SURGES IN CAPITAL FLOWS AND DEVELOPMENT: AN OVERVIEW OF POLICY ISSUES*

Robert Devlin
Ricardo Ffrench-Davis
Stephany Griffith-Jones

* To be published in Ricardo Ffrench-Davis and Stephany Griffith-Jones, Coping with capital surges: Latin American macroeconomics and investment, Lynne Rienner, Boulder and London, 1994.

INDEX

SURGES IN CAPITAL FLOWS AND DEVELOPMENT:
AN OVERVIEW OF POLICY ISSUES*

Robert Devlin
Ricardo Ffrench-Davis
Stephany Griffith-Jones

INTRODUCTION

International capital markets have grown dramatically since the mid-1960s. Although international capital movements partly reflect expanding economies, increasing world trade and the globalization of production, they also involve purely financial factors that rise notably faster. In the 1960s, the growing presence of little-regulated international offshore financial centers stimulated capital movements by evading national financial regulations, capital controls and taxes. Then, in the 1970s and 1980s, many countries began to deregulate their domestic financial sectors and to relax or abandon the regulation of foreign exchange transactions. This, combined with revolutionary technological advances in the handling of information and telecommunications and the emergence of increasingly sophisticated financial engineering, contributed to a boom in both national and international financial flows.

It is premature to speak of integrated financial markets, since international capital mobility is clearly far from perfect. Nevertheless, there is no doubt that capital flows and global financial integration are increasing steadily. These developments have aroused controversy. At one extreme, there are those who see rising integration as a sign of greater efficiency; according to this interpretation, markets are overcoming the financial repression characteristic of inefficient government regulation. At

* We are grateful for the valuable comments received from policy makers, academics and staff of financial institutions, at Seminars in the Brookings Institution, the Institute for Latin American Studies of the University of London, the IDB, the Secretariat of the United Nations in New York and ECLAC in Santiago.

the other extreme, there are those who see the boom in capital flows as high risk speculation that threatens national sovereignty. Of course, between these two extremes there are various intermediate positions which recognize the significant potential advantages of greater international capital mobility, but are also concerned about issues such as the sustainability, composition and terms of capital flows, and the need to ensure that they are consistent with macroeconomic stability, international competitiveness, growth and social equity.

Recently, this controversy has assumed greater importance for Latin America. In the 1980s, the links with international capital markets were largely severed as a result of a massive debt crisis with commercial banks.[1] However, the region has enjoyed a booming expansion of capital flows during 1991-93. These inflows were most welcome because they overcame a binding external constraint that was contributing to low investment levels and to a severe economic recession in the region. Nevertheless, these inflows have also had an unwelcome effect on the evolution of exchange rates, the degree of control over the money supply, external liabilities and, possibly, future vulnerability to new external shocks.

This article presents policy issues regarding capital inflows, drawing on case studies that form part of this project as well as other recent work on the subject. Section I reviews the conceptual foundations of the role of external capital flows in development and the issue of financial liberalization and capital account opening. Section II focuses on the sources of the recent boom in capital flows and some of the policy implications that emerge from the supply side. This is followed by an appraisal, in section III, of the current impact of these capital flows on the economies of Latin America and examine the policy implications.

---

[1] For an extensive analysis of the region's insertion into capital markets during the 1970s and the emergence of the debt crisis see Devlin (1989); Feinberg and Ffrench-Davis (1988); Griffith-Jones and Rodríguez (1992), World Bank (1993), and Devlin and Ffrench-Davis (1994).

There is a common overarching theme which emerges from this paper. Capital flows are clearly an extremely valuable instrument in economic development, and in the process of integration of the world economy. However, the intertemporal character of financial transactions and incompleteness of available instruments contribute to making finance markets some of the most imperfectly functioning in the market economy. Hence, improved information, financial sector regulation and broad prudential macro management(direct and indirect) of financial flows constitutes a public good for which there is a shared role for governments: on the supply side for industrialized country officials and on the demand side for developing country authorities, coordinated -where relevant- by international organizations.

I. OPEN CAPITAL ACCOUNTS AND EXTERNAL SAVINGS

1. External capital and development

In recent years there has been increasing attention to the positive contributions of capital mobility generally, which has given rise to policy recommendations for capital account opening. The arguments in favor of freely mobile capital are backed by powerful theoretical arguments. However, unfortunately the real second best world in which we live can seriously condition many of the textbook appreciations. This in turn gives rise to concern about interpreting fashionable theories too literally, and applying them to policy without attention to the important caveats that can arise out of a more empirically-rooted evaluation of the role of capital mobility in the development process. This can be illustrated by reviewing some of the most commonly cited reasons to promote capital mobility. Before doing so, we wish to stress that we share the view that international capital mobility plays a number of highly significant roles in development. Amongst the main ones are: the channeling of external savings towards countries with insufficient capital and the compensatory financing of external shocks, which helps stabilize domestic spending.

At the aggregate level, capital movements from developed to developing countries are said to improve the efficiency of world resource allocation (Mathieson and Rojas-Suárez, 1993), because real returns on marginal investment in capital-rich countries are typically lower than those in capital-scarce countries. Like many theoretical arguments, the predicted outcomes depend on compliance with some conditions. Among these is the condition that financial markets, which intermediate most international movements of capital, must have what Tobin (1984) terms fundamental valuation efficiency: i.e., market valuations must accurately reflect the present value of the dividends that the assets in question can be reasonably expected to generate over time.

Accurate pricing is extremely important because prices are the main signal for the market's reallocation of capital. Unfortunately, price movements in financial markets are known to often not reflect fundamentals (Tobin, 1984; Stiglitz, 1993; Kenen, 1993). Thus, empirical studies (summarized in Tobin, 1984; Akyuz, 1993; Lessard, 1991) as well as historical analyses (Kindleberger, 1978) suggest that serious inefficiencies can arise from the allocative mechanisms of capital markets.

In the short term the imperfections in question can cause financial markets to allocate too much or too little capital (vis-a-vis the underlying returns) to some recipients at a given moment. When the short-term misallocation is very large, it can induce a crisis and have devastating consequences for firms, economic sectors and nations.

These short-term disturbances in finance, which seriously disrupt output and distort returns to capital, can obviously impart arbitrary advantages and disadvantages on different economic agents, which in themselves can become determinants of returns and thus of international resource allocation trends. It is evident that the phenomenon of hysteresis is extremely relevant in financial matters and their interrelationship with the real economy.

Mobilization of external savings is the classic role for capital flows to a developing country. This has been perhaps the most traditional, and certainly the strongest, argument in favor of international capital mobility and flows to LDCs. Indeed, net inflows of external savings can supplement domestic savings, raise investment and boost growth. In turn, expansion of aggregate income can further raise domestic savings and investment, thereby creating a virtuous circle in which there is sustained economic expansion, eventual elimination of net foreign debt and transformation of the country into a capital exporter (see ECLAC, 1994, ch. X).

While obviously highly stylized, this traditional framework has some powerful messages. First, external capital flows should consistently go to augment aggregate investment, and not be diverted to consumption. Second, an aggressive domestic savings effort is called for: from the outset of a debt cycle, the marginal savings rate must be kept at a level which is much higher than the country's average savings rate and also considerably greater than the investment rate, thus eventually permitting a savings surplus to emerge for repayment of debt. Third, the investment must be efficient. Fourth, the country must aggressively invest in tradable goods in order to be able to create a trade surplus large enough to transform domestic savings into convertible currency, so as to service the debt. Fifth, it requires creditors willing to provide stable and predictable flows of finance on reasonable terms.

These conditions may not all be complied with in practice: countries may experience an ongoing substitution of domestic savings by foreign savings; investments may not always be efficient or channeled sufficiently into tradable goods, and creditor behavior may differ from the desired pattern. Indeed, as convincing as the traditional argument for the transfer of international savings to relatively poorer countries is, the above problems and ensuing payments crises have often caused this valuable developmental mechanism to operate only feebly. Notwithstanding these serious difficulties, foreign savings have historically played a significant role in the development of many countries, with some emerging as industrialized nations and subsequently evolving into major capital exporters.

Capital mobility also can help to spread out over time the costs of intertemporal differences between output and expenditure. However, this process may not always evolve smoothly in practice. If the transitory swings in external variables are reasonably predictable, free capital markets could provide the desired finance without much difficulty. But in developing countries it is not always easy to ascertain whether a downturn in the external sector is transitory or not and for how long, and this uncertainty, coupled with imperfections in international capital markets (especially informational asymmetries and enforcement problems, Stiglitz and Weiss, 1981), all represent obstacles to the arrival of adequate amounts of external finance.

When this valuable role of international capital mobility is played only imperfectly, the costs of adjustment for developing countries can be enormous. That is because in the face of a negative external shock (and easily exhaustible domestic international reserves), any shortfalls in capital inflows will require immediate cutbacks in domestic expenditure to restore the external balance. Output will almost certainly fall because of the natural rigidities standing in the way of resource reallocation, while there also tends to be a disproportionate cutback in investment. Latin America's external adjustment in the 1980s illustrates these points very well (ECLAC, 1984; Ramos, 1985; Devlin and Ffrench-Davis, 1994).

