

Latin America's reentry into private financial markets: domestic and international policy issues*

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Summary: 1. Introduction; 2. Recent evolution of international capital markets; 3. Some characteristics of Latin America's reentry; 4. Domestic policy issues; 5. International policy issues; 6. Summary and conclusions.

1. Introduction

Starting in 1989, and continuing through early 1993, there has been a dramatic increase in voluntary new private flows to Latin America. According to the IMF, while capital inflows to Latin America averaged about US\$8 billion a year in the second half of the 1980s, they surged to US\$24 billion in 1990, US\$40 billion in 1991. Mexico was the most important recipient country, followed by Brazil, Argentina, Chile, Colombia and Venezuela. Capital seems to be returning to most Latin American countries despite the wide differences in macroeconomic policies and economic performance between them. In most countries, the increased capital inflows are accompanied by an appreciation in the real exchange rate, booming (and bumping) stock and real estate markets, faster economic growth, a strong accumulation of international reserves, and a significant recovery of secondary market prices for foreign loans.¹

As a result of these developments, the key external financing issues for an important group of Latin American countries now concern the management of the new spontaneous capital flows, rather than dealing with the existing debt. It is to these management concerns that this paper is addressed.

For an adequate understanding of the rapid return of private flows to Latin America, it seems appropriate to start with a consideration of the dramatic changes in international capital markets in the last two decades. These changes are briefly surveyed in the next section. Section 3 summarizes leading events which help explaining Latin America's recent reentry into private financial markets.

Section 4 concerns domestic policy issues. Attention is centered on what seems to be the most important problem raised by the substantial capital inflows of the last few years — their volatile, short-term nature.

* Prepared for a joint research program of the Interamerican Development Bank (IDB) and the United Nations Economic Commission for Latin America and the Caribbean (Eclac). The views expressed here are those of the author and do not necessarily reflect those of the IDB or Eclac.

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¹ For alternative analyses of the capital inflows to Latin America, see Calvo, Leiderman & Reinhart (1992a, 1992b); Cline (1992); El-Erian (1992); Griffith-Jones & Culpeper (1992); Griffith-Jones, Marr & Rodriguez (1992); and Kuczynski (1992).

Section 5 summarizes a set of policy recommendations directed at multilateral forums, industrial countries, and international financial institutions, the general purpose of which is to provide more resilience and sustainability to the renewed access of developing countries to private capital markets.² Conclusions are collected in section 6.

2. Recent evolution of international capital markets³

The purpose of this section is to provide a background for an analysis of main policy issues raised by Latin America's recent reentry into private capital markets. It summarizes the most significant trends in international financial markets in the last two decades, followed by a brief discussion of important international policy issues raised by this evolution.

Four main trends in international capital markets during the 1970s and 1980s were as follows:

- (a) sharp expansion in the scale of net and gross capital flows among the industrial countries, as well as much increased participation by foreign investors and by foreign financial institutions in the major domestic financial markets;
- (b) easing of capital controls and broader liberalization of financial markets in industrial countries, which stimulated competition and brought about a growing integration of domestic and offshore markets;
- (c) private rather than official capital flows became the principal source of financing the historically large current account and fiscal imbalances of the industrial countries in the 1970s and 1980s. Thus, private flows accounted for approximately 75 percent of the financing of the cumulative U.S. current account deficit during 1983-88;
- (d) competition-driven disintermediation from banking systems — particularly from wholesale banking — into securitized money and capital markets. The relationship banking is being replaced with transactions-driven securities finance. This securitization is farthest advanced in the United States, the United Kingdom, and France, but it is also picking up steam in Japan and in other industrial countries.

These worldwide movements of financial integration and innovation had a major impact on domestic macroeconomic effectiveness, with implications for international policy coordination.

Monetary policy

Financial innovation and the availability of credit from offshore markets diluted the potential for domestic monetary control because of the growth of close substitutes for bank deposit liabilities, and forced the monetary authorities to move away from quantitative restric-

² These recommendations are summarized from Bacha (1993).

³ This section is based on IMF (1991b) and Goldstein et al. (1992).

tions on domestic lending towards instruments that operate more through "market prices", namely, exchange rates and interest rates. The difficulties with monetary targeting and direct credit controls have led the authorities in a number of industrial countries toward a more "eclectic" approach to monetary policy. Price data from centralized auction markets such as bond, foreign exchange, and commodity markets are increasingly viewed as providing useful summaries: since such asset market prices embody expectations about future developments, they can contain information about inflation expectations and can be a much better indicator of market conditions during a crisis than most forms of monetary or reserve aggregates.

Moreover, more liquid and securitized financial markets require that the monetary authorities be prepared to engage in close surveillance of financial institutions, and to step in firmly when there is a major liquidity disturbance, constantly mindful of the moral hazards involved. The problem is that closely involving the central bank in regulation and supervision of financial markets may distract it from its primary responsibility of implementing monetary policy, with adverse consequences for inflation performance. To witness, in Germany the fact that bank supervision is lodged in a separate agency combines with the lesser need to monitor liquidity on a short-term basis, because a few large, universal banks continue to dominate the German financial system, and private securities markets have remained relatively illiquid and of secondary importance. This would give the Deutsche Bundesbank a clear advantage in implementing monetary policy.

Fiscal policy

The availability of external savings has allowed creditworthy countries to finance large fiscal and current account deficits longer than previously. The integration of major capital markets seems to have created a double-edged sword for fiscal discipline: greater availability of external resources with sound policies, but increased capital flight with questionable policies. It is the concern about the ability of the market to evaluate creditworthiness properly and to apply discipline smoothly and gradually that has led to proposals for fixed rules for fiscal policy, as those adopted by the European Community in the Maastrich Treaty.

