the capital needs of German reunification and the need for reconstruction in the Middle East after the Gulf war raised concerns that developing countries could perhaps be crowded out of world markets.[16]

Such concerns have tended to diminish in 1992, as the depth of recession or slowness of the recovery in large parts of the developed world reduced demand for investment there and as it became evident that a clear distinction needs to be made between needs (notional demand) and effective demand. For example, the demand for savings has become effective in some cases like Kuwait; however, for much of Eastern Europe and the CIS, important uncertainties are inhibiting private flows to these countries. Finally, the very fact that certain LAC countries actually regained access to capital markets in 1990 and 1991 seemed to show that the capital shortage constraint was at least at the time not so restrictive as some had feared.

However, the fact that long-term real interest rates in practically all the major industrial economies remain high, and real interest rates have risen recently in some (e.g. European) countries, seems to indicate that the worldwide demand for savings relative to supply remains strong. This is only partly linked to the increases in new demands for savings outlined; it is also widely perceived to be linked to factors restraining the long-term global supply of savings, such as demographic factors and high public sector dissavings, e.g. in the US. Furthermore, there remain fears that the constraints on bank intermediation, partly linked to tighter regulatory and supervisory regimes, could lead to banks scaling down asset growth, particularly internationally. These fears have also been somewhat scaled down, partly by the fact that - as discussed above - intermediation has increasingly been carried out via securitized forms of lending.

Because of the factors outlined above, some concern about future capital shortage is valid, especially if and when demand for investment increases in developed countries, as these economies eventually recover. A potential capital shortage in the 1990s would probably lead to higher interest rate costs, but it seems unlikely to lead to an abrupt rationing of capital to developing countries, especially the more creditworthy ones,

---

[16] See, for example, IMF International Capital Markets, Development and Prospects, May 1991; World Bank world Debt Tables, 1991-92.

though it could make market re-entry somewhat more difficult for those just regaining creditworthiness. As we suggest below, this subject seems to require further study and monitoring.

Before continuing our analysis, it seems worthwhile to stress again that it is however very encouraging that certain LAC countries have regained access to international financial and capital markets at a time (1990/91) when several international factors (declining German current account surplus, increased demands from EE and CIS, fragility of some international banks) were either problematic and/or highly uncertain.

We will now examine the factors which attracted flows specifically to certain Latin American countries.

Clearly improved domestic policies and economic prospects in Latin American countries played a key role in attracting new flows, particularly but not only to some of the biggest countries in the region, as did other important factors which we discuss below.

Improved domestic policies and prospects

There is consensus that a very important factor explaining access to foreign flows, especially long-term ones, (as well as encouragement of return capital by nationals) is the reduction of domestic financial imbalances - where these existed - due to improved budgetary performance and prudent monetary policies. Amongst the relevant factors are reinforcement of fiscal revenue efforts and positive real interest rates. Secondly, macro-economic policies that enhance the supply response of the economy are clearly important, including that of production of tradeables. As, for example, the Chilean experience in the '80s clearly shows, a competitive exchange rate plays a key role in promoting production of tradeables. A third area where domestic policies seem important is improving economic efficiency through structural reforms, such as trade liberalisation, tax reform, rationalisation of legal and other procedures ruling foreign investment, etc. It should however be emphasised that some of these structural reforms, and especially trade liberalisations, initially have high costs, especially if carried out very rapidly and during periods of foreign exchange insecurity, as is well illustrated by the

Chilean experience during the 1970s.

Latin American countries have made particularly significant efforts also to relax limitations on foreign ownership as a way to attract foreign direct investment. As N. Lustig[17] emphasises for the Mexican case, "after 1982 it was no longer possible to wait for foreign investment to follow growth. Foreign investment had to come before growth was in place. It became a needed ingredient for growth...", therefore major efforts were made to attract it. Two types of measures that have clearly encouraged foreign capital inflows are privatisation (and the high rates of return associated with it) and development of the domestic capital markets, especially but not only of the stock exchanges.

There are two areas not so frequently stressed in the academic literature which however seem important factors to explain both foreign capital inflows and return of flight capital. One is economic growth or the prospect of increased growth. The former was initially illustrated by the Chilean case and the latter illustrated by the Mexican case, where prospects of growth are not only bolstered by recent figures, but also very crucially by the increasingly certain prospects of the FTA with the US and Canada. Furthermore, in 1991, for several Latin American countries growth prospects both improved and were seen to improve significantly. However, serious problems remain partly inherited from the 1980s, such as still relatively low levels of investment and a heavily concentrated distribution of income. A second additional factor is political stability, preferably in the context of a relatively consensual and democratic political process. The increase in capital inflows into Chile during the first year of democratic government provides evidence for the importance of this factor. More generally, the fairly broad transition towards democratic governments in the LAC region seems to be a factor increasing its attractiveness to foreign investors and lenders.

[17] Lustig, N. "Mexico's Integration Strategy with North America" in C. Bradford (ed.) Strategic Options for Latin America, OECD Development Centre and IADB 1992, Paris.

Restructuring of existing debt

There is now also agreement in the economic literature[18] that for many countries it is a pre-condition for renewed capital flows that the "old debt overhang" be eliminated or significantly reduced. There is now strong evidence (for example from Mexico) that at least for some countries there can be a strong complementarity between some debt reduction (as in Mexico via its Brady deal) and increased capital inflows. As had been hoped by the Mexican government,[19] the positive indirect effects of Mexico's Brady deal became more important than the direct effects. The multi-annual Mexican Brady deal, which not only reduced debt service but also shifted amortisations forward for an important number of years, reduced uncertainty and provided confidence, contributing to indirect benefits (including significantly increased capital flows and return of capital flight), which are estimated - at least in the short-term - to have been more important than the cash flow effects of the Brady package.[20]

In the case of Venezuela, there is preliminary evidence that also its Brady deal has contributed to increased capital flows. The case of Chile is somewhat different, as its debt overhang was dealt with through pure market-based techniques (mainly via debt-equity swaps) and - in 1990 - a more conventional rescheduling of commercial debt. However, also in this case, the reduction of the debt overhang (together with rapidly growing exports) was an important factor in encouraging new private flows.

