Financing for Development

in Latin America and the Caribbean

Edited by
Andrés Franco

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Latin America and the Caribbean

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Edited by
ANDRÉS FRANCO

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Abbreviations

ADC	Andean Development Corporation
ADR	American Depository Receipt
ALIDE	Asociación Latinoamericana de Instituciones Financieras para el Desarrollo
ASEAN	Association of South East Asian Nations
CCL	Contingent Credit Line (IMF)
CEPAL	Comisión Económica para América Latina
ECLAC	Economic Commission for Latin America and the Caribbean (UN)
EDM	emerging debt market
FDI	foreign direct investment
FLAR	Fondo Latinoamericano de Reservas (Latin American Reserve Fund)
GDP	gross domestic product
HDI	human development index
HIPC	heavily indebted poor country
IDA	International Development Association
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IFIs	international financial institutions
ILAS	Institute of Latin American Studies (Columbia University)
IMF	International Monetary Fund
LAC	Latin America and the Caribbean
MNE	multinational enterprise
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
PSI	private sector involvement
SDRs	special drawing rights
UNCTAD	United Nations Conference on Trade and Development

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I wish very specially to thank the Permanent Representative of Colombia to the United Nations, Ambassador Alfonso Valdivieso, for his constant leadership and advice, and for creating a positive and encouraging environment that facilitated progress in this venture even in difficult moments.

Financial support was provided by ADC. ADC's own success stories allow it to testify genuinely to the importance of financing for development for Latin America and the Caribbean and this may perhaps explain its interest in making this project a reality. In ADC, I must thank its President, Enrique García (who contributed Chapter 4 on the role of regional development financial institutions), and Luis Palau, Director of ADC's office in Bogotá.

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The Ministry of Foreign Affairs of Colombia has honored me by appointing me the editor and coordinator of this book. It is in this capacity that I wish to extend my gratitude to the contributors to this book, and to recognize the energy and commitment that characterized their participation in all stages of this project.

Andrés Franco
Bronxville, NY
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Introduction

Financing for Development on the Agenda of the Rio Group

Guillermo Fernández de Soto
Minister for Foreign Affairs of the
Republic of Colombia

On behalf of the Rio Group, I am pleased to present the results of this final project on financing for development whose successful completion owes much to the support received from the Andean Development Corporation. We are confident that this book will make a significant contribution to global understanding of a subject that is of vital importance to the Rio Group and to each of its members.

The framework for this project has been the convening by the General Assembly of the United Nations of an International Conference on Financing for Development in 2002 in Mexico, which has kindly offered to host this very important event. I would therefore like to use this introductory chapter to highlight some of the issues which the contributors to this book have examined in greater depth and on which the Rio Group has on various occasions stated its views.

Reform of the international financial system and financing for development have been a thematic priority for the Rio Group this past decade, which has witnessed the unfolding of an international financial crisis of major proportions. A number of Latin American countries were affected by the ensuing economic difficulties, necessitating the elaboration of common political positions in order to facilitate a collective articulation of objectives.

The most recent statements by the Rio Group have been particularly important for the Conference on Financing for Development whose preparatory process has been moving steadily forward since 1999. It would be useful to take a closer look here at these statements.

The Heads of State and Government of the Rio Group drew attention to the subject in 1998 when they made reference to the instability of international financial markets and, more particularly, to the implications of that instability for the region's economies. It was and continues to be a worrying period, since the instability and volatility of the financial markets have visibly affected trade and finances in Rio Group countries.

It was therefore natural that the issue should have been taken to the General Assembly of the United Nations, which provided a forum for discussing the situation with the entire international community. This situation was not exclusive to Latin America and the Caribbean, but, on the contrary, had affected much of the developing world. Panama, in its capacity as pro tempore Secretariat, reiterated on behalf of the Rio Group the need to focus immediate attention on the imbalances and instabilities of the international financial system and to raise the alarm over the disturbing trend towards declining levels of official development assistance, which was of considerable importance to certain countries of the region.

In its first statement for 1998, the Rio Group expressed its strong support for the initiative to convene a United Nations conference on financing for development. Not only did the Group offer political support for an event of this type, but it also put forward specific proposals for the conference to focus on such issues as public and private financial flows, public and private external debt, reform of the international financial and monetary system, mechanisms to create a favorable international economic environment and consideration of new and innovative resources for development.

A few months later, in March 1999, one of the regular meetings of Ministers for Foreign Affairs was held. On this occasion, we were invited to Vera Cruz by Mexico, the new pro tempore Secretariat of the Rio Group for the year 1999. Given the keen interest of the Rio Group countries and, in particular, of the host country, which had demonstrated a great capacity in various forums to offer proposals on international financial issues, we collectively decided to issue a statement on the subject. We did so in order to highlight the importance of having open financial markets functioning in an orderly manner within a stable international financial system that included financial institutions with sufficient resources and reliable crisis prevention mechanisms.

This ministerial meeting was of crucial importance for the meeting some months later of the Heads of State and Government of the Rio Group. Under the leadership of then President Ernesto Zedillo—today Chairman of the Committee of Experts established by the Secretary-General of the United Nations to formulate recommendations on the subject of financing for development—the Rio Group reiterated its commitment to policies of open economies in the region and underscored the importance of adopting policies for promoting direct investment and fiscal discipline.

In September 1999 a useful meeting was held at the ministerial level with members of the Association of South East Asian Nations (ASEAN), all of which had been severely affected by the financial crises of the previous years. The Rio Group and ASEAN reached agreement on a number of important issues, including:

1. preparedness for possible future crises must not be sacrificed to the process of economic recovery;
2. a critical review of banking systems is necessary in order to ensure that crises can be prevented in a timely manner;
3. the Group of Seven must support domestic processes by adopting measures to stabilize the international financial and monetary system;
4. the Bretton Woods institutions need greater transparency and greater credibility;
5. political crisis management decisions must take into account the social impact of these situations;
6. decisions must reflect the link between financial and trade issues.

Also in September 1999, the Rio Group once again brought up in the General Assembly the subject of a High-Level International Intergovernmental Event for the Consideration of Financing for Development, as defined in Resolution 52/179 adopted by the General Assembly in 1997. In addition to reiterating what it had stated in the General Assembly in 1998, the Rio Group stressed the need for the participation of various important actors in the flow of resources for development.

Mexico contributed to the discussion of the issue within the region by organizing a regional high-level meeting in 1999 on the subject "Towards a more predictable and stable international financial system and its relationship to social development." This meeting, which was supported by the Economic Commission for Latin America and the Caribbean (ECLAC), served to reaffirm the key role of the United Nations in the promotion of development and the redesign of the global financial architecture.

The year 2000 began for the Rio Group with a new pro tempore Secretariat. This time the honor fell to Colombia. From the outset, the issue of financing for development was defined as one of the thematic priorities for the year, which enabled us to launch a number of activities aimed at situating the Rio Group as one of the key players in the overall preparatory process for the International Conference on Financing for Development.

In June 2000, the Heads of State and Government of the Rio Group, meeting in Cartagena de Indias, adopted a Millennium Declaration that contained an explicit reference to reform of the international financial system. They identified various courses of action that should be taken, including:

- a focus on national, regional, and global efforts to prevent external crises;
- promotion of more responsible economic policies as a way of reducing the vulnerability of our countries;
- reform of the institutions responsible for regulating the global financial system;
- support for the institutionalization of internationally acceptable standards in such areas as banking, financial regulation, and oversight, as the foundations for stability;
- promotion of financial assistance for those countries engaged in balance-of-payments adjustment processes;
- providing liquidity to prevent the proliferation of financial crises through improved credit facilities that help countries to remain solvent and to regain access to financial markets;

- encouraging private sector participation in overcoming and preventing crises;
- developing regional and subregional financial institutions and promoting coordination at the regional level;
- the provision of long-term resources and technical assistance for economic and social development and for infrastructure projects; and, lastly,
- strengthening policies in support of social security networks aimed at improving living conditions in our region.

Many of these concerns were raised in the United Nations General Assembly and discussed during the negotiations on the Millennium Declaration, which was adopted by the Heads of State and Government at the Millennium Summit in New York in September 2000. In addition to the diplomatic work carried out at the United Nations in the area of financing for development, we have been in the forefront of three activities which I would like to highlight briefly.

First, jointly with ECLAC we organized the regional consultation of Latin America and the Caribbean on financing for development, which was held in Bogotá on 9 and 10 November 2000. That consultation facilitated a high-level technical intergovernmental exchange and the adoption of a declaration in which we presented the perspective of Latin America and the Caribbean on the United Nations Conference on Financing for Development. This document represented a substantive contribution by the region to the preparatory process and touches upon many of the region's concerns about this global process.

Secondly, we convened a public diplomatic event organized in association with the Andean Development Corporation. This event was directly related to the International Conference on Financing for Development. Specifically, we organized a roundtable on financing for development in collaboration with the Institute of Latin American Studies (ILAS) of Columbia University and with the participation of, among others, the President of the Andean Development Corporation, Dr. Enrique García; Dr. Robert Grosse of Thunderbird; Dr. Arvid Lukauskas of Columbia University; Dr. Federico Kaune of Goldman, Sachs & Co.; and Ambassador Oscar R. de Rojas of the

Department of Economic and Social Affairs of the United Nations Secretariat. The event was held on November 15, 2000, with the participation of experts from a large number of delegations and non-governmental organizations actively involved in the planning for the United Nations conference. At the end of this book, a brief report has been included on the discussions held during the event.

Finally, this book has been prepared with the assistance of the Andean Development Corporation and we submit it for the consideration of a broad public interested in the subject. We have been careful to include very high-level papers written by experts in the different aspects of financing for development. The book's structure mirrors the key issues raised in the Millennium Declaration adopted by the Heads of State and Government of the Rio Group at their meeting in Cartagena de Indias in June 2000.

In conclusion, the subject of financing for development is one that has high priority on the agenda of the Rio Group and this has been an ongoing concern since 1997, when the financial crisis began. As such, the member countries of the Group have a political interest in seeing the problem addressed at a global level in a way that will no doubt take us beyond the convening of the United Nations Conference on Financing for Development.

1

The International Conference on Financing for Development

Oscar R. de Rojas
Department of Economic and
Social Affairs, United Nations

After having worked closely for many years as a diplomat from Venezuela with other delegates on the intergovernmental processes that are the core of the United Nations, I have been given the privileged opportunity—as Executive Coordinator of the United Nations Secretariat on Financing for Development—to assist in the technical and coordination work of the UN Secretariat, through the Department of Economic and Social Affairs, in providing support to the Preparatory Committee and Bureau on Financing for Development. The International Conference on Financing for Development is now set to take place in Mexico in the first trimester of 2002. It will be one of the most important UN projects since the Millennium Summit in New York in 2000.

There can be no undertaking of greater importance to all our nations, and to coming generations, than the sustainable development of all the world's countries and peoples, and the removal of all obstacles to that development effort. The role that financing plays in that effort cannot be overestimated. The challenge facing the world today is to secure adequate resources and to use them appropriately, efficiently, and equitably to meet the needs of people the world over. That is why world leaders at the UN Millennium Summit gave such prominence to this topic and agreed to "make every effort to ensure the success of the High-level International Intergovernmental Event on Financing for Development" (as it was called before the designation "International Conference" was finally agreed upon in February 2001).

Let me take just a moment to bring all readers up to date with this Financing for Development effort. The process began in the General Assembly, in 1997, after financial crises hit Asia, Latin America, and elsewhere, and when concerns about the negative impacts of globalization were high on the agendas of many countries. Developing and developed countries alike, as well as countries with economies in transition, were faced with difficult questions regarding financing for development: what were the opportunities and challenges, where were the greatest bottlenecks, what were the successes and failures? By the end of 1997, after adopting the very noteworthy "Agenda for Development," the United Nations had decided that intensive discussion on these broad financing and other macroeconomic issues was essential.

The Financing for Development initiative should also be seen in the context of the long-standing belief that the pursuit of development is inseparable from the pursuit of peace. (That is why the adoption of the "Agenda for Development" was so pertinent, a year after the adoption of the "Agenda for Peace"). Indeed, as many have said, in a world without cooperation, without solidarity, without justice, there can be *no* lasting peace. A world in which two-thirds of people live in dehumanizing poverty and have yet to see the barest fruits of the progress enjoyed by a minority is not a sustainable world.

After a rigorous and inclusive consultative process, the UN member states thus identified the following six areas as being critical for addressing all aspects related to the availability of financing for development. They are:

1. mobilizing domestic resources;
2. mobilizing international resources for development, including foreign direct investment and other private flows;
3. expanding trade;

4. increasing international financial cooperation for development including, *inter alia,* official development assistance (ODA), as well as identifying innovative resources for financing;

5. tackling debt; and

6. addressing systemic issues, including enhancing the coherence and consistency of the international monetary, financial, and trading systems.

All these issues are interrelated, and one of the characteristics of the Financing for Development process is that there has been an agreement to deal with these issues "holistically" or "comprehensively," so that the output of the conference constitutes a balanced whole. No such undertaking had been attempted in the United Nations, in the economic area, for over 20 years.

Moreover, the ongoing discussions within the United Nations should be seen as only the first step in a lengthy exercise, since most agree that the Financing for Development initiative should be considered the start of a process, not an end. But how much progress we make in each of the above areas, and each of the sub-themes within them, will depend very much on the political will mobilized—particularly in the industrialized countries—to address these problems comprehensively, and on the resources, both financial and human, that we can bring to bear. Each individual, government, and institution has its specific role to play, and it cannot be emphasized enough that it is only with the concerted efforts of all—civil society and private sector included—that we will obtain tangible results.

It is encouraging to note that tremendous efforts have already gone into the Financing for Development process. Among these, we should mention that:

- member state delegations have devoted much of their attention to financing for development issues since 1998, recognizing the central role that it plays in their efforts to create a better world for future generations;
- representatives of civil society have used their often scarce human and financial resources to call attention to existing conditions at the

community level, giving voice to the aspirations of the poor and disenfranchised, and to put forward very bold ideas and initiatives;
- international and regional institutions, particularly the Bretton Woods institutions (the World Bank and the International Monetary Fund), have allocated staff resources to the technical work under way, showing great willingness to set aside institutional rivalries in order to make progress;
- private sector partners have willingly joined our discussions, often at their own expense, to share with us their own perspectives on how globalization can be fostered in a way that maximizes the benefits and helps minimize the costs and make it a "win–win" game for all.

With all of this hard work, we are hopeful that concrete initiatives will be within our grasp in the near future. But, as indicated before, the process is not free of challenges. All of the main actors are constantly called upon to rise above their own particular preferences and priorities to reach compromises that benefit the whole even as they remain responsive to their own constituencies' concerns. Securing adequate resources continues to be an uphill battle. Sadly, in some countries of the North we observe a propensity to reduce aid budgets, which often is associated with what we might rightfully refer to as isolationist tendencies. Moreover, resource discussions come with questions of how existing funds can be used more effectively, as well as the struggle to seek the fulfillment of earlier commitments by all parties to existing agreements. All are mindful of these challenges and will not cease to search for workable solutions.

Besides the political considerations already referred to, there are many practical and economically sound reasons for working on financing for development. The globalizing world has brought us all closer together, for better or for worse. Thus, the ills that plague a farmer or worker in one corner of the world today may have consequences later for the city dweller in another country, thousands of miles away. By the same token, the fruits of that laborer now find their way to the consumption basket of that far-away city dweller.

At the Millennium Summit, world leaders solemnly said: "We believe the central challenge we face today is to ensure that globalization becomes a positive force for all the world's people. For while globalization offers great opportunities, at present its benefits are very unevenly shared, while its costs are unevenly distributed . . . . We are committed to making the right to development a reality for everyone, and to freeing the entire human race from want" (United Nations 2000, para. 5).

Following this line, we have been proposing that, besides the many obvious political and economic considerations, there are also *ethical* arguments that can and should become the principal guide to our deliberations on international economic cooperation issues in general, and on Financing for Development in particular. As believers in social justice, we cannot rely solely on criteria of "mutual benefit" or "common interest" and turn a blind eye to the widespread poverty and despair that continue to prevail in so many parts of the world today. We cannot ignore the tremendous burdens faced by men, women, and children the world over, including in the most industrialized countries. One of the most powerful sentences in the Millennium Declaration states: "Global challenges must be managed in a way that distributes the costs and burdens fairly in accordance with basic principles of equity and social justice. Those who suffer, or who benefit least, deserve help from those who benefit most" (United Nations 2000, para. 6).

In the end, there is one common and universal goal that keeps us focused: that we should put into place a system that is more responsive to the world's problems; more respectful of all of the world's people, especially the poor; more protective of our precious and scarce natural resources; more cognizant of the riches with which our diversity endows us; and more willing to use our human and financial resources to fulfill the aspirations of the world's people, regardless of where they are—in other words, a world in which solidarity is the overriding guiding principle. Some say this is utopia, but have not all the world's major changes for the better been powered by great ideals and convictions? With the UN Charter to guide us, we should continuously strive to do better.

In closing, let me then reiterate that we see in the UN Financing for Development process, to culminate in the Mexico conference in 2002, a wonderful opportunity for the world community to make effective the Millennium Summit commitments to international development cooperation and solidarity. I have in mind, in particular, the commitment to "spare no effort to free our fellow men, women and children from the abject and dehumanizing conditions of extreme poverty, to which more than a billion of them are currently subjected. . . . No individual and no nation must be denied the opportunity to benefit from development" (United Nations 2000, para. 11). This concerns us all.

Reference

United Nations (2000). *United Nations Millennium Declaration.* Resolution A\RES\55\2, adopted by the General Assembly of the United Nations, September 18, 2000.

2

The Role of the United Nations in Financing for Development: An Institutional Approach

Gert Rosenthal
Permanent Mission of Guatemala to the United Nations

I

In the United Nations, certain words or phrases have specific connotations that go beyond their textual meaning. A special lexicon exists for a specialized fraternity (the experts and diplomats who prowl the corridors of the United Nations Headquarters in New York), which the uninitiated find difficult to penetrate. Many of these words or phrases contain an emotional charge that tends to polarize viewpoints. "Financing for development" is one of these phrases.

For some, it means the risk of intrusion by the United Nations into the jurisdictional sphere of the multilateral financial institutions, with the consequent potential for duplication of functions and overlapping of their respective programs of work. Behind this concern lurks the perception of an even greater risk—a gradual shift in decision-making in this area away from institutions in which votes are weighted to reflect the level of capital contributions to the multilateral financial institutions and towards bodies in which decisions are adopted by majority vote. It also touches upon another sensitive subject: the national actors that have responsibility in this area.

According to this school of thought, the multilateral institutions deal with ministries of finance ("serious and responsible actors"), whereas the United Nations deals with ministries of foreign affairs (perhaps equally responsible but where form is just as important as substance, if not more so). It is for these reasons that the simple idea that a United Nations forum should conceive of attempting to influence the global financial order (the "financial architecture") creates panic in certain circles.

For others, it is a natural progression within the scope of the concerns of the United Nations to create greater awareness of the major obstacles to development. Just as the Organization has helped to place on the priority global agenda such issues as environment and development, population and development, the status of women in development, and many others, some argue that the time has come to view financing as a fundamental determinant of development. This determinant, it is argued, has two aspects. The first approaches financing as a potential problem by exploring its adverse effects on stability and on increased volatility in the movement of short-term capital. The other places the accent on investment as an indispensable ingredient for development, on the premise that without investment and without financing there can be no development.

It does not require any great wizardry to identify the countries or groups of countries that have been supporting these respective points of view. Faced with the insistence of the developing countries (in the Group of 77) since the early 1990s that the subject should be included on the agenda of the United Nations, the developed countries aligned themselves in resolute opposition to the idea. Little by little, however, this resistance began to give way. The Group of Seven shifted their position from unqualified opposition in 1990 to forgiveness of the bilateral public debt of a group of highly indebted poor countries, to acceptance, and then finally to promotion of the idea of debt forgiveness after 1998. At the same time, they gradually accepted the idea that the United Nations could after all play a role in facilitating financing for development. The discussion no longer centered on whether or not it was appropriate to discuss the subject in the United Nations, but tended to move in the direction of the content and scope of this discussion, how it was related to what was happening in other multilateral institutions, and what type of participation private actors should have in that effort.

Thus it was that, in 1997, the General Assembly accepted the idea of taking up the consideration of financing for development (Resolution 52/179) and the idea has since then gained increasing acceptance. By mid-2000, the call was being made for a High-level International Intergovernmental Event on Financing for Development (Resolution 54/279). It is now generally accepted that the subject should be considered in a holistic manner and within the broader context of development.