If finance is treated analytically analogously to goods, social benefits could be perceived in a two-way international trade in financial assets, since capital mobility would allow individuals to satisfy their risk preferences more fully through greater asset diversification. This micro benefit is presently the most common argument in favor of capital mobility (Mathieson and Rojas-Suárez, 1993),[2] and has been a widely-used argument for justifying a full opening of the capital account of developed and developing countries alike.

The analogy between free trade in goods and free trade in financial assets may be mistaken. Trading in international financial assets is not identical to, for example, cross-border trade of wheat for textiles (Díaz-Alejandro, 1985; Devlin, 1989). The latter transaction is complete and instantaneous, whereas trade in financial instruments is inherently incomplete and of uncertain value, since it is based on a promise to pay in the future. In a world of uncertainty, incomplete insurance markets, informational costs and other distortions, ex ante and ex post valuations of financial assets may be radically different. Moreover, the gap in time between a financial transaction and payment for it, coupled with informational barriers, generates externalities in market transactions that can magnify and multiply errors in subjective valuations, to the point where finally the market corrections may be very abrupt and destabilizing. It is precisely because of this that social well-being may decline with deregulation of trade in financial assets and actually rise with a certain degree of increased public intervention (Stiglitz, 1993). Thus, some forms of regulation of trade in certain financial assets not only make markets function better, but improve the overall performance of the economy through the enhancement of macroeconomic stability and better long term investment performance.

2. Liberalization of the capital account: the evolution of policy

There is a broad consensus that international capital mobility is a necessary component of the development process. However, most general equilibrium frameworks analyze capital-as-a-whole and take

[2] For diverse theoretical views of the micro effects of freely mobile external capital, see ECLAC (1994).

no account of important real world conditions such as informational bottlenecks, the institutional peculiarities of investors, the structure of the market within which investors operate, the volume and timing of financing, and its costs and volatility. These and other factors do not always mix in ways which permit countries to tap the full potential benefits of external capital movements. Indeed, systemic market failure can and does occur. Frequent reminders of this problem are the major financial crises, accompanied by macroeconomic collapse, that have repeatedly appeared in economic history, including the recent debt crisis in Latin America.

Since the real world can condition the merits of even the most attractive theoretical arguments, it is not surprising that lively debates have arisen over the functioning of international financial markets and capital mobility. For many years, the number of proponents of open capital accounts in developing countries has steadily grown, to the point where many consider that full openness should be a central objective of economic policy. More recently, there seems to be a growing trend towards more pragmatic thinking regarding capital account opening; this view counsels caution and gradualism, to the point of severely questioning the urgency of a perfectly open capital account. There has been some sympathy for the idea of permanently monitoring flows, with regulation being used if necessary to protect domestic macroeconomic balances. A review of trends is given below.

a) From closed to open economies

During the 1950s and 1960s mainstream professional thinking on development predominantly focused on real economic activity rather than questions of money and financial markets. Moreover, the analysis of capital inflows concentrated on a limited number of channels of funding, basically bilateral aid, multilateral lending and foreign direct investment (FDI). Most developed and developing countries had comprehensive controls on capital movements.

This situation had its roots in the concrete historical circumstance of the Great Depression and the sluggish activity of international private finance in particular, up through the early 1960s. This policy orientation did not have a monopoly of ideas, however. Indeed it was confronted by competing paradigms, particularly variants of classical laissez faire economics. Moreover, these latter ideas enjoyed a growing international following towards the end of the 1960s, due partly to the increasing difficulties that governments were encountering in bringing their regulation in line with the realities of domestic and international market activity.

The new trends also contributed to a decisive change in the direction of development policy. Major studies emerged which focused on the need to reduce government intervention and to liberalize markets, with special emphasis on domestic finance.

It was also held that an open capital account was needed as a way to raise national savings, deepen domestic financial markets, reduce the costs of financial intermediation through enhanced competition, satisfy individuals' demand for risk diversification and optimize resource allocation: in short, most of the benefits of capital mobility outlined above were invoked.

b) Opening up and sequencing

While those attracted to this approach were in broad agreement on the diagnosis and general policy prescription, there were big differences of opinion regarding implementation. Some argued that basic reforms were part of a "seamless web"and should ideally be undertaken simultaneously in a type of "big bang" (Shaw, 1973). Others favored the sequencing of reforms, with the capital account being opened up only after consolidation of the other liberalization measures, with domestic financial reform and trade liberalization being given the highest priority (McKinnon, 1973).

The capital account was deemed an especially sensitive area because, if it were opened up in conjunction with other reforms, it could induce a surge of capital inflows which could bring premature exchange rate appreciation, with negative consequences for the trade liberalization and resource allocation. According to this view, a competitive exchange rate was crucial to trade reform. Hence, the regulation of capital flows could be justified as a way to temporarily reduce pressures for exchange rate appreciation.

The different policy approaches began to have real implications for Latin America in the mid-1970s when three Southern Cone countries underwent radical economic liberalization processes, inspired partly by the financial repression hypothesis and the theoretical simplicity of the monetary approach to the balance of payments (see Ffrench-Davis, 1983).

There was an additional incentive for encouraging capital account opening. Many analysts viewed the 1970s world-wide boom in international bank lending as an inherently benign event for development. On the supply side, private financial markets -and especially the unregulated Eurocurrency market- were considered to be highly efficient and capable of imposing "market discipline" on borrowers, in contrast to the allegedly inefficient and permissive lending of official agencies (Friedman, 1977). Furthermore, it was felt that portfolio and direct investment decisions were based on the long-term key variables ("fundamentals") of the countries concerned, and were therefore inherently favorable to greater order and discipline. On the demand side, there was also a popular notion that if the borrowers were from the private sector -in contrast to public sector agencies- the resources would be deployed efficiently (Robichek, 1981).

As is well known, the Southern Cone experiment ended in failure, as the economies collapsed under large price disequilibria and speculative bubbles on asset prices, low domestic savings and investment, a huge external debt, and domestic insolvencies. The most popular explanations of the bad experience were the failure of international financial markets and/or flawed sequencing of the liberalization reforms.

As far as market failure is concerned, it was concluded that the so-called discipline of the private financial market had simply not materialized, for instead of facing an upward supply curve for loans, with credit rationing, as would be assumed for a market with efficient lenders, many developing countries in the 1970s apparently faced a horizontal supply curve (with decreasing spreads charged by lenders and appreciating exchange rates in borrower markets), which gave perverse price signals for the savings/investment process. As for the reasons for the horizontal supply curve and market failure, some have laid stress on the existence of direct or indirect public guarantees for lenders and borrowers (McKinnon, 1991), while others have stressed flaws in the structure of financial markets and institutional lending practices, as well as permissiveness in national and international regulatory frameworks (Devlin, 1989).

As far as sequencing is concerned, there is now some consensus in support of the idea that the capital account opening was premature and should have been postponed until other major reforms had been consolidated and equilibrium prices established. The lesson is that during adjustment, open capital accounts (especially in periods of elastic supply of international finance) can induce surges of capital inflows with destabilizing macroeconomic and sectoral effects.

First, if domestic financial markets are still shallow and uncompetitive, they will not be able to efficiently intermediate a surge in capital flows, thereby threatening the sustainability of the flows themselves. Secondly, fiscal parameters must be consolidated and policy must be flexible, for without a solid tax base and flexible fiscal instruments, authorities must rely too much on monetary policy to regulate the domestic economy. Furthermore, the tax base must be strong enough to sustain adequate levels of public spending consistent with long-term development needs.

Lastly, since part of the capital flows are inevitably spent on non-tradables, the relative price of the latter tends to rise, with consequent real exchange rate appreciation. This in turn is reflected in widening of the current account deficit. The real appreciation of the exchange rate can obviously distort resource allocation and investment, seriously weakening a country's medium-term structural objective of penetrating external markets with new exports. Real appreciation also tends to bring unnecessary social costs, as domestic resources most probably will later have to be switched back to production of more tradable goods, through real exchange rate depreciation (Edwards, 1984; Park and Park, 1993; World Bank, 1993). This is because the counterpart of the current account deficit is an accumulation of external liabilities, which must eventually be serviced in foreign exchange.

A considerable body of expert opinion has thus emerged which urges that capital account opening should only take place after the consolidation of other major liberalization programmes, especially in the areas of trade and domestic finance; indeed, according to McKinnon (1991, p. 117), "during liberalization, stringent controls on suddenly increased inflows (or outflows) of short-term capital are warranted" (see also World Bank, 1993).

Where there has been perhaps most divergence of opinion is with respect to the speed of capital account opening once the decision is taken: some have advocated rapid and ambitious opening-up, while others counsel a gradual approach. The first-named position is favored by those who distrust government intervention in foreign exchange and capital markets and/or fear that vested interests will paralyse liberalization programmes. The second approach stems from the belief that macroeconomic stability also requires a certain sequence in capital account opening itself. At a more general level, a clear distinction is drawn between inflows and outflows, and it is suggested that countries should liberalize the former before the latter, partly because the benefits that can be derived from outflows are more evident for a country that has accumulated substantial net foreign assets (Williamson, 1991 and 1993). There could also be sequencing within the components of inflows and outflows: for instance, long-term inflows could be liberalized before short-term transactions, while in the case of outflows, priority might be given to direct export-oriented investments and trade credit.