In the case of Costa Rica, the country with the deepest debt reduction achieved

---

[18] Amongst those stressing the direct link between debt reduction and new capital flows, see M. Dooley, "Market valuation of external debt", in J. Frenkel, M. Dooley and P. Wickan (eds.), Analytical Issues in Debt, 1990, IMF Washington, D.C. and S. van Wijnbergen (1991), "Mexico and the Brady Plan", Economic Policy, April; Sachs, Krugman and others have argued in the similar way.

[19] See, P. Aspe, "The Renegotiation of Mexico's External Debt", in M. Faber and S. Griffith-Jones (eds.), Approaches to Third World Debt Reduction, IDS Bulletin, Vol.21, No.2, April 1990.

[20] For a more detailed discussion, see S. Griffith-Jones (1991), Is there still a Latin American debt crisis? Paper prepared for CEPAL.

via a Brady deal,[21] new flows from the banks were deliberately not an option on the Brady menu, but new flows to that country have reportedly started to arrive, after the Brady deal was finalised.

However, it should be mentioned here that rather surprisingly countries - like Brazil and Argentina - which had not reached an agreement with the commercial banks, and (in the case of Brazil) which had not yet put "their macro-economic house in order" have had since 1991 access to new capital flows (though at less attractive financial terms and especially for flows of a more short-term nature). It is interesting that these new private flows may, in the case of Brazil, contribute to a reduction in the debt overhang (by reducing arrears and/or easing the serviceability of foreign debt), thus reversing the causality observed in other countries! Indeed, the sharp increase in Brazil's foreign exchange reserves in 1991, partly caused by these large inflows, may help the Brazilian government put together a Brady type debt reduction package, as part of these reserves could be used to pay for collateral required by banks for this purpose.

These flows seem to have come partly[22] on the expectation that Brazil and Argentina will follow the same positive path of Chile, Mexico and Venezuela (a sort of positive regionalisation of expectations) and partly is linked to the fact that it is highly creditworthy companies (allowed unrestricted access to foreign exchange and with a good payment record in the past) which have been attracting these flows. However, in the medium-term, for companies in those countries to borrow significant amounts and at cheaper and longer terms, it seems an important pre-requisite that the countries' macro-economic situation improves and that the debt overhang has some kind of definite settlement.

Nevertheless, it is important to stress that the "quality" of the companies attracting the flows (whether public or private, or - as often occurred recently - in the context of privatisation), is a very significant element in attracting new flows. Large, well-known, creditworthy companies, especially if they are exporters, will find this task much easier.

---

[21] See, S. Griffith-Jones and R. Gottschalk "Is there still a Latin American debt crisis?" Paper prepared for ECLAC, September 1991.

[22] Interview material.

It seems to be that the size, and reputation of the companies rather than particular sectors is what attracts foreign flows. Indeed, foreign flows have been attracted by companies in sectors as diverse as oil, paper, tourism, banks, telephone companies and copper mines; perhaps the main common feature is their ability to generate foreign exchange income via their sales. It would also seem that countries with a large domestic market may have some advantage in attracting private flows: foreign and domestic markets often complement each other. This is an area where further study is required, both on the empirical evidence (which is incomplete for small countries) and on analysis of causes.

Indeed, at present, It is unclear whether small countries in the region (with fewer and less well known companies of the category described above) will be equally able to attract in such a large scale the type of new private inflows that are now coming into Mexico, Chile, Venezuela, Colombia and may continue to enter Argentina and Brazil, though preliminary evidence does indicate some increase in new private flows to countries such as Costa Rica, where Brady deals have been reached. Their task is made even more difficult if they still have an unresolved debt overhang, as several (e.g. Ecuador) do. In this sense, it seems important if that is the case that: i) they get - where necessary - relatively more debt reduction than those countries which can attract new flows; ii) they get strong support from the IFIs in reaching soon a favourable debt settlement (as commercial banks may be less keen in those cases to do so, and as they may require more debt reduction); iii) they continue to have significant access to official flows, and iv) that special efforts are made by IFIs and industrial governments to help those countries attract private flows.

Reduced transaction costs

Though perhaps somewhat less important, but also of significance, is the fact that there has been a reduction in transaction costs for developing countries to access international capital markets, and especially that of the USA. The 1990 approval of "Regulation S" and "Rule 144A" has reduced transaction costs and liquidity problems for

LAC countries tapping US markets.[23] Regulation S exempts securities from registration and disclosure requirements (with costs for first time LDC issues estimated formerly in the order of US $500.000 to US $700.000); simultaneously, the adoption of rule 144A reduced the loss of liquidity associated with "private placements" (in the past buyers of securities through private placements has to hold them for at least two years after the initial offering). Since 1990, "qualified institutional buyers" (e.g. entities managing and owning at least $100 million in securities) have had the 2 year holding requirement relaxed.

These changes have also reportedly reinforced the possibilities offered by the American Depository Receipts (ADR) programme without meeting the full costs of offerings/listings. This has helped LAC countries (e.g. Chile, Mexico, as described above) to place shares in the US market.