Policy coordination

The growing integration of major domestic and offshore financial markets has increased the pressure for greater coordination of financial and macroeconomic policies. Since financial institutions are now relatively free to relocate their activities, differences in regulatory or tax policies can induce a shift of activities from one market to another. This has led to a coordinated and uniform approach to bank capital adequacy requirements across the Group of Ten countries. Efforts are also under way to develop more uniform treatment of capital adequacy for securities houses, disclosure requirements, accounting standards, and the legal codes governing financial transactions.

The spillover effects from domestic macroeconomic policies have also increased as the linkages between major financial markets have expanded. Major movements in asset prices, especially exchange rates, interest rates, and equity prices, have often played a key role in intensifying efforts to improve policy coordination. The growing integration of major financial markets has also created a need for coordinated crisis management policies, especially among central banks. Indeed, this may be the area where the need for a coordinated official

response has increased most during the 1980s. Since the global markets for key government securities and foreign exchange operate on a 24-hour basis, emergency liquidity support during a major financial crisis may need to be coordinated to provide both continuing market support and the appropriate amounts in the different currencies.

Systemic risks

The experience of the last two decades shows that the process of deregulation, globalization, and innovation in financial markets has been a two-edged sword. On one side, these developments have increased financial market efficiency; on the other, they have increased volatility in financial markets and introduced new and highly complex elements of risk — some of a systemic variety — that make the pricing of financial instruments more difficult and that can contribute to abrupt changes in credit flows once previously unforeseen risks become evident. Which structure of financial markets — bank-based or securities-driven — will yield the best combination of efficiency and stability remains an open question. The possibility of a trade-off between efficiency and stability is illustrated by the evolution of the financial structure in the major industrial countries. As financial systems have become more competitive, more securitized, and more liquid, they have become more efficient. At the same time, such financial systems may be more susceptible to liquidity strains and crises than are less liquid, more bank-intermediated financial structures.

Thus, wholesale banks are responding to competitive pressures from securities firms partly by undertaking higher risk and higher return activities. In addition, the growth of off-balance sheet business has contributed much to a growing opaqueness of the financial system. Another source of systemic risk is the ever greater dependence of securities markets and financial institutions on the uninterrupted availability of liquidity.

The evidence shows that a number of recent financial crisis were preceded by the introduction of a new financial instrument or by a sharp increase in debt. This was particularly evident with the growth of interbank positions prior to 1974, the expansion of developing country debt prior to 1982, the large issuance of floating rate notes in the early 1980s, the accumulation of high risk real estate loans and noninvestment grade bonds by the U.S. thrift institutions during the 1980s, and the highly concentrated lending of Canadian regional banks to the agriculture and energy sectors in the early 1980s.

These crises suggest that a disturbance in markets for securities or foreign exchange would be most likely to threaten system stability if it fundamentally disrupted major national and international payments, settlement, and clearance systems. Cross-border systems are more exposed to these problems than major domestic systems because the former must operate across mixed legal and fiscal systems that can complicate the transfer of title to securities and the enforcement of settlement arrangements.

Policy responses

Official measures to limit contagion and to reduce systemic risks in international financial markets have focused on (1) strengthening the structures of major financial institutions and payments, clearance, and settlement systems so that they can better withstand financial crises; and (2) developing improved techniques for crisis management.

Besides new capital adequacy standards for international banks, adopted in the 1989 Basle Accord,⁴ these standards are also being discussed by the International Organization of Securities Commissions. A problem is in defining equivalent capital standards across systems where banks' participation in security activities and transactions differs markedly.

After the October 1987 stock market crisis, the U.S. authorities imposed circuit breakers in response to program trading. Those breakers stop trading for some period after prices declines by a prespecified amount, in both the stock and stock-index futures markets. But the higher capital adequacy standards for banks and the circuit breakers raise the costs of financial intermediation and create incentives for large portfolio managers and corporate treasurers to transact directly with each other rather than through financial intermediaries or exchanges. If that happens, it would be even more difficult to obtain an accurate view of the scale and direction of international capital flows.

In response to the legitimate concern whether existing institutional arrangements can cope efficiently with the new volume of transactions, both within and across the major national and international clearance, settlement, and payment systems, and manage the risks created by counterparty failure and liquidity crises, the authorities and private institutions in the clearinghouses have taken steps in several countries to limit the risks they face by requiring higher quality and larger amounts of collateral from members, by shortening the settlement period, by moving towards delivery versus payments methods, by placing limits on daylight overdrafts in payments systems, and by making more intensive use of netting arrangements to reduce the volume of transactions. But in an environment in which financial institutions are now relatively free to relocate their activities, efforts by any country on its own to impose stiffer regulatory standards face the problem of regulatory arbitrage. Again, here, a coordinated approach can accomplish what a competitive, uncoordinated approach cannot.

Official capital flows

Leaving aside military assistance, the dominant official flows among industrial countries have reflected exchange market intervention. But exchange rates are only one element in the set of asset prices that influence private sector portfolio and trade decisions. Asset price volatility in a major segment of international financial markets, such as for bonds or equities, could create just as much private sector uncertainty as exchange rate instability. However, intervention in a broad range of markets would raise the issue of how private risk taking activities would be affected by the knowledge that the authorities would regularly intervene to stabilize asset prices during periods of financial disturbance.