The gradualist approach is more consistent with the insights gained from the international discussion on the sequencing of reforms. Thus, even though developing countries may have made radical reforms, it may take many years before conditions emerge, i.e., a deep and institutionally diversified domestic financial market, a broad, consolidated tax base, a diversified, internationally competitive export sector, and a wide range of available macroeconomic policy instruments-- which will allow their economies to absorb unregulated movements of external capital in ways that are consistent with sustained growth and social equity.

The proponents of sequencing, only question the order and timing of liberalization, not the ultimate objective of an open capital account. Yet the overriding importance of macroeconomic stability, coupled with the overwhelming size of international capital markets compared with the much smaller Latin American economies and the serious imperfections existing in such markets, may make an inflexible commitment in all circumstances to a permanent open capital account undesirable. Indeed, the increasing volatility of international capital flows, and their size, have already given rise to renewed discussion in the industrialized countries on the potentially destabilizing behavior of capital markets and the possible need for their regulation, especially under certain circumstances.

II. THE SURGE OF PRIVATE CAPITAL FLOWS IN THE 1990s: POLICY IMPLICATIONS FROM THE SUPPLY SIDE

1. Broad supply trends

a) Massive increase in scale of flows

The first point that needs stressing is the massive scale of private capital flows to Latin America in the early 1990s, as well as the fact that such massive inflows were unexpected.

As can be seen in table 1, the net capital inflow into Latin America (LAC) reached in 1992-93 an overall record, climbing to an average of US$62 billion. Furthermore, net capital inflows reached 4.7% of GDP, which is a ratio similar to that of the previous historical peak, -4.5% in 1977-81.

Table 1

Particularly dramatic has been the sharp increase in flows to Mexico (see again table 1), where net capital inflows were nearly zero in the 1983-90 period, while in 1991-93 they reached 8% of GDP, a ratio well above that in 1977-81. As can also be seen in table 1, both Argentina and Chile recorded large increases in their capital inflows in the early 1990s, but these were less dramatic than those of Mexico.[3]

b) Change in type of flows

A second important trend of these capital inflows into Latin America is the significant diversification of sources and -above all- the change in their composition. As can be seen in table 2, the share of FDI doubled between 1977-81 and 1991-92, portfolio equity emerged as a new source of finance for the LAC region (and increased its importance further in 1993), bonds also increased their participation notoriously, while the share of commercial bank lending has fallen quite dramatically.

Overall these changes in the structure of finance seem positive, as they favor apparently more sustainable flows, and as flows with variable interest rates (particularly badly suited for funding long-term development as shown by the debt crisis of the 1980s) represent a small proportion of total inflows. However, there are some important caveats to this overall positive evaluation of the composition of flows, most of which we will discuss below. Nevertheless, it seems worthwhile stressing here that a source of potential concern is that, as ECLAC (1994) points

[3] Notice that Chile adopted effective policies to moderate short-run capital inflows. See Ffrench-Davis, Agosin and Uthoff (1994).

out, a fairly high proportion of net capital inflows in the early 1990s (and a higher one than in previous decades) corresponds to short-term flows, where the risk of volatility is both intuitively and empirically higher.

Table 2

Finally, as regards the change in composition of flows, it is important to emphasize -as this is often forgotten- that these changes follow overall very similar trends to global ones, especially as regards declining importance of commercial bank lending and rapid rise of securities (both bonds and equities). The trend towards more short-term flows also seems to be a global one, though it is more true for the LAC region.

c) The regional composition of the supply flows

The USA is a very major source of the private capital flows that come to LACs. Indeed, as regards FDI, for the 1987-90 period, around 35% of these flows originated in the USA, spurred subsequently by the prospects of NAFTA and broader hemispheric integration. In 1987-90, around 25% of total FDI to the region came from Europe (Griffith-Jones, 1994). Japan provided a far smaller share of the total, reaching only around 5%. It is also interesting that, as Chuhan and Jun (1994) point out, the dominant share of Japanese investment in the LAC region is in tax havens countries; indeed, tax havens such as Cayman Islands, Bahamas, Bermuda, Virgin Islands, Netherlands Antilles and Panama received nearly three quarters of Japanese FDI to the region in 1991.

As regards equities, especially initially, flows were very dominantly from USA based sources (including return of Latin American flight capital). Indeed, as Culpeper (1994) reports, U.S. investors have provided a significant proportion of flows to stock markets of major Latin American countries, including Mexico, Brazil and Argentina, with the share for Mexico being particularly large. On the other hand, Japanese investors have clearly and consistently favored East Asian markets. In contrast, initially European based sources focussed on the Pacific Basin; however, reportedly European investors later increased the share of their equity flows going to Latin America; in 1991, European investors are estimated to reach a peak of 40% of total secondary flows to Latin American emerging markets, with this share declining somewhat in later years.

As regards bonds, which in 1993 became the largest source of private flows going to LACs, it is extremely difficult to distinguish the regional sources of bond financing, especially in the international (or Eurobond) markets, which during the 1990s have absorbed from three to five times the volume of foreign bond issues offered in the main domestic markets of the USA, Japan and Europe. However, it seems worth stressing that an extremely high share of Latin American bonds are raised in dollars, which does give some indication that U.S. based investors (including Latin American flight capital based in the USA) are a major source of such funding. The high share of dollar denominated bonds would seem to reflect both currency preference of investors and currency composition of Latin American companies' receipts. Also, very low U.S. interest rates in 1991-93 have encouraged U.S. based investors to buy Latin American equities. It should be mentioned that, though a vast proportion of LAC bonds are dollar denominated, they are practically all listed in Europe (mainly in Luxembourg); this is due to the greater regulatory freedom and possible tax advantages of European based transactions in dollar denominated paper.

Like in the case of FDI and equities, Japanese sources have played a minor role in funding LAC bonds. The near absence of Latin American borrowers from the Japanese bond market contrasts with the fairly important presence of some other emerging market countries, especially in the Samurai sector; some of these issuers have been attracted to the Japanese bond market by a cost differential in it, vis-a-vis the eurodollar market.

As regards the much smaller domestic bond markets, Latin American borrowers have been mainly active in the U.S. private placement market, where the easing of regulations (and specially rule 144 A) has greatly facilitated borrowing. In contrast, both

European and Japanese domestic bond markets have hardly been tapped by Latin American borrowers.

We can therefore conclude that -as regards flows going to LACs-, U.S. based lenders and investors emerge in the early 1990s as the main source; this seems linked to a number of factors, which include traditional factors such as geographical proximity, strong political links, and greater knowledge of the area, to which are added fairly new factors, such as hemispheric integration -and particularly NAFTA, as well as its likely extension southwards- and the large yield differential between investments in the USA and in the LAC region. European flows, though second to the USA, are more important than is generally perceived in the region. Furthermore, they seem to have had certain features, which make them of particular interest. For example, European foreign direct investors have behaved as "bad weather friends", as in 1983-88, when FDI flows from Japan fell and U.S. ones became negative (due to the debt crisis); European funding fell far less, and became the largest source of FDI flows to LACs (Griffith-Jones, 1994). Also, European FDI in LACs is especially active in manufacturing, contrasting with the USA and Japan, reported to be especially active in primary sectors. It may therefore be worthwhile for Latin American companies to make greater efforts than is made at present to tap European markets as sources of funds, both in securities and in FDI.

An area which has emerged as having likely great future potential for LAC borrowers is that of U.S. and Continental European institutional investors, as both the value of their assets -and the proportion of those assets invested internationally- are likely to rise quite significantly in coming years.

As regards Japanese sources for funding the LAC region, till now its main feature is its rather low level. This is disappointing, because Japan offers special advantages, not only in potentially better financial terms in some cases (e.g. bonds), but, possibly of more importance, because of collateral benefits. For example, the high quality of Japanese technological and managerial know-how, may make Japanese FDI particularly valuable in certain sectors. The reasons for low Japanese flows to the LAC region (and declining Japanese investment abroad) are partly transitory, including the wealth effects related to the decline of the Japanese stock market, the decline in the property market, as well as the appreciation of the yen in relation to the dollar. Interestingly, weak Japanese economic growth is reported by Chuhan and Jun (1994) to be another transitory factor that depresses outward investment. This is in contrast with the U.S. situation, where most analysts have argued that recession and/or slow growth have encouraged outflows in search of more profitable opportunities.