Also, access to bond markets for LAC countries has lead to and has been helped by established market-credible credit ratings, thus reducing investors' costs, and allowing access by LAC countries to new segments of the international capital markets, with Mexico receiving its first credit rating by Moody's Investors in December 1990. The ceiling rating for Mexico debt was set at B a 2, just below investment grade, but there seems to be good possibilities for an upgrading. Indeed, it could be argued that the market is already giving investment grade to Mexico and the credit ratings are lagging behind.

These improvements in access to US capital markets should also be accompanied by similar (or equivalent) changes, if necessary, in European and/or Japanese markets. Some steps have already been taken. For example, in Japan, in June 1991, the authorities lowered the minimum credit rating standards for public bond issues on the Samurai market (from single A to triple B). In Switzerland, steps are being taken to abolish minimum credit requirements.

[23] G. Pfefferman and A. Madarassy, op. cit.

Possibility of customising financial instruments

One option for improving access to capital markets, especially by countries at a stage when they are re-establishing (or establishing) fully their reputation in those markets, is to provide explicit credit enhancements, via collateralisation (e.g. on the basis of existing assets, such as deposits abroad), or expected stream of receivables, (such as Telmex's attracting investors by providing them a claim on payments due to it by the US company AT and T on account of international communications). Another technique recently used by LAC borrowers has been enhancement by early redemption options, and particularly by a "put option" which provides the holder with the discretion to resell (put) the bond to the borrower at a predetermined price.

Such mechanisms have been innovatively used in recent year by Mexican, Venezuelan and other LAC companies; their use could be broadened, if necessary, to companies and countries that need to offer this type of "comfort", and to investors still somewhat worried about credit and transfer risk. However, possible costs of extensive use of this mechanism need to be carefully evaluated, and should be a cause of some concern. These costs include in particular the reduction of flexibility for the country and the company on use of its future income, as well as costs associated with legal and technical arrangements. These should be compared with the advantage of initially helping restore market access and of possibly obtaining funds cheaper than would have been otherwise possible. More broadly, the proliferation of explicit or implicit government guarantees should be avoided, unless they are essential.

Other structural elements

As regards foreign direct investment, besides the factors outlined above, there seems to be additional, more structural elements, which influence its level. Thus, a 1992 IFC study[24] concludes rather categorically that recent research suggests that the traditional determinants of FDI levels, such as labour costs and country risk have become far less important then in the past. On the contrary, structural factors - such as

---

[24] G. Pfefferman and A. Madarassy, op. cit.

the availability of an educated and highly skilled work-force, market size, quality of infrastructure, level of industrialisation and the size of the existing stock of FDI, as an indicator of the quality of the business climate in the country - play an increasingly important role.

4

Key policy issues for capital-importing countries

Undoubtedly, the fact that private capital flows are flowing back to certain major countries in Latin America is a very positive trend, reflecting international recognition of those countries' improved growth performance, international competitiveness, and declining inflation Both policy-makers and major social actors in those countries clearly deserve praise for having achieved such important turnarounds in their economies, that have encouraged such a rapid renewed access to private capital markets, so soon after the major debt crises of the 1980s.

In clearly welcoming these trends, certain policy-relevant questions need to be asked. Are the current high levels of net private flows to those countries likely to be sustainable for a long period? Are the terms, in relation to maturities, costs and guarantees particularly of borrowing, not too onerous for the recipient economies? Are the risks taken by lenders/investors not eventually going to become too high? Are the external resources being productively invested in the country? Is a sufficiently high proportion of this investment in foreign exchange generating/saving economic activity, that will help service the debt or generate other flows abroad? Are these large flows not having undesirable, as well as clearly desirable, macro-economic effects on recipient economies? What measures are being taken by governments of recipient economies to counteract such problematic effects, and how effective are they? It seems rather urgent to conduct fairly detailed empirical research which will provide a more informed basis for answering such questions.

On a more positive note, questions need to be asked on what lessons can be learnt from Chile, Mexico and others by other developing countries as well as East European countries and CIS Republics, on how they can regain or gain access to international private capital markets? Is it likely that other countries (in Latin America, but also in poorer parts of the world, like in Africa) can gain/regain access to new private flows? Or are there structural reasons, which make it more difficult? If so, what can be done, within and outside those countries, to help them gain access to private capital markets? What role should be played by guarantee mechanisms, for example via the World Bank and/or regional banks to encourage new private flows to the poorer, less creditworthy countries?

Returning to the Latin American countries that have regained market access, policy questions need to be asked both in countries where flows originate and are received. At one level, what can be done to improve, deepen and make sustainable access by those countries to developed countries' flows? What can be done especially for improving access to flows that are more long-term, and have lower as well as less variable cost? At another level, should regulators and supervisors in developed and developing countries increase their monitoring, supervision and possibly regulation, especially of the new categories of flows that are coming in, such as for example portfolio investment? How best can a balance be achieved, which satisfies prudential needs, without unduly constraining access to LDCs? Should central banks take policy action to regulate the total level of capital flows coming in, especially those of a more short-term nature? What measures are more appropriate?

The need to ask this type of question arises both out of economic history and out of economic analysis. Writers such as Bagehot,[25] as far back as 1873, and far more recently Kindleberger,[26] have pointed out that private capital markets tend to be characterised by successive periods of over-lending and under-lending, often resulting in costly financial crises. Kindleberger analyses the pattern of boom (usually in times

[25] Bagehot, W. (1873), Lombard Street: A Description of the Money Market, J. Murray, 1917 reprint editions, London.