Transactions tax

Proposals for throwing "sand in the wheels" of the world capital market, by imposing transactions taxes on trades in short-term securities, reflect the view that short-run trading in foreign exchange and securities markets can be dominated by noise traders who ignore fundamentals and thereby contribute to excess asset price volatility. Transactions taxes are not without problems. One is that they may also discourage trades based on fundamentals, as

⁴ For details on the Basle Accord, see Goldstein (1992, p. 12).

well as those based on noise. The second is that, to be effective, they need to be imposed on a global basis. If implemented only in a few markets, activity would quickly shift to other markets. Interest on an international transfer tax on foreign exchange transactions has recently increased, as a consequence of the turbulence in European foreign exchange markets since September 1992. A working group of officials of the G-7 has been created to consider the feasibility of instituting international controls as a possible remedy for the flows of hot money.⁵

3. Some characteristics of Latin America's reentry

The return of private capital flows to Latin America since the late 1980s needs to be appreciated in the general context of the major changes in international capital markets recorded in the previous section.

In particular, the rapid growth of securitized forms of lending (such as bonds, CDs and CPs) *vis-à-vis* bank loans, and the increasing role that institutional investors (such as pension funds, insurance and mutual funds) have assumed in world capital markets are leading to a greater geographical diversification of investment, which favored Latin America, particularly because these movements were more pronounced in the United States, whose geographical and economic proximity naturally induced the new investors and investment forms to search for profit opportunities in the region.

Secondly, the rapid sequence of commercial bank debt restructuring agreements with the countries in the region, which have already been negotiated or are in advanced process of negotiation, are allowing the reestablishment of the normalcy of the regions' external debt payments, thus clearing the way for new private debt flows. Commercial banks are more reluctant participants of these new inflows, both because of their losses with past lending, and of their capital and reserves constraints, in view of the Basle Accord and the provisioning requirements against rescheduling countries. Security market participants enjoyed *de facto* senior status in their lending to Latin America in the 1960s and 1970s, and are up now free from capital constraints and provisioning requirements in their home countries; and hence, much more willing and capable to profit from the new opportunities for investment in Latin America.

Thirdly, the sharp drop in U.S. interest rates since 1989 provided a powerful incentive for repatriation of Latin America capital flight held in the U.S. financial system. As reported by Collins (1992), market participants estimate that up to 1991 between 60 and 70 percent of investment in Latin American instruments came from flight capital, and 20 to 25 percent from high yield investor and investment funds. Mainstream institutional investors such as insurance companies, pension funds, and nondedicated mutual funds may account for no more than 5 percent of total investment in Latin American securities, although this share seems to be growing.

Finally, the privatizations and other liberalizing economic reforms in the region, both actual and prospective, have enhanced the profit opportunities for foreign investors, and hence stimulated the inflow of foreign capital. For the region as a whole, inflows seems to be roughly distributed in the following form: 1/3 for the stock markets, 1/3 for the "hot"

⁵ Cf. *The Economist* (1992).

money markets, and 1/3 for direct investment. Countries more advanced in the process of stabilization and economic reform, such as Chile and Mexico, display a larger share of direct investment and medium term debt, while in countries far behind, such as Brazil and Peru, most of the inflows are short-term.

In spite of the marked improvement in Latin America's access to international finance in the last few years, the financing outlook for the region is still fragile. The decline in U.S. and international interest rates have been critically important in the new wave of private financing. Some countries, now with an avalanche of foreign savings, such as Chile, were unable to attract such investment before, even though they had healthy economies. The drastic resurgence of private flows may overestimate the degree to which successful severely indebted middle income countries have regained sustained market access. In fact, Latin American history is full with episodes where lack of credibility and a short term financial bubble were associated with large inflows of "hot money" from abroad. Moreover, portfolio debt flows, especially short term deposits, are more volatile than long term commercial banks loans and trade financing. Likewise, portfolio equity flows in emerging markets can be taken out fast at low costs. The risk of such reversal is heightened by the volatility of international interest rates.

4. Domestic policy issues

In a recent interview, Mexico's Minister of Finance Pedro Aspe asserted that "we should not worry about the permanent capital inflows, although we should worry about the short-term capital inflows."⁶

This in fact seems to be the main policy issue concerning the new private capital flows to Latin America, i.e., how to control short-term inflows, but in such a way as not to interfere with long-term inflows?

Why are short-term inflows undesirable? Mostly because they are volatile and unpredictable. They also disturb domestic monetary policy-making and induce undesirable changes in exchange rates with negative effects on export promotion policies. Furthermore, dealing with the short-term inflows without controls require the build up of large international reserve, which involve substantial money-losing sterilization operations.

Why on the other hand might one want not to interfere with the short-term flows? Mostly, it seems, to build confidence for long term capital to come in. Governments may also want to promote the expansion of domestic stock markets, and in this case there is no substitute for portfolio investment from abroad. Naturally, the funds that the authorities should be searching for are those of established institutional investors — pension, insurance, and non-committed mutual funds. But these funds will only come in if they are free to leave as they wish. It is also very difficult to permit only "institutional" investors in and leave out the "speculative" ones. There are however some financial alternatives for well-known companies, such as the issuance of stocks directly in international financial markets, through the mechanism of "depository receipts", which can only be negotiated abroad, and hence do not directly affect the domestic foreign exchange market.

⁶ Cf. Aspe et al. (1992, p. 7).

Short-term funds also have other plus signs: they may instill more competition in domestic financial markets, and help bring fight capital back to the country. The point is that a country has to start somewhere in its reentry process, and the short-term end of the market may be the only port available to it.