It is clear that many issues still remain to be resolved. Some countries are opposed in principle to large United Nations conferences—in the style of those held in the 1990s—simply for budgetary reasons. These countries, and in particular the United States of America, prefer the format of special sessions of the General Assembly held in New York, which avoid the considerable costs of transferring Secretariat personnel to another country. On the other hand, those countries that argue for a higher profile for the conferences, precisely because these events are ultimately aimed at creating greater public awareness, contend that they should be held in locations away from United Nations Headquarters in order to underscore the special nature of the event. Thus it is that the conferences held in the 1990s are often identified in United Nations jargon only by the place where they were held: Rio, Cairo, Beijing, Copenhagen, and so on.

II

As regards the substance of the matter, the United Nations has dealt with financial issues and financing for development since its creation, as the numerous studies on various specialized aspects of the subject will attest. Since the 1960s, concern for financing has occupied a central place in the program of work of the Secretariat and, in particular, of some of the regional economic commissions (especially the Economic Commission for Latin America and the Caribbean, ECLAC) and in the United Nations Conference on Trade and Development (UNCTAD). It is true that the Organization has always tended to approach the subject from the viewpoint of the resources needed to promote development. The emphasis at times was on internal resources and especially on public finances. At other times it was on movements of international capital. In the latter case, the analysis tended to focus on the effects of those movements within the framework of the asymmetry that characterized the relationship between the countries of the "center" and those of the "periphery." Invariably, however, the subject of financing was approached not in isolation but as a function of development. The subject was dealt with in analytical studies and discussed in many expert and intergovernmental meetings. In this sense, there is nothing particularly new or surprising about including the concerns relating to financing for development on the agenda of the United Nations. What perhaps is new is the intention to organize a global high-level "event" on the subject.

Why, under current economic conditions, is financing for development a concern for the United Nations? What led the General Assembly to adopt Resolution 52/179? There now appears to be some degree of consensus about the reply. Most countries agree, and the developing countries insist, that one of the core activities of the Organization is to promote the well-being of all the peoples of the earth (the Charter itself establishes as one of the main purposes of the Organization the "promotion of the economic and social advancement of all peoples"). They therefore insist that the United Nations should adopt a proactive policy towards the major challenges to development. According to this school of thought, financing is in effect one of the major obstacles to development at the dawn of the new millennium, given its crucial role and influence on stability, growth, and equity. The financial crisis that hit Mexico in late 1994 and the financial crisis that with much greater force affected various countries in Asia after mid-1997 and spread to many developing nations also highlighted the adverse impact that capital flows, and in particular short-term flows, could have on development.

On the other hand, without investment and financing there can be no development. In most developing regions, and for various reasons, domestic savings have been limited in recent times, while the profile of international financial flows has been erratic, to say the least. As is well known, official development assistance has seen significant declines. The problem of the over-indebtedness of many countries, especially low-income countries, has not been resolved and this has prevented access by those countries to capital markets. Direct investment, meanwhile, has gone disproportionately to a small number of middle-income countries. There is therefore a legitimate concern to increase the level of resources attracted—both domestic resources in each country as well as international resources—to permit the orderly and sustained expansion of productive capacity.

Although it would be unrealistic to think that the United Nations can contribute directly to increasing the level of resources attracted, it is reasonable to argue that the Organization could help, as it has so often done in the past, to create an environment within member countries (both developed and developing) and at the international level that is conducive to the mobilization of resources and the channeling of those resources into development activities. This task, as I have said, can be carried out by clarifying and discussing the issues and by examining different ways of approaching them as well as the manner in which the results of the debate influence our collective awareness. Thus, when financing for development is dealt with in the United Nations, financing is a means and development the end. In other words, in the phrase "financing for development," for the purposes of the United Nations the accent will be on development. It is not the intention, nor is it appropriate, to encroach upon the jurisdictional preserve of the international financial institutions. It is precisely because no one questions the fact that development is a legitimate issue for the United Nations to be involved with that the approach has been to view financing from the perspective of development.

III

How should the subject be approached? Once again, the Charter of the United Nations provides the answer. With the exception of the Security Council on matters that threaten peace, United Nations organs are usually deliberative. Their decisions contain a heavy burden of moral responsibility but, unless these are translated into international conventions, they are not legally binding. This in no way detracts from the value of their decisions, contained in resolutions, plans of action, or political declarations. Nor does it take away any intrinsic value from the socialization of ideas that occurs during the preparatory process, the "event" itself, and the implementation of the agreements reached.

Thus, perhaps one of the greatest contributions of the Organization to the well-being of mankind—and this is what the United Nations does best—is its work to promote greater public awareness and its capacity to influence the international agenda. The convening of high-level international conferences plays a crucial role in these efforts. Through the studies that it undertakes, the Organization also fulfills its advocacy role for various causes, contributes to the establishment of norms and standards, provides technical cooperation, and promotes the dissemination of ideas. There is little doubt that, taken as a whole, these activities have had an enormous impact on the orientation, content, and characteristics of public policies. In other words, a United Nations forum should not be expected to redesign the international financial order. It is plausible to believe, however, that the seed of an idea might be planted in these forums and that, in time, it might bear fruit in other intergovernmental forums that have greater decision-making capacity.

It is therefore entirely legitimate to suggest that United Nations organs and the Bretton Woods institutions complement each other. Although the Secretariat of the United Nations and the administrations of the World Bank and of the International Monetary Fund might have different views about various subjects, and the constituencies of the two groups may differ (as we have said before, the United Nations usually deals with ministries of foreign affairs, the World Bank with ministries of finance, and the International Monetary Fund with central banks), they are intergovernmental bodies in the service of the member governments themselves. Their very different attributes merely increase the potential for fruitful collaboration, based on their respective comparative advantages. We have therefore witnessed a marked trend in recent times towards increasing cooperation between these organizations, as shown, for example, in Resolutions 50/91, 50/227, and 51/166 of the United Nations General Assembly and in Resolution 1996/43 of the Economic and Social Council. The preparatory activities and the convening of a United Nations Conference on Financing for Development could optimize the exploitation of that potential.

What the United Nations brings to the partnership with the multilateral financial institutions is its moral authority, its capacity to bring groups together (recently confirmed by the spectacular attendance of Heads of State and Government at the Millennium Summit), and, as already mentioned, its considerable capacity to raise public awareness and to engage in advocacy for the cause of development. Moreover, a Conference on Financing for Development offers at least the possibility of building bridges between two bureaucratic cultures that coexist but rarely understand each other in most member countries: ministries of foreign affairs and treasury departments or ministries of finance. If a United Nations conference were to bring about, as a by-product, greater *rapprochement* between these two governmental organizations, that in itself would fully justify the holding of such a conference.

IV

If the principal asset of the United Nations is its ability to raise public awareness, what type of seminal ideas could be nurtured in a conference or "event" such as the one that is being considered? I have already noted that the Organization can help to create an environment conducive to the mobilization of resources and the channeling of those resources into development. For purposes of illustration only, 10 examples are listed below where this task of raising public awareness could lead to tangible achievements in the near or medium term.

1. The Conference clearly has the potential to improve the international political environment, particularly in the countries of the Organisation for Economic Co-operation and Development (OECD),

in the area of official development assistance. It is common knowledge that the level of such assistance has declined year after year, partly because of the lack of public interest—read, taxpayer interest—in the developed countries. It is indefensible that the average percentage of the gross domestic product of the member countries of the Development Assistance Committee should have declined from the already tiny proportion of 0.33 percent in 1990 to barely 0.20 percent in 1999 (estimates of the World Bank in its annual publication, *Global Development Finance*). The United Nations, through this Conference, could make a difference by reversing this trend.

2. The Conference also has the potential to contribute to a better international political environment that recognizes the importance of an open and transparent trading regime, not only because of its direct impact on the level of economic activity and employment, but also because of its contribution, direct and indirect, on domestic savings that could be allocated to financing for development. Here, there is a very direct correlation between export performance and the level of domestic savings.

3. It is now more important than ever to draw attention to the risks of a “race to the bottom” in policies and more particularly in tax rates. This suggests an urgent need for some type of global cooperation regime in tax matters. This cooperation should extend far beyond the traditional agreements on the avoidance of double taxation and provide for cooperation in different areas, such as tax administration, tax harmonization, and the harmonization of legislation to reduce tax evasion and tax avoidance. It is clear that the strengthening of public finances is one way of contributing to financing for development.

4. The Conference would offer at least the possibility of a calm debate on a modest international tax, if not on legitimizing such a tax—on energy, on trade, or on capital flows, depending on the subsidiary policy objectives—that would automatically finance the capital replenishment of the multilateral financial organizations. An initiative of this type would not necessarily be supranational in character since it could be conceived in such a way as to be administered by national tax authorities so that these authorities could in turn contribute an equal amount to one or several funds established for

the above-mentioned purpose. In this connection too, the proposal to discourage strictly speculative capital movements through a modest tax, which has so far been stoutly resisted by most developed countries, could once again be examined. It will be recalled that Professor James Tobin formulated this proposal more than 20 years ago.

5. Another controversial subject that will no doubt be resisted by some countries that specialize in the export of financial services, but that deserves calm analysis, is the role played by tax havens in financing for development. On the one hand, these havens offer incentives for the movement of capital—reverse flows—from developing countries to the countries that provide such havens. On the other hand, they are potential sources of resources that could be channeled into development. At the same time, they constitute perhaps the principal source of export (of services) of a small number of small developing nations.

6. A subject that is very closely linked to the preceding one is the need to explore the issue of the perverse incentives that exist in some developed countries to attract private capital from developing countries, thereby contributing to the negative transfer of resources. There is no doubt that the ability of any Latin American citizen to maintain deposits in the United States, totally exempt from taxes, is a further obstacle to the mobilization of domestic savings and their channeling into productive activities in the country of that citizen. Although no decision to change US tax laws can be taken in a United Nations forum, it is nevertheless vital to raise public awareness about the need to "level the playing field" in terms of incentives for the mobilization of savings and their channeling into development.

7. The Conference offers the possibility of once again touching upon those key elements that help to create an enabling environment for savings and investment in the developing countries. Although there should, of course, be no attempt to pursue an all-encompassing agenda, neither should the scope of the Conference be limited to strictly financial issues. This would be, in effect, what is meant by combining "financing" and "development."

8. As a related idea, the Conference provides a forum for discussing the key components of an enabling environment for savings and investment within the global economy. In other words, what

steps can be taken within the framework of international cooperation to encourage flows of private capital and official assistance, both bilateral and multilateral, to the developing countries? What would be the minimum requirements for the institutional and legal order to function appropriately at the global level?

9. Closely related to the point just mentioned, although the international financial architecture will clearly not be redesigned in a United Nations forum, we could at least examine those factors that lead to greater or lesser volatility of capital movements with a view to reducing the "wild swings" that have been observed in recent times. A number of economic policy initiatives should be undertaken in each country and others at the international level, including the strengthening of the International Monetary Fund to respond to the needs of developing countries that are affected by speculative attacks on their respective currencies.

10. As has been stated again and again in numerous forums, the steps taken in recent years to assist highly indebted poor countries have been too slow, cumbersome, and inadequate. The Conference will surely take up this issue and consider, among other things, what additional steps could be taken to provide additional relief and to overcome the situation of those countries.

In short, and as this list of issues shows, financing for development may take very specific forms and be closely linked to traditional UN activities. It is by no means, therefore, forcing the issue for the United Nations to organize a meeting of the type that we are discussing, especially if it does so in collaboration with the multilateral financial institutions, and in particular the Bretton Woods institutions.

V

Finally, there is an additional reason for convening a Conference that allows us to embark upon a holistic consideration of development, this time from the perspective of financing. And it is this: when the Heads of State and Government of the UN member countries met in New York during the Millennium Summit, they adopted the Millennium Declaration on September 13, 2000. In that Declaration, they agreed to strengthen the United Nations and to adapt it to the needs of the twenty-first century. They also stated that they would "spare no effort to free our fellow men, women and children from the abject and dehumanizing conditions of extreme poverty." They further resolved to create in national and international plans an environment favorable to development and to the elimination of poverty. The Conference on Financing for Development will offer the first opportunity to give greater specificity and content to the guidelines contained in the Millennium Declaration. Consequently, it has the potential to become an event of outstanding significance.

The agenda of the Conference, moreover, will no doubt encompass the internal economic policies of each country, international cooperation, and the way in which the two interact. A successful Conference will avoid the old debate about whether the emphasis must be placed on domestic efforts or on the external environment: each has an impact on the other and it would be artificial to try to separate the two. The Conference is therefore an event that should bring together all member countries of the Organization, both developed and developing. Moreover, as I have already said, it could help to develop fruitful cooperation between the United Nations and the Bretton Woods institutions while at the same time facilitating dialogue between member governments and civil society, particularly the private sector.

For all these reasons, there is more than enough justification for the inclusion of financing for development on the priority agenda of the United Nations. It clearly falls within the scope of the Organization's competence and contains all the elements to give greater impetus to the Organization in its urgent task of promoting development in all countries.

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3

Regional Trends in Global Perspective

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The 1990s witnessed a number of subtle but important shifts in financing for development in emerging market countries. As before, most investment throughout the developing world continued to be financed by domestic sources of capital. The balance between private and public investment changed, however, moving even more decisively in favor of the former. Flows of external financing to emerging markets resumed, following the disastrous 1980s when emerging markets' access to international capital markets was severely restricted. Indeed, the early 1990s saw an explosion of direct and portfolio investment flows to emerging markets, prompting leaders of developed countries to fret publicly about the prospects of a capital drain from the industrialized world. The second half of the decade, however, witnessed huge reversals of portfolio investment and net outflows of bank credit from several countries, contributing to severe financial crises in Mexico, Thailand, South Korea, and Indonesia, among others. In contrast, foreign direct investment (FDI) grew steadily and rapidly throughout the whole tumultuous decade.

Financing trends in Latin America and the Caribbean (LAC) mirrored worldwide developments, but with subtle differences. LAC experienced the fastest increase of private investment of any region. The rapid growth in investment and a low savings rate created a huge gap between domestic savings and investment, forcing LAC countries to seek out extensive external financing. In fact, external funds accounted for a larger share of fixed private investment in LAC than in other regions of the world during the 1990s. FDI became the largest component of flows to LAC and it showed steady, rapid growth throughout the 1990s. Overall, LAC fared well compared with other regions of the developing world during the tumultuous late 1990s.

This chapter has four objectives. First, it identifies alternative strategies of financing for development in emerging market countries. Second, it describes global trends in financing for development, including trends in private and public investment, the balance between domestic and external sources of financing, and the composition of external flows. Third, the chapter analyzes how financing patterns in LAC compare with those in the rest of the developing world. Finally, it explores options for managing the "mixed blessing" of capital inflows, drawing especially on recent Asian and LAC experience.

1. Options for financing for development

Domestic resources

Most national economic activity is financed by domestic sources of capital, thus mobilizing domestic resources remains the key to increasing the availability of investment funds. Indeed, despite the widespread perception that foreign investment flows have dramatically risen in significance, they have financed only about 10 percent of private fixed investment in the developing world recently; this figure is actually lower than the average for most regions in the 1970s.[1] One reason for this perception is probably that two types of foreign private capital flows, direct and portfolio investment, grew rapidly and attracted public attention during part of the 1990s.

Standard prescriptions for augmenting a country's pool of domestic investment capital center on promoting national savings and improving financial intermediation. Most economists believe that achieving a structural fiscal balance and ending repression of the financial sector while deepening bond and equity markets are essential steps in attaining these objectives. Financial repression occurs through government policies that serve as a tax on financial assets, especially interest rate controls and discriminatory taxation of the banking system (through reserve requirements or obligatory holdings of government bonds).[2] Most economists view this set of policies as damaging to long-term growth and development. Interest rate controls limit the growth of loanable funds by discouraging savings, thereby restricting the resources available for productive investment, and distort relative factor prices, encouraging an overly capital-intensive mode of production. Taxation of the banking system increases the costs of financial intermediation and contributes to the inefficient allocation of capital by favoring the public sector at the expense of the private sector.

Financial liberalization is seen as a remedy for many of these problems.[3] Deregulating interest rates augments the supply of investible funds by raising returns to savers. Removing credit controls improves the allocation of credit by putting decisions about how to distribute available funds among competing users in the hands of private markets. Eliminating taxation of the banking system reduces financial intermediation costs and promotes distributive efficiency by removing the bias in favor of the public sector. Finally, opening the domestic financial system permits the injection of foreign capital and increases competition in the financial sector. All these steps should increase overall financial efficiency and, thus, economic growth.

Deepening capital markets is critical for the efficient use of available domestic resources (and attracting foreign portfolio investment). Achieving this goal requires improving financial reporting by firms and banks; modernizing the system of contracting and brokerage on exchanges; encouraging institutional investors, including pension funds, investment companies, and insurers; and facilitating the introduction of new financial intermediaries and products. One interesting strategy for mobilizing domestic resources occurred in Chile, where the authorities created a private pension fund program to replace an insolvent state social security system.[4] This is a defined contribution scheme requiring employers to set aside 10 percent of workers' salaries, which is invested on behalf of individuals by private investment companies. The private pension system has increased the amount of national savings and channeled it into formal capital markets, leading to the growth or development of various product markets and the overall deepening of the financial system.

Economists have long debated whether private or public investment is more effective for promoting economic development and modernization. Currently, most economists favor private investment, claiming that public investment is often dedicated to political projects ("white elephants") or is poorly managed. Many empirical studies in fact suggest that private investment has a greater role in long-run economic growth than public investment.[5] Nonetheless, evidence indicates that public and private spending are often complementary, creating synergies if public spending is well designed. Components of public spending that seem to raise the efficiency of private investment are investment in education and infrastructure.[6]

External financing

Tapping international capital markets allows a country to supplement its pool of domestic funds, permitting it to invest more than it otherwise could if it were only able to draw on national savings, thereby potentially increasing welfare and economic growth. If the return that can be earned on funds borrowed from abroad exceeds their cost, then a rationale exists for pursuing external financing. In addition, if foreign flows come in the form of direct investment, a country's firms may also have the opportunity to improve their technology or management skills.

Foreign borrowing is inherently more risky, however, and the risks are greater if a country's export earnings are prone to fluctuations or exchange rates are volatile. Some types of capital can flow out very quickly, with devastating consequences. Moreover, countries experiencing large inflows in a short period of time can face serious macroeconomic difficulties, among them real exchange rate appreciation that can contribute to a larger trade deficit. If flows are intermediated through a poorly regulated banking system, inflows can lead to an unsustainable boom in lending that often results in disastrous financial crashes, featuring intertwined banking and currency collapses, a lesson learned by several emerging market countries this past decade, including such development stars as South Korea. I return to this topic in the final section of this chapter.

Official versus private external flows

The two broadest categories of foreign funds are official and private. Official lending takes various forms, but can be divided broadly into aid supplied to resolve economic crises and other assistance. Most official flows come with considerable economic and/or political conditionality. Balance-of-payments assistance provided by the International Monetary Fund (IMF), for instance, typically comes with demands for substantial economic and, increasingly, political reforms. In the case of bilateral credits, the provision of funds may be contingent upon specific political or economic measures (for example, purchase of the lending country's goods). Official lending not prompted by a crisis tends to go to economic activities rarely funded by private markets, such as large infrastructure projects. For many developing countries, especially low-income countries, official aid represents their only reliable source of external financing.

Types of private flows

Foreign direct investment. FDI occurs when non-residents make investments with the purpose of acquiring a lasting management interest over the affairs of an existing local enterprise or to establish a new subsidiary.[7] FDI promises to increase a country's capital and, perhaps more importantly, to effect the transfer of technology or management skills to the recipient country, depending on the nature of the investment. Unlike portfolio finance, FDI tends to be highly stable, with little year-to-year fluctuation.[8] The detractors of FDI have traditionally expressed fears that it might lead to foreign control over key sectors of the economy, suppression of indigenous development of technology, or distortion of the local economy. Empirical evidence, however, suggests that FDI generally has mildly positive effects for the host country, although some authors find specific cases that might have been harmful.[9]

Portfolio investment. Portfolio investment comprises investment in bonds and equities that does not result in a lasting management interest. The most salient feature of portfolio flows is that they are "liquid" and, therefore, present a potential risk of sudden, dramatic reversals, which can cause exchange rates to collapse and wreak havoc with the banking system and real economy. Indeed, reversals of so-called "hot money" have been implicated in the Mexican and Asian financial crises of the past decade. The advantage of portfolio flows is that countries gain access to additional capital without the conditionality often attached to other types of lending. In addition, portfolio investment increases liquidity in domestic capital markets, lowers the cost of financing for firms, and raises the rate of return for savers.

Bank lending. Cross-border bank lending can be short term or long term and the characteristics of these types of flows are very different. Short maturities have become common in bank lending to emerging markets, as banks seek to limit their exposure to risk in a context where contracting, agency, and information problems are sometimes severe. Short-term bank lending can be extremely volatile, with sudden reversals of flows when banks call loans or refuse to renew credit lines. Indeed, in the past decade, reversals of short-term cross-border bank credit have been associated with lending booms and manias, followed by severe financial crises, notably, in Mexico, Thailand, and South Korea.