[26] Kindleberger, C. (1978), Manias, Panics and Crashes: A History of Financial Crisis, Macmillan, Basingstoke and New York.

of upward movement in the business cycle) and over-contraction of lending, usually in times of slow-down of economic activity, and has illustrated this pattern with historical examples, going as far back as the South-Sea Bubble. Marichal[27] and others have described the five great debt crisis resulting from previous lending booms that have occurred in Latin America since Independence, in the mid 1820s, in the mid 1870s, in early 1890s, in the 1930s and in the 1980s.

A useful framework of analysis for current new flows is suggested by a recent paper of Corden, and by John Williamson's comments on it,[28] focused on lessons of experience from lending booms in the 1970s and the debt crises of the 1980s. Based on empirical analysis Corden examines phenomena of increased spending in developing countries whether on consumption and investment, caused mainly by ready availability of funds from world capital markets; he stresses public spending booms, but recognises that private sector booms have in practice similar effects (as illustrated by the Chilean experience in the 1970s and early 1980s). Two effects of the booms need to be carefully distinguished. The first is the Keynesian effect, which reflects itself via higher demand for home-produced goods and a reduction of the foreign exchange constraint, in a short-term rise in the growth rate; to the extent that the increase in demand and the inflows of capital are temporary, this Keynesian boom is temporary. Not only does the rate of growth of output initially rise, but to the extent that the boom was financed by foreign flows, spending can grow even faster. Once - and if - a debt crisis starts, investment and growth of output falls, often drastically; debt service payments are rising very fast, the rate of growth - or the level of national income - fall even more. Usually in the first phase, there is an appreciation of the exchange rate, as the capital inflows create a "Dutch disease" type of pressure, often initially welcomed by governments understandably anxious to lower inflation or avoid its increase (for a more detailed discussion, see below).

---

[27] Marichal, C. (1988), Historia de la deuda externa de América Latina, Alianza Editorial, Madrid.

[28] M. Corden, "Macro-economic Policy and Growth: Some Lessons of Experience", J. Williamson "Comment on Corden's paper", both in World Bank, Proceedings of the World Bank Annual Conference on Development Economics 1990, Washington, D.C.

The second type of effect of lending booms (that need to be carefully distinguished, from the former) are on growth of capacity (on the supply side). It is crucial here what proportion of external flows goes to investment in the country, how productive it is, and what proportion of it is - directly and/or indirectly - converted into tradeables. If enough efficient investment takes place and output rises sufficiently (and is converted into tradeables in a large enough proportion), it is more likely that future debt service or other flows generated by the original inflows can be financed without problem.[29] The rise in debt or foreign investment will not have been a problem; indeed, it will have temporarily increased the rate of growth and made the country permanently better off. What Corden surprisingly does not mention, if other positive effects are unchained (such as increased productivity of investment and/or increase in domestic saving and investment), the long-term effects on growth can be even bigger and more sustainable.

However, there is also a less rosy scenario. If increased investment proves insufficient and/or inefficient (the latter, either because it was ex-ante inefficient or because unexpected adverse movements of international interest rates, terms of trade or other changes occur) and if not enough production of tradeables is generated, then the initial output growth is followed by a debt problem, leading possibly to reductions in total absorption below levels that could have been sustained in the absence of the earlier boom. Thus, particularly the total effect (through time) of such flows on the country's retained income can be negative, even if the effect on output may have been positive.

The rosy scenario is more likely to materialise if the modality of flows is better suited for long-term growth. This implies preferably long-term, low cost modalities, or even better mechanisms where outflows are linked to results. In this sense, it is important that LDC borrowers make use of instruments available on the market, that reduce vulnerability to variables such as commodity prices and international interest rates, and that they contribute to the further development of such instruments. Short-term lending at variable interest rates is, on the other hand, particularly undesirable, as the experience of the 1980s so dramatically shows.

---

[29] For a more detailed discussion, see S. Griffith-Jones, "International Financial Markets; A Case of Market Failure", in C. Colclough and J. Manor (eds.) (1991) States or Markets? Neo-liberalism and the Development Policy, Clarendon Press, Oxford.

Because of the risk of the less rosy scenario occurring, precautions would seem essential to minimise such risks and to maximise the likelihood that both investors, lenders, as well as recipients and borrowers, obtain not just short-term but also sustainable benefits from such flows. A strengthening of international public compensatory mechanisms (e.g. via enlargement of the IMF facility for this purpose) could give an additional layer of protection, against instability in international variables, such as commodity prices and interest rates.

However, it should be stressed that the renewal of private flows to Latin America in the early 1990s has played a key positive role in helping kick-start economic recovery, in reviving domestic private sector confidence and increasing government revenues, thus making the funding of urgently needed social spending possible in reviving domestic private sector confidence and increasing government revenues. The value of this initial, positive Keynesian effect of foreign flows should therefore not be under-estimated, especially in a region, emerging from a "lost decade" in terms of growth and development.

More problematic has been, and may continue to be, the appreciation of real exchange rates accruing as a result of large capital inflows. Of 18 Latin American countries, 15 had their exchange rate appreciate, between 5-20 per cent during 1991. Though partly in the correct direction, as they compensate for massive real devaluations in the 1980s, these revaluations in 1991 and early 1992 pose a number of risks, including that of growing and increasingly unsustainable trade deficits, especially in some countries.

Indeed, the macro-economic (and especially exchange rate) effects of large capital inflows have rightly become a source of concern to the monetary and financial authorities in the LAC region, as well as to institutions like the IADB, the World Bank and the IMF.[30]

---

[30] Two conferences have been organised, where papers related to this subject have recently been presented. One was the LIV Meeting of Governors of Central Banks of Latin America and Spain, held in San Salvador in May 1992 and a World Bank Conference on "The Capital Account and Macro-Economic Policies" held in June 1992.