Special efforts by LAC governments and companies may be particularly necessary to overcome the more institutional factors which limit Japanese outflows to LAC, such as fairly stringent regulatory requirements, which imply for example that "non-investment grade" borrowers are not afforded access to the Japanese bond market; it is to be noted that some of these restrictions have begun to be eased. However, a more binding constraint for Japanese institutional investors to place funds in emerging markets is their preference for highly creditworthy investments. In relation to LAC borrowers, the memories of the 1980s debt crisis seem to lead to prudence amongst Japanese lenders and investors, to a far greater extent than those from the USA or Europe. As a result, special efforts may be required to persuade Japanese investors and lenders, as well as government officials, that the turnaround in economic fortunes in the region is a sustainable one.

d) Some similarities and differences of flows from diverse regions

There are some important similarities and differences between flows originating in the USA, Europe and Japan. Though such comparisons are useful for a better and deeper understanding of the different markets, it is necessary to stress that there are limits to the distinction, due to a significant movement towards the globalization of such markets. Furthermore, though we are stressing in our analysis the USA, Europe and Japan, it is important to mention two caveats: Firstly, there are other, new geographical sources of funds; one example are flows from Taiwan. Secondly, it may be useful for some purpose to disaggregate European flows, distinguishing for example between the U.K. and the Continent, as both traditions and regulations imply significant differences amongst them, even though the Single European Market has begun to erode such diversities.

A broad similarity in the three large markets analyzed, is that in all of them institutional investors, and especially pension funds and insurance companies, have seen their total assets increase dramatically in the last decade (see table 3), as institutional investors play a significant role in mobilizing resources in the major industrial countries. This is particularly the case of U.S. pension funds and insurance companies, whose US$ 5-6 trillion in assets at end 1992 accounted for nearly 15% of all U.S. financial assets and over 30% of assets of financial institutions. Japanese and European (especially U.K.) assets of institutional investors are also very large, and have grown rapidly (Chuhan and Jun, 1993).

Table 3

There has been a clear trend, in some institutional investors, towards an increase in the proportion of foreign assets, as a percentage of their total assets (see Griffith-Jones, 1994, table 12). Particularly sharp has been the increase of this ratio in the U.K. pension funds, where by 1990 it reached around 20%, and in the Dutch pension funds, where it reached 15%. This is in sharp contrast with German pension funds where by 1990 only 1% of total assets were in foreign assets. The U.S. pension funds are in an intermediate position, as their share of foreign assets was still fairly low in 1990 (at 4% of the total), but it is likely to increase sharply as experts advising these funds have recommended that they should rapidly increase their investment abroad. As a result of these trends, there is a large effective and potential supply of funds available for investing in developing countries, and in particular in the LAC region.

A second similar trend in the major countries is that regulatory changes have taken place which improve access by developing countries to their equities and bond markets. Perhaps particularly important have been measures which facilitate access to the U.S. stock exchange and the private placement segment of the U.S. bond market (see Culpeper, 1994). However, there have also been regulatory changes that facilitate access to the Japanese market, such as the relaxation of quality guidelines for Samurai bond issues and of rules relating to the private placement market for non-Japanese issues (see Chuhan and Jun, 1994).. To a lesser extent there has been liberalization of regulations in some European countries, for example the U.K. Securities Investment Board is proposing that the concept of approved markets for authorized Unit Trusts be abolished. Changes at E.C. level, linked to the Single Financial Market, also tend to liberalize regulations (see Griffith-Jones, 1994).

Indeed, broad regulations do not seem to be the major constraint for access by Latin America borrowers to bonds and equities' markets in the industrial countries, even though regulations of institutional investors in some cases do pose important restrictions. Further study is required to ascertain whether this is the case, and detect which are the remaining regulations that unduly restrict such access. Indeed, the main reason why institutional investors in the major industrial countries -investors which are attractive from the perspective of the borrowers, given their more long-term horizon- are only slowly beginning to invest in or lend to Latin America is not due to regulations; it is because -though conscious of important improvements in Latin American economies and higher returns-, they still see them as potentially volatile, both economically and politically. Japanese institutional investors are especially prudent, both because they tend to purchase only high investment grade securities and because memories of the Latin American debt crisis are stronger in Japan due to the closer integration between different segments of investors and lenders. In contrast, U.S. institutional investors have invested relatively more than their European or Japanese counterparts in Latin American paper, and especially in Mexico. As said, the relatively stronger interest of such investors is explained by geographical proximity, as well as growing business links with the region, further stimulated by the prospects of broader hemispheric integration.

2. Issues of data

Because the mechanisms through which capital flows in the 1990s to the LAC region are on the whole new ones, data on these flows tend to be incomplete. Specially incomplete is information on portfolio flows, and in particular on secondary market and derivative transactions. Information on how much institutional investors from the major countries are investing in LACs is also particularly incomplete and tentative. It is difficult for policy-makers and regulators to take correct decisions if they have very incomplete data on the magnitude of different types of flows; this was demonstrated in the late 1970s, when poor and incomplete information on bank lending to the LAC region became an important factor influencing incorrect decisions both by market actors and regulators (ECLAC, 1994).

Though important efforts have been made to improve data, additional work is urgently required in this field. At a global level, and for developing countries as a whole, the IMF and the World Bank need to improve data further. At a regional level, institutions like ECLAC and/or the Inter-American Development Bank can further improve their reporting of these flows. Last but not least, major source countries need to improve information on outflows to different emerging markets. More complete, consistent and prompt reporting of private flows will be beneficial to all participants, -source and recipient countries-, savers, investors and borrowers alike.

A second area in which data is insufficient and incomplete is information- available to brokers, investment managers and particularly institutional investors' managers- on Latin American economies and on individual companies. When lenders feel that they know too much less about credit risk than borrowers, they may choose to ration credit rather than raise interest rates, particularly to borrowers whose credit quality is more difficult to ascertain (Stiglitz and Weiss, 1981). This will tend to occur in a context where uncertainty increases, which can cause financial instability (Mishkin, 1991).

Therefore, there are strong practical and theoretical reasons to significantly improve the quality of information about Latin American borrowers that reaches different investors and/or lenders. In particular, the depth of contact should be improved, to channel information towards for example large pension fund and insurance managers directly. As regards the key U.S. market, Culpeper (1994) reports that the chief constraints on issuers of equity or bonds now appear to be the transparency of their financial reporting. For this reason, the implementation across the region of standardized Generally Accepted Accounting Principles (GAAP) would apparently be a powerful way to give LAC companies greater access to the U.S. market. Similar efforts need to be made to help tap the European, Japanese and other markets.

A third area in which information and analysis is very incomplete relates to the ultimate use of the private flows in the different recipient countries. To what extent are these flows being channeled to investment, how efficient is such investment, and what proportion is being channelled to tradables? An answer to such questions would be crucial to help establish that inflows will effectively contribute to long-term growth and development, and that the danger of a future serious debt problem is minimized. The primary responsibility for monitoring the use of such flows would seem to lie with the central banks and regulators of the recipient countries, even though lenders and investors (as well as central banks and regulatory authorities of source countries) would also be expected to take a keen interest in the subject. Systematic monitoring on this topic, as well as more in-depth research where feasible, seems very crucial (see section III).

3. The financial risks of the new capital flows

The benefits of interaction with private capital flows for the development of recipient economies is partly dependent on stable and predictable access to financial markets. The risk of abrupt restrictions in supply and/or inordinately sharp increases in cost and shortening of the maturity terms of external liabilities are partly determined by perceptions of risk and hence host country policies. But from the standpoint of LDCs, access also can be heavily conditioned by exogenously determined supply-side dynamics, related to industrialized country policies in the areas of macroeconomics and prudential regulation.

From this latter perspective, Latin America may be confronting considerable risks of volatility regarding the new financial flows of the 1990s. Firstly, there is a degree of consensus that one driving force behind the new inflow of capital has been exogenously based in a conjunctural relaxation of monetary policy in the OECD area, and a consequent dramatic decline in international interest rates, especially U.S. ones (Calvo, Leiderman and Reinhart, 1993). The increased differential yields on investments in the region have attracted investors that had become accustomed to a decade of relatively high real interest rates in the low risk OECD area. Moreover, given the special conjunctural setting in Latin America -recovery from a deep and protracted recession- investors were able to capture high returns, with low informational costs, as the need to discriminate among countries and firms was not great. Any significant rise in international interest rates, coupled with higher informational costs for locating high yields, could induce a reversal in the flow of some of the less committed investors. The negative impact on flows into the LAC region of the fairly small

1994 increase in U.S. interest rates further illustrates this point.

The international financial markets may be also more structurally vulnerable than in the past to volatile swings in pricing and volume. For example, many new financial instruments are complex and sometimes not completely understood by all participants, or even the brokers that put the deals together. There is a growing potential for market instability as derivatives become increasingly important in financial activity; on the one hand, these transactions are unregulated with no margin or capital standards; on the other, the marketing of these instruments is driven by the upfront fees which the seller accrues immediately without risk. Finally, information on derivative transactions is extremely incomplete.

In addition to more systemic risks, countries should also be aware of the potential specific risks of the particular modalities through which capital flows to Latin America in the nineties. This would allow them to maximize benefits and minimize potential costs of private flows.

A major source of the new flows to Latin America are bonds. These have the advantage of being mainly at fixed interest rate. However, as discussed in Griffith-Jones (1994), the average maturity for those bonds in the 1990s is very short (around four years). This implies that a high share of the stock could be rapidly withdrawn, should bonds not be renewed. Less dramatic, but also a cause of concern, is the risk that, if renewal of bonds is possible *pari passu* with higher interest rates, the average cost of borrowing would significantly increase fairly soon, as maturities are so short.