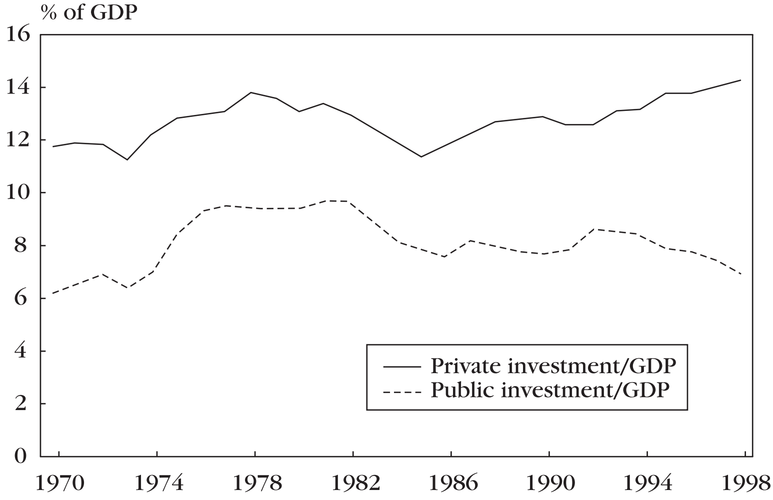
2. Global trends in financing for development

This section explores the most important recent global trends in financing for development in emerging markets; section 3 then compares these trends with patterns in LAC. A caveat is in order from the start: drawing definitive conclusions about long-term trends is difficult because many of the variables examined here have shown cyclical behavior historically. For instance, bank lending to emerging markets surged in the 1970s, was cut back dramatically in the 1980s, re-emerged in the early 1990s, and then dropped precipitously after 1996, owing to several major financial crises in Latin America and Asia. Indeed, as Michael Bordo (2001) notes, capital flows to emerging markets have historically been subject to booms and busts. He concludes: “the lesson we learn from history is that there has always been optimism followed by pessimism in a world with imperfect and asymmetric information.”[10] This boom and bust cycle in flows to developing countries was especially prevalent in the nineteenth century, but also occurred in the latter part of the twentieth century.

Trends in private and public investment

Figure 3.1 presents the data on private and public investment trends in the developing world expressed as a percentage of GDP. Most recent growth in fixed investment has been driven by private not public investment, although considerable regional variation exists. (As discussed in the next section, LAC has seen the fastest growth in private investment.) Still, the long-term trend in the overall balance between private and public investment is not pronounced; in particular, the relative importance of public investment remains roughly

Figure 3.1. Private and public investment in all developing countries, 1970–1998



Source: Bouton and Sumlinski (2000).

the same as 30 years ago. Nevertheless, substantial change seems to be under way. Public investment has declined since 1992, and is currently much lower than it was during its peak in the late 1970s and early 1980s. Private investment, in contrast, has risen steadily since 1985 and has reached its highest level in the past 30 years. Consequently, the gap between private and public investment has widened steadily over the past decade.

What accounts for the shift in balance between private and public investment? Reasons undoubtedly vary slightly across regions, but tight government budgets and disenchantment with the state as organizer of economic activity have constrained public investment. Pressure to reduce public spending has become intense in many countries as governments struggle with chronic budget deficits. In the drive to impose fiscal discipline, governments often reduce capital budgets first, because the political costs associated with curtailing current spending are prohibitive. In many emerging market countries, ambitious privatization programs, aimed in part at raising government revenue, have greatly contributed to the drop in public investment and encouraged private investment.

Some of the pressure for fiscal tightening is domestic, as leaders strive to improve economic performance in the face of rising political opposition, but it can also come from external sources. Countries requesting financial assistance from the IMF to cope with balance-of-payments problems, for instance, generally must commit to lower government spending as part of the conditionality attached to their aid packages. More indirectly, capital mobility has pushed governments to reduce public spending since they must compete with other countries to attract international investors, which generally favor lower levels of public involvement in the economy.

What implications does this shift have for economic growth? As already noted, many economists applaud the increasing weight of private investment, contending that evidence indicates it is a superior means of promoting growth and development. Nonetheless, the available evidence probably does not allow us to draw any definitive conclusions quite yet; in fact, the literature on growth suggests that public spending on human capital and infrastructure raises the efficiency of private investment.

The balance between domestic and foreign capital

National savings rates in emerging market countries are slightly higher than the world average. Specifically, in 1995 they averaged 25 percent and 22 percent in low- and middle-income countries, respectively, versus an average of 21 percent for the world as a whole (and 21 percent in high-income countries).[11] Nevertheless, it is not obvious that this rate is sufficient to finance economic development and modernization, especially since some scholars believe that in many emerging market countries domestic funds are not intermediated or allocated efficiently because the banking system is underdeveloped and poorly regulated, as discussed previously. In contrast, most scholars believe that foreign inflows are allocated more efficiently among competing users of funds, because non-residents invest with the sole purpose of earning the highest return. Thus, external financing may be very important for promoting growth, even if its magnitude remains relatively small.

Despite the widespread perception that foreign flows now account for an increased portion of investment, most investment in emerging market countries continues to be financed by domestic capital. The average percentage of private fixed investment accounted for by foreign flows increased greatly from the 1980s, when net capital flows to emerging markets virtually dried up owing to the debt crisis, but is actually lower now (about 10 percent) than the average for most regions in the 1970s (about 20 percent), as noted previously. This is still a significant portion of investment, so variation in external capital flows can have a profound impact on economic growth. In LAC, for instance, the 1980s debt crisis suppressed capital inflows dramatically, contributing to a general scaling back of investment (as can be appreciated in Figure 3.3 below) and slower economic growth.

Foreign flows to developing countries have contracted and expanded historically in response to variations in several economic and political factors; in addition, the nature of those flows has changed quite dramatically, as the next section discusses. One set of variables that influences the amount of external financing available to emerging markets concerns the supply of capital by the developed world, which is typically called its "surplus savings." The supply of savings by industrialized countries is affected by their private savings and investment rates; patterns of government revenue and spending; level of interest rates; and financial regulatory regimes, which shape the ability or willingness of investors to commit capital to developing countries. A number of factors related to developing countries themselves also influence flows, including their actual and expected growth rates; perceptions of the quality of their exchange rate, fiscal, and monetary policies; their levels of external indebtedness; and general perceptions of their political risk.

The 1990s witnessed a rapid expansion of private capital flows to emerging market countries, coming on the heels of the disastrous 1980s when their access to international capital markets was severely restricted. A primary reason for this surge was that the savings–investment balance in industrialized countries moved toward a larger surplus, making the residual balance available to meet the external financing needs of emerging market countries. In addition, interest rates were low during much of the 1990s, particularly in the United States, encouraging investors to seek out higher (but riskier) returns in developing countries. Finally, developing countries themselves became more attractive, many having undergone tough stabilization and structural adjustment programs and resuming economic growth.

Table 3.1 shows net capital flows to emerging markets, expressed as a percentage of recipient countries' gross domestic product (GDP), in the period from 1992 to 1999. Table 3.2 exhibits gross private market financing to emerging markets by region. A striking feature of the 1990s is that overall flows to the emerging markets, with the notable exception of bank credit, were fairly stable despite a number of severe financial crises, such as the Mexican "peso crisis" (1994), the Asian financial crisis (1997–8), and the Russian crisis (1998). In the Asian case, flows to the crisis-affected countries fell sharply during and in the immediate aftermath of the crisis, but portfolio investment quickly staged a recovery, with rapid growth after 1999, and FDI remained steady.[12] Moreover, the drop in flows from the mid-1990s onwards has not resulted in major disruptions in developing countries' financial markets or economies (except in

Table 3.1. Net capital flows to emerging markets and LAC, 1992–1999 (as % of recipient countries' GDP)

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
All emerging market countries								
Total net private capital flows	2.3	3.0	2.3	3.5	3.0	2.0	1.1	1.1
Net FDI	0.7	1.0	1.4	1.4	1.6	1.9	2.1	2.1
Net portfolio	1.1	1.5	1.9	0.6	1.1	0.7	0.1	0.3
Net bank loans and other	0.4	0.5	−1.0	1.5	0.4	−0.6	−1.1	−1.3
Net official capital flows	0.4	0.3	0.1	0.2	0.0	0.3	0.6	0.0
LAC								
Total net private capital flows	3.7	3.4	2.7	3.2	4.0	4.3	3.5	2.9

Source: IMF (2000).

crisis-affected countries), primarily because their current accounts and reserve positions improved in this period.[13] As detailed below, the persistent expansion of FDI was primarily responsible for the greater stability of private capital flows in this period.

Recent developments indicate that emerging market countries may be attempting to establish new sources of domestic capital in a bid to lessen reliance on external financing. Local currency bond markets are growing rapidly in many developing countries, especially in Asia, providing firms with a new way to raise capital and contributing to a gradual deepening of domestic capital markets.

Table 3.2. Gross private market financing to emerging markets, by region, 1994–1999

	1994	*1995*	*1996*	*1997*	*1998*	*1999*
All emerging markets (US$ billion)	133.4	160.3	226.1	297.2	157.4	178.5
Western hemisphere	25.8	36.3	64.9	96.2	66.6	65.4
Asia	83.5	88.1	123.4	130.6	41.1	66.6
Middle East	8.9	9.2	10.3	16.3	9.6	15.5
Africa	3.6	9.4	5.7	15.2	3.9	4.7
Europe	11.7	17.4	21.9	38.9	36.2	26.3
LAC as % of total	19.3	22.6	28.7	32.4	42.3	36.6

Source: IMF (2000).

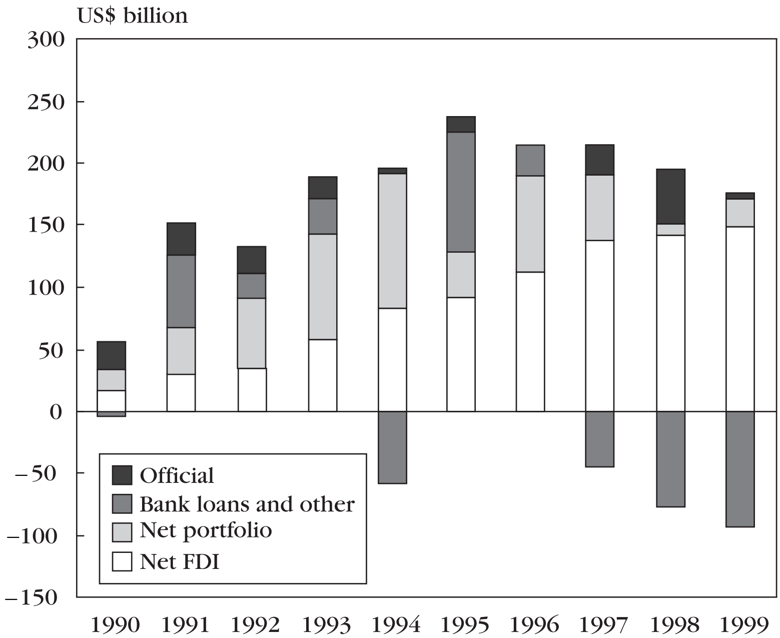
One force behind the growth of these markets has been government efforts to create effective debt markets to finance their budget deficits. Equity markets in many countries have also experienced deepening and modernization, encouraging many firms to go public or raise additional capital through new issues. On the negative side, firms in high-tech sectors increasingly have bypassed local markets and gone directly to international exchanges to raise capital, depriving emerging markets of the most attractive companies and new issues.

Composition of capital flows

Figure 3.2 displays the breakdown of net capital flows to developing countries in the 1990s by type of instrument. (Table 3.1 shows the flows by type expressed as a percentage of emerging market countries' GDP.) Direct investment accounts for the largest percentage of net capital flows and is the most stable component. Indeed, FDI grew at a rapid and steady rate throughout the 1990s, jumping from 0.2 percent of developing countries' GDP in 1970, to 0.6 percent in 1990, to 2.6 percent in 1998.[14] In absolute terms, FDI grew from US$18.8 billion in 1990 to US$149.8 billion in 1999 (current US$). The ratio of FDI to total net long-term flows to developing countries jumped from 24.2 percent in 1990 to 52.9 percent in 1998.[15] The share of total worldwide FDI captured by developing countries has also risen appreciably, from 12.7 percent in 1990 to 41.5 percent in 1997.[16]

Another noteworthy trend has been the rapid expansion of portfolio flows to emerging markets since the mid-1980s (particularly after 1990). Portfolio flows reached a peak of 1.9 percent of emerging market countries' GDP in 1994 and were high again in 1996. They have since declined for a variety of reasons, including the high incidence of financial crises in the major recipients of portfolio flows, subsequent fears among investors about investing in any emerging market, and the sensational performance of equity (and, in some cases, bond markets) in the industrialized world, especially the United States, which has drawn investors' interest away from developing countries.

Figure 3.2. Net capital flows to emerging markets, 1990–1999



Source: IMF (2000).

What accounts for the sharp increase in direct and portfolio investment? These flows have grown rapidly owing to capital market opening in emerging markets and improvements in information and data processing technologies, which make it easier for firms to manage investments and production on a global basis. Explanations for capital account opening vary. One claim is that emerging market countries, especially heavily indebted ones, were anxious to attract external capital to restart growth after the dramatic deterioration in economic performance in the 1980s. Increased capital mobility might also have increased the political strength of private groups that favor capital account opening within developing countries, and they have been able to put effective pressure on governments to open their financial systems.[17]

Net bank lending to emerging markets fluctuated widely in the 1990s, with huge net outflows in the period after 1997. This out-

Table 3.3. Gross private market financing to emerging markets, by type of instrument, 1994–1999

	1994	*1995*	*1996*	*1997*	*1998*	*1999*
Value (US$ billion)						
Bonds	53.8	59.2	105.3	133.2	80.2	87.0
Equities	17.9	10.0	17.8	26.2	9.4	23.2
Loans	61.6	91.1	103.0	137.8	67.7	68.4
Share (% of total)						
Bonds	40.3	36.9	46.6	44.8	51.0	48.7
Equities	13.5	6.2	7.9	8.8	6.0	13.0
Loans	46.2	56.9	45.5	46.4	43.0	38.3

Source: IMF (2000).

flow reflected net repayments to international banks and banks' sharp reduction of new loans as they sought to limit their exposure to developing regions after the onset of the Asian crisis. Much of the cross-border bank lending to the Asian crisis countries (and Mexico) was short term, making it easy for foreign banks to undo their positions, and most scholars believe that this contributed to the rapidity and severity of those crises. Still, syndicated bank lending remains an important, albeit declining, source of gross financing to emerging market countries (especially to sovereign borrowers), as Table 3.3 indicates. The decline in significance of bank lending to emerging markets should continue into the future, mirroring a similar, ongoing trend in developed markets. This decline is due to the broad process of securitization that has swept global financial markets in recent decades, as firms and others raise funds through the issue of marketable securities, eschewing traditional forms of bank lending.

Official flows in the 1990s declined sharply from previous decades to an average of about 0.25 percent of GDP; moreover, they varied greatly from year to year.[18] The spikes in official flows during the 1990s came in response to economic crises in Mexico, Asia, and Russia. Non-crisis-related official flows are unlikely to pick up in the future, because support in industrialized countries for expanding official assistance has dwindled, except, perhaps, for the very poorest countries. The reasons for this shift in sentiment are that many developed countries have put a high priority on cutting government spending, and the end of the Cold War has weakened the geopolitical motives for much official assistance.

Trends since 1999

Portfolio flows to emerging markets have staged a slight comeback since 1999, while bank lending is still experiencing net outflows (as repayments continue and international banks maintain limited exposure to emerging markets). Better access to international bond and equity markets has mostly been limited to Asian borrowers, with some broadening to other regions in 2000. Technology, media, and communications companies in particular have succeeded in raising capital in international equity markets, with numerous new listings on the New York and London stock exchanges. Emerging market access to bond markets has improved more slowly, with some regions actually seeing net declines. In general, spreads on emerging market bonds (relative to US Treasury securities) have declined slightly since 1998, reducing borrowing costs for emerging market borrowers.[19] The flow of FDI shows no signs of abating. Strikingly, countries with large bank and portfolio outflows have not tended to experience reduced direct investment inflows.[20]

3. Trends in financing for development in Latin America and the Caribbean

History

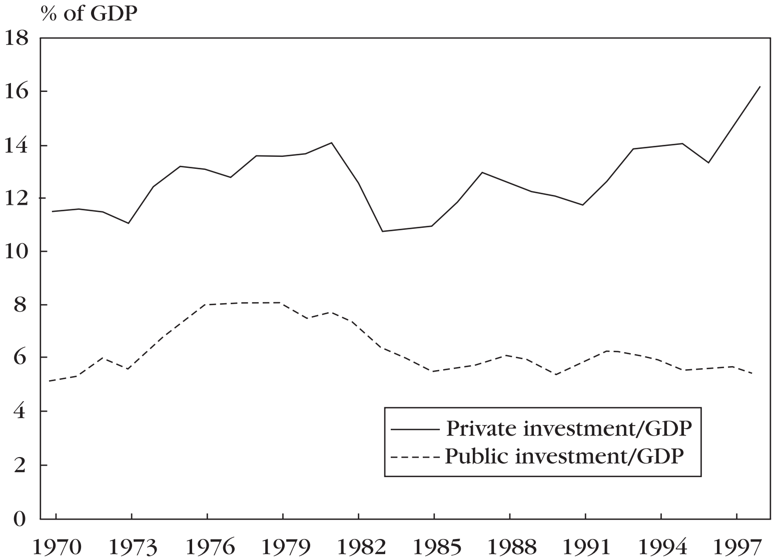
As in most developing areas, LAC countries relied heavily upon external financing to spur early economic development. Perhaps more than any other region of the world, LAC has experienced tremendous volatility of capital flows. Bordo (2001) notes that there were four major boom–bust cycles before the 1930s Great Depression ended flows of private capital to the region for the next 40 years. External financing in this period took the form of direct investment and lending through sovereign bonds. The first cycle occurred in the 1820s, when British investors ploughed funds into newly independent Latin American nations to finance mining and infrastructure investments, only to suffer panic, crash, and defaults by all these states years later. The second boom was in the 1850s and 1860s to finance railroads, and it ended in 1873 with massive defaults. The third cycle took place in the 1880s to fund railroads and infrastructure projects, particularly in Argentina and Uruguay, and concluded with the crash of 1890 and the infamous Baring Crisis in England. The last boom–bust wave happened in the 1920s, to finance municipal infrastructure projects, and terminated in another round of defaults and the Great Depression.

Private capital flows to LAC were inconsequential in the years following World War II. This was largely owing to the Bretton Woods agreement, which permitted countries to implement controls on capital account (but not current account) transactions, and to perceptions of high risk in investing in LAC. Most capital inflows in this period were in the form of lending by official creditors, much of it as bilateral development assistance. Private flows started pouring in during the 1970s, thanks mostly to commercial bank lending to sovereign states through rapidly expanding Eurocurrency markets. Massive defaults on bank debt in the 1980s brought external financing to an abrupt end until a wave of reforms late in the decade helped convince investors that LAC was finally taking the steps necessary to get its economic house in order, sparking a resurgence of capital inflows.

Trends in private and public investment

Figure 3.3 shows the trends in private and public investment as a percentage of GDP in LAC. Private investment in LAC grew very rapidly during the 1990s, exhibiting the fastest growth of any region in the world, whereas public investment remained flat. The sharp increase in private investment is all the more impressive because of the numerous financial difficulties that hit the region during the 1990s. LAC has a higher percentage of private investment

Figure 3.3. Private and public investment in Latin America and the Caribbean, 1970–1998



Source: Bouton and Sumlinski (2000).

and lower percentage of public investment than the global average; only East Asia has had a higher level of private investment as a percentage of GDP. Thus, private investment has clearly become the motor of economic growth in LAC, reflecting the widely noted shift toward a more favorable policy environment for private sector development and growing restraints on public spending in the region.

The balance of domestic and external capital

Savings rates in LAC during the 1990s were significantly lower than in previous decades.[21] The gap between domestic savings and investment was very large throughout the decade, averaging about 2.5 percent of GDP, making it imperative for countries to seek out external financing to sustain rapidly growing private investment.[22] Consequently, foreign flows as a percentage of private fixed investment in LAC increased dramatically from the 1980s, when flows averaged only 1 percent because of the debt crisis, to the 1990s, when they averaged about 15 percent.[23] In general, capital inflows accounted for a considerably larger share of fixed private investment in LAC than in other regions of the world during the 1990s. The primary reasons for this were the aforementioned high need for external financing in LAC as well as the general perception among international investors that LAC countries had become a good place to commit capital.