A debate is just starting about the likely macro-economic effects of such inflows, as well as the correct policy response to these flows.

As Roberto Zahler, the Governor of the Chilean Central Bank[31] points out, a large inflow of capital may not only increase the economy's liquidity, make domestic interest rates fall and lead to an increase in aggregate expenditure, which poses dangers of increasing inflationary pressures, but also may lead to an over-valuation of the exchange rate, which encourages a larger current account deficit; this may be unsustainable in the medium-term. Furthermore, as Zahler correctly argues, an over-valued exchange rate discourages exports, whose dynamism has played a key role in many Latin American and Caribbean countries' recent development, for example by leading and encouraging technological development in those countries. An over-valued exchange rate could lead to bankruptcies in the export sectors and to a disincentive for new investment in them, with negative effects on development. Furthermore, if the inflows are at least in part temporary, at some time it will become necessary to devalue, in real terms, which will then generate inflationary pressures.

The range of policy options to attempt to regulate the exchange rate in conditions of major capital inflows include: i) efforts at increasing national savings, which by lowering domestic interest rates discourage inflows. This can relatively more easily be done in the short-term via fiscal policy, and in particular via cuts in government spending. However, this approach (especially on a large scale) may not be politically feasible and/or economically desirable, especially if high priority spending had to be cut; ii) sterilized intervention, whereby the central bank sells government debt in exchange for its purchases of foreign exchange. This approach, used fairly extensively in South-East Asia has the attractive feature that it does not affect the domestic monetary base and moderates the impact of capital flows on the exchange rate, though the magnitude of its impact on the exchange rate is somewhat debated in the literature.[32] However,

---

[31] R. Zahler Politica Monetaria en un Contexto de Apertura de la Cuenta de Capitales, LIV Reunion de Gobernadores de Bancos Centrales de America Latina y de España. San Salvador, Mayo de 1992.

[32] See, G. Calvo, L. Leiderman and C. Reinhart, op. cit. and Balassa, Bela and John Williamson, Adjusting to Success: Balance of Payments Policy in the East Asian NICs (Washington: IIE, 1987)

this approach has costs. In particular, it may impose important losses on Central Banks, if the rate of interest at which the resources are invested abroad is significantly lower than the rate of interest at which it can place its debt domestically. If large, this loss, which increases the "quasi-fiscal deficit" imposes either a present and future fiscal burden and/or future increases in the money supply. Furthermore, other possible undesirable effects may include the perpetuation of a relatively high domestic/foreign interest rate differential, thus increasing the persistence of capital inflows. The higher domestic interest rates could also increase total domestic debt service by the government, which again is undesirable. Finally, by sterilizing and re-exporting the capital inflow, it has been argued that the country is unable to use the additional foreign exchange to increase its productive capacity with imported capital goods.[33]

iii) Measures can be taken to discourage capital inflows, both in general, or (as is more often done) discourage short-term capital inflows. The measures taken often seek to equalise the cost of foreign and domestic borrowing, by making the former more expensive, either via taxes or via reserve requirements. This both allows the monetary authority to maintain greater autonomy in its domestic interest rate policy, while reducing the magnitude of foreign inflows and therefore reducing the over-valuation of the exchange rate. Furthermore, these types of measures, if only applied to certain flows, allow at least a certain degree of discrimination in favour of more long-term flows.

These measures also have problems, particularly if sustained over a fairly long period, as market actors increasingly find mechanisms to circumvent or evade these measures. Furthermore, as Zahler, points out, these measures have some micro-economic costs, as foreign borrowing is more expensive than it would otherwise be. However, this needs to be compared with the macro-economic positive effects of these measures, linked to a greater exchange rate stability (and thus with a more sustainable current account deficit) and to better monetary management.

iv) Finally, there is the option of no policy intervention, which implies allowing

[33] M. Mancera "La Politica Monetaria en el Contexto de un Flujo Amplio de Capitales Procedentes del Exterior". Paper presented to LIV Meeting of Governors of Central Banks from Latin America and Spain.

the nominal and real exchange rate to increase, and the monetary base to expand.

The decision whether and how to intervene is a complex one; it is to an important extent based on judgement of whether the flows are likely to be permanent or transitory. If the flows are likely to continue coming in at a fairly stable level, and are unlikely to be reversed, it seems desirable to allow their entry and especially to encourage their use in productive investment. In such a case, the over-valuation of the exchange rate may be less problematic. However, if the flows are more short-term and volatile, measures to control them or moderate their effects (such as were discussed above) become more appropriate, as they would smooth out large fluctuations in both nominal and real variables, such as the nominal and real exchange rate.

An important element of research on these capital flows is therefore to try to determine the extent to which (for different countries) they are temporary or permanent. Therefore, part of the proposed IDRC research should, as discussed below, focus on trying to clarify this central element.

5

Conclusions and policy suggestions

Drawing on this analysis, it seems important to stress the following:

1. As regards the scale of private flows, and especially debt-creating ones, it seems desirable that all involved err on the side of prudence. It is when international private flows represent a very large proportion of developing countries' GDP or (particularly) exports, that their impact on borrowers and lenders are more likely to become problematic.

2. Some type of flows seem more desirable than others, and where possible recipient and originating countries' governments should encourage a desirable mix. Foreign direct investment on the whole seems more desirable than lending, as it tends to imply more careful cost-benefit calculation by investors, is more likely to bring additional efficiency gains and as profit-remittances tend to be more closely linked to the success of the project than debt servicing. However, in some cases the rates of profit remittances may surpass debt servicing. This is a subject where more recent analysis of empirical trends may be required. Within borrowing countries, longer maturities are obviously preferable to short-term ones; fixed interest instruments are preferable to variable interest ones, unless expectations of declining interest rates are strong, and - obviously, but often forgotten -borrowing at very high cost may unless the country has no other option be less desirable than not borrowing at all. Again, more detailed analysis of the conditions (term, level and variability of interest rates) with which lending is now taking place is desirable.