A new form of external private funding for Latin America is equity investment. This has the advantage of a cyclical sensitivity of dividends. However, equity flows also carry important risks for recipient countries. Foreign financiers could, for different reasons, stop investing in equities, and even try to sell their stocks quickly, if they feared a worsening prospect in the country.

This could either lead to pressure on the exchange rate and/or lead to price falls in the domestic stock exchange. Though the latter effect would diminish the risk of a large foreign exchange outflow, it could have a negative impact on aggregate demand -via a wealth effect- and on the domestic financial system, especially if banks and securities activities are closely integrated either through cross holdings or investor leveraging. To the extent that a growing part of investment in Latin American shares originate in institutional investors, who seem to allocate their assets using more long-term criteria, the risk of large reversals of flows is smaller. But as long as markets are moved in an important proportion by players which specialize in short term yields, and equity markets remain relatively thin, the risks of great volatility are inherent to this new modality of external financing.

As regards FDI flows, on the whole, these seem to be more stable and long-term. It is therefore desirable that a far higher proportion of capital inflows to Latin America, than in the 1970s, come in the form of foreign direct investment.

Less encouraging is the fairly high proportion of short-term capital flows. (Exact figures are not available; again here an important issue of data improvement arises.) Such short-term flows, by their very nature, pose higher threats of volatility. Indeed, statistical analysis in ECLAC (1994, ch. IX) confirms that short-term flows have been quite volatile in the 1950-92 period.

4. Policy initiatives on the supply side

From the perspective of supply, a number of policy issues arise as a result of the greater availability of private flows.

a) *Press for eliminating existing discriminatory regulatory barriers*

The understanding of regulations and their changes allows borrowing countries to detect barriers in source countries, which still imply discrimination against Latin American borrowers, that are not based on economic reason. Very strict restrictions on institutional investors' ability to diversify in some source countries toward developing areas would seem to be only one of several possible examples.

In those cases, recipient countries' governments -either on their own or more effectively jointly- should lobby for such regulatory barriers to be lowered or eliminated. Again here regional institutions like the IDB and/or ECLAC could play a valuable supportive role, as could more global organizations like the IMF and/or the World Bank.

b) Participate in global discussions of regulation.

There are a number of fora, either global ones, like IOSCO (International Organization of Securities Commissions), or industrial country ones, like the BIS, where issues of systemic risk of international flows are analyzed, and regulations suggested or implemented geared to reduce systemic risk and/or protect investors.

Latin American central banks and governments should actively seek to participate in such regulatory fora; within them, they should press and/or support regulatory changes that imply a reduction of systemic risk. Indeed, less systemic risk internationally benefits Latin American countries, which historically have been particularly vulnerable to instability in world financial markets. The types of global regulatory issues which are of crucial interest to LACs, seem to include:

i) A coordinated supervision globally of securities markets. Though important efforts have been made to deal with the difficult issues of regulating capital adequacy for banks' securities activities, no equivalent basis yet exists for non-banks securities. Indeed, to achieve a more closely integrated system of supervision of internationally active intermediaries in securities markets, seems to require regulators to develop their equivalent of the Basle Concordat for bank supervisors. This is an important regulatory gap which needs filling.

ii) More broadly, a serious effort needs to be made to extend regulatory coverage to financial institutions that are now effectively unregulated, such as financial conglomerates.

iii) Though agreements on capital requirements for banks reached in the context of the Basle agreement, provide a key regulatory step forward, there also needs to be a large effort to reach agreement on standards, such as accounting and disclosure ones, in the different sectors of the financial industry.

iv) Also in other aspects, the task of supervisors and regulators goes beyond examination of appropriate capitalization of financial institutions (area best developed till now), to include more difficult aspects such as concentration of risk, implications of innovations, and potential liquidity of intermediaries' assets and liabilities in crisis situations.

v) There seems to be an increasing need for far better global integration of contract law, so contracts can be internationally challenged and regulators carry out liquidation proceedings that are internationally equitable and effective.

vi) As Lamfalussy (1992), the President of the embryonic European Central Bank suggested, increasing exposure by banks to off-balance-sheet risks (via swaps, forward agreements, etc.) aggravate problems of information on bank portfolios, thus increasing the risk of runs. Because derivatives have increased linkages between market segments, disruption in one segment may more easily feed into others, generating systemic risk.

The potential threats posed by derivatives to systemic stability are difficult for regulators to handle, particularly as most trades occur privately between dealers and their customers, and are therefore not listed on the exchanges (Culpeper, 1994). Nevertheless, this is an important challenge for regulators that needs tackling.

c) Participation in global macro-economic policy discussions

As mentioned above, the sustainability of private capital flows and the avoidance of rapid withdrawal, potentially leading to crisis, does not just depend on the structure and regulation of international capital markets; is also crucially depends on global macroeconomic conditions.

For this reason, it seems important for Latin American governments to be given the opportunity to participate in discussions of global macroeconomic coordination (such as are dealt with by the G7), particularly in the case of variables, such as interest rates and exchange rates, which so directly affect them. Latin American countries should also put forward their concerns and views to the authorities in individual major industrial countries, as regards the potential impact of those countries' macroeconomic policies on Latin American economies. Again here the IDB and/or ECLAC may be particularly effective.

An important step toward regional macroeconomic co-ordination was taken in April 1994, when the governments of Canada, Mexico and the United States (parties to NAFTA) reached an agreement to establish an exchange stabilization fund of US$8.8 billion.[4] The agreement came after the Mexican peso had experienced several weeks of volatility and uncertainty in foreign exchange markets, threatening to undermine the government's economic program.

It was not envisaged that this facility would often be drawn upon to defend the currencies in question; rather, the fund was designed to be large enough to discourage speculation and thereby reduce short-term exchange-rate volatility. In addition, however, the three countries established a consultative group (the North American Financial Group), involving the finance ministers and central bank governors of the NAFTA parties. This group will engage in regular consultations on economic and financial policy arrangements. This consultative mechanism could provide a vital channel of communication and co-ordination, in the event that exchange-rate adjustment is precipitated by the domestic policies of one of the partners (e.g. increases in interest rates by the U.S. Federal Reserve Board).

---

[4] We thank Roy Culpeper for suggesting and developing this point.

As regional trade liberalization and economic integration spreads throughout the western hemisphere, it is crucial that such mechanisms of economic and financial co-ordination be broadened. The establishment of the NAFTA stabilization fund is an acknowledgement of the rapidly growing interdependence among countries, and of the fact that individual countries (particularly by the larger ones), should not take macroeconomic policy decisions based on domestic considerations alone, without taking into account their impact on trading partners.

d) Greater prudence by market participants

Market participants need to examine market conditions frequently, and the consequent appropriateness of their pricing of risk. They need to understand for example how assured are their credit lines, how strong is their asset backing, and how much their exposure to different types of risk has been increasing? This refers both to domestic and foreign liabilities; as regards the latter and their risks, interactions among participants from different countries (e.g. via international associations) seem very valuable.

III. THE SURGE OF CAPITAL FLOWS IN THE 1990S: POLICY ISSUES FROM THE DEMAND SIDE

1. Capital inflows and their macroeconomic effects

The sudden surge in capital inflows has brought to light an important policy dilemma as regards efforts to restore economies to a situation of growth. They have provided the financing needed to continue, in a more socially efficient way, the structural adjustment programmes initiated by several countries in the 1980s. However, they have posed challenges as regards introducing safeguards designed to prevent them from triggering financial crises, guarantee the stability and sustainability of macroeconomic equilibria and promote investment. Concern about these challenges has re-emerged as a key element in policy design.

For the region as a whole, the entry of capital has had positive Keynesian-like effects, in that it has reduced the foreign exchange constraint, enabling existing productive capacity to be used more fully and production, incomes and employment to pick up as a result. The lifting of the external constraint since the beginning of the 1990s has contributed to the recovery of economic growth, whose annual rate increased from 1.6% in 1983-90 to 3.4% in 1991-93 (see table 4, line 17).

Table 4

The recovery is based largely on the fact that the greater availability of foreign savings has made it possible to finance the larger imports associated to an increased use of existing productive capacity; this, through its effect on output and income, has reactivated aggregate demand. The expansive effect has been general throughout the region, and particularly strong for some countries (for example Argentina, Chile and Venezuela); nevertheless, there are exceptions. Thus Mexico -while experiencing a particularly large influx of private capital- has not seen such a recovery of growth during the period. The extent to which private capital inflows lead to growth is greatly influenced by the existing gap between actual GDP and productive capacity, the nature of domestic economic policies, particularly macroeconomic ones, expectations of economic agents, political developments, and external factors such as the terms of trade.

Since 1990, net capital inflows surged, reaching an annual average of around US$ 62 billion in 1992-93 (see table 1). About half of net inflows in 1991 went to build up the Latin American depleted international reserves; this share has steadily decreased to 30% in 1993, *pari passu* with the increased absorptive capacity of the region. Obviously, this capacity has been enhanced by the significative exchange-rate appreciations allowed or pushed by several LACs.