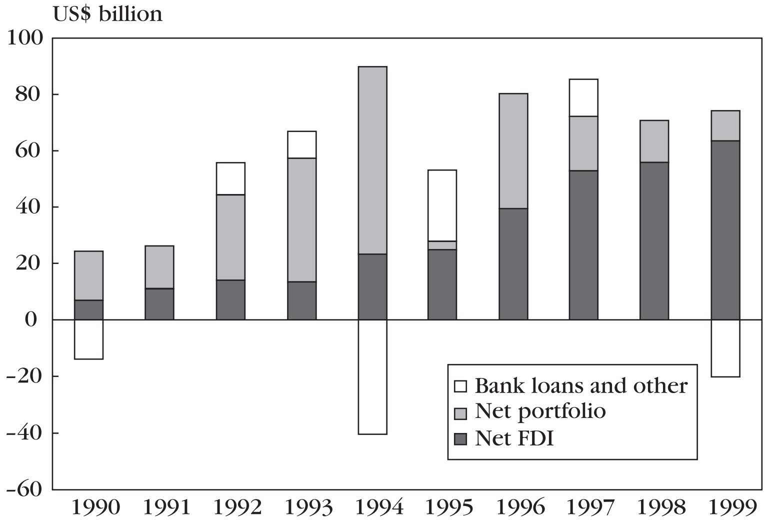
Net capital inflows to LAC grew sharply until 1994, when the Mexican peso crisis and its contagion via the "tequila effect" scared away portfolio investors, at least temporarily. Flows to the region picked up again after 1996 and remained fairly stable despite the Asian financial crisis and economic problems in Brazil. In fact, LAC fared better in this period of volatility than emerging markets as a whole, primarily because the region had been so successful in attracting FDI and had not been as affected by net outflows of bank credit. This is clearly indicated in Table 3.2, which shows gross private market financing to emerging markets by region, including the share captured by LAC. Table 3.1 displays net private capital flows to LAC expressed as a percentage of recipient countries' GDP.

Of course, aggregate regional data may mask considerable variation at the level of individual countries and such variation certainly exists among LAC countries. Private flows have been concentrated in countries with higher relative incomes, such as Argentina, Brazil, and Mexico. Relatively less developed countries within the region have had to rely on financing from multilateral, regional, and subregional institutions and official assistance. I provide an example of the disparities in external financing by noting variations in the amount of FDI received by different LAC countries in the next subsection.

Composition of capital inflows

Figure 3.4 displays the composition of net private capital inflows to LAC during the 1990s. Net official flows to the region averaged about 0.0 percent of GDP in the decade, with surges around the

Figure 3.4. Net capital flows to Latin America and the Caribbean, 1990–1999



Source: IMF (2000).

time of the Mexican and Brazilian crises (see Figure 3.2 above). FDI has become the largest component of flows to LAC (as it is in the rest of the developing world), and it showed steady, rapid growth throughout the 1990s, averaging over 20 percent annually in real terms. In absolute terms, FDI soared from US$15.4 billion (constant US$) in 1992 to US$62.0 billion in 1999. The share of long-term capital net inflows in LAC accounted for by FDI jumped from 38 percent in 1990 to 70 percent in 1998. FDI flows measured as a percentage of GNP jumped from 0.7 percent of GNP in 1990 to 3.1 percent in 1998.[24]

LAC, along with East Asia, has captured the majority of FDI going to emerging market regions. In 1998, for example, LAC and East Asia received 38 percent and 40 percent of FDI flows to emerging markets, respectively. In 1998, 6 of the top 12 recipients of FDI in the emerging world were in LAC.[25] Within LAC, the bulk of flows went to two countries, Brazil (US$72.8 billion total net flow, 1990–8) and Mexico (US$73.7 billion); Argentina (US$39.8 billion), Chile (US$25.2 billion), Colombia (US$19.8 billion), and Venezuela (US$17.1 billion) also attracted large amounts of FDI. Some countries, notably El Salvador, Guyana, Honduras, Nicaragua, Paraguay, and Uruguay, have received very little FDI. Examining FDI as a percentage of GNP, the countries with the highest ratios are Panama (4.8 percent), Ecuador (4.2 percent), Chile (4.0 percent), and Costa Rica (3.9 percent); the ratios for Brazil and Mexico are 1.0 percent and 2.4 percent, respectively.[26]

Why did LAC witness such a large surge in FDI? The most important reason is that governments lifted barriers to direct investment, making the LAC region about as FDI-friendly as most high-income countries, and certainly more so than any other developing country region.[27] The intense process of privatization that swept many LAC countries also contributed by creating opportunities for foreign investors to purchase controlling shares of local firms. Finally, many LAC countries transformed their macroeconomic environments, implementing stabilization programs that have rectified internal and external imbalances, and improved management of their exchange rates somewhat, although a tendency toward real exchange rate appreciation remains a problem in several LAC countries.

Portfolio flows grew very rapidly in the early part of the 1990s, but dropped off sharply after 1996 (with the peak in flows occurring in 1994). LAC countries have been slow to take advantage of the recent pick-up in growth in bond and equity financing to emerging markets, which has mainly flowed to Asian countries, though there were signs of a rebound in 2000.[28] On the positive side, large corporations have recently found it easier to raise capital through domestic debt markets. Domestic venture capital and private equity activity in technology projects has also grown in the region.[29] Private bank lending to LAC was quite variable in the 1990s, reflecting the great volatility of this type of flow to emerging markets generally. The big drops in 1994 and 1999 were due to financial crises in Mexico and Brazil, respectively.

4. Managing and promoting capital flows

Managing capital inflows

This chapter suggested at the outset that, since most investment is still funded by domestic sources of capital, countries must devote the greatest attention to mobilizing domestic resources in order to improve financing for development. In LAC the challenge is especially great, because countries have to find a way to close the large gap between savings and investment that persisted throughout the 1990s. Nevertheless, external financing remains vitally important for development financing and LAC countries must dedicate themselves to devising an effective means of handling the "mixed blessing" of external flows.

After the high incidence of financial crises in the 1990s, which some scholars blamed on premature and overly aggressive capital account opening, a heated debate has arisen among academics and practitioners concerning whether emerging market countries should opt for complete openness or attempt to manage inflows and outflows. Large and sudden capital movements can create severe problems for emerging market economies. Sudden outflows may provoke a currency collapse, banking crisis, widespread bankruptcies, recession, and a host of other severe economic difficulties. Large inflows can lead to excessive money supply growth, fueling inflation and exchange rate appreciation, which will put considerable pressure on the balance of payments. In addition, if inflows, especially short-term credit, are channeled through a poorly regulated banking system, they can lead to credit booms, speculation in real estate and equities, and risky lending.[30] Any number of events, such as an increase in world interest rates, can subsequently spark a serious financial crisis by raising doubts about the creditworthiness of borrowers or the solvency of banks.

Most economists have argued against capital controls, contending that they deprive countries of badly needed capital, remove an important source of discipline on government policymakers, and have largely lost their effectiveness in an era of increasing financial interdependence in which firms, banks, and investors have numerous means of circumventing controls on the capital account.[31] Others have claimed that controls are desirable to prevent rapid, destabilizing capital movements.[32] They assert that the advantages of financial opening, although fairly clear in theory, have not always materialized in practice. Some countries have benefited from capital account liberalization, but others, perhaps because they opened prematurely or without improving regulation of other aspects of the financial system, have witnessed poor or even disastrous results.[33] Wade and Veneroso (1998), for instance, have stated that improper opening helped precipitate the recent crises in Asia by encouraging massive inflows of capital that subsequently exited suddenly, contributing to steep currency depreciations and severe recessions. Furthermore, empirical studies have not found a significant positive relationship between capital account liberalization and economic performance among developing countries.[34] Finally, it has not gone unnoticed that Chile and Colombia weathered the 1994 peso crisis relatively well when they had significant barriers to entry and/or exit.

Acceptance of limited capital controls is also growing among the official bodies that help shape financial policy globally, even among previously staunch opponents. The United Nations Conference on Trade and Development (UNCTAD) has argued that developing countries should be able to introduce controls to impede rapid capital outflows during crises.[35] The World Bank in turn has asserted that restrictions on capital flows may be useful for developing countries under certain conditions.[36] The IMF's 1998 Annual Report stated: "Some Directors suggested that emerging market countries—at least during a period of transition that might have to be relatively long—should adopt market-based safeguards aimed at limiting the exposure of financial and corporate sectors to reversals of short-term capital movements."[37] Several countries have begun openly to consider reimposing limits on flows; Malaysia, which was mostly open before its crisis, actually implemented strict capital controls in 1998.

Most proposals to control flows concentrate on limiting short-term flows, especially of cross-border bank lending, which are seen as most volatile. One popular suggestion is strictly to regulate the ability of banks to engage in cross-border short-term bank borrowing, either through direct limits or by forcing them to match the denomination and term structure of their assets to their liabilities. Paul Krugman (1998), however, has also advocated temporary controls on capital outflows during crisis situations, of the sort recently used by Malaysia. He argues that governments should implement such controls to help them avoid deflationary pressures, enabling policymakers to keep interest rates low and use government stimulus to spur the economy.

A favored solution among proponents of managing capital movements who do not approve of direct controls are taxes on short-term capital inflows, as practiced by Chile during much of the 1990s.[38] In 1991, the Chilean government imposed a reserve requirement on all incoming foreign investment, in the form of an one-year non-interest-bearing deposit at the central bank.[39] The government was concerned about the inflationary and exchange rate impacts of surging capital inflows and, thus, imposed taxes on foreign investment in part to manage them. However, this instrument was also designed to influence the maturity profile of inflows, as well as to hinder rapid, potentially destabilizing outflows. That is, Chile's policy sought to impede but not prohibit short-term, speculative investment and to discourage panicked exit by foreign investors.[40] The problem for many emerging market countries of using this tool is that only those with strong economies and a low need for external capital are likely to be able to implement it successfully.[41] Countries with poor economic records will find it difficult enough to attract outside investors without putting in place taxes on inflows that increase risk and potentially lower returns.

Reinhart and Reinhart (1998) identify eight other tools for managing flows, but generally find them wanting in practice. One of these tools, sterilized intervention in currency markets, has been popular in LAC for dealing with the problems created by sudden inflows, especially exchange rate appreciation.[42] In 1991, for example, the Colombian central bank increased bank reserve requirements and issued its own debt to sterilize money supply increases caused by intervention in exchange markets. In general, sterilized interventions have not been very effective. Evidence suggests that they actually increase the overall volume of inflows (by increasing interest rates, which attract more capital) and skew their composition toward shorter maturities. In addition, sterilized intervention can lead to heavy losses for the central bank. In Colombia, for example, the central bank suffered heavy losses (equivalent to about 0.5 percent of GDP) because it was forced to acquire relatively low-yielding foreign exchange reserves and issue high-yield bonds. The authors suggest that even the best policy mix cannot avoid the problems associated with capital volatility, but that it may be able to dampen the wild swings in flows and their consequences. They conclude: "the strongest policy lesson that emerges is the need for conservative fiscal policies, a zealous supervision of the domestic financial sector at all times, and a strengthening of this commitment during the boom phase of the cycle, when expectations are buoyant."[43]

Promoting capital flows

A broad consensus is emerging that LAC countries should strive to attract FDI, which is the least volatile of capital inflows and offers the additional benefit of transfer of management skills and technology, and avoid excess reliance on short-term flows, particularly of cross-border bank loans. This view contrasts with the widespread aversion toward FDI in the 1970s by most developing countries, which feared direct investment because of concerns over a loss of autonomy in economic policy-making and the threat of exploitation. More controversy exists over whether or not to promote portfolio flows actively, given the volatility of these flows earlier in the decade, but bond and equity market deepening and modernization (which will surely attract more foreign flows) are firmly on the agenda in many LAC countries.

One of the biggest perceived barriers to augmenting FDI flows to LAC is the persistence of corruption in many countries. A survey of multinationals revealed that 50 percent of firm managers believed that corruption was a barrier to doing business in the region.[44] Other legal, social, and microeconomic problems are also important, including regulatory uncertainty, political patronage, tax regulations, policy instability, labor and environmental regulations, inadequate infrastructure, and crime. Governments will have to tackle these issues head on to sustain the steady increase of FDI to their countries over the long term. Also, LAC countries must continue their efforts to create a sound macroeconomic policy environment; in many countries, this will require further structural adjustment measures.

5. Conclusion

Financing for development in emerging markets generally and in LAC in particular is undergoing a subtle transformation even while many basic features remain little changed. First, most investment is still financed by domestic sources of capital, not external financing. In most developing regions, private investment has grown rapidly while public investment has stagnated. LAC experienced the fastest increase of private investment of any region. Second, net private capital flows surged in the 1990s, following the unfortunate 1980s when developing countries' access to international capital markets was severely restricted. The first half of the decade witnessed a surge of direct and portfolio investment flows to emerging markets after many countries implemented stabilization and structural adjustment programs and opened their financial markets. The second half, however, saw huge reversals of portfolio investment and bank credit in many countries, as international investors reacted to a series of financial crises in several large emerging markets. Flows of FDI, on the other hand, grew at a steady, rapid rate despite the turmoil, with LAC and East Asia receiving the bulk of the flows. Overall, LAC fared reasonably well during the 1990s in that the region received an ample share of external financing to the developing world and its flows were relatively stable. Aggregate regional data, nevertheless, mask variation at the individual country level; indeed, private flows were concentrated in countries with higher relative incomes, such as Argentina, Brazil, and Mexico.

The challenge for LAC countries moving forward is to find ways to mobilize domestic resources to close the large gap between savings and investment and to manage external flows wisely. The former task involves a number of areas of public policy, but a central element of any viable strategy must include deepening the financial system, with a special focus on bond and equity markets. Fortunately, domestic bond and, to a lesser extent, equity markets have begun to expand and modernize since 1999, creating new options for firms and savers. The latter task is inherently problematic, because emerging market countries can do everything right and still be confronted with dangerous volatility of flows. The most sensible approach is to design policies that can help improve the profile of inflows, specifically encouraging long-term, stable inflows such as FDI, while limiting short-term flows that tend to be highly volatile, such as cross-border bank credit.

Notes

1. The average for most regions in the 1970s was close to 20 percent. The nature of capital flows, however, was quite different, with banking credit and official lending playing a far greater role in the 1970s. See Jaspersen, Aylward, and Sumlinski (1995), pp. 5, 30.
2. Fry (1995) provides a comprehensive review of the features of financial repression.
3. McKinnon (1991) and Fry (1995) examine the merits of financial liberalization.
4. See Davis (1995), chap. 11.
5. See Bouton and Sumlinski (2000), chap. 2, for a brief review.
6. Jaspersen, Aylward, and Sumlinski (1995), pp. 15–16.
7. Most countries categorize an investment as FDI when a foreign investor acquires 10 percent or more of the equity of a domestic firm, because this constitutes a "lasting management interest." The 10 percent standard, however, is arbitrary, since 10 percent of equity may not provide a foreign investor with a controlling stake in some countries, whereas in others a much smaller share may give the investor such a stake.
8. A number of accounting and reporting conventions help to account for the stability of FDI. For instance, measurement of FDI includes retained earnings on all previous FDI, which tend to fluctuate little from year to year. For more on this topic, see IMF (2000), p. 48.
9. Moran (1985) compiles a set of cases that find a wide range of outcomes for host countries, ranging from highly beneficial to harmful. See also Moran (1998).
10. Bordo (2001), p. 79.
11. World Bank (1997), pp. 238–9.
12. The crisis-affected countries continued to experience net private capital outflows because net bank credit turned highly negative as they made repayments and banks curtailed their lending. See IMF (2000), pp. 46, 52, 70.

13. See IMF (2000), p. 45.
14. Rivera-Batiz (2000), table 33.
15. World Bank (2000).
16. World Bank (1999).
17. One claim in the literature is that financial globalization has empowered the holders of non-fixed assets vis-à-vis other domestic groups because they can credibly threaten to withdraw their capital from the country if their demands are not met. This "exit option" enables these actors to influence government policy and advance their strong preference for greater financial openness. For example, see Kurzer (1993).
18. IMF (2000), p. 47.
19. Ibid., pp. 52–64.
20. Ibid., p. 48.
21. In 1980, the average domestic savings rate in LAC was 21 percent of GDP. In the 1980s, rates fluctuated widely, but were lower than in the previous decade. Savings rates dropped to an average of roughly 18 percent in the 1990s. Data provided by the Economic Commission for Latin America and the Caribbean.
22. CEPAL (2000), table A-4. In 1999, the gap totaled 3.0 percent of GDP or about US$55 billion.
23. Jaspersen, Aylward, and Sumlinski (1995), p. 30.
24. All data on FDI are from Rivera-Batiz (2000), pp. 162–4.
25. World Bank (2000), country tables. China, with net FDI of US$45.6 billion, was the top recipient.
26. Rivera-Batiz (2000), table 36.
27. Ibid., pp. 176–8.
28. Fischer (2000), p. 2.
29. IMF (2000), p. 49.
30. See Garber (1996).
31. For example, see Eichengreen (1996) and Greenspan (1998).
32. Bhagwati (1998), Krugman (1998), and Wade and Veneroso (1998) are among those who have argued in favor of some form of capital controls, either temporary or permanent.
33. Good surveys of experiences with financial opening are Goldstein (1995) and Reinhart and Reinhart (1998).
34. For example, see Rodrik (1998). Quinn (1997) finds that capital account opening has contributed to faster economic growth, but includes only OECD countries.
35. UNCTAD (1998).
36. World Bank (1998), p. 161.
37. IMF (1998), p. 27. The IMF's Interim Committee of the Board of Governors has asked the Board of Governors to "review the experience with the use of controls on capital movements, and the circumstances under which such measures may be appropriate." Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund, October 4, 1998.
38. Eichengreen (1996) is typical of this position. Other countries have implemented taxes on capital inflows at various times; for example, Colombia in 1993 and Thailand in 1996.

39. For details on Chilean capital inflow taxes, see Velasco and Cabezas (1998).
40. Changes in the composition of the capital account in the 1990s demonstrate the effectiveness of Chile's controls and constitute *prima facie* evidence of their intent. FDI and long-term portfolio investment grew in importance relative to total external indebtedness and the nature of external borrowing shifted, with a trend towards a larger share of medium- and long-term debt and a reduction in external short-term financing. Le Fort-V. and Budnevich L. (1998), pp. 62–4, 76. See also Nadal-De Simone and Sorsa (1999).
41. See Lukauskas and Minushkin (2000).
42. Sterilized intervention in the foreign exchange market involves purchasing foreign currency to stem currency appreciation. Because this leads to an increase in reserves and, as a consequence, an increase in money supply, central banks attempt to sterilize this increase by either open market operations or an increase in bank reserve requirements.
43. Reinhart and Reinhart (1998), p. 124.
44. Rivera-Batiz (2000), p. 178.

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4

The Role of Regional Development Financial Institutions

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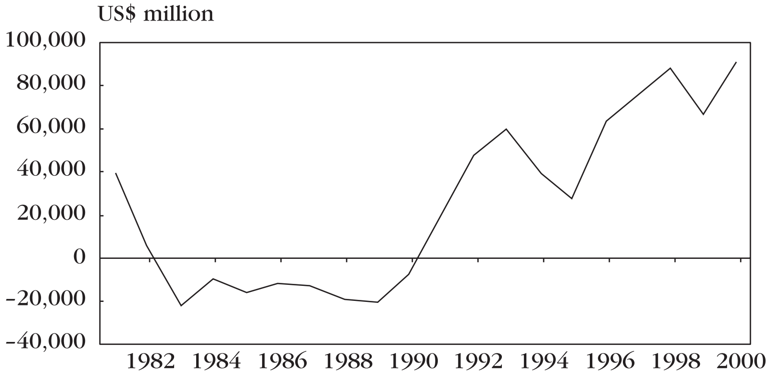
This chapter looks at the problems of financing for development in the countries of the region, based on the characteristics of capital flows in the region and the imperfections of its markets, which make the presence of regional development financial institutions both necessary and essential for providing resources to key sectors not serviced by private capital markets.

1. Capital flows to the region

The external debt crisis of the 1980s contributed to the scarcity of capital flows, with a total of US$119,666 million fleeing the region during that period, as can be seen from the profile of the Latin American capital account aggregate in Figure 4.1. Indeed, net capital outflows were recorded in each year during the period between 1983 and 1990.

During the 1990s, capital flows to the region increased, however, led by higher volumes of direct foreign investment and short-term capital, owing in part to the globalization of the region's financial markets. The process was further spurred by greater financial openness of the region's economies and fewer restrictions on capital

Figure 4.1. Latin America: Capital account, 1981–2000



Note: data for 2000 are estimated.
Source: International Monetary Fund.

accounts. The policy of financial openness attracted international banks into the region and encouraged the establishment of a network of offshore banks with subsidiaries in the local banking systems, thereby facilitating the management of accounts in foreign currency and greater capital mobility. Following the financial crises that affected a number of countries in the region and the international crisis of 1998–9, questions were raised about the lack of restrictions on the opening of capital accounts, on the grounds that it was first necessary for countries to have a solid institutional framework before moving towards greater openness. Also noteworthy in this connection have been the initiatives to keep certain restrictions in place, as Chile has done, in order to remove the incentive for the inflow of short-term capital. There is also a need to increase the regulation, monitoring, and prudent oversight of financial systems in order to identify and prevent any problems that may be caused in part by the greater mobility of capital.