The preliminary evidence presented in Section II seems to indicate that most of the private flows of the early 1990s have a better profile than those of the 1970s, in that a higher proportion (e.g. Chile and Mexico) comes as foreign direct investment, and a higher proportion of lending to some countries (e.g. Mexico) comes via fixed interest bonds. Furthermore, as discussed above, the conditions on bonds, particularly for Mexico have improved rather significantly, especially in terms of large reduction in risk premiums. In the case of other countries, e.g. Brazil and Peru, a large proportion of flows seem to come in via rather short-term and high cost lending, which is far more problematic.

This leads to two preliminary conclusions. One is the need by the recipient countries and by international institutions, such as the IMF and BIS, to monitor carefully and precisely all capital inflows into different Latin American countries, as well as their conditions. This is no easy task as some of the flows may not be currently registered and as there are methodological problems (such as, for example, to calculate effective yields on bonds rather than initial yields, which are normally recorded). Efforts need to be made in this direction, to avoid the problems of the mid to late 1970s, when information on private flows was so insufficient, that it contributed to incorrect decision-making. A second conclusion is that it may be necessary for recipient countries in particular to discourage excessive inflows, particularly of certain types of inflows. In this sense, recent measures (through different mechanisms by the Chilean, Mexican and Brazilian Governments either to discourage all flows or more short-term ones) seem clearly well taken. Further measures may be required in those or other countries both to regulate flows and/or to regulate their effects if flows continue at excessive levels.

As regards type of flows, it has been argued in certain circles that there is a smaller risk of negative effects if the flows originate in and go to the private sector. In relation to bonds, for Mexico (in 1991) and Brazil (1991), Tables 10 and 11 clearly indicate that <u>most of the bond finance flowed into the private sector</u>, though in the case of Mexico, the situation was different in 1989 and 1990, (see again Table 10). Though this should provide some comfort, as the private sector is likely to be more efficient than state enterprises, it needs to be remembered that some of the previous boom-bust lending cycles have also involved private actors as both lenders and borrowers.

Table 10
Mexico: Issue of Bonds, by Type of Borrowers

	Number of Issues			Amount in %		
	1989	1990	1991*	1989	1990	1991*
Public						
Sovereign			2			
Banks		4	1	29.9	21.9	5.1
Development banks		2	1		4.4	6.4
Eximbank	1	1	2		6.6	8.9
PEMEX		4	3		11.0	14.0
TELMEX	1	2		47.8	22.6	
CFE		1			10.3	
Sub total	2	14	9	77.6	76.7	34.4
Private						
Banks		1	2		2.2	4.8
Cement	1	1	2	22.4	4.4	29.3
Mining		2			6.6	
Telmex			1		0.0	29.0
Tobacco		1			2.9	
Oil		1	1		1.4	2.5
Steel		1			2.2	
Others		2			3.6	
Sub total	1	9	6	22.4	23.3	65.6
Total	3	23	15	100.0	100.0	100.0

*Till September 1991
Source: Data based on Banco de Mexico information.

Table 11
- 1991 Brazil -

	Issues	Amount (US$ million)	%
Public			
Sovereign			
Banks			
Development bank	1	55	1.61
Eximbank			
PETROBRAS	5	842	24.72
TELEBRAS[(a)]	2	225	6.61
Sub total		1122	32.94
Private			
Steel	1	200	5.87
Bank	2	130	3.82
Celulose	1	40	1.17
Computers	1	100	2.94
Deriv. Oil	1	50	1.47
Chemical	3	120	3.52
Others	4	186	5.46
Others <20mUSD		1458	42.81
Sub total		2284	67.06
Grand total		3406	100.0

[(a)] It is expected that Telebras will start being privatised in 1993.

Source: Data based on Salomon Brothers, 1992, op. cit.

While private actors may be more efficient at taking decisions and managing enterprises at a micro-economic level, governments and public international organisations do have an advantage to analyze trends at a macro-economic level, and evaluate whether the sum of micro-economic decisions taken by private actors is efficient and sustainable in the present and future. Hence, the need for government monitoring, supervision and regulation of private flows.

Furthermore, as regards private investors, especially in bonds, it is interesting that the risk is not wholly taken by them, as most bond issues (particularly to private sector borrowers) are either collateralised by receivables and by letters of credit or have put options; this transfers part of the risk to the borrower. Though attractive and ingenious as a mechanism for helping re-entry to capital markets, it implies that investors may not evaluate the risk as fully as they would in other circumstances, and as a result of these conditions, the supply of finance does not reflect pure market risk/reward ratios.

More broadly, private lenders and borrowers (and especially large ones) may assume, based on past experience, that there are implicit government guarantees/insurance on their flows; this may further increase supply beyond levels that pure market considerations would determine. This provides a particularly strong, theoretical and practical reason for government supervision and regulation, at the stage when new flows are expanding, as governments may be brought in anyway at a later stage, if things go wrong, to bail out the private sector at taxpayers' expense. Even more generally, it can be argued that because financial markets are prone to over-react, in both directions, and this may have severe costs for the society as a whole, the need to avoid such market failures justifies the need for regulation and supervision.