In Brazil, for example, an interesting discussion is currently under way, about the administrative impediments that the central bank created in late 1992 for the internment of debt-related short-term funds into the country. A two-and-a-half year maturity minimum is now required, and income-tax exemption only applies for instruments of five years or more. The purpose of this restrictive legislation is to avoid an exchange rate overvaluation and/or an expensive sterilization operation which would otherwise have to occur as a consequence of the short-term capital inflow.

The counterpoint of domestic financial market operators is that a "market solution" should be found for these problems,⁷ that is, a mechanism which would permit the circulation of foreign capital flows inside of the domestic private sector, without affecting the government accounts. One demand is that the central bank allows the foreign exchange deposits of exporters to be made with domestic private banks (currently, these deposits can only be made in banks abroad, up to the limit date in which they must irrevocably be turned in to the central bank). The same permission, so goes the argument, should be given for depositing in domestic banks of the short-term loans and stock exchange funds from abroad. Further, the request is made for the creation of a financial device allowing the exchange of dollars for cruzeiros without putting pressure on the monetary base. This could be achieved with the central bank authorization for the issuance of commercial bank CDs in cruzeiros, backed up by the dollar deposits of exporters and foreign investors.

The implications of these proposals are clear: they point out to the "dollarization" of the domestic financial system, a solution towards which Argentina finally opted for in its fixed-exchange-rate convertibility program. The peculiarity of this proposal in the case of Brazil is that there seems to be a significant "repressed" demand for dollars or dollar-backed short-term instruments in the country, which could be satisfied with the short-term foreign capital inflows, without necessarily provoking a tendency towards an exchange rate overvaluation if and when the liberalization measures were adopted.

One major problem with this "market solution" is however that it would tend to crowd-out short-term government securities from the Brazilian money market, or else force the government to offer much higher real interest rates on these securities in order to made them competitive with the dollar-backed banks' CDs. To avoid this problem, Nobre's (1993) suggestion is that the central bank impose regulatory limits on the emission of the new dollarized private market instruments.

Fiscal problems apart (which, as in Argentina, would need to be taken care of before a dollarization proposal could be adopted),⁸ it is interesting to note that similar dollarization trends in the Mexican financial system were cut short by the Mexican government in August 1991, when it decided to impose a 100 percent reserve requirement on the banks so that they were forced to stop bringing in money from the outside. Two problems were at stake: one is that the commercial banks were acquiring a capacity to "create money", independently of

⁷ See Nobre (1993).

⁸ On the prerequisites for opening the capital account, see Dooley & Isard (1991), Fischer & Reisen (1992), Mathieson & Rojas-Suarez (1992).

the central bank domestic credit decisions. The other is that the banks were exposing themselves to "foreign exchange risk" in such a measure that it would inevitably require central bank intervention in case the foreign exchange bubble would burst.

Concern has been expressed in some policy circles about the loss of macroeconomic policy autonomy brought about by the influx of short term capital inflows. The concern is correct as far as monetary policy is involved, but not necessarily so with respect to exchange rate policy, for short-term inflows allow for example the prolongation of an overvaluation policy designed to bring domestic inflation down. This may be for good or for bad, but at a minimum, time is bought for the government to implement the "structural adjustments" necessary to make the disinflation policy succeed. In other words, a policy of inflation control through monetary stringency is made more difficult; but one that uses an exchange rate anchor is made to last longer, provided that domestic interest rates are maintained at an attractive level for foreign capital to flow in. In fact, the objection has been presented, as pointed out in section 2, that financial openness may fail to impose adequate fiscal discipline on governments (or the domestic private sector, as illustrated by Chile in the 1970s and the U.K. in the 1980s), given the apparent easiness with which fiscal and private sector deficits can be financed in international financial markets. Hence, from a domestic savings point of view, perhaps a case could be made that financial openness brings in excessive domestic macroeconomic policy autonomy!

Calvo, Leiderman and Reinhart (1992a) provide an excellent summary of this whole discussion, focussing on three domestic policy concerns raised by short-term capital inflows:

(a) since capital inflows are typically associated with real exchange appreciation and increased exchange rate volatility, these may have adverse effects, especially in the export sector. Changes in exports associated with capital inflows may have economy-wide effects that are not fully internalized by the private sector — thus providing a rationale for policy intervention;

(b) capital inflows, particularly when massive, may not be properly intermediated and, therefore, may lead to a misallocation of resources. Improper intermediation could be the result of speculative bubbles, improperly-priced explicit or implicit government insurance, lack of policy credibility, and market failures (externalities, economies of scale, nominal wage/price rigidity). In practice, governments may be unable to make a credible commitment not to intervene when a speculative bubble bursts, especially when this involves the possibility of bank failures. This problem would provide another ground for intervention, as discussed before.

(c) "hot money" inflows could be reversed on short notice, possibly leading to a domestic financial crisis. In an environment characterized by asymmetric information, a sudden capital outflow may induce lenders to conclude that the country has suffered a negative supply shock, say, even when no shock has occurred. This may bring about the discontinuation of efficient investment projects, provoking a deadweight loss which may be observationally equivalent to an exogenous negative supply shock. Thus, this self-fulfilling prophecy example gives another reason for intervention. The example also shows that policy intervention may be called for, even when the funds are channeled to investment projects.