In this connection, it may be observed from Table 4.1 that capital flows to the region during the period 1992–5 amounted to US$265,300 million, rising to US$316,900 million in the period 1996–9. However, this increase has been heterogeneous, asymmetrical, and concentrated, in that the principal beneficiaries have been

Table 4.1. Capital flows to Latin America, 1992–1999 (US$ billion)

	1992–1995	*1996–1999*
Current account	−169.5	−245.2
Change in reserves	−60.0	−23.6
Errors	−35.8	−48.1
Total on capital account	*265.3*	*316.9*
Capital not including debt, FDI	76.5	214.9
Debt	188.8	100.7
Official sources	3.2	1.4
Banks	−27.7	12.8
Others, including multilateral	204.2	90.9
IMF	9.1	−4.4

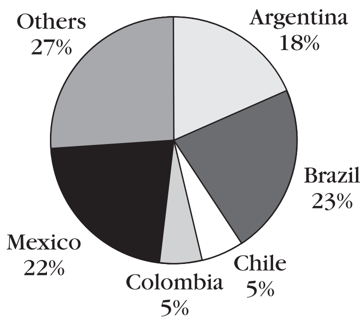
Source: International Monetary Fund.

those countries with relatively higher per capita incomes: Argentina, Brazil, Colombia, Chile, and Mexico (see Figure 4.2).

Direct foreign investment, in addition to being concentrated in a few countries, has gone mainly into two sectors: (1) privatization; and (2) investments in natural resources such as petroleum, gas, and mining. Moreover, capital flows continue to be volatile, which presents serious risks for the economies of the region. This was seen in the recent international crisis of 1998–9, which had a contagious effect that led to capital flight, including from countries with sound macroeconomic fundamentals.

A pro-cyclical pattern is also observed in capital flows, which in turn further accentuates economic cycles by producing perverse effects when countries enter into recession: just when they are most in need of resources, capital flows diminish, thereby triggering and further deepening the economic crises in the region. Figure 4.3 shows how during most of the 1990s capital flows paralleled economic performance, rising in times of growth and falling in times of recession. This was demonstrated during the period 1998–9, when several countries in the region encountered problems that were due in part to the international crisis, which reduced capital inflows and thus worsened the economic situation in Argentina, Brazil, Colombia, Ecuador, Venezuela, and other countries.

Figure 4.2. Destination of capital flows into Latin America, 1992–1999

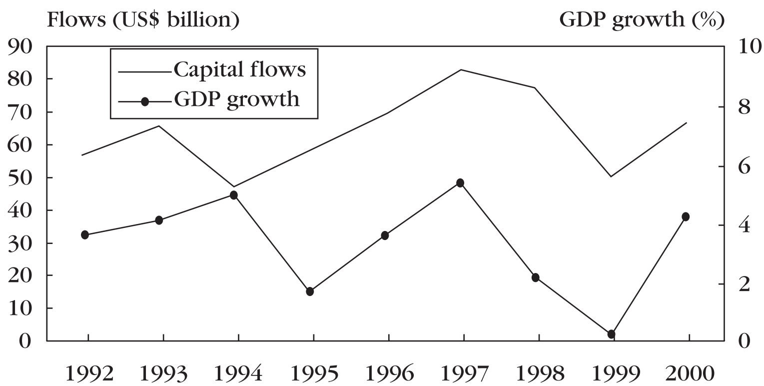


Capital account, 1992-9

	US$ m.
Argentina	104,421
Brazil	136,165
Chile	30,149
Colombia	29,714
Mexico	127,850
Others	153,901
Total	**582,200**

Source: International Monetary Fund.

Figure 4.3. Capital flows and economic cycles in Latin America, 1992–2000



Source: International Monetary Fund.
Note: Data for 2000 are estimated.

The impact of these characteristics of capital flows is magnified by a series of imperfections in the operation of markets. These present obstacles to financing for development in the countries of the region, a situation we shall examine in the next section.

2. Market imperfections

The main mission of development banks is to provide financing for development agents and initiatives where public benefit is to be derived from doing so and where the mere operation of the market is insufficient.[1] Indeed, the inefficient allocation of resources creates a number of problems, such as market imperfections and information asymmetries. This section will examine the most serious problems that countries face as a result of restrictions on access to adequate levels of credit and on the terms required for their development.

Imperfect markets and scarcity of financing

There is a scarcity of resources in relation to the considerable needs of countries that can be met neither by the international institutions nor by the private sector: the deficit between savings and investments in Latin America in 1999 was 2.9 percent of GDP, or US$54.2 billion (see Table 4.2). Moreover, compared with other developing countries, this gap is the highest for any region. In both Africa and the Middle East the gap is smaller, while in Asia the net savings rate is positive. A number of studies show that, in order to reduce the gap in income relative to the developed countries and to reduce poverty to reasonable levels, the LAC countries need to achieve sustained growth at an annual rate of at least 6 percent, which would require rates of investment higher than those that have been recorded thus far (ECLAC 2000). In order to prevent a worsening of the external imbalances, the increase in investments must come from higher levels of domestic savings. Simultaneous efforts are therefore required to increase the contributions of company, family, and public sector savings and to create an enabling environment for investments in the productive sectors to compete favorably with other uses

Table 4.2. Savings/investment gap in developing countries, 1992–2000 (US$ billion)

Region	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000e*
Africa	−10,000	−11,200	−11,500	−16,500	−7,000	−7,400	−20,000	−16,800	−7,700
Asia	−12,600	−34,000	−20,400	−56,300	−38,700	−6,800	48,900	42,300	31,700
Middle East	−26,800	−29,200	−4,500	−1,800	9,800	5,600	−30,300	−4,000	20,900
Latin America	−34,500	−46,000	−52,200	−36,800	−38,800	−64,100	−88,600	−54,200	−56,500
Total	−83,900	−120,400	−88,600	−111,400	−74,200	−59,100	−90,000	−32,700	−11,600

Source: International Monetary Fund.
Note: The figures for 2000 are estimated. The savings/investment gap is equivalent to the balance on current account.

of financial resources and to improve the process of financial intermediation through improvements in the financial systems.

In short, the required levels of financing for development are greater than the levels available, which in turn acts as a brake on development and economic growth in the countries of the region.

Asymmetries in information and resource allocation problems

The absence of perfect information to distinguish "good" from "bad" projects creates distortions that require creditors to adopt rational lending criteria in order to avoid the consequences of poor selection and moral risk. Activities deemed to carry greater risk are not financed because of the lack of information, thereby leading to restrictions on credit.

The problem of premature maturities

Financing for development usually requires long maturity periods in order to be viable. In a number of Latin American economies, volatile exchange rates and undeveloped financial systems have been obstacles to the creation and expansion of long-term credit mechanisms in the national currency. Long-term loans for the acquisition of assets, for example, expose commercial banks in developing countries to the risks inherent in the asymmetry between the period when the investment begins to yield benefits and the maturity period of the loans, which are frequently short and medium term. It would not be prudent to grant short-term loans when the nature and purpose of the loan require longer-term financing. Inadequate structuring of the credit, in terms of its maturity period, would result in almost certain non-performance or continuous rescheduling, thereby affecting not only the financial situation of the client country and its exposure to interest rate fluctuations, but also the liquidity position of the lending financial institution.

Private and commercial banks tend to lend only in financially profitable sectors

A number of sectors are not serviced by commercial banks because they are not financially profitable. Natural market incentives based on notions of profit and returns lead banks to maximize their efficiency by investing in sectors that enable them to obtain a high rate of financial return. It is for this reason that basic investments of low financial profitability—for example, infrastructural projects, social programs, education, health, and the financing of reforms—require resources that are provided for the most part by development institutions.

3. The importance of the presence of regional development institutions

Given the heterogeneity, asymmetry, concentration, volatility, and pro-cyclical nature of capital flows to the region, as well as the existence of imperfections in the market, regional development institutions have a very important role to play. They can help to ensure that capital flows are less concentrated, more regular and stable, and at levels high enough to spur domestic savings and investment and thereby reverse the trends that have been noted. The problems noted above require the presence of these institutions to meet the needs of countries that are underserved by the market.

But what distinguishes regional development institutions from those that operate at a global level? Many of the operations of these two types of institutions are complementary insofar as they service similar sectors but, given the scarcity of resources, there is need for both types of institutions and for better coordination between them. There are some cases, however, in which, because of their specialization, regional development institutions have begun to participate in a new range of operations and activities. These differentiate them from such institutions as the World Bank, since they are more flexible, more nimble, and more in tune with the political, economic, and social realities of the regions in which they operate.

Nevertheless, a number of elements are essential for the successful management of a regional financial institution: it must have a clear and focused mission; it must have firm and sustained support from institutional shareholders; it must have autonomous but accountable management; it must pursue prudent financial, administrative, and operational policies; and its performance in terms of profitability, financial indices, and efficiency levels must be satisfactory. These elements are all necessary to obtain investment-grade risk certification, a precondition for access to capital markets. The Andean Development Corporation, for example, is an exclusively Latin American organization geared to servicing the particular priorities of the region. Its status is that of a preferred lender with high-level political representation on its board of directors. It is nonetheless free of political interference, thanks to its sufficiently autonomous administrative management, which has made it flexible, agile, innovative, adaptive to its environment, and positioned as a financial agent for the promotion of integration in South and Latin America. However, regional financial institutions require greater effort than global institutions in order to be sustainable, because multilateral institutions such as the World Bank have the industrialized countries as partners. This gives them the highest risk certification, which facilitates their access to capital markets in optimum conditions in terms of costs, repayment periods, and loan amounts.

Now that we have examined the distinctions between regional and global organizations, we will look more closely at the role of regional institutions.

4. The current role of regional development financial institutions

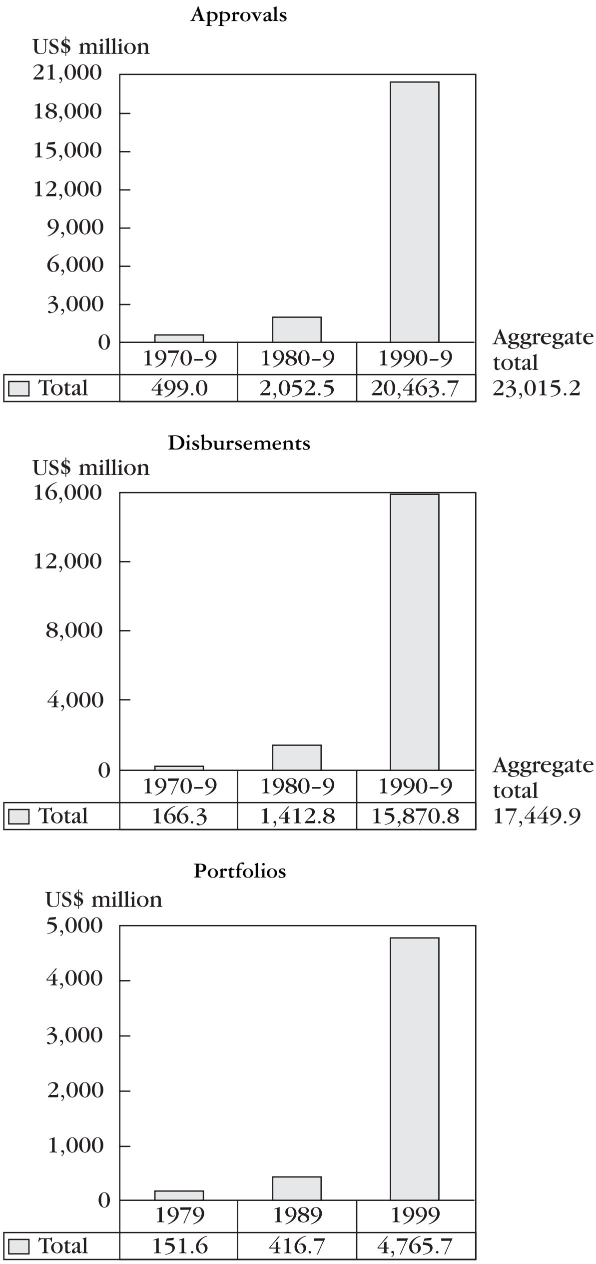
As we have seen in the preceding section, the roles of global and regional multilateral development institutions are complementary, but, because of their specialization, regional institutions have engaged in a diverse range of operations, expanding into activities other than the traditional funding of projects (see Figure 4.4).

Catalysts for attracting resources

Through "A/B" credits,[2] co-financings, portfolio sales, political risk insurance, loan guarantees, and support to countries in the international dissemination of business and investment opportunities in priority sectors, the imperfections of the financial markets are being addressed in part, by seeking to leverage the resources of regional multilateral institutions to attract a greater inflow of capital into the region. This is evident in the case of the ADC, since the leveraging of resources has increased to the point where assets amounted to 26 percent of all liabilities in 1999, compared with 53 percent in 1990 (Figure 4.5).

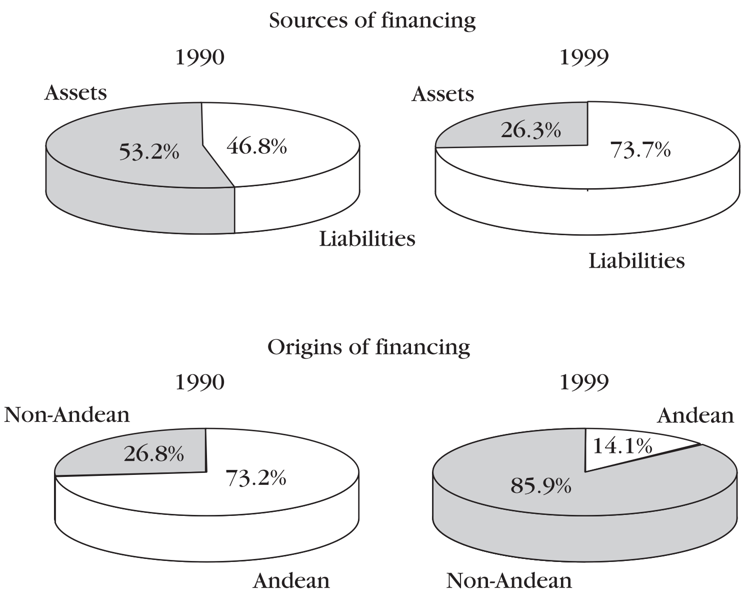
Since regional development institutions also have limited resources, their operations must add value and have a high impact. They should also spur a multiplier effect by creating additional resources through innovative mechanisms. The ADC, for example, has been involved in these types of activities and in promoting the creation and development of capital markets as a

Figure 4.4. ADC: Loan approvals, disbursements, and portfolios, 1970–1999



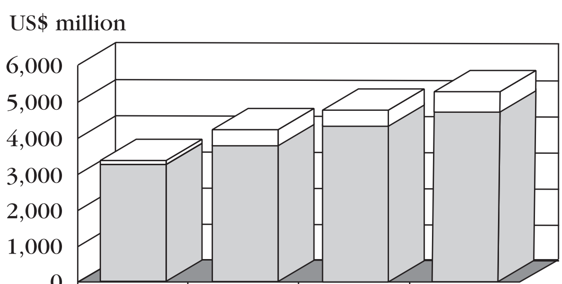
Source: Andean Development Corporation.

Figure 4.5. ADC: Sources and origins of financing, 1990 and 1999



Source: Andean Development Corporation.

Figure 4.6. ADC: Expanding role as a catalyst, 1997–2000



	1997	1998	1999	2000
☐ Third-party portfolios	73	332	427	560
■ Directly held portfolios	3,288	3,739	4,341	4,740

Source: Andean Development Corporation.

new source of financing for the region's productive sectors (see Figure 4.6).

The role of intermediation in reducing the cost of resources

The high credit rating granted to development institutions such as the Andean Development Corporation by risk certification agencies (see Table 4.3) enables them to attract resources from capital markets on better terms than the countries themselves could obtain,

Table 4.3. Risk certification of development institutions and countries of the region

Standard & Poor's		*Moody's*		*Fitch*	
AAA	IADB WB/IFC	Aaa	IADB WB/IFC	AAA	IADB WB/IFC
AA+		Aa1		AA+	
AA		Aa2		AA	
AA–		Aa3		AA–	
A+		A1		A+	
A	ADC(*)	A2		A	ADC(***)
A–	Chile	A3	ADC(**)	A–	Chile
BBB+		Baa1	Chile	BBB+	
BBB		Baa2		BBB	
BBB–	Uruguay, Trinidad & Tobago	Baa3	Uruguay, El Salvador, Mexico, Trinidad & Tobago	BBB–	Uruguay
BB+	Panama, El Salvador, Mexico	Ba1	Costa Rica, Panama	BB+	Panama, Colombia, Mexico
BB	Colombia/Argentina, Costa Rica	Ba2	Colombia, Guatemala	BB	Argentina, Peru, Costa Rica
BB–	Peru	Ba3	Peru, Jamaica	BB–	Venezuela, Brazil
B+	Bolivia, Brazil/ Dominican Rep.	B1	Bolivia, Brazil, Dominican Republic, Argentina	B+	
B	Venezula, Paraguay, Jamaica	B2	Nicaragua, Paraguay, Venezuela, Honduras	B	
B–	Ecuador	B3		B–	
CCC+		Caa1	Cuba	CCC+	
CCC		Caa2	Ecuador	CCC	
CCC–		Caa3		CCC–	
				CC	

Sources: Standard & Poor's, Moody's, and Fitch.

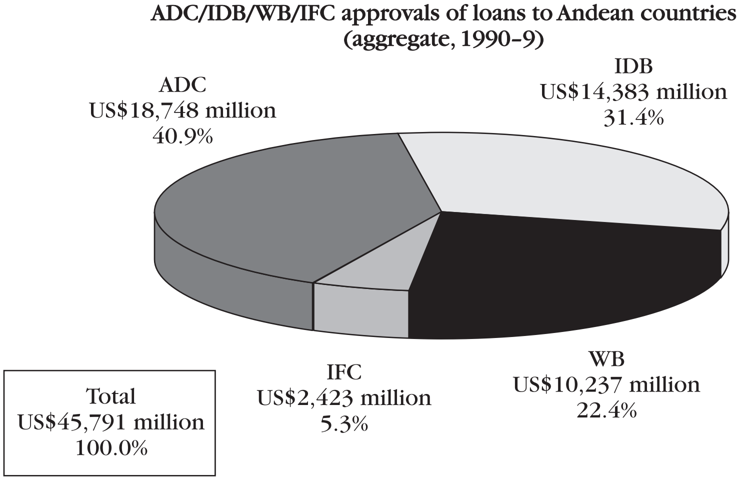
Table 4.4. ADC: Bond issues, 1993–2000

Date of issue	*Market*	*Value (US$ million)*
April 1993	Euromarket	100
October 1993	Euromarket	100
December 1993	Japan (Samurai)	100
June 1994	Hong Kong/Singapore (Dragon)	125
November 1994	Japan (Samurai)	125
February 1995	Euromarket	120
July 1995	EU (Yankee)	250
January 1996	EU (Yankee)	200
February 1997	EU (Yankee)	200
January 1998	Germany (DM)	110
March 1998	EU (Yankee)	150
May 1998	Euromarket	200
June 1998	Euromarket (Italian lira)	115
October 1998	Euromarket	100
February 1999	EU (Yankee)	200
April 1999	Euromarket (euros)	320
July 1999	Japan (Samurai)	165
September 1999	Euro Medium Term Note (EMTN)	47
May 2000	EU (Yankee)	225
August 2000	US Commercial Paper (USCP)	400
November 2000	Euromarket (euros)	173
	Other smaller issues	198
	TOTAL	3,723

Source: Andean Development Corporation.

thereby reducing the cost of financing for the region. Indeed, since 1993, the ADC has issued bonds totaling US$3,723 million in the Euromarket, the European Union, Japan, and Hong Kong (Table 4.4). This has enabled the ADC to become the principal source of multilateral financing for the member countries of the Andean Community, as may be seen from the figures for loan approvals and net financial flows into the region in Figure 4.7.