3. It is necessary that the projects which new flows are to finance should be carefully evaluated, with cost-benefit techniques, which compare the present value of estimated total costs and revenues, and examine in particular the estimated foreign exchange cost-benefit balance of individual projects, as well as the overall sum of costs and benefits for all inflows. As Corden and Williamson op. cit., correctly point out, due account needs to be taken in such evaluations of future likely devaluations, if and when the lending boom diminishes.

As risks tend to be distributed in an unclear fashion among private lenders/investors and borrowers, and among private and public institutions (both in originating and recipient countries), it seems important that at least one actor carries out rigorous and careful cost-benefit analysis. In this sense, it would seem desirable that Governments in recipient countries either carry out such analysis themselves or verify strictly that the private sector is doing so, and provide the necessary technical assistance if required.

It is naturally essential that such evaluations, and other necessary supervisory or regulatory measures (e.g. of local stock exchanges) are not done in a way that would stifle such flows, with unnecessary red tape. The need for agility should however be combined with a minimum of prudence. Such a balance is not easy, given the speed with which booms of lending/investment originate and develop, as well as the large scale on which they often take place. Relevant timely and independent technical assistance (from IFIs, developed country regulators, from other LDC regulators) may be very valuable; rapid exchange of information among regulators of different sectors (banking, securities, others) and different countries may need to be organised on a systematic basis. Regulatory and information gaps need to be filled quickly to the extent that the creation of new markets may not yet have been accompanied by appropriate supervisory and regulatory institutions.

In the case of developed countries, the need for more appropriate regulation and supervision of flows to developing countries in certain sectors (e.g. insurance companies, pension funds) needs to be put in a broader context of appropriate regulation of all these institutions' investments.

4. Difficult issues of macro-economic management are raised for recipient countries, especially as regards their level of spending, control of the money supply and level of the exchange rate.

Williamson and Corden conclude that countries should try to restrict their spending to the level of their permanent income. Equally, they need an exchange rate, that is consistent with long-term equilibrium in the balance of payments. However, in practice, these are complex matters, as for example the level of permanent income or of an "equilibrium exchange rate" crucially depends (amongst other factors) on how large and how permanent private capital flows will be, on future evaluation of terms of trade, international interest rates, etc. Again erring on the side of prudence may be advisable, as regards some counter-cyclical policy and avoiding excessive over-valuation.

Further policy-relevant research is required, that studies the policy dilemmas in the new circumstances (both internationally and nationally), taking into account the far more deregulated international environment and the greater openness and reliance on market forces of recipient economies. Interchange of policy experiences amongst countries and an analysis of their effectiveness will be very valuable.

5. Finally, it should be emphasised that creditors and investors do have very good long-term reasons to channel long-term funds especially into certain Latin American countries. These have made major and costly efforts at very successfully restoring macro-economic equilibrium, under very difficult circumstances; they have also introduced a number of structural reforms, which have increased dramatically those countries' ability to augment exports. Partly, as a result of such efforts, growth has in some countries increased (though investment levels are still relatively low and income distribution is very unequal) and inflation has come down. More importantly perhaps, there is strong consensus within these countries for continuation of such policies.

There is however perhaps need for a final word of warning. This is for both lenders/investors to beware of euphoria; also, successful governments in Latin American countries would probably do well to remember Williamson's suggestion, that all positive shocks should be treated as though they were transitory and all negative shocks as though they were permanent. The most hopeful element about the new situation is perhaps precisely that in many aspects many Latin American governments (though clearly not all) seem to be taking such advice seriously. If this continues, perhaps the new private capital inflows to them may be sustainable in the medium-term, and the "rosy scenario" may materialise, as it has in some selected developing countries, such as South Korea.

Besides prudence in financial and macro-economic matters, as well as the other elements discussed above, a pre-condition for the "rosy scenario" may be sustained efforts, e.g. by increases in government social spending, in education and health to improve the welfare of the poorest groups in Latin American countries. Besides it being equitable, such measures would both improve political stability and sustainability and contribute to human capital development, essential both for growth and for attracting long-term capital flows. Furthermore, given the current macro-economic situation, such increases in social spending could be more easily funded in a non-inflationary manner. Indeed, for example, the very fact that international and domestic interest rates are declining for many Latin American governments, as well as the revaluation of their currencies, eases the domestic currency cost for those governments to service their debt, both domestic and foreign. This allows them some room for increasing, in a non-inflationary way, social spending.

6

Questions for the IDRC research project

The rapid increase of private capital flows to Latin America poses a number of both empirical and policy issues for: i) industrialised countries and ii) re-entrant receiving developing countries.[1] Studies on both sets of countries need to be clearly set into historical context, since outflows and inflows of capital have profoundly affected their economic development over the past two centuries. In other words, current trends will be examined with a view to their historical continuity.

i) As regards **industrialised countries**, the analysis would separate out three major geographical areas, from which private flows originate: North America (i.e. US/Canada); the European Community; and Japan. The project will focus on the first two (North America and Europe).

In both geographical areas, careful distinctions would be made between different segments of the capital markets, following the hypothesis that various segments of the capital market seem to respond to fairly different behavioral norms and strategic objectives. Thus, for example, foreign direct investment may be better understood as strategic market behaviour by multinational corporations, rather than in terms of conventional capital flows. Both portfolio and bond investors would seem to respond

---

[1] It also poses issues for <u>other developing countries</u>, particularly debt-distressed ones, on what lessons to draw from countries that have maintained or especially regained capital market access and how relevant these lessons are for their own economies. This important issue will only be addressed indirectly in the project, though clearly important lessons can be learnt from the material gathered here.

to more classical risk/return considerations, though of a somewhat different nature in each case. Finally, bank lending seems increasingly influenced not just by pure risk/return considerations, but also by the impact of the regulatory and tax framework and by more general weaknesses in some bank, as well as perhaps by the memory of the debt crises of the 1980s. The behaviour of each of these sectors in the capital market will be compared and contrasted - do they each pursue a different "rationality"? How does a different "mix" of lending and investing reflect the various issues at hand?