Since the terms of trade have worsened significantly during the 1990s (see table 4, line 4), there still prevails a sizable gap between GDP and gross national income (see lines 15 and 16).

The investment rate, for its part, only in 1992 achieved a level above the average of 1983-90. Furthermore, for only some few of the countries in the region, which have received large capital inflows, such as Chile, this increase in capital inflows has been accompanied by a comparatively high investment rate. In all, if we compare 1983-90 with 1993, net external savings (capital flows minus the increase in reserves) have risen by about three percentage points of GDP, while the investment ratio increased only by one point. The remainder has gone to consumption or to compensate worsening terms of trade.

Together with economic recovery, the speed with which capital inflows have closed the external gap and generated a surplus of foreign funds has been reflected in a tendency towards exchange rate appreciation, a rapid reduction in trade surpluses and an increase in the current account deficit (see ECLAC, 1994). These trends reflected, initially, the recovery of "normal" levels of aggregate demand, imports and the real exchange rate, all of which were conditioned by external constraints during the period 1983-89. However, the continuing abundance of capital is tending to maintain these trends over time, and has confronted the economic authorities with a dilemma crucial to future stability, in that, if capital inflows fall, the levels of aggregate demand and imports and the exchange rate may not be sustainable in the medium term. In their equilibrium values, these variables should reflect the conditions of the domestic goods and money markets, as well as the availability of external savings, which depends on the permanent or transitory nature of capital flows.

During 1991-93: i) a larger proportion of capital inflows was devoted to the accumulation of reserves than in the 1970s, thereby moderating the impact of these resources on the region's economies; ii) domestic expenditure rose faster than domestic output and national income, with the surplus in the non-financial current account at constant prices being reduced and a deficit at current prices appearing, for the first time since 1981, by 1992; and iii) national savings were (moderately) crowded-out by external savings, as reflected in the fact that the increase in total investment was lower than that in external savings (see table 4).

The effects of the new inflows of capital have not been the same in every country. This is associated to the access to such resources, but particularly to the use which the region's economies have made of international financing. The capacity to absorb these flows, and the policies pursued by countries, have been affected by the point reached by each country in the process of economic adjustment. Indeed, the renewed links with international financial markets caught countries at different stages of their adjustment programmes.

2. Policy approaches

When the authorities are faced with an unexpected abundance of external financing, which they consider to be partly transitory or as flowing too fast for the economy to absorb it efficiently, they can intervene at three levels. At the first level, they can act to moderate the impact on the exchange rate through purchasing foreign currency (i.e., accumulating reserves) by the Central Bank. At a second, deeper level, they can adopt sterilization policies (e.g., open domestic market operations) to mitigate the monetary impact of the accumulation of reserves at the first level of intervention. At the third level, they can adopt policies on incentives, surcharges or quantitative controls to regulate capital inflows, thereby influencing the latter's composition and volume. The aim is to encourage flows whose volume is consistent with the economy's domestic absorptive capacity, channelling them into productive investment projects, and, conversely, to discourage the entry of short-term capital.

In general, within a context of financial liberalization, the instruments adopted have been directed primarily at the so-called first and second levels of intervention. Depending on the importance attached to mitigating trends towards appreciation, the authorities of several LACs have carried out different interventions in the foreign exchange market; moreover, according to whether they have chosen to pursue an active or a passive monetary policy, they have introduced different degrees of intervention to regulate aggregate demand. Some countries have also directly regulated capital flows in order to influence their composition and bring them more into line with their development objectives.

The possible combinations between the first and second levels yield different mixes of exchange rate and monetary policies, which lead to distinguish two major intervention alternatives.

i) Non-sterilized intervention. The first level of intervention, has been frequently adopted by countries which especially target price stability as the main objective, anchoring it to a fixed nominal exchange-rate, and are willing to accept a passive monetary policy. In fact, the central bank must accumulate substantial international reserves as it buys foreign currency brought in by the capital inflows, without sterilizing the monetary effect of these operations. The bet is that national interest rates and inflation rates will converge rapidly with international rates.

An important part of the success of this strategy will ultimately depend on the confidence of economic agents in the capacity of monetary authorities to maintain the nominal exchange rate. Success also depends on the relationship between the nominal exchange rate and inflation. In the face of inertial components of inflation and/or lags in adjustment of imports -which can cause the monetary base to expand beyond desirable levels or prices of importables to remain high- the use of the exchange rate as an anchor to stabilize prices can cause marked real exchange rate appreciation, a growing excess of aggregate expenditure and a change in the composition of output biased against tradables. An extreme reliance on this approach to attack inflation is clearly a high risk strategy; should important disequilibria emerge, the policy options often narrow down to a severe recession or abrupt and destabilizing corrective measures. Indeed, some would counsel the alternative of direct action on inflation through active fiscal, income and monetary policies: as Professor Peter Kenen(1993) has commented:"no sensible sailor throws out the anchor before the boat stops moving".

While in practice the countries of the region have used different policy mixes, one can single out Chile in 1979-82 and Argentina in the 1990s, among the countries which have come the closest to the pure form of this alternative. The trade-offs in Argentina recently, at least for the medium term, have been relatively large (Fanelli and Machinea, 1994). Inflation has come down sharply and the economy has experienced a sizeable recovery in investment and economic activity. However, exchange rate appreciation, coupled with import liberalization, has contributed to a marked deterioration of the trade balance and the current account deficit has been expanding, while domestic and national savings have shown a downward trend. Since domestic activity is being fueled disproportionately by external savings, the trajectory of the economy is heavily reliant on sustainability of capital flows.

ii) Sterilized intervention. This approach involves a sterilization of the monetary effects of accumulating reserves during surges of capital inflows. The purpose is to isolate the money stock from large fluctuations stemming from the mobility of foreign capital. This type of sterilization, if effective, prevents domestic real interest rates from falling and limits the expansion of aggregate demand. This second level of intervention has been preferred by countries which have left behind a recessive conjuncture, maintain an active monetary policy and, at the same time, a more cautious position as regards capital inflows. It reflects a concern for the sustained development of the tradables sector, and the channelling of foreign capital towards savings and investment (preferably in that sector).

In economies that are making full use of their productive capacity, sterilization has the advantage of helping control aggregate spending and preventing further appreciation of the real exchange rate. However, if interest rate differentials persist, capital inflows continue to be stimulated, generating further needs for sterilization; at the same time, the intervention may be a source of quasi-fiscal deficits, since the Central Bank is placing commercial paper in the domestic market at higher interest rates than those it obtains on its international reserves.

Thus, sterilized intervention is not problem-free. Conflicts arise more strongly when there is too little flexibility in the tax system for national economic authorities to be able to use this policy to offset domestic or external shocks. What happens in these cases is that the other policy instruments are overcommitted; in effect, authorities must rely solely on monetary and exchange rate instruments to moderate aggregate spending or to stimulate the economy. A more flexible tax system would permit a better policy mix and more stable interest and exchange rates.

In the absence of a flexible fiscal policy, the problems of sterilized intervention are heightened, enhancing the dilemma confronting the economic authorities when they try to control, simultaneously, the real interest rate (as a monetary instrument for implementing stabilization policies) and the real exchange rate (as an instrument of trade policy for promoting the growth of tradable-production). If an interest rate consistent with the objective of curbing inflation (by sterilizing the monetary effects of accumulating reserves) is higher than the international rate adjusted for expectations of devaluation, capital inflows will continue to exert pressure towards real exchange rate appreciation, thereby jeopardizing the objective of competitivity of the tradables sector. Conversely, if the domestic interest rate is allowed to fall, both objectives are thwarted, since the higher expenditure induced by lower interest rates will put pressure on prices and will also lead to a real appreciation (Zahler, 1992).

It is for this reason that, in practice, the alternative of sterilized intervention has been combined with other policy measures: i) additional policies at the first level of intervention, to influence the foreign exchange market; ii) at the second level, to regulate aggregate demand through mechanisms other than the interest rate; and iii) at the third level, to modify the volume and composition of capital flows, either directly, through restrictions and charges aimed particularly at short-term capital, or indirectly, by generating exchange rate uncertainty for short-run dealers (see Ffrench-Davis, Agosin and Uthoff, 1994). Among the possible measures, the following are noteworthy:

At the first level of intervention, designed to influence the effects on the foreign exchange market: i) increase the demand for foreign exchange through incentives for the outflow of capital during periods of surplus; this can be done by relaxing the rules governing investment by nationals abroad and the repatriation of FDI, and by authorizing various debtors to make advance payments; ii) encourage increased investment intensive in imported capital goods and inputs; iii) fostering mechanisms which encourage productivity increases in keeping with exchange rate appreciation.

At the second level of intervention, the purpose of which is to control the impact on aggregate demand: i) introduce mechanisms regulating financial systems in order to avoid distortions and market incompleteness in the sector, and remove weaknesses in the prudential regulation of the financial system (see ECLAC, 1994, chs. VII and XII); ii) impose fiscal discipline avoiding excessive pressures on demand; iii) supplement exchange rate policy with social contracts related to prices and wages (as in Mexico).