These three policy concerns, as pointed out by Calvo and associates are not new. In fact the depth of the debt crisis of the 1980s had a lot to do with the magnitude and sudden reversal of international capital flows to Latin America. Based on these considerations, these authors discuss six different intervention policies:

(1) *Tax on capital imports.* This policy may be effective in the short run, although experience suggests that the private sector is quick in finding ways to dodge those taxes. In any case,⁹ the effectiveness of capital controls depends on the size of the prospective gains from evading these controls (which suggests that domestic interest rates corrected for prospective exchange rate overvaluation cannot be way out of line with foreign interest rates; but also that raising the short-term unpredictability of exchange rate changes may in fact help to deter speculative capital flows without negatively affecting long-term export decisions), the ability to evade controls without being detected (which suggests that capital controls on commercial banks may be relatively effective, given the strictly regulation to which they are normally submitted, and also that it may be easier to place restrictions on capital inflows than in capital outflows), and the costs of being detected. Moreover, the ability of residents to evade capital controls will generally depend on arrangements governing convertibility for current account transactions. This is why most countries that claim to have established current account convertibility have actually retained various exchange restrictions on current account transactions, implicitly recognizing the dangers of capital flows through the current account. Clearly, consideration should be given to devising mechanisms that minimize the bureaucratic hassles and administrative costs of filing documents and obtaining or disposing of foreign exchange, and that keep the market for foreign exchange reasonably competitive.

(2) *Trade policy.* Calvo et al. suggest that the authorities could help insulate the trade sector from real exchange rate appreciation by increasing both export subsidies and import tariffs, and announcing that those subsidies/tariffs will be phased out in the future. But this would require such a “fine tuning” of the temporary trade policy measures with the intensity and direction of the short-term capital flows that would certainly make them impracticable. An alternative measure, to avoid the exchange rate overvaluation caused by the capital inflows, would be to accelerate import liberalization measures, but in this case the authorities would need to be convinced either that the short-term capital inflows are here to stay or else that meanwhile the export sector would be building up capacity which could then be used in the future when these inflows dry up.

(3) *Fiscal tightening.* While a “leaning against the wind” fiscal policy is not likely to stop the capital inflow, it may lower aggregate demand and therefore may cushion the inflationary impact of capital inflows. Overall, it is hard to provide a strong case for adjustment fiscal policy — which is usually set on the basis of medium or long-term considerations — in response to short-term fluctuations in international capital flows. However, if the authorities had envisioned a tightening of the fiscal stance, the presence of capital inflow may call for earlier action in this respect. It would remain to be seen how the government will be able to convince the electorate and the legislature that taxes need to be raised or expenditures reduced exactly when foreign finance is abundantly available.

⁹ The following discussion builds on Dooley & Isard (1991).

(4) *Central bank sterilized intervention.* This has been one of the most popular policy responses to the present episode of capital inflows in Latin America, as reported in Calvo et al. They point out two main difficulties with this policy under present circumstances. First, sterilization leads to an increase in the differential between the interest rate on domestic government debt and international reserves, thus creating a quasi-fiscal deficit. Second, by preventing a sharp fall in the domestic/foreign interest rate, sterilization tends to perpetuate the capital inflow thus exacerbating any problems caused by this inflow. Furthermore, as pointed out by Mathieson and Rojas-Suarez (1992), open market operations would do little to satisfy a generalized demand for increased holdings of a broad range of domestic assets at the initial configuration of yields on domestic securities (including equities and private debt instruments). In order for the private sector to be satisfied with placing all of its repatriated funds into government securities, it would very likely have to see a high real return on such securities, which could drive up government borrowing costs substantially. Consequently, serious doubts can be cast on the desirability of sterilized intervention in the present episode in Latin America, where countries are still attempting to solve their domestic and international debt difficulties, and their public sector budgets require further trimming.

The case of Brazil in 1992 is exemplary. In this year, the government accumulated some US\$10 billion of foreign reserves which were fully sterilized. Domestic sterilization implied the issuance of short-term domestic debt costing some 33 percent in dollar terms to the government, whereas reserves were remunerated at some 3 percent per year. This means that the Brazilian government spent some US\$3 billion or 0.75 percent of the country's GDP to sterilize the short-term inflows from abroad. The counterpoint of this fiscal cost was that Brazil's central bank accumulated a formidable total of US\$20 billion in foreign reserves, which at least guaranteed that the domestic currency would not be object of speculative attacks (given, additionally, the high level of domestic interest rates) while the country's president was being impeached for corruption by the Brazilian Congress. Interestingly enough, once the president was deposed and a new constitutional president took oath, a fierce discussion started in the country on what uses could be made of the central bank's "excessive" reserves, and one of the main concerns was how to do it without provoking an exchange rate revaluation.

(5) *Central bank nonsterilized intervention.* An alternative to sterilized intervention would be nonsterilized intervention, whereby the central bank purchases the foreign exchange brought in by the capital inflows in exchange for domestic money. This policy can help avoid *nominal* exchange rate appreciation, and is likely to narrow the domestic/foreign interest rate differential. However, it may generate an increase in the domestic monetary base beyond the central bank's target, contributing to fuel inflationary pressures and to appreciate the *real* exchange rate.

Calvo and associates find, in this connection, that floating exchange rates may have an edge over fixed exchange rates, because in the former regime the real exchange rate appreciation required by the capital inflow would not involve an inflation acceleration. They also claim that the central bank in a floating exchange rate regime could effectively act as a lender of last resort, whereas under fixed rates and fractional-reserve banking, preventing liquidity-type financial crises would call for the central bank to hold a large stock of international reserves, a costly if not unfeasible undertaking. They suggest that these considerations would give some support to a regime of floating exchange rates when the economy is subject to substantial capital flows. One major difficulty with this recommendation is however

the reversible and unpredictable character of the capital flows, which may result in an un-called for volatility of nominal (and real) exchange rates. Perhaps a more attractive policy would be the recent Mexican alternative of using wide bands for a limited exchange rate fluctuation, which allows the maintenance of both short-term flexibility and long-term predictability of exchange rate fluctuations.