Within each case study (US/Canada and EEC), and for each major category of investor/lender (FDI, bonds, portfolio investors and bank lending), it would be necessary to:

a) Ascertain how important developing countries are, and among them, the Latin American/Caribbean ones, among total and international destinations of these flows.

b) What are the motivations behind different categories of investors'/lenders' decisions to channel funds to developing countries, and especially to Latin America and Caribbean ones? What factors influence their decisions most? Country considerations or general market trends? Which ones? How likely are those motivations to remain? Is their main interest in channelling flows to LAC a temporary profit, or a more long-term link with the country/firms in that country? Do they therefore perceive it as likely that they will continue channelling flows at a similar level to those countries? Under what (if any) conditions would they consider taking out their funds rapidly? Do they see other (e.g. more long-term) flows playing a potentially larger role in the future?

c) How are the different investment/lending flows to LAC countries regulated by the authorities of the sending countries? How are these regulations linked to overall regulations of such flows by the relevant authorities? How, if at all, do regulators of different types of lending coordinate amongst each other within the sending country? How, if at all, do regulators of different sending countries coordinate amongst each other and with international institutions like the IMF? For example, what (if any) is the role of the European Commission in regulating different flows from EEC countries? Is there coordination amongst US and Canadian authorities?

How different are the regulatory regimes in North America and Europe?

What criteria are used for regulation? What major analytical issues arise in such regulation (both from the perspective of the sending and the recipient countries)? For example, how at the same time can genuine prudential concerns for the protection of the integrity of their financial systems be fully met to avoid future costly future costly financial crises, whilst allowing sufficient regulatory flexibility to avoid undue rationing and excessive costs for developing country borrowers and recipients as well as to avoid unnecessary interference with effective market discipline mechanisms? To what extent are there official guarantee schemes (either explicit or implicit) in place, and what are their potential benefits and costs? What changes/improvements, etc., could be suggested to facilitate long-term market access to developing countries? What changes/improvements could be suggested to improve monitoring, supervision and regulation of different categories of such flows? Is the current regulatory system (including governments, central banks, the IMF, and the BIS, and private market actors) adequate to maintain transparency and accountability? These "systemic" questions will be dealt with in the North America and Europe case studies.

Points b) and c) would be carried out not only by reviewing relevant literature, but mainly by conducting interviews in the major financial centres in North America (New York, Washington) and Europe (Basle, Frankfurt and London).

d) To the extent possible, the analysis in a), b) and c) would be complemented by a discussion of likely more long-term trends (including the possibility of a growing "capital shortage") for both evolving demand and supply tendencies in capital and financial markets in both North America and the EEC. The differences between the behaviour of European and North American investors would be analyzed. Are US investors disproportionately represented in Latin America (relative to European counterparts)? If so, does this reflect investor preferences, or less than perfect capital mobility and/or information? Finally, there would be a summary assessment of the degree of integration of world capital markets based on flows to Latin America from various investing countries.

ii) As regards re-entrant **recipient countries**, the case studies would need to address the following issues (several of which have been developed in some detail in Sections II and IV above).

a) What are the main features and scale of the flows coming in to the country? What are the main categories of flows coming in, relating to FDI, portfolio investment, bonds, bank lending and others? What are their financial conditions, in terms of maturities, costs and guarantees (by the recipient government)? What financial innovations took place which facilitated their inflow? Do these innovations carry different risks than more traditional instruments? In particular, in what proportion do these flows seem to be permanent or transitory?

b) What are the main reasons why different categories of flows are seen to enter the country? What role do the institutions and mechanisms of financial intermediation play? For example, how have stock and bond market institutions been adapted to attract foreign investors? How has legislation and/or foreign investment codes been changed? Have these had their desired effect, or have foreign investors responded to other signals (eg. economic growth, rates of return, etc)? How are these factors likely to evolve?

c) How are these external private flows being used in the country? What sectors are they going into? If possible, determine to what extent they are going into productive investment, especially in tradeables. What other destinations do they have?

If possible, some micro-economic analysis, for some cases of the destination, profitability and likely net foreign exchange effects of specific flows, would be interesting.

To what extent is the government/private sector monitoring the micro-economic impact of these flows, in individual cases, at a sectoral level and in aggregate? If it is not, would it be desirable/feasible? How could this be done, in the existing institutional and policy framework? What other, if any, monitoring, regulation and supervision of such flows is being done? Is it appropriate, sufficient or excessive? What changes could be made to improve monitoring?

d) What have the macro-economic effects of different kinds of flows been? What are the likely future macro-economic effects of these flows?

In particular, what are estimated effects on aggregate output and demand, as well as on net investment? What are the estimated effects of recent flows on levels of foreign exchange reserves, the level of money supply, level of interest rates and the level of both nominal and real exchange rates? What are the likely long-term growth and developmental effects, if the level of flows is sustained, if it increases and if and when it decreases?

e) What has the policy response of the monetary and other financial authorities been? To what extent have they adopted an active policy response? What policy instruments have been used? Have all (some) inflows been discouraged, sterilized? How had these flows initially been encouraged by the authorities? What other (e.g. fiscal) measures been taken to compensate for the effect of these flows? What effects have they had on the nominal and real effective exchange rate? Has exchange rate appreciation caused by capital inflows impaired export performance? What lessons can be drawn from this experience? What alternative policy measures could have been used? How and why would their effects have been more desirable?