At the third level of intervention, designed to alter the composition of capital flows: i) apply indirect exchange rate measures aimed at reducing the entry (and fostering outflows) of short-term capital by introducing uncertainty as to the short-run evolution of the exchange rate, through intervention by the respective Central Bank in the determination of this rate; ii) adopt direct measures imposing restrictions on capital inflows, which can take the form of reserve requirements, without interest, on bank deposits or other credits from abroad, and various kinds of quantitative controls (requirements as to minimum maturity periods, minimum volumes for bond issues, and regulations on the participation of foreign capital in the stock market).

Among the countries which have opted for active intervention, Chile has done so most persistently, but others, such as Colombia, Costa Rica and Mexico, also deserve mention (see ECLAC, 1994, table XI.4).

Chile is illustrative of a country deploying a battery of policies at the three levels, so far with excellent results regarding growth, increased domestic savings and investment (Ffrench-Davis, Agosin and Uthoff, 1994). The Chilean authorities opted for intervention because they wanted to regulate domestic activity via an active monetary policy, and also to support the country's hard won export drive by influencing the determination of the real exchange rate in the short term, on the basis of two assumptions: i) the monetary authority has a better idea of future macroeconomic trends in the balance of payments and their long-term effects on the economy; and ii) more fundamentally its objectives are longer-term than those of agents operating in short-term markets (Zahler, 1992). Hence, in the face of intense capital inflows, the authorities, interpreting part of this to have a permanent character, allowed for some appreciation. However, they significantly moderated the size of the change, with an active and rather comprehensive intervention, including use of a number of regulations on short term capital. Naturally, in order to moderate appreciation of the exchange rate, the country had to be more flexible in its goal at arriving at one digit inflation. But at 13% in 1993, inflation is quite manageable and low by historical standards. As a consequence, Chilean management of capital flows seems particularly effective up to early 1994.

Mexico is an intermediate case between Chile and Argentina. On the one hand, has given primary attention to convergence of domestic inflation (with that in the USA). However, it has not gone to the extreme of fixing the nominal exchange rate as has Argentina. While there has been considerable real appreciation of the exchange rate, this has been moderated by significant degrees of levels two and three types of intervention (Gurría, 1994), although less comprehensively than Chile. The result has indeed been the achievement of one digit inflation. However, very tight monetary and fiscal policy, along with political problems in 1994, have kept growth down. Indeed, it could be said that Mexico introduced elements of heterodox management of foreign capital flows (such as a band in the exchange-rate) a bit late.[5]

It is a cause of concern that even with an extremely low growth rate (of 0.5% of GDP in 1993), the Mexican current account deficit was very high that year. Though the approval of NAFTA opens new possibilities for the Mexican economy, the high level of the current account deficit makes the country very dependent on foreign capital inflows; it is consequently vulnerable to any major decline in such capital inflows. To help avoid such a decline, the economic authorities need to use high interest rates, which have negative effects on the domestic economy.

3. A policy prescription for stability and sustained growth

From a public policy standpoint, the ideal way to evaluate a response to a surge of capital inflows would be to separate the permanent components from the temporary ones. If there is a permanent additional flow, such related phenomena as real exchange rate appreciation, growth of the current account deficit and increased consumption could be interpreted as stabilizing

[5] Nevertheless, the band, together with the exchange stabilization fund, resulted to be extremely effective in the emergency faced by Mexico in early 1994.

adjustments and, therefore, economically healthy. If capital flows are temporary, the aforesaid movements in key variables would be distortionary, since they would create economic imbalances and the likelihood of disruptive future adjustments with potentially high costs. This distinction is, of course, very difficult to make in practice. However, there are economic policy measures which can have a differentiated impact on short- and long-term flows or on flows of productive as opposed to purely financial investment (see Ffrench-Davis, Agosin and Uthoff, 1994).

The externalities and other major imperfections of international capital markets give rise, among other things, to frequent cycles of abundance and scarcity of resources and to systemic crises, with the result that even potentially permanent flows can disappear overnight (Guttentag and Herring, 1984). Accordingly, it is always advisable for governments to exercise a degree of caution where capital inflows are concerned, in order to promote a situation where their aggregate amount and main components are consistent with macroeconomic stability, investment, and growth based on international competitiveness. Particularly if the size and composition of capital flows are inconsistent with these parameters, sooner or later their sustainability could be threatened, making it necessary to resort to socially costly national adjustments. This problem of the level and quality of domestic absorptive capacity is compounded by the inherent risks of short-term external shocks in international financial markets.

Since capital flows can affect, and are affected by, national macroeconomic variables, governments should exercise caution on two fronts. First, they should avoid a situation where capital inflows create atypical values (outliers) or major distortions in key domestic macroeconomic indicators, such as real interest and exchange rates, sectoral and national indebtedness, inflation (including asset prices), consumption, investment and the production of tradables.

Second, governments should guard against using capital inflows as their main instrument for achieving a rigid or extreme target for a single domestic economic variable, especially over a prolonged period of time. Doing so usually throws other important variables out of balance, thereby affecting the very instrument they used in the first place, namely, capital inflows.

Capital flows clearly are not always consistent with the objectives of macroeconomic stability in its broad sense, sustained economic growth and social equity; a degree of direct or indirect public "management"in order to influence the volume and composition of these flows is therefore justified. There have been numerous past experiences, successful and unsuccessful, in applying this approach. What constitutes an appropriate degree of liberalization of the capital account could vary over time, depending on short-term domestic and international conditions and the level and needs of national development.

With respect to the speed at which the capital account should be liberalized, the process must be tailored also to the economy's capacity to absorb and efficiently allocate external resources. For instance, as discussed in Section I, a distinction could be made between capital inflows and outflows and different components of each (Williamson, 1991).

Capital-account liberalization in the industrialized countries has been fairly slow and gradual, accelerating only in the past 10 years as capital markets have become globalized. It is interesting to note that Spain, Portugal and Ireland introduced certain restrictions on capital movements in 1992 to combat exchange rate instability. Once the objectives of stability were achieved, the restrictions were lifted. This highlights the importance of flexible instruments that, according to circumstances, allow some temporary constraints to be imposed on capital movements to support efforts towards macroeconomic stability.

In periods when resources are scarce, there would be justification for seeking specific and more general ways of attracting capital inflows and erecting certain barriers to capital outflows. The situation in the first half of 1994, of diminished flows to much of Latin America, illustrates clearly how rapidly external flows can dry up and how -in these circumstances- it is important for governments to make special efforts to attract capital inflows. The reverse would apply when there was an obvious abundance of capital in the markets, as in the 1990-93 period for many Latin American countries: it seems desirable in such circumstances that certain kinds of inflows were restricted and some channels for capital outflows were promoted.

There are a number of ways to manage capital flows. The more pressing the need for management, and the more underdeveloped fiscal and monetary policy is, the more likely it is that the use of direct regulations on certain types of capital flows will be warranted, even if only temporarily. Of course, controls of any type are often considered inefficient and capable of being circumvented by ever more sophisticated capital market operations. But as Williamson (1991, p. 139) points out, "assertions about the ineffectiveness of capital controls are vastly exaggerated." As mentioned earlier, there are obviously costs involved in the use of these instruments. However, these must be measured against the global social benefits in terms of macroeconomic stability, investment and growth as well as against the feasibility and reliability of possible alternative ways to achieve the same goal. As Zahler (1992) argues, the possible microeconomic costs of regulating capital movements may be more than offset by the benefits resulting from greater macroeconomic stability. Naturally, the net result will depend on the nature of the economic climate and the quality of the regulation policies applied.

Managing capital flows entails some costs. However, experience has shown that always leaving the market to determine the volume and composition of such flows may also entail costs, and these may be notably larger. There is no instrument, or set of instruments, which can operate with complete efficiency; in an imperfect world, they must be judged by their overall results. Pragmatic use must be made of the policy instruments that offer the greatest net benefits in terms of macroeconomic stability and growth, while minimizing costs.

The reorganization of financial systems, including the opening of the capital account, should give priority to channelling resources into savings and investment. Thus the relationship between the financial system and national savings and investment processes, and between the domestic financial system and external markets, also must be considered carefully.

Where the relationship between financial markets and capital formation for development is concerned, an institutional framework is needed to complete or perfect markets according to two criteria. The first is that a dynamic long-term segment of the financial market must be developed in order to finance productive projects. This involves discouraging short-term segments and concentrating on long-term international capital accompanied by access to technology and to export markets. This is particularly relevant for small and medium-sized firms discouraged by the segmentation of the capital market. To that end, credit institutions and guarantee mechanisms are needed to do what capital markets have failed to do spontaneously. Second, it must be recognized that, in countries with "emerging" stock markets, financial liberalization of the capital account, by opening it to international portfolio investment, runs the risk of creating external debt overhang and excessive stock market and exchange rate fluctuations. Large-scale foreign capital inflows to domestic markets can trigger both "stock market bubbles" and appreciation of the local currency at the same time. The subsequent decline in stock market prices can, in turn, cause capital outflows and depreciation of the currency.

Concern about risks associated with financial markets such as the generation of speculative "bubbles", implies the need to introduce regulatory and supervisory mechanisms to ensure the stability of financial institutions operating in capital markets. Such mechanisms are particularly essential in open, free-market economies. Strengthening prudential regulation can soften the above risks and contribute to a more orderly, stable process of attracting portfolio investments from abroad. Of course, effective regulation will require countries to improve their monitoring systems for external capital flows. This must be done not only at the micro level for individual financial institutions, but also at the macro level to ensure that the volume and composition of flows are consistent with economic stability.

REFERENCES

Akyüz, Y. (1993), "Financial liberalization: the key issues", Discussion Papers, No.56, UNCTAD, Geneva.

Calvo, G., E. Leiderman and C. Reinhart (1993), "Capital inflows and real exchange rate appreciation in Latin America: the role of external factors", IMF Staff Papers, vol. 40, No.1, March.

Chuhan, P. and K.Jun (1994), "Latin American financing in Japan's capital markets", in this volume.

Culpeper, R. (1994), "Resurgence of private flows to Latin America: the role of North American investors", in this volume.

Devlin, R. (1989), Debt and crisis in Latin America: the supply side of the story, Princeton University Press, Princeton.

Devlin, R. and R. Ffrench-Davis (1994), "The great Latin American debt crisis: a decade of asymmetric adjustment", in G. Helleiner, ed., Poverty, prosperity and the world economy, MacMillan, London.

ECLAC (1984), "Políticas de ajuste y renegociación de la deuda externa en América Latina", Cuadernos de la CEPAL, N° 48, Santiago, United Nations publication, Sales No. S.84.II.G.18.

---------------- (1994), Policies to improve linkages with the global economy (LC/G.1800(SES.25/3), United Nations, Santiago.

Edwards, S. (1984), "The order of liberalization of the balance of payments. Should the current account be opened first?", Staff Working Papers, No. 710, World Bank, Washington, D.C., December.

Fanelli, J.M. and J.L. Machinea (1994), "Capital movements in Argentina", in this volume.

Feinberg, R. and R. Ffrench-Davis (1988), eds., Development and external debt in Latin America, University of Notre Dame Press, Indiana.

Ffrench-Davis, R. (1983), ed., Relaciones financieras externas: su efecto en la economía latinoamericana, Fondo de Cultura Económica, México.

Ffrench-Davis, M. Agosin and A. Uthoff (1994), "Capital movements, export strategy and macroeconomic stability in Chile", in this volume.

Friedman, I. (1977), The emerging role of private banks in the developing world, Citicorp, New York.

Griffith-Jones, S. (1994), "European private flows to Latin America; the facts and the issues", in this volume.

Griffith-Jones, S. and E. Rodríguez (1992), eds., Cross conditionality, banking regulation and Third World debt, MacMillan, London.

Gurría, J.A. (1994), "Capital flows: the Mexican case", in this volume.

Guttentag, J. and R. Herring (1984), "Credit rationing and financial disorder", Journal of Finance, vol.39, December.

Kenen, P. (1993), "Financial opening and the exchange rate regime", in H. Reisen and B. Fischer (eds.), Financial Opening, Organization for Economic Cooperation and Development (OECD), Paris.

Kindleberger, Ch. (1978), Manias, panics and crashes, Basic Books, New York.

Lamfalussy, A. (1992), "The restructuring of the financial industry: a central banking perspective", lecture at City University, mimeo, London, March.

Lessard, D. (1991), "The international efficiency of world capital markets", in H. Siebert (ed.), Capital Flows in the World Economy: Symposium 1990, J.C.B. Mohr, Tubingen.

McKinnon, R. (1973), Money and capital, Brookings Institution, Washington, D.C.

---------------- (1984), "The international capital market and economic liberalization in LDCs", The Developing Economies, vol.22, December.

---------------- (1991), The order of economic liberalization: financial control in the transition to a market economy, Johns Hopkins University Press, Baltimore.

Mathieson, D. and L. Rojas-Suárez (1993), "Liberalization of the capital account", Occasional Papers, No. 103, International Monetary Fund, Washington, D.C., March.

Mishkin, F.S. (1991), "Assymetric information and financial crises: an historical perspective", in R.G. Hubbard (ed.), Financial markets and financial crises, University of Chicago Press, Chicago.

Park, Y.Ch. and W.A. Park (1993), "Capital movement, real asset speculation, and macroeconomic adjustment in Korea", in H. Reisen and B. Fischer (eds.), Financial Opening, OECD, Paris.

Ramos, J. (1985), "Stabilization and adjustment policies in the southern cone, 1974-1983", CEPAL Review, No.25, Santiago, April.

Robichek, W. (1981), "Some reflections about external public debt management", Estudios Monetarios VII, Banco Central de Chile, Santiago.

Shaw, E. (1973), Financial deepening in economic development, Oxford University Press, New York.

Stiglitz, J. (1993), "The role of the State in financial markets", Proceedings of the World Bank Annual Conference on Development Economics, vol.2, World Bank, Washington, D.C., May.

Stiglitz, J. and A. Weiss (1981), "Credit returning in markets with imperfect information", American Economic Review, vol.71, June.

Tobin, J. (1984), "On the efficiency of the financial system", Lloyds Bank Review, No. 153, July.

Williamson, J. (1991), "On liberalizing the capital account", in R. O'Brien (ed.), Finance and the International Economy, No.5, Amex Bank, London.

---------------- (1993), "A cost-benefit analysis of capital account liberalization", in H. Reisen and B. Fischer (eds.), Financial Opening, Organization for Economic Cooperation and Development (OECD), Paris.

World Bank (1993), A decade after the debt crisis, Latin American and the Caribbean Region, Washington, D.C., September.

Zahler, R. (1992), "Monetary policy and an open capital account", CEPAL Review, No.48 (LC/G.1748-P), Santiago.

Table 1. Net Capital Flows to Latin America[a]

(annual averages)

	Total net flows (US$ billion)						% of GDP					
	1977-81	1983-90	1990	1991	1992[b]	1993[b]	1977-81	1983-90	1990	1991	1992[b]	1993[b]
Latin America and the Caribbean	29.4	10.1	21.6	37.0	59.4	64.2	4.5	1.3	2.0	3.2	4.7	4.7
Argentina	1.9	1.8	1.5	3.0	10.9	10.0	2.0	2.3	1.1	1.6	4.9	4.1
Chile	2.6	1.5	3.1	1.4	3.5	2.8	12.7	7.0	10.3	4.2	8.6	6.3
Mexico	8.2	0.8	11.6	21.9	24.7	28.5	5.1	0.3	4.8	7.6	7.5	8.3

Source: ECLAC, Policies to improve linkages with the global economy. Report for the XXV sessions' period. Santiago, 1994, Chapter IX.

[a] Includes long and short-term capital, unrequited official transfers and errors and omissions.
[b] Preliminary figures.

Table 2. Capital Flows, Western Hemisphere
(annual averages in % of total)[a]

	1977-81	1991-92
Foreign direct investment	10.7	23.7
Portfolio equity	--	9.9
Bonds	4.5	17.0
Commercial bank loans	66.7	10.4
Suppliers and export credits	6.2	7.3
Official loans	11.1	26.9
Grants	0.8	4.8
TOTAL	100.0	100.0
(US$ billion)	(49.7)	(56.0)

Source: Based on IMF, World Economic Outlook, October 1993.

[a] Gross flows (excluding short-term loans).

Table 3. Total Assets of Institutional Investors
(billions of US$)

	1980	1988	1990	1991	1992
Pension funds					
Canada	43.3	131.3	171.8	188.4	
Germany*	17.2	41.6	55.2	58.6	67.5 (Sept.92)
Japan	24.3	134.1	158.8	182.3	191.9
UK**	151.3	483.9	583.5	642.7	
USA	667.7	1.919.2	2.257.3	3.070.9	3.334.3
Life Ins. Co.					
Canada***	36.8	85.5	106.1	118.1	
Germany	88.4	213.6	299.5	325.7	375.3 (Sept.92)
Japan	124.6	734.7	946.9	1.113.7	1.214.9
UK**	145.7	358.9	447.9	516.7	
USA	464.2	1.132.7	1.367.4	1.505.3	1.624.5
Insurance Co.					
Canada***	46.0	108.2	132.9	141.4	
Germany	125.1	301.1	425.8	453.1	529.3 (Sept.92)
Japan	159.2	890.7	1.137.2	1.329.2	1.433.3
UK**	177.0	431.1	533.2	606.3	
USA	646.3	1.586.6	1.896.6	2.096.9	2.253.2

Sources: Statistics Canada, Quarterly Estimates of Trusteed Pension Funds & Financial Statistics; Bank of Canada Review; Statistics Canada, Financial Institutions' Financial Statistics; Geschaftsberichs des Bundesaufsichtsemtes; Bank of Japan, Economic Statistics Monthly; Board of Governors of the Federal Reserve System, Flow of Funds Accounts; Central Statistical Office, Financial Statistics.

* Pension and burial funds for 1980 and 1988.

** Figures in the first column are for 1981.

*** Assets held in Canada.