(6) *Rise in marginal reserve requirements on bank deposits and more regulated bank investment in equity and real estate markets.* In cases where most of the inflows take the form of increased short term bank deposits, a sudden reversal of capital inflows may quickly result in bank failures. Marginal reserve requirements could be sharply raised such that they become higher as the maturity of deposits shortens; in fact a 100 percent required reserve ratio could be imposed as in Mexico on deposits with the shortest maturity. While this scheme could result in some disintermediation of the capital inflows, it has the advantage of decreasing banks' exposure to the risks of capital flows reversals. In addition, a regulation that limits the exposure of banks to the volatility in equity and real estate markets would further insulate the banking system from the bubbles associated with sizable capital inflows.

Calvo et al. proposals for bank regulation may be difficult to implement in the context of universal banking, which seems very common in Latin America, where regulatory barriers are difficult to erect to prevent the interactions between activities within a same banking group.¹⁰ It is also not clear that governments are less likely to intervene in the event of a stock market crisis and/or a real estate market crisis than in the case of a banking crisis, which broadens the "moral hazard" case for preventive regulation affecting short-term funds for both deposits and stock market investments.

In this connection, opinions may also diverge with respect to the alternatives of outright prohibition of short-term flows (as in Brazil) or a system of incremental taxes (or central bank deposits) according to the duration of the flows. Prohibitions may be easier to implement, but they are also more distorting than taxes. Perhaps a sequencing approach could be tried out. First, eliminating the quantitative restrictions, perhaps at the same time substantially increasing reserve requirements according to maturity periods (with a 100 percent required reserve ratio for very short flows). Then, applying a policy of progressive reduction of these reserve requirements, in the measure that the country solves its fiscal and other structural problems, including appropriate domestic financial sector regulation.

5. International policy issues

Beyond the very relevant policy concerns with short-term inflows discussed in the previous section, for Latin American and other developing countries important issues concern the need for policies, both at the domestic and international levels, which might contribute for the renewed capital inflows to take a more sustainable, less speculative, form and also reach a larger group of recipient countries.

Sustainability of the capital inflows will depend on the course of domestic reform policies in developing countries, but also on international economic policies, as adopted by the

¹⁰ For example, in the case of Brazil, short term funds which officially entered the country for investment in stock markets are known to market participants to be most of the time invested in fixed-income securities.

multilateral forums, the industrial countries, and the international financial institutions.¹¹ This section summarizes selected international policy measures which might contribute to the sustainability of the capital inflows not only to the region but to other developing countries as well.¹²

Multilateral economic policy making

This initial group of recommendations relates to decisions concerning the multilateral forums of international economic policy making.

LDC representation in the G-7. The G-7 is the most important focus of international macroeconomic policy coordination in the world, but macroeconomic policy issues of direct interest to developing countries are only marginally taken into account in this forum. Time may thus have come to pressure the industrial countries to allow LDC representation into the G-7 level of international policy coordination. This would in particular facilitate the consideration and implementation of the recommendations to follow.

Multilateral foreign direct investment facility. In view of the importance of FDI as a sustainable source of externally financed growth, and of the relative success already attained by limited efforts of the Interamerican Development Bank and the European Community in this direction, the UN-CTC proposed in its 1992 report (UN, 1992, pp. 287-91) the establishment of a multilateral FDI facility with a view to providing loans to developing countries to promote development through FDI. Such facility would consist of a capital investment fund and of a fund through which other activities would be financed. A special window of the facility could be devoted to the promotion of outward FDI by TNCs from developing countries.

Another factor that significantly affects the climate for direct investment inflows, as pointed out by Dooley & Isard (1991), is the perceived attitude of the industrialized countries toward opening their markets to imports from the developing economies. For example, a clear invitation to other Latin American and Caribbean countries besides Mexico to eventually join the North Atlantic Free Trade Area could significantly stimulate foreign direct investment flows into export-oriented activities in the region — particularly if the invitations are accompanied by a commitment on the part of Nafta to keep trade barriers low in the interim.

International official debt restructuring agency. There seems to be a broad consensus — as expressed by Griffith-Jones, Helleiner and de Vries (in Teunissen, 1992, p. 118) — that the Paris Club machinery for resettling official debt contracts is a rather awkward and outmoded one, and that a new more agile institutional machinery is badly needed. In this context, John Williamson's (1992) proposal for an (official) debt restructuring agency linked to the Bretton Woods institutions might be a much welcome replacement to the Paris Club. Once in

¹¹ For a discussion of domestic reforms contributing to the attraction of foreign capital flows, see Collins (1992, pp. 31-42) and Mathieson & Rojas-Suarez (1992). For a counterpoint to these IMF views, see Akyuz (1992).

¹² This section summarizes the arguments developed in Bacha (1993).

place, this new Official Debt Restructuring Agency could serve as a natural international locus for an early recognition of an eventual future debt crisis involving private creditors.

International taxation of short-term flows. The enormous volatility and massive amounts of short-term international capital flows pose at times unsurmountable difficulties for the economic policy making of industrial and developing countries alike. In this context, measures leading to an international harmonization of tax treatment of nonresident deposits would appear as a priority topic for developing country governments. Equally important would be a serious international discussion of the oft-cited but never implemented 1978 Tobin's proposal for an international transfer tax on foreign-exchange transactions. Such a tax hopefully could be designed to make short-term currency speculation less attractive without doing much harm to long-term international investment.