Figure 4.7. Approvals of multilateral and financial flows to the Andean Community, 1990–1999



Net financial flows from Andean Community countries (US$ billion)

	1990–3	1994–7	1998–9
Multilateral	3.5	2.0	3.0
ADC	0.4	0.9	1.4
Others	2.7	10.5	0.4
TOTAL	6.2	12.5	3.4
ADC/TOTAL	6.5%	7.2%	41.2%
ADC/Multilateral	11.4%	45.0%	46.7%

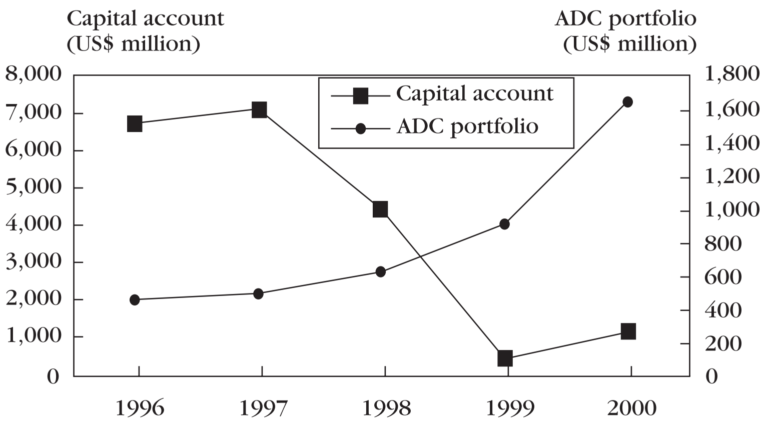
Sources: Andean Development Corporation (ADC), Inter-American Development Bank (IDB), World Bank (WB), International Finance Corporation (IFC), regional central banks.

Note: "Others" = capital markets, international banks, bilateral sources, others.

The anti-cyclical role of financing

Regional development financing institutions seek to compensate, at least partially, for the abrupt reduction in private financing during periods of crisis through anti-cyclical financing. Institutions such as the ADC have had an outstanding record of providing Andean coun-

Figure 4.8. Colombia: Capital flows and ADC portfolio, 1996–2000



Sources: Bank of the Republic, Andean Development Corporation.
Note: data for 2000 are estimated.

tries with resources during difficult periods, as was the case in Peru and more recently in Ecuador and Colombia, all countries that experienced a significant decline in private capital inflows in 1998–9. Figure 4.8 illustrates the case of Colombia.

Support for the restoration of macroeconomic balances and increased competitiveness

Regional development institutions' support for the efforts of countries to strengthen their fiscal, external, monetary, and financial sectors is fundamental to maintaining stability in the evolution of prices and exchange rates, and to return countries to the path of sustained economic growth. These institutions also provide support for the elaboration of strategies and the implementation of public policies aimed at improving the region's competitive environment, including such microeconomic factors as competitiveness, investment climate and international trade, environmental sustainability, science and technology, and governance.

Support for the process of state reform

The regional development institutions promote the modernization and decentralization of the state to help bring about the institutional changes necessary to make the reallocation of resources and responsibilities from central government agencies to the population more efficient. This process of modernization requires the strengthening of the public sector's capacity to prepare, execute, and manage its program and activities. The regional development institutions also finance structural adjustment operations tied to the fulfillment of programs that promote advances in reform and the adoption of sustainable economic policies.

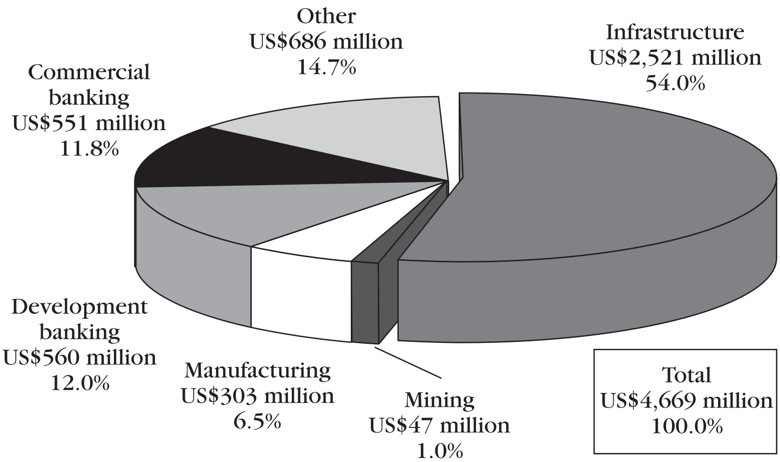
Strengthening of financial markets and systems

An essential requirement for the development of the region is the existence of stable and secure financial systems backed by effective regulatory frameworks. The stock market is a crucial source of medium- and long-term resources and its development is therefore of vital importance. Regional development institutions play a major role in the formation and strengthening of stock markets by promoting the establishment of stock exchanges, the training of market agents, and the creation of a stock exchange culture that familiarizes the public with the various aspects of the market. They also support the strengthening of regulatory and oversight bodies in order to foster a healthy and stable environment within which to develop a more efficient and complex financial market.

Financing of sustainable infrastructure to promote integration and enhance production

Regional development institutions can promote the structuring and financing of projects in such sectors as transportation, road systems, energy generation and transmission, natural resources conservation, river basin management, and water supply and purification, based on the criteria of environmental and social sustainability. The ADC,

Figure 4.9. ADC: Portfolio distribution by economic sector, to September 2000



Source: Andean Development Corporation.

for example, has played a very important role in this area: 54 percent of its portfolio is allocated to infrastructure (Figure 4.9). Of particular note is the funding of projects for the integration of the Andean region and Brazil through road, river, and energy networks.

The promotion of private capital participation

The processes of privatization are supported by the promotion of private sector participation in financing infrastructural works and providing public services on concessionary terms.

The promotion and financing of microenterprises and small- and medium-sized enterprises

The financing of these sectors has an enormous impact on the creation and sustainability of productive activities that increase employment and reduce poverty among the most vulnerable groups of society. Today's small borrowers may become tomorrow's large industrialists by expanding their operations, increasing their incomes, and contributing in a more significant way to the development of their economies. The problem of asymmetric information is addressed here directly, since projects are financed that would otherwise have been considered "high risk" by the commercial banks owing to a lack of information and experience, thereby partially offsetting the credit restrictions that result from the information asymmetries.

Support for the financing of environmentally strategic activities

Because the sustainability and conservation of natural resources are essential, economic development activities must be compatible with preservation of the environment. This goal can be achieved through soft loans or non-reimbursable resources for sustainable development projects and sound environmental management of the various projects financed by regional development organizations.

Financing of sectors of high social value

Sectors of high social value have limited access to private capital markets but are essential to a country's development. Financing education, health and nutritional, and social programs helps to improve the living conditions of the population.

5. What role for these institutions?

In a dynamic and changing world, and given the need for greater creativity in contributing in various ways to the development of countries, regional development institutions must adapt and innovate. Here we look at some of the activities in which these institutions may participate.

- Activities other than traditional financing that do not require abundant resources but are very important—for example, innovative operations in investment banking and studies and programs in the areas of competitiveness, the new economy, biodiversity, etc., which have significant potential for contributing to a country's development.

- Seeking more tangible progress toward the physical, commercial, and economic integration of the countries by expanding integration to include broader geographic areas: the Andean Community, Mercosur, and Latin America.
- Improving and streamlining response capacity through timely disbursement of funds to offset temporary interruptions in private capital flows to the countries of the region.
- Developing and strengthening capital markets. Regional development organizations could contribute significantly to the expansion of capital markets by participating in local issues, thereby serving as "creators of markets." Participation in bond issues and in home ownership programs will contribute to the development of primary markets and the expansion of secondary markets in beneficiary countries. This could be achieved by contributing to the establishment of mechanisms to guarantee bond issuances or their direct purchase as a means of spurring the creation of markets for such instruments.

Notes

1. From an idea presented by Marfán (2000).
2. A/B credits are registered under the ADC or another multilateral institution and have two parts: "A" are resources provided directly by the multilateral institution; "B" are credits provided by one or more private banks. The multilateral institution acts as "lender of record" so both A and B credits are covered under the privileges and immunities convention that benefits multilaterals. This structure helps to mitigate certain (political or exchange) risks and acts as a catalyst in bringing resources to the region.

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5

The International Financial Architecture: Towards the Creation of a Stable Framework for Financial and Exchange Markets

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The most notable failures of global economic management lie no doubt in our current financial institutions. The international financial crisis that struck the developing world between mid-1997 and early 1999, from Asia to Brazil, and the "tequila effect" a few years earlier in Mexico and Argentina highlighted the marked asymmetry between an increasingly sophisticated but unstable financial world and the institutions that regulate it—in other words, a world that lacks appropriate institutions for financial globalization.

The crisis has thus once again placed on the table the subject of reform of the international financial system, a problem to which no solution has been found since the collapse in 1971 of the Bretton Woods system of fixed parities. The globalization of finances that has taken place since then, the worsening of the crises that have accompanied this phenomenon, and the particularly adverse effects the crises have had on developing countries lend a special urgency to the debate on the incomplete reform of the international financial system.

This chapter examines the subject from various perspectives. It begins by describing the recent financial crises as a way of introducing the elements required for effective reform. The second section posits the need to adopt preventive policies both at the international level and in countries in receipt of financial resources. The third section looks at the reforms required at the multilateral level to manage crises once they occur. The chapter concludes with a review of the role of regional and subregional institutions.

As discussed in this chapter, the distinction between preventive policies and crisis management is quite an arbitrary one. Institutions that manage crises effectively do help to reduce the likelihood that crises will occur, since they modify the behavior of economic agents in the desired direction. The current absence of adequate institutions to manage the system is reinforced by behavior on the part of the agents operating in international capital markets that increases the likelihood that the economies of recipient countries will be thrown into crisis, and vice versa.

1. Capital flows and the latest generation of financial crises

The financial crises of the 1990s highlighted the shortcomings of the current international financial system. Instead of contributing to growth and economic stability, some components of capital flows were very destabilizing and therefore restricted long-term growth in the recipient countries.

It is essential to distinguish between the various types of capital flows, because they have different time horizons, respond to different incentives, and have different agents behind them and very dissimilar effects on the recipient economies. On the one hand, direct foreign investment by transnational corporations has long-term repayment periods as well as the potential to contribute not only capital but also technology and marketing networks for the exports of recipient countries. The corresponding flows have proven to be the most stable source of resources for developing countries during recent periods of crisis. Medium- and long-term international loans from the international banking community and suppliers of capital goods also have maturity terms of several years. In practice, however, these have proven to be much more susceptible than direct foreign investment to the periodic crises of confidence that characterize the financial markets.

At the other end of the spectrum, the most problematic and potentially destabilizing capital flows to debtor countries are short-term loans and portfolio flows. Both tend towards excess at their peak and at times of capital flight. The herd mentality that characterizes such flows is well known: they respond more to the expectations of what other operators are doing than to the economic fundamentals of the recipient country (see Eatwell 1997, and Eatwell and Taylor 2000). It is still not fully understood why a country becomes fashionable as a recipient country. Sometimes it is because it has carried out structural reforms that please the international markets or has achieved a macroeconomic balance that is perceived to be sustainable. At other times, it is because that country's terms of trade are improving without any expectation of a reversal in the foreseeable future. In some cases, even when economic operators are aware that a country has unsustainable imbalances (Russia before its crisis of 1998, for example), capital inflows persist because markets continue to be liquid and operators are confident that they will be able to withdraw before the crisis hits.

Perhaps the most important characteristic of international capital flows is that they have a highly exogenous component in relation to the policies of the recipient countries. It is well known that one of the variables that had the greatest influence on the high volumes of capital entering the countries of Latin America in the early 1990s was the decline in interest rates in the United States (Calvo, Leiderman, and Reinhart 1993). Similarly, the scarcity of capital that has affected the region since 1999 has been due in part to the sustained increase in US interest rates and to a growing aversion to risk on the part of operators in the international financial market. This has affected both the activities of the so-called new economy and capital flows to emerging economies.

The marked exogeneity of international capital flows holds an important lesson for recipient countries: it is not enough to main-

Table 5.1. Net flows of capital to M2 in selected developed and emerging economies, 1990–1998 (%)

Country	*1990–8*	*1990–4*	*1995–8*
Japan	1.7	1.8	1.7
Canada	3.1	4.2	1.7
United States	3.1	2.1	4.2
Switzerland	5.7	5.3	6.0
Korea	5.7	4.7	7.0
Brazil	7.2	3.3	10.4
Indonesia	9.1	8.9	8.4
Malaysia	11.2	13.2	6.3
Venezuela	14.5	18.5	11.4
Chile	18.6	18.9	19.2
Colombia	18.5	11.8	26.0
Mexico	18.9	23.8	12.9
Ecuador	19.6	16.4	19.3
Argentina	22.0	25.5	18.2

Source: International Monetary Fund, *International Financial Statistics,* Washington, DC, February 2000.
Note: Net flows of capital refer to net inflows or outflows (outflows in Switzerland and Japan, inflows in other countries).

tain macroeconomic balances in order for capital flows to be stable. Sometimes, macroeconomic stability itself, if this is perceived as permanent, can attract such high volumes of capital that these very inflows have the effect of destabilizing the economies of the recipient countries.

Another characteristic of capital flows is that they can be disproportionate to the size of the recipient economies. It is not uncommon for a country that is in vogue in international capital markets to receive inflows amounting to some 10 percent of GDP. Similarly, net capital flows to emerging economies are usually very high in relation to the size of their financial markets. In contrast with developed economies, where the proportion of net capital flows to money supply (measured by M2) rarely exceeds 5 percent, in emerging economies the proportion may be between 10 percent and 25 percent during boom periods (see Table 5.1).

Inflows of such magnitudes are very difficult to absorb without destabilizing the host economy. Typically, the real exchange rate goes up, the deficit on current account increases beyond prudent levels, money supply expands, stock markets and real estate prices surge, and external savings replace domestic savings. This occurs even in countries whose authorities pursue active policies to stabilize the real rate of exchange and to sterilize the monetary effects of their interventions in the exchange markets.

When operators realize that economic fundamentals have changed, the direction of capital flows is reversed, leading eventually to massive capital flight. The detonator is often (but not always) the accumulation of short-term debt in amounts higher than the levels of international reserves. Everyone wants to avoid being caught in a country with insufficient reserves to meet its obligations. Creditors do not renew their credits and portfolio investors liquidate their positions even if this means losing part of their capital. Holders of medium- and long-term bonds cannot withdraw and are "trapped" in economies in crisis, while the markets for such instruments become illiquid and debtors (whether governments or corporations) face serious difficulties in placing new issues.

In financially open economies, such as exist in most Latin American countries, the behavior of national operators usually worsens the imbalances caused by external financial operators. In periods of heavy inflows of capital, national operators change the composition of their portfolios in favor of assets denominated in the national currency. In times of crisis, they liquidate national assets and seek refuge in assets in foreign currencies. Moreover, during peak periods it becomes very attractive to take on debt in foreign currencies, which leads to increased vulnerability in times of crisis. The depreciation in the exchange rate that occurs at such times places corporations that have contracted debt in foreign currencies in serious financial difficulties and leads many of them into bankruptcy.

In other words, capital flows, especially short-term and portfolio flows, are unstable. The internal dynamic generated by their own aggregate behavior is an important part of the explanation for that instability, and their impact on recipient economies can be very destabilizing.

Most balance-of-payments crises have arisen in the past as a result of trade disruptions caused mainly by worsening terms of trade or by the effects of unsound macroeconomic policies on the current account of the balance of payments—an expansionist fiscal policy, with monetization of fiscal deficits and overvalued exchange rates that generate deficits on the current account that cannot be financed from autonomous capital inflows.[1] Balance-of-payments crises today are associated with capital account trends and are brought about by excessive inflows of capital that cannot be absorbed without creating conditions that encourage subsequent capital flight. The International Monetary Fund (IMF) is equipped to deal with the first type of difficulties and has only recently been belatedly gearing up to deal with those caused by sudden movements in capital accounts. The conditionalities imposed on the use of its resources are also based on that criterion: they are appropriate for current account crises, especially those associated with poor macroeconomic management, but are questionable when the origin of the problem lies in changes in opinions and expectations in the financial markets.

An additional characteristic of the latest generation of financial crises—which is also evidence that capital flows exhibit a high degree of exogeneity—is their contagion effect. When a crisis occurs in one country, international creditors and investors try to anticipate similar phenomena that might occur in other countries that have experienced heavy inflows of foreign capital. In addition, some highly leveraged international investors, after making losses in one country, are obliged to liquidate their positions in other countries in order to meet the demands of their creditors. This can cause the financial crisis to spread even to countries with excellent macroeconomic fundamentals.

Contagion has a strong regional component. After the Mexican crisis of December 1994, Argentina too experienced heavy outflows of capital. The same phenomenon occurred, although on a much smaller scale, in other Latin American countries. After the crisis in Thailand in July 1997, there was a stampede of capital from Indonesia, Malaysia, the Philippines, Hong Kong, Singapore, Taiwan, and South Korea. Some of these economies (Hong Kong, Singapore, and Taiwan) were prepared to deal with the crisis. Others exhibited various degrees of vulnerability.[2] In 1998–2000, practically all the countries of Latin America experienced serious international financial difficulties, even though in many of them their macroeconomic fundamentals were quite solid before the difficulties arose. One of the lessons of the recent financial crisis is therefore that both the virtuous and the sinners can be affected.

2. Preventive measures

International measures

The failure of international institutions to provide an appropriate framework for the regulation of international capital transactions is becoming increasingly evident. The international community does not currently have the mechanisms to provide an increasingly globalized economic system with a range of essential global public goods (Helleiner 2000; Kaul, Grunberg, and Stern 1999). From the viewpoint of the subject of this chapter, global financial stability is a global public good that, if it is to be supplied in appropriate quantities, requires action in three areas: (1) global macroeconomic management aimed at reducing the likelihood of future financial crises and global economic instability; (2) financial institutions that prevent economic agents from assuming unmanageable risks and providing insufficient information to the markets; and (3) a capacity for timely responses to crises that threaten that stability because of the international volatility of capital and the contagion mechanisms described above. The last area is examined in greater detail in section 3 of this paper, which looks at mechanisms for the management of crises.

The instability of the key variables of the global economy, such as rates of exchange between the principal currencies and interest rates in world financial centers, is one of the principal factors encouraging the disproportionate increase in international financial movements (Eatwell 1997). A large part of these flows are the result of arbitrage, hedging, or speculative transactions associated with movements in interest and exchange rates. They are unstable largely because of the absence of effective mechanisms for coordination among the principal economies. As Krugman (1989) observes, since the collapse of the Bretton Woods system of fixed (but adjustable) parities, nominal and real variabilities in exchange rates between the currencies of the developed countries have increased tremendously. The growing mobility of international capital, the lack of macroeconomic coordination between the countries of origin of such capital, and exchange rate instability are factors that are closely related and mutually reinforcing.

This means that the world economy requires better coordination of the economic policies of the major economies and that those coordination mechanisms should adequately internalize their impact on the international financial markets and on developing countries. This coordination should be accompanied by surveillance of the macroeconomic policies of all countries, both developed and developing. This function is currently the responsibility of the International Monetary Fund and is carried out through the annual consultations that take place within the framework of article IV of its Articles of Agreement. These consultations should have a clearly preventive objective and should therefore be accompanied by the monitoring of developments in the financial markets and by the elaboration of vulnerability or early warning indicators.

The IMF has also begun to develop standards to improve the management and transparency of macroeconomic policy. These standards currently encompass codes of good practice, fiscal transparency, and transparency in monetary and financial policies. Codes of good practice for public and external debt management are also likely to be added.

The elaboration of codes, in these and other areas, should take account of two basic principles. The first is that developing countries should maintain their autonomy in designing their policies, including the choice of exchange rate regime and such measures to regulate their capital accounts as may be appropriate to their national situation (United Nations 1999; Ocampo 1999). The second is the limited capacity of these countries to adhere to complex norms. The adoption of norms should therefore take into account the institutional limitations of these countries, especially the relatively less developed among them, and their traditions of macroeconomic and regulatory policy.

International financial stability also requires an appropriate global institutional framework. This framework should have two important elements: minimum standards of regulation, and prudent oversight of financial systems, and systems for the supply of information required by the financial markets in order to function effectively. Regulation and oversight play a fundamental role in preventing financial agents from assuming excessive risks and ensuring that their assets are adequate for the risks they assume. The primary objective of these various mechanisms is to ensure that problems of a systemic nature do not arise. These norms should therefore be rigorously consistent with the risks assumed by economic operators as a group and not as individuals.

In the case of the industrialized countries, relatively greater emphasis should be placed on the regulation and oversight of institutions and more highly leveraged operations. Although these problems have been recognized, progress in this area has been limited and confined mostly to indirect regulation (of the intermediaries that provide credit) rather than direct regulation. On the other hand, the industrialized countries should place equal emphasis on evaluating the risk inherent in operations involving countries that contract net debt (particularly short-term debt) on a scale that is disproportionate to the size of their economies and financial sectors, thereby discouraging high-risk financing. In the case of extra-territorial financial centers, regulatory and oversight standards should also seek to promote global financial stability. All of these issues are being discussed within the framework of the Financial Stability Forum created by the Group of Seven, but adequate representation of the developing countries is missing from this mechanism. The standards that should be applied to the latter countries are discussed later in this chapter. Effective measures must be adopted in all countries to prevent and punish money laundering and other financial crimes.

The importance of information for the proper functioning of financial systems has been widely recognized in recent economic literature. Although some information problems have no solution (the asymmetry between the information on projects available to creditors and debtors and the information on debtors' financial situation), measures aimed at improving the quality, quantity, and transparency of the information available to economic operators may help to enhance the efficiency of markets and the stability of capital flows (Ahluwalia 2000). A number of important initiatives have been put forward in this area in recent years, within both the International Monetary Fund (with respect to standards of macroeconomic information) and the International Accounting Standards Committee (with the aim of standardizing accounting information for companies seeking to attract financial resources in international markets). These initiatives deserve the support of the developing countries.

The volatility of capital flows is unlikely to be reduced, however, merely by providing more or better information. Basic information on the macroeconomic conditions of the principal "emerging economies" was available long before the various crises unfolded. The cause of the problem is that the same information is interpreted differently at different times, depending on the expectations of the economic agents. This is true even of the best-informed economic agents—investment banks, risk certification agencies, intergovernmental organizations, and governments themselves. In other words, the main problem is the volatility of the opinions and expectations of economic agents, and not necessarily the factual information on which they base their decisions (Ocampo 1999; Eatwell and Taylor 2000).

Risk certification agencies are one of the principal private institutions that supply information to investors. During the turbulent financial boom and bust cycles of the 1990s, risk certification agencies were not spared the volatility that characterized the opinions and expectations of the economic agents operating in emerging markets. Thus, instead of mitigating the volatility of the financial cycles (which is the effect that a good information system should have), their activities tended to intensify them. Governments of the developed countries, perhaps with the support of the multilateral financial institutions, should therefore encourage private institutions to certify sovereign risk in accordance with strict, objective, and publicly known parameters. One alternative would be for oversight bodies in countries of issuance to begin themselves to issue certifications of sovereign risks, based on internationally agreed objective parameters.

Sound management of booms: The role of national policies

The first requirement of any crisis prevention policy is the sound and flexible macroeconomic management of booms by national authorities.[3] The objective should be to prevent public and private operators from accumulating debts that are unsustainable by reason of their scale, and thereby prevent more significant price disequilibria, particularly in exchange rates and in the prices of national assets (financial assets and real property). On the fiscal side, the authorities should pursue structural balance in public finances to help strengthen the savings capacity of the economy and to give the authorities additional tools for anti-cyclical management. This requires the generation of fiscal surpluses during periods of boom, preferably through general funds for the stabilization of public incomes (in addition to special tax revenue stabilization funds for commodity prices, where necessary); these give the authorities the necessary freedom to reduce fiscal restrictions in the subsequent bust. In addition, monetary and exchange rate policies should be aimed at preventing temporary economic booms from causing too abrupt increases in external and domestic credit to the private sector and unsustainable increases in real exchange rates.

The prudent management of booms also means activist policies towards capital flows. Developing countries must retain the right to apply prudent restrictions on capital inflows. Chile and Colombia have had positive experiences from the imposition of noninterest-bearing reserve requirements on financial inflows (Agosín and Ffrench-Davis 1997; Barrera and Cárdenas 1997; De Gregorio, Edwards, and Valdés 2000; Le Fort and Lehmann 2000; Ocampo and Tovar 1999; Villar and Rincón 2000).[4] Studies show that reserve policies for external capital have successfully shifted the debt structure towards longer-term debt and have probably reduced total capital inflows. Indeed, the reserve requirement cost for foreign capital rises in inverse proportion to the term of the transaction, declining to insignificant levels for investments or loans with terms of several years. Disincentives to short-term capital naturally result in a decline in total inflows, because long-term capital is an imperfect substitute (especially on the supply side) for short-term capital.

It has been argued that improved regulation and oversight of financial systems would be a substitute for the regulation of capital flows (Mishkin 1999). According to that argument, high reserve or liquidity requirements could be introduced for financial intermediaries' foreign currency loans that are inversely proportional to their term or that increase sharply as they mature. However, regulatory policies aimed exclusively at financial entities are no substitute for policies to regulate capital flows, for the simple reason that such entities are not the only national operators that contract debts abroad. The major national and foreign enterprises also have direct access to capital markets. The currency exposure of such companies can affect the solvency of the national financial system insofar as these companies maintain debts with national financial entities. Nor are credits from foreign banks the only flows that can be excessive or destabilizing. Portfolio investments are usually extraordinarily volatile and can assume sizable proportions in countries now embarking on financial liberalization. A reserve requirement or tax on all foreign investment is probably the best option because it increases the cost of all capital inflows and attacks the main source of the imbalance. This tax should be flexible, precisely because capital flows are volatile. It should be increased during periods of excessive flows and reduced in times of scarcity.

Fischer (1998) has argued that another alternative to reserve requirements would be to regulate companies' net debt positions in foreign currency. This could be a useful mechanism but would be rather more complicated and difficult to manage than policies that address the problem directly.

In any case, sound regulation and financial oversight are indispensable instruments for internal macroeconomic stability and for strengthening defenses against the instabilities associated with capital flows. An important element of financial regulation in small and financially open countries is follow-up and monitoring of the exposure between assets and liabilities in foreign currencies. However, as has already been indicated, even a perfect match is no guarantee against the fragility of financial entities exposed to possible exchange rate depreciations, because their debtors have direct access to international financial markets. The exchange rate risks to which these debtors are exposed during periods of crisis may become credit risks for the national financial entities.

It has been demonstrated that the banking oversight norms developed by the Basel Committee on Banking Regulations and Supervisory Practices can have pro-cyclical effects. In times of boom, the profits earned by financial intermediaries and the relatively low level of matured portfolio provisions lead to increases in capital and, given the constant ratio of loans to capital, to an expansion in the supply of credit. During periods of crisis, in contrast, the portfolio of mature loans increases. The corresponding provisions then erode capital and thereby restrict the capacity of banks to make loans. This cyclical pattern is mirrored by the behavior of debtors and accentuated by the evolution in the prices of assets. In boom times, the fixed assets and shares used by debtors to guarantee loans are valued at inflated prices and used to justify excessive lending. The opposite occurs during periods of scarce capital.

These factors should all be considered when introducing measures to regulate the activities of financial intermediaries. During periods of boom, capital requirements should be increased. Alternatively, or as a complement, certification rules and portfolio penalties could be made more stringent or additional deposit or liquidity requirements established for financial intermediaries. It would also be useful to prescribe the value of shares and fixed assets that can be used as collateral for loans. The activities of regulatory bodies should be intensified, especially in their oversight of financial intermediaries that experience rapid increases in their portfolios and/or foreign currency operations.

The rate of exchange is a key price in emerging economies. The long-term performance of exports, their rate of diversification, and their growth are all strongly influenced by the real exchange rate. A high degree of stability in the real exchange rate is therefore desirable. However, under conditions in which economies are subject to severe external disruptions, both financial and real, absolute stability in the real exchange rate is impossible to achieve and may even be unhelpful. Indeed, it may be desirable for the authorities to absorb a part of these disruptions by adjusting the exchange rate. This instrument thus faces opposing demands in today's world, where stability and flexibility are both required at the same time. Viewed from another angle, the exchange rate has enormous influence on the real economy and on growth objectives. In a context of financial liberalization, however, it is being increasingly determined by financial factors.

In recent times, the idea has gained currency that the only stable exchange rate regimes are the extremes of a free exchange rate and a nominal "hard" base for domestic prices. However, neither of these extremes is desirable. Even in countries with prudent macroeconomic policies, if capital flows are themselves volatile, a fluctuating exchange rate regime increases even further the volatility of both the nominal and the real exchange rates. Such volatility could only be harmful to growth. In all modern economies, prices show upward flexibility and downward rigidity. Nominal depreciations could therefore have an inflationary impact, whereas appreciations fail to have symmetrical effects on the downward pressure on prices and wages.

In a system of nominal fixed rates, in contrast, the real exchange rate and the rate of inflation are stable but the volatility of capital flows makes real activity extremely unstable. During periods of heavy inflows of capital, the authority monetizes increases in reserves (which it cannot sterilize if, in addition, it uses a convertibility fund) and economic activity is buoyant. During periods of pessimism, there is an outward flow of capital, the money supply is reduced, production levels fall, and unemployment rates increase.

Consequently, the key is in managing the factors that determine the real rate of exchange: capital flows.[5] It is precisely the oversight of capital flows that permits the efficient use of intermediate systems of "managed flexibility," which include dirty floating, exchange bands, and crawling pegs. Through regulation, it is therefore possible, within certain limits, to reconcile the opposing demands for stability and flexibility that currently face exchange rate regimes.

In more general terms, the most important lesson we can learn from the history of exchange rates over the past few decades is that no exchange rate regime is perfect for all countries at all times. Each country has to choose the degree of nominal exchange rate flexibility that it needs in accordance with its objectives and real capacity to manage the other variables of economic policy.[6]

A final element in the prudent management of booms is the accumulation of reserves—current or stand-by—to deal with future crises as a form of "self-insurance." This instrument, although useful, is of limited effectiveness. The reserves necessary to deal with the problems caused by massive capital flight are enormous. In a sufficiently severe crisis, national operators can themselves convert a high percentage of their national currency holdings into foreign currency. International reserves have a high opportunity cost. Stand-by lines of credit opened with international banks during boom periods also have a cost (equivalent to the cost of an option), and the volume of resources available is probably insufficient to deal with the crises.

3. Multilateral aspects of the management of external crises

Reform of the financial architecture to enable the international community to deal effectively with crises also has preventive effects. The mere existence of an effective international response capacity will change the behavior of agents and, consequently, make financial crises less frequent.

The international community is not currently in a position to deal with international financial crises. This in itself is a destabilizing element within the system. Whereas international capital flows have increased exponentially, the international community's capacity to manage the financial system has weakened. Central bank international reserves have fallen dramatically in relation to cross-border capital flows. Whereas in 1977 annual transactions in exchange markets represented 15 times the total levels of international reserves, by 1998 this figure had surged to 234 times (estimates based on Felix 2000, table 6). This means that, together with the huge increase in international capital transactions, the capacity, even of the largest countries, to combat speculative trends in international capital markets has declined systemically.

The International Monetary Fund has had, moreover, neither the authority nor the resources to undertake this task. Even though the main mechanism for mobilizing resources in exceptional circumstances (loan agreements with industrialized countries) was expanded during the recent crisis, the resources available to the IMF are still limited. When a major crisis threatens the stability of the world economy, recourse must be had to ad hoc bilateral arrangements. The uncertainty surrounding these financing mechanisms reduces the Fund's capacity to instill confidence, especially when faced with crises of steadily increasing severity and rapidity.

In theory, there are two ways of dealing with financial crises once they have broken out. One is to establish a financial facility with functions similar to those of a lender of last resort. The second is to permit countries affected by crises related to their capital accounts temporarily to suspend servicing of their debt and outflows of portfolio capital. A series of orderly multilateral measures may also be developed for this option.

One of the theses of this chapter is that, far from being exclusionary, both options are essential components of a new international financial architecture. The mere creation of an emergency financing facility can act as an incentive for imprudent behavior on the part of debtors and creditors and may therefore contain a harmful dose of moral risk. The existence of mechanisms for the suspension of payments serves to mitigate those risks. On the other hand, the adoption of mechanisms for the suspension of payments would in itself merely worsen the crises and their impact. First, without an adequately funded financing facility, the system would lack the means to deal with the problem of contagion. Secondly, the affected countries would be very reluctant to return to the capital markets. Lastly, any temporary liquidity crisis could develop into a prolonged crisis.

Stand-by financing facility

The objectives of a new international stand-by financing facility and improved emergency facilities would be two-fold. First, such a facility should offer protection from speculative attacks against countries with sound economic fundamentals and a solid balance-of-payments position on current account. Secondly, the facility could prevent the spread of financial crises through contagion. Its mere existence would change the international regime and the behavior of operators.

This type of facility would also play a role at the international level that is more similar to the role played by central banks at the national level. It should be noted here that, as currently constituted, the IMF is not in a position to become a lender of last resort, for a number of reasons (see Eichengreen 1999, pp. 98–102; Ocampo 2001; Rodrik 1999). Insofar as it lacks the power to create money, the IMF does not have the resources to play the role of central bank to central banks.[7] Nor does the Fund have the authority to ensure that it would recover the funds lent.

After the Mexican crisis, the IMF established mechanisms that gave it the power to act rapidly at times of severe crisis. It created two additional facilities: the Supplementary Stand-by Facility, for exceptionally large financing needs, and the Stand-by Line of Credit, designed to assist countries exposed to financial contagion. The first window is subject to the traditional stand-by agreements and has already been used. In order to access the Stand-by Line of Credit, countries must have been positively evaluated during the annual consultations held pursuant to article IV of the Fund's Articles of Agreement and must have met the standards for the dissemination of information and complied with the codes of transparency recently adopted by the Fund (and possibly those to be adopted in the future). For the disbursement of the corresponding resources, they must also enter into a stand-by agreement. In view of the complexity of the process of accessing this line (which was re-established in September 2000), the possible negative signal sent to the markets if a country accesses the line, and the modest amount of resources available, it is not surprising that no country has thus far requested access.

Consequently, although some progress has been made towards the establishment of a stand-by facility, the system still does not have the type of facility that is needed. The new facility should have adequate resources to assist affected countries and be easy to access (see the proposal by Williamson 1996). Loans granted under the facility and the existing expanded emergency facility should be short term (subject to rescheduling, if necessary) and attract relatively high interest rates to encourage users to repay the loans in the shortest period possible. It is obvious that a stand-by facility should have few conditions, not only because conditionalities are inappropriate in speculative attacks launched for reasons that have nothing to do with national policies, but also because their imposition might delay the response to a crisis.

In order to ensure that its resources are not being used to defend unsustainable policies, the Fund should use a number of basic and proven eligibility criteria relating to the maintenance of macroeconomic stability and balance on the current account (for example, the deficit on the current account should not exceed GDP by more than a certain percentage). A number of observers have pointed out that the Fund cannot take away a country's eligibility certification without provoking a crisis. One alternative is not to introduce eligibility criteria but to establish instead a system that provides for the prompt examination of each request, based on simple criteria, when the market is experiencing turbulence. The best way to finance such a facility, as well as the emergency facilities, would be through the issue of special drawing rights (SDRs). One approach might be to issue SDRs to all member countries in proportion to their quotas. Another option might be for SDRs to be issued exclusively to member countries in crisis and to be reimbursed to the Fund for destruction once the crisis has been overcome (see also Ezekiel 1998). A third option is for the Fund to issue SDRs to itself in cases of crisis and to destroy them once the crisis is passed (Ahluwalia 1999).[8] These last two options would require an amendment of the Fund's Articles of Agreement.

A related issue concerns the conditions attached to the Fund's financing programs. As we have already argued, conditionalities in themselves are not appropriate for emergency financing where crises are caused through contagion.[9] Moreover, in the latest financial crisis—and also in keeping with a longer-term trend—the Fund extended the conditions on which affected countries could access its resources into areas far removed from macroeconomic policy and balance of payments, including the functioning of the labor market, the opening up of financial markets to the outside world, and relations between the state and the private sector, conditions universally held to be a wholly inappropriate extension of the prerogatives of the institution and that are a subject for national policy decisions (see United Nations 1999, section 5). In this, a large number of analysts with very different ideological positions and views about the role of the IMF are in agreement (Collier and Gunning 1999; Council on Foreign Relations 1999; Feldstein 1998; Helleiner 2000; Meltzer 2000; and Rodrik 1999). Conditionalities should therefore again be limited to the traditional areas of macroeconomic policy, with the addition, given the current situation, of conditions relating to regulatory and oversight mechanisms for the sound management of financial systems.

An orderly moratorium on payments

The indispensable complement to the creation of an emergency financial facility is an orderly moratorium on payments. In its most extreme form, this would involve renegotiation between debtor and creditors to reschedule and possibly reduce the debt load. For obvious reasons, this is a path that few countries wish to take, because it would rupture relations with the international capital markets. Regaining credibility might be a slow and costly process. Only countries on the edge of bankruptcy will have recourse to such solutions.

There is, however, a variant of this solution that could help to resolve problems of liquidity once a crisis has broken out. By international agreement, debtor countries should include clauses in their debt contracts—sovereign bonds, private bonds, or loans from private banks—that allow them to defer payments (with interest accumulating), for a limited period, in cases of capital flight over which they have no control. Temporary suspensions of payments could be extended to cover outflows of portfolio capital. To overcome the reluctance of creditors (and possibly debtors) to participate in these solutions, loan contracts should also include provisions for collective action. Important precedents exist for this practice in the issuance of bonds in the British market (Griffith-Jones 1998). These provisions should be universally adopted in order to ensure that the market does not discriminate against those countries that adopt them.

The IMF could become involved by authorizing the corresponding action by affected countries pursuing sound macroeconomic policies. Under article VI of its Articles of Agreement, the Fund is already authorized to take this type of action. One alternative would be to establish multilateral arbitration mechanisms to which parties could have recourse to settle any disputes that might arise in the refinancing or renegotiation of debt as a result of the declaration of a moratorium. In both cases, it would be useful to encourage flexible agreements that provide for relatively predictable contingencies so as to avoid renegotiations and explicitly to encourage creditors to continue to provide resources to countries in difficulty during periods of crisis.

It is important to emphasize that, like the emergency and standby facilities, an orderly moratorium with international support for emergency cases could help to ensure that capital inflows are more moderate during boom periods, because creditors and investors would have greater exposure to the risk of illiquidity in recipient countries. It thus also plays a preventive role.

4. The role of regional institutions

The establishment of regional and subregional institutions, or their strengthening where they already exist, can play an important role in ensuring a greater degree of international financial stability. An ambitious proposal to create an Asian Monetary Fund was presented by Japan to the IMF meeting held in Hong Kong in 1997. The idea took concrete form in May 2000 with the agreement reached among 13 Asian countries—members of the Association of South East Asian Nations (ASEAN), China, South Korea, and Japan—to establish mechanisms for swaps among their various currencies (Park and Wang 2000).

Latin America has had one of the most interesting experiences in this area, namely the Fondo Latinoamericano de Reservas (FLAR, or Latin American Reserve Fund), which for two decades has provided balance-of-payments support to the countries of the Andean Community (Bolivia, Colombia, Ecuador, Peru, and Venezuela). For countries of smaller size (Bolivia and Ecuador), FLAR has been just as important a creditor as the IMF. With the recent accession to membership of Costa Rica, FLAR has begun a process of expansion to include Latin American countries that are not members of the Andean Community, as a step towards expanding the scope of the institution (FLAR 2000).

The regional element of the international financial architecture should be considered as the equivalent at the monetary level of regional development banks. In the same way as the regional development banks do not replace the World Bank, but rather complement it, the regional funds would complement the IMF and could become an important additional line of defense against financial turbulence. By acting in the same way as an effective crisis management facility in the Fund, regional funds could protect member countries from contagion and help to bring about a change in the behavior of financial operators.

Indeed, since financial contagion has an important regional component, the presence of regional funds would have significant advantages over an architecture that consists of only a global fund (see Agosín 2000; Mistry 1999; Ocampo 1999). The first advantage lies in the possibility mentioned above of changing the expectations of financial operators and their behavior towards the economies of the region. Increased international reserves provided by other members of the fund, and perhaps also lines of credit obtained by the fund in international markets, would make participating countries much better equipped to deal with crises. The regional funds would probably obtain lines of credit in international capital markets on better terms and in higher volumes than individual countries could. It is also likely that the coordination of macroeconomic policies at the regional level to keep bilateral exchange rates at levels conducive to the deepening of interregional trade would be easier to achieve if a regional fund existed to prevent financial contagion and to protect member countries from international financial turbulence.

Is a Latin American fund feasible? As can be seen in Table 5.2, the combined reserves of 11 Latin American countries (including all the larger countries with the exception of Mexico) totaled US$136 bil-

Table 5.2. International reserves, short-term debt, and money mass: Selected Latin American countries, 1997 (US$ billion)

Country	*International reserves*	*Short-term debt*	*Money mass (M1)*	*Money mass (M2)*
Argentina	22.8	18.0	21.5	77.6
Bolivia	1.2	0.4	0.7	3.8
Brazil	52.0	36.2	47.3	236.5
Chile	17.7	9.9	7.7	33.6
Colombia	9.7	5.7	10.3	24.9
Costa Rica	1.3	0.5	1.5	4.0
Ecuador	2.2	2.1	1.7	6.7
Paraguay	0.7	0.5	0.9	2.9
Peru	11.3	6.8	5.7	16.8
Uruguay	1.7	1.9	1.1	8.6
Venezuela	15.2	4.4	11.4	19.0
Total	135.8	86.3		

Sources: World Bank, *Global Financial Indicators,* Washington DC, 1999; International Monetary Fund, *International Financial Statistics,* Washington DC, 1999.

lion in 1997. A fund consisting of 15 percent of these reserves (approximately US$20 billion) could provide financing to counter capital flight in an amount equivalent to the entire short-term debt of the countries considered individually. At the same time, a fund of this size could deal with capital flight from each country considered individually in an amount equivalent to its entire money mass (M2), with the exception of Argentina and Brazil. In the case of Argentina, a fund of US$20 billion would be sufficient to complement its reserves in such a way as to enable it to deal with capital flight in an amount equivalent to its entire M1 (notes and coins in circulation plus sight deposits) and more than half of its M2. This shows that even an effort to establish a joint fund with a modest percentage of the region's reserves could protect them from major financial crises. This calculation does not consider the possibilities of the fund's stand-by indebtedness in international capital markets or contributions from the developed countries or from the IMF.

On the other hand, it should be noted that, although there is a degree of covariance between capital movements in different countries, it is not such that a regional fund might be required to deal with simultaneous flights from all the countries (Agosín 2000). Indeed, the experience of FLAR indicates that, even in a subregion such as the Andean subregion, the need for emergency financing is sufficiently distant in time to permit a reserve fund to fulfill an important function. Moreover, the basic premise is that, by resolving an early crisis in one country, a regional fund helps to ensure that it does not spread to other countries.

The regional funds could be recognized by the IMF as an integral part of the international financial system. In that case, they could become in part the intermediaries between the Fund and individual countries. In times of crisis, regional funds could be authorized to access IMF resources almost automatically. If a new stand-by facility in the Fund is financed from SDR issuances, the regional funds could be authorized to acquire SDRs paid for in the national currencies of members so that loans could then be made to the countries in crisis.

Notes

1. Of course, some crises continue to be caused by a temporary deterioration in the terms of trade. Even though the IMF has a Compensatory Financing Facility to provide resources to countries affected by a worsening in their terms of trade (as well as for other related causes), for reasons beyond their control, the facility is infrequently used and is not completely without conditionalities.
2. For a comparison between South Korea and Taiwan, see Agosín (2001).
3. For a more detailed analysis of the issues dealt with in this section, see ECLAC (2000), chap. 8, and Ocampo (2000).
4. Up until May 2000, Chile also required portfolio and direct investment flows to remain in the country for one year and Colombia had direct regulations governing such investments.
5. Clearly, there are other determinants of real exchange rates (such as terms of trade and the strength of aggregate demand). Here emphasis is being placed on the role of capital flows.
6. For a more in-depth analysis of the issues dealt with in this section, see Frankel (1999), Velasco (2000), and Williamson (2000).
7. The creation of special drawing rights (SDRs) is one way of issuing means of payments, but this requires the explicit agreement of the Fund's directors in

each case, with a majority of 85 percent of the votes. The last time that special drawing rights were issued was in January 1981.
8. In any of these scenarios, countries that are net users of SDRs would have to pay interest whereas countries that are net recipients would be remunerated.
9. It has been argued that the standard conditionalities of the Fund (restrictive fiscal objectives and increases in interest rates) deepened the economic crises in affected countries because of the capital flight that took place during the most recent crisis (see Radelet and Sachs 1998; and Furman and Stiglitz 1998).

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6

External Indebtedness and Economic and Social Development

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1. Introduction: The problem of high external indebtedness

Access to external financial resources is crucial to economic and social progress in developing countries. External resources play many different roles. They are needed, first of all, to make up for the shortfall in domestic savings and to meet the demand for investment in economically profitable projects that promote growth and generate future resources for the repayment of these obligations. External financing is also needed to offset unexpected shortfalls in a country's income as a result of adverse external shocks or natural disasters, permitting temporary deficits to be balanced by future savings and growth and consumption patterns to be tempered.

Developing countries obtain external resources from a number of different sources. Although the type may vary, external resources include official flows from multilateral and bilateral organizations, such as the World Bank, the Inter-American Development Bank, and the development agencies of the industrialized countries, as well as private capital flows, principally bank financing, bonds, and direct foreign investment.

In recent decades, the flow of resources to the developing countries has increased significantly, especially those that give rise to external indebtedness. Indeed, between 1970 and 1999, the total external debt of this group of countries increased 22-fold, rising from 15 percent to 38 percent of GDP (IMF 2000). Despite the increased flow of external resources, the economic performance of most countries in this group has been very poor.

External financing alone is clearly not sufficient to guarantee economic growth. The question is whether these resources are utilized efficiently for productive investments in an environment of domestic policies that ensure the fiscal and external soundness of their economies. Otherwise, countries tend to contract fresh debt to pay off earlier debt, thereby increasing their total load of debt to unsustainable levels, which in turn acts as a brake on economic and social development.

A large body of literature examines how high levels of external debt are obstacles to economic growth. Various explanations exist for this. An excessive debt burden acts as an indirect tax on and disincentive to private investment, since economic agents fear that the need for future payments to creditors would require governments to impose new taxes or other forms of asset appropriation, such as exchange rate controls, freezing of funds, or expropriations. In such an environment, both the level of investment and possibilities for growth are reduced.[1]

Debt burden is also one of the key indicators for assessing a country's credit risk. High leveraging increases the perception of risk, which in turn increases the cost and reduces access to financing for both the public and private sectors. It has a negative impact on investment too.

In addition, high levels of debt give rise to problems of "moral abuse" and redistributive conflict in countries that elect to postpone reforms in order to reduce their debt burden and to continue to contract fresh debt in the expectation of some form of future debt relief. This leads to frequent forced restructuring and defaults that have a destabilizing effect and reduce the possibilities of growth.

The experience of developing countries with debt problems has been widely studied, especially after the debt crisis of the 1980s.[2] The explanations of this crisis have been many and point to a confluence of adverse external factors—the oil shock, worsening terms of trade, increase in international interest rates, and global recession—with inconsistent macroeconomic management at the domestic level, which led to high fiscal and external deficits and very low rates of domestic savings.

By the early 1980s, the debt burden had reached unsustainable levels and a number of countries suspended their debt servicing. Initially, it was thought that this was a temporary problem of liquidity and it was tackled by successive debt reschedulings, which provided some cash flow relief but did not address the root problem. By the end of the decade, it was generally agreed that the problem was not only one of liquidity but also one of solvency and that, consequently, relief would be required both for servicing and for paying off the balance of the external debt, usually within the framework of stabilization and structural adjustment programs.

The debt owed to private external banks was restructured under the so-called Brady Plan, which significantly reduced both the balance and the flow of bank debt payments by exchanging the debt for new market instruments. This was complemented by rescheduling the repayment of loans from official sources and by granting fresh loans on concessionary terms, particularly to low-income countries.[3]

Several developing countries, mainly the higher-income countries of Latin America, adopted stabilization programs and structural reforms that were marked by commercial openness, financial liberalization, privatization, and market policies, and thus managed successfully to reinsert themselves into the voluntary capital markets. Indeed, in the 1990s, Latin America significantly increased both its access to external resources and its share of direct foreign investment (though this was limited to the sectors of natural resources, financial services, and privatization of public enterprises). Traditional bank financing gave way to new forms of financing in capital markets, especially through the issuance of bonds in international markets, which benefited both the public sector and the region's largest private corporations. For this group of middle-income countries, issues related to high debt levels have ceased to be priorities in their current agendas and new problems have emerged, especially problems related to the volatility and cost of international financing flows, the prevention of international financial crises, and the new international financial architecture.[4]

Nevertheless, for the poorest group of countries, the debate on the external debt is ongoing. Despite the fact that many of these countries received significant aid on concessional terms and debt reduction, their economic performance has been hardly satisfactory: debt levels continue to be high and economic growth rates low.

After 1996, the international financial community launched the highly indebted poor countries initiative (HIPC). This seeks to reduce the debt burden to sustainable levels in highly indebted countries.[5] These countries must demonstrate and pursue responsible policies to promote growth and direct any savings accruing from debt relief to social expenditure.[6] According to the International Monetary Fund (IMF) and the World Bank, the HIPC initiative represents an important step towards placing debt reduction within a global framework of poverty reduction.[7] It is still too early comprehensively to evaluate the initiative, and in particular its effectiveness in promoting economic and social development in the countries concerned. Only a small group of countries has benefited from the initiative and sufficient information is not available to determine whether there have been substantial changes in their performance and well-being.

However, a review of recent experience shows that concessional aid and debt reduction initiatives are not enough to guarantee better performance. A recent study (Easterly 1999) suggests that the poor performance of these countries is the result of poor economic policies, which instead of being corrected are maintained through debt reduction initiatives. Consequently, a number of questions have emerged about the validity of these types of program and their impact on countries and their economic policies.

This chapter attempts to address some of these questions. First, it explores the relationship between high debt levels and economic and social development. Various studies have looked at the negative impact of debt on growth. In addition, there is evidence that adverse macroeconomic conditions can have a detrimental impact on social variables.[8] It may therefore be assumed that heavy indebtedness could also adversely affect social indicators. However, none of the studies explicitly links these variables. This chapter looks at the impact of high debt levels on development, as measured by economic and social indicators of human development.

The chapter next looks at the impact on human development indicators of the debt reduction initiatives and concessional aid flows received by countries that would currently qualify for the HIPC initiative. This is to help us determine whether these initiatives have helped to improve the indicators and mitigate the adverse impact of the debt.

Lastly, the chapter considers whether the specific characteristics or particular situation of each country, including poor policies as described by Easterly (1999), could explain the differences in human development indicators and neutralize the benefits of debt reduction policies. This consideration is key to the design and successful implementation of this type of initiative.

In sum, section 2 describes the evolution of and relationship between human development and debt indicators in developing countries; section 3 contains an empirical analysis of the relationship between debt and development, and this relationship is explicitly differentiated for those countries that are eligible to benefit from the HIPC initiative. Finally, we present the conclusions of the study.

2. Heavy indebtedness and human development

Recent decades have witnessed not only soaring debt levels among developing countries but also a very pronounced difference between countries whose debt levels rose to unsustainable levels—and that are now eligible for the HIPC initiative—and others that succeeded in improving their payments profile. It would be useful to examine the relationship between debt and economic and social development in these groups of countries.

Table 6.1 summarizes the different variables associated with debt and human development.[9] The current economic and social performance of HIPC countries is clearly much poorer than that of other developing countries.[10] HIPC countries are—by definition—

Table 6.1. The variables associated with debt and human development

Variable	*1970*	*1980*	*1990*	*1997*
Debt/GDP (%)				
HIPC	27.9	62.4	183.4	139.5
Non-HIPC	23.0	34.9	60.6	52.8
IDA+IMF/Debt (%)				
HIPC	15.4	17.8	27.9	33.3
Non-HIPC	11.9	14.1	16.0	12.5
Adult literacy				
HIPC	30.32	39.05	48.68	55.76
Non-HIPC	58.71	66.93	74.14	78.61
GDP (PPP$)				
HIPC	495[a]	716	955	1,107
Non-HIPC	975[a]	1,848	3,029	3,979
Life expectancy				
HIPC	45.15	49.45	52.08	52.47
Non-HIPC	56.59	61.18	65.14	66.80
Human development index				
HIPC	0.27654	0.29364	0.31749	0.33314
Non-HIPC	0.58347	0.63173	0.68455	0.69428

Source: Own calculations based on World Bank (1999) figures.
Notes: PPP = Purchasing Power Parity; IDA = debt to International Development Association, a World Bank agency that provides loans on concessionary terms.
a. In 1980 PPP$.

currently those with heavier debt burdens. Their debt/GDP ratio in the earlier 1990s was 183.4 percent, or three times higher than the average for non-HIPC countries.

However, this was not always the case. In the 1970s, the weight and breakdown of debt in HIPC countries were rather similar to those of other countries. The decades that followed witnessed a significant increase in HIPC debt levels. Most of this increase was multilateral—the proportion of loans from the IMF and the International Development Association (IDA) was practically twice in HIPC countries compared with non-HIPC countries in 1990 and continued rising in the 1990s to nearly three times the amount.

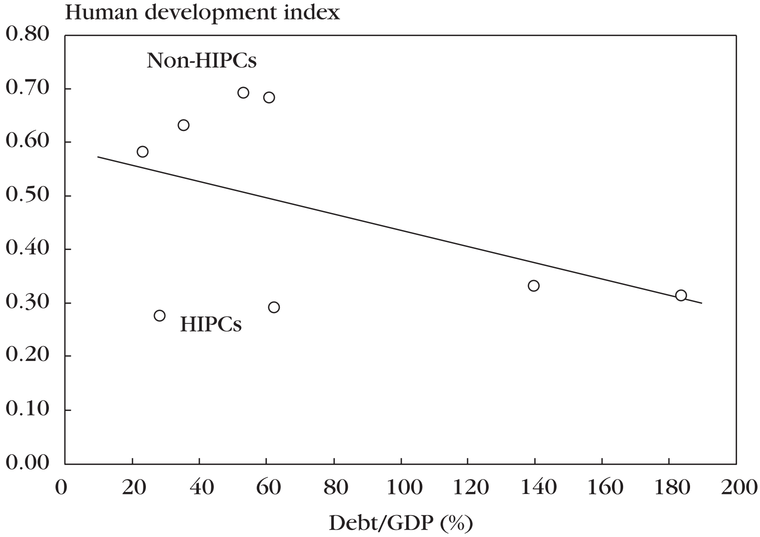
Both groups of countries increased their indebtedness up to the 1990s (though the HIPC countries increased theirs much more rapidly) and reduced it towards the end of the decade. The weight of multilateral debt in the non-HIPC countries was declining by the end of the 1990s, which shows that these countries had access to international capital markets. For the HIPC countries, multilateral debt continues to increase. These two facts, the reduction of the debt together with the increase in multilateral debt in the HIPC countries, reflect the impact of debt reduction and concessional aid programs.[11]

The economic and social indicators of HIPC countries are evidently much worse than those of non-HIPC countries. Per capita income in the less indebted countries (proxied by GDP/capita) was twice as high in the early 1970s, and rose to nearly four times as high by the end of the 1990s. Similar disparities are observed in the indicators for education and health. For a comprehensive analysis of economic and social development, we have developed a human development index that combines economic, educational, and health indicators using the United Nations methodology.[12] Table 6.1 shows that, in countries classified as HIPC, the human development index (HDI) is less than half the index of non-HIPC countries and, despite the relative improvement of the past three decades, the gap has not been narrowing in relative terms.[13]

Is there some relationship between these differences in human development and indebtedness? A simple observation of levels of indebtedness and economic and social development reveals an inverse relationship between these two variables, as Figure 6.1 shows. This would confirm the theory of the negative impact of over-indebtedness on human development. However, the same figure shows how this simple relationship hides other factors. The figure separates HIPC countries from non-HIPC countries, and we can see that the debt appears to have a different impact within each group of countries.

A further question is the impact on human development indicators of the resources acquired from contracting multilateral debt. If we assume that the programs of the multilateral institutions are geared towards development and poverty reduction, then a positive relationship between these variables should be expected. However, a simple correlation provides no evidence of this. The evidence

Figure 6.1. Debt and social development



Note: HIPC = highly indebted poor country.

described in this section suggests that a more in-depth analysis of the impact of such policies is required.

3. The empirical approach

In this section, we present a brief empirical study of the impact of debt on human development. We have carried out an econometric exercise to determine the extent to which various variables of debt can explain the differences in the human development index. The index was designed for developing countries for which comprehensive data were available from 1970 onwards. Three periods were studied: 1970–80, 1980–90, and 1990–7.[14]

The point of departure was a simple function:

$$\Delta L(\mathrm{HDI})_{i,t} = \alpha_0 L(\mathrm{HDI})_{i,t-1} + \alpha_1 \Delta \mathrm{Debt}_{i,t} + \alpha_2 \Delta \mathrm{Multilateral}_{i,t} + \lambda_i + \Sigma_{i,t},$$

where $\Delta L(\text{HDI})_{i,t}$ is the rate of average annual increase in the human development index between the periods $t - 1$ and t. $L(\text{HDI})_{i,t-1}$ is the logarithm of the human development index during the period $t - 1$. $\Delta\text{Debt}_{i,t}$ represents the average annual increase in debt (as a fraction of gross domestic product) in the period between $t - 1$ and t. $\Delta\text{Multilateral}_{i,t}$ represents the average annual increase in multilateral financing (as a fraction of the total external debt) in the period between $t - 1$ and t. Finally, λ_i is a variable that covers the possibility of an individual impact of each country on the behavior of the index in that country.

In addition, the countries selected are those currently eligible for the HIPC initiative. These were separated and studied to determine whether their behavior was different from that of non-HIPC countries when debt relief and concessional aid programs were implemented. To see the impact of these initiatives, the periods prior to the introduction of such programs (1970–80 and 1980–90) were separated from the period during which they were implemented (1990–7).[15] The results are shown in Table 6.2.

The first two columns show a basic regression, where, adding to the value of the human development index at the beginning of the period, debt variables impact further on the index, without introducing any differences between the groups. For each case presented here, estimates were made using random effects and fixed effects models. In general, the statistical tests (Hausmann) always rejected the hypothesis that there are no fixed effects. In other words, regressions with fixed effects are the most appropriate, implying that there are elements specific to each country that explain the behavior of the human development index.

We see how the lag effect of the index is always significant and negative. This accords with various theories of convergence according to which countries that start out at a lower level tend to grow more rapidly and to converge at the levels of the more advanced countries (assuming that other factors remain constant).[16] This effect is consistently maintained in all of our estimates.

One important finding is the negative impact of the debt on the human development index. As can be seen in column 1, the sign of this variable is negative, although it is not determined with a high

Table 6.2. The impact of different variables of debt on the human development index

	(1) Random effects	*(2) Fixed effects*	*(3) Random effects*	*(4) Fixed effects*	*(5) Random effects*	*(6) Fixed effects*
Log(HDI)	−.0102479	−.0330789	−.0105243	−.036994	−.0097783	−.0365545
	(−4.615)*	(−5.020)*	(−4.672)*	(−5.300)*	(−4.334)*	(−4.531)*
Δ% Debt/GDP	−.0242429	−.0175115	−.0343191	−.021340	−.0631792	−.0381269
	(−1.683)***	(−1.215)	(−2.142)**	(−1.290)	(−3.583)*	(−2.000)**
Δ% Multilateral/Debt	.0036883	.0031609	.0045195	.002616	−.0093469	−.0075819
	(0.365)	(0.759)	(0.441)	(0.253)	(−0.883)	(− 0.704)
HIPC[a]			−.0094702	−.0054859	−.0028014	−.0021025
			(−1.895)	(−1.040)	(−.0538)	(−0.384)
HIPC*Δ% Debt/GDP			.0872701	.1485653	.1211017	.1654756
			(1.343)	(2.129)**	(1.905)***	(2.433)**
HIPC*Δ% Multilateral/Debt			.1233794	.2212115	.1399152	.2257534
			(1.078)	(1.845)***	(1.265)	(1.937)***
1980–90					.0033218	.0055081
					(1.489)	(2.455)***
1990–7					−.0081552	−.00229
					(−2.683)*	(−0.657)
No. of observations	189	189	189	189	189	189
N	63	63	63	63	63	63
R^2	.1249	.1813	.1236	.2163	.1891	.2735
p value (regression)	.0000	.0003	.0001	.0000	.0000	.0000
Hausmann	20.01*	–	59.03*	–	30.47*	–
p value (fixed effects)	—	.0000	—	.0000	—	.0000

Notes: t-statistics in parentheses.

*, **, *** significant at 1%, 5%, and 10% respectively.

a. Dummy equals 1 when the country is HIPC and the period is 1990–7.

degree of statistical significance. Moreover, it tends to be less significant once the fixed effects or "country effects" are included, as shown in column 2. On the other hand, no significant relationship was found in these regressions between multilateral debt and the human development index.

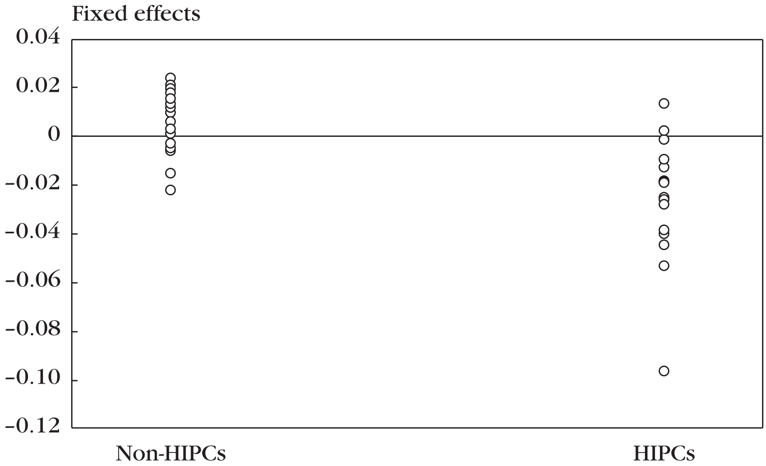
However, as discussed in the previous section, the behavior of HIPC countries is different from that of the other countries. In order to take account of these possible differences, we produced a second set of estimates (columns 3 and 4) in which we introduced a dichotomous variable or dummy that indicates whether the country is HIPC and the period is 1990–7, the period in which this group of countries benefited from