Industrial countries' domestic policies

Industrial countries' domestic policies could critically affect the availability of capital flows to developing countries in at least two respects: public sector savings and regulation of domestic financial markets.

Increased public sector savings. One means of increasing the external resources that could potentially be made available to developing countries would be to increase the level of public sector savings (or decrease the level of public sector disavings) in the industrial countries. The extent to which a reduction in these fiscal deficits would increase the resources available to developing countries would depend on the developing countries' access to international financial markets.¹³ If their access remains limited, a reduction of fiscal deficits would result in lower interest rates but also in a decline in industrial countries' GDPs, which would reduce developing countries' exports. Thus, to guarantee maximum benefit it would be important to act on measures both to reduce fiscal deficits in industrial countries and to expand the access of developing countries to their domestic financial markets.

Financial market regulatory changes. El-Erian (1992) identifies the following regulatory moves that could positively influence the nature of private market flows to developing countries:

(a) graduation from loan loss regulatory provisioning regimes. Several industrial countries regulatory authorities require that banks maintain loan loss provisions against loans to a wide range of developing countries that have previously defaulted or whose debt has recently been restructured. In many countries, these requirements are determined by backward looking factors, typically responding with a five-year lag to a recovery in debtors' prospects. An example of increased flexibility, which could be followed by other countries, is provided by the Canadian system, where the Superintendent of Financial Institutions may at his/her discretion remove a country from the provisioning list two years (rather than the standard five years) after the most recent rescheduling if the country has shown ability to raise funds of over one year maturity on international capital markets;

¹³ Cf. IMF (1991a, p. 42).

(b) determination of appropriate risk weights for computing banks' adherence to regulatory capital adequacy requirements. Under the Basle Accord, loans to developing countries that are not members of the OECD or lenders under the General Arrangements to Borrow carry a 100 percent risk factor in the determination of the capital asset ratio; other sovereign loans carry a zero risk factor. This regulatory requirement discourages bank lending to developing countries. It would thus need to be adjusted to reflect sustained improvements in developing countries' debt-servicing capacity;

(c) flexibility in the use of cut-off credit rating standards and other regulatory restrictions for mobilizing funds on industrial country securities markets. Pension and insurance funds are a potential important source of long term capital for emerging market countries. An easing of restrictions on pension and insurance funds' asset composition — particularly in Germany and also in the U.S., where restrictive state laws prevail on public pension funds — would tend to increase these institutions' investments in foreign securities including those of developing countries.

International financial institutions policies

Recommended new actions of the IFIs, designed to further capital flows to developing countries, comprise the following ones:

IMF/BIS convertibility guarantee. Lack of currency convertibility is a major deterrent of capital inflows to developing countries. For this reason, Mitsuhiro Fukao (in Teunissen, 1992, p. 114) proposed that the IMF supports the maintenance of convertibility of LDC currencies more vigorously. One possible procedure would be that the IMF gives a very generous stand-by compensatory and contingency financing facility, in return to a very tight guarantee of the convertibility similar to the establishment of a currency board. If the BIS capital rule could be tied to this facility by giving a lower risk weight for those countries with this agreement, bank loans could be encouraged besides other flows.

The importance of this recommendation is dramatized by the current experience of Argentina, which is holding on to a far-reaching convertibility program, temporarily financed by the foreign exchange proceedings of massive privatizations. Faced with a disturbing currency overvaluation, Argentina is now being advised by foreign experts to generate a massive fiscal retrenchment to force domestic prices and wages down. If, instead, the Argentine government had access to Fukao's "very generous" convertibility facility, it could attempt resolving the overvaluation problem through non-deflationary means (either through a credible one-shot devaluation or a Mexican-type crawling peg).

Debt enhancement through collateralization. In the case of Mexico, part of the reentry strategy into international financial markets was its acceptance that enhancement of debt instruments by the public sector may be required in the initial stages of the reentry process. Other countries with sufficiently attractive natural resources, well developed export sectors, or large domestic markets may be able to develop these financial enhancements by themselves (even in this case, technical advice from the multilateral institutions would be welcomed). Many other developing economies would need more direct financial support from the multilateral institutions, which, with their participation in the Brady Plan deals, should by

now have overcome their long-standing aversion to the provision of guarantees and other debt-enhancement facilities.

Improved international risk assessment of developing countries. To sustain spontaneous capital flows to developing countries, it will be important to broaden the investor base for the securities of the reentrant countries, both in terms of type of investor and geographical location. The most effective means of broadening investor participation will be to reduce associated risk, both by decreasing underlying uncertainties and ensuring increased provision of information. In this context, the IFIs, which have close contact with the countries concerned, could study with the interested developing country governments means by which they could make information on the these countries' economies more regularly available to potential investors in industrial countries. Additionally, the IFIs could extend special credit lines to help the developing countries to pay for the services of bond rating agencies, in the understanding that, independently of the rating obtained, this would provide greater certainty and assurance to potential investors, thus increasing the net proceeds of the country at the time of issue.¹⁴

Technical assistance in financial engineering and domestic financial market reform. One characteristic of modern international financial markets is the extreme complexity of instruments and operations. For this reason, Chile's Finance Minister Alejandro Foxley (in Aspe et al., 1992, p. 20) points out to the need for international organizations to offer technical assistance in financial engineering so that countries will not be amateurish players in a truly sophisticated world capital market. This would be an important job for the World Bank, a point which Foxley already brought to the attention of the Development Committee. Much information and experience is also available in the IFIs concerning financial market reforms. This experience could profitably be passed on to developing countries that are still struggling to reform their domestic financial sectors, as required for a mutually profitable involvement with private international capital flows.¹⁵

Special treatment for small countries. Latin America's reentry into international securities markets has been the almost exclusive prerogative of large, well known, creditworthy companies of the large countries in the region. Small countries in the region, with fewer and less well known companies and banks, do not seem to be able to attract in large scale the type of new private inflows that are now coming to the large countries. For this reason, Griffith-Jones & Culpeper (1992) point out the importance that smaller countries: (a) get strong support from the IFIs in reaching soon a favorable debt settlement with foreign commercial banks, as the banks have little incentive to incur the administrative costs of regularizing these countries' debts, for which they are heavily provisioned, discounts are high, and exposure is relatively small; (b) continue to have significant access to official capital flows; and (c) benefit from special efforts by IFIs and industrial governments, perhaps through guarantee mechanisms, to encourage new private flows to them.

¹⁴ On the real function of bond rating agencies in international bond markets, see Wakeman (1984).

¹⁵ On the need for domestic financial reform previously to external financial opening, see Fischer & Reisen (1992).

6. Summary and conclusions

The background for Latin America's rapid return to international private markets since 1989 is provided by the worldwide movement of financial integration and innovation in the last two decades, which played havoc with traditional domestic macroeconomic policy management tools and imposed the need for increasing coordination of financial and macroeconomic policies among industrial countries. A key feature of the new financial environment is the competition-driven disintermediation from banking systems — particularly from wholesale banking — into securitized money and capital markets.

The securitization of international capital markets is one component for the understanding of Latin America's reentry process. But the timing and rapidity with which this process took place can only be explained by the sharp drop in U.S. interest rates since 1989, which provided a powerful incentive for the repatriation of Latin America capital flight. Commercial bank debt restructuring, privatization, and other liberalizing domestic market reforms were clearly important, but the most impressive phenomenon is that capital seems to be returning to most Latin American countries despite the wide differences in macroeconomic policies and economic performance between them.

In spite of the marked improvement in Latin America's access to international finance in the last few years, the financing outlook for these countries is still fragile. The decline in U.S. and international interest rates have been critically important in the new wave of private financing to middle income countries. Some countries, now with an avalanche of foreign savings, such as Chile, were unable to attract such investment before, even though they had healthy economies. The drastic resurgence of private flows may overestimate the degree to which successful severely indebted middle income countries have regained sustained market access. In fact, Latin American history is full with episodes where lack of credibility and a short term financial bubble were associated with large inflows of "hot money" from abroad.

The main domestic policy issue concerning the new private capital flows to Latin America is how to control short-term inflows, but in such a way as not to interfere with long-term inflows. Short-term inflows are undesirable mostly because of their volatility and unpredictability. They also disturb domestic monetary policy-making and induce undesirable changes in exchange rates, with negative effects on export promotion policies. Furthermore, dealing with the short-term inflows without controls requires the build-up of large international reserves, which involves substantial money-losing sterilization operations. On the other hand, short-term flows may be the only available entrance door giving access to longer-term funds, and they also help to instill more competition in domestic financial markets, and help bring flight capital back to the country.

A discussion of these issues, based on Calvo, Leiderman & Reinhart (1992a), leads to the conclusion that there are legitimate grounds to support a policy of intervention based on a graduated tax on short-term capital imports, on widening the bands of permissible short-run exchange rate fluctuation, and on raising the marginal reserve requirements on bank deposits and other short-term flows. Given the likely fiscal costs, it is hard to make a strong case in favor of sterilized intervention, unless countries exhibit a strong fiscal stance, and capital inflows are expected to be short-lived.

The promotion of longer-term capital inflows is a priority item in the policy agenda. Latin American countries should persevere with strong stabilization policies, privatizations, and other liberalizing economic reforms (without losing attention to the need of close sur-

veillance of the newly liberalized financial markets). But action on the part of the international community also would seem to be badly needed, particularly now that, under a new administration, the U.S. seems prone to an economic recovery which should improve its domestic investment prospects and increase short term interest rates, thus tending to attract Latin America's "flight capital" back to their offshore bases.

The recommendations for international action designed to strengthen and give sustainability to international capital flows to developing countries — summarized from a companion paper, Bacha (1993) — start with the suggestion for the inclusion of a developing country delegate in the G-7 deliberations. The establishment of a multilateral foreign direct investment facility, and opening the Nafta market to imports from other Latin American countries would significantly affect the climate for direct investment inflows to these countries. The replacement of the Paris Club by an official debt agency linked to the Bretton Woods institutions would benefit both developing and industrial countries. An international transactions tax on trades in short-term securities would help to reduce speculative runs and excessive international asset price volatility.

One means of expanding the external resources that could be made available to developing countries would be to increase the level of public sector savings in the industrial countries. But it would be important to act on measures both to reduce fiscal deficits and to expand the access of developing countries to the domestic financial markets in the industrial countries.

The recommendations for new actions of the international financial institutions include the establishment of a currency convertibility facility jointly sponsored by the IMF and BIS; a new facility to provide new debt enhancement through collateralization and other financial techniques; measures to improve the quality of developing countries' risk assessment by international financial markets; technical assistance to developing countries on financial engineering and domestic financial market reform; and special treatment for small countries which are unlikely to reenter a securitized international private capital market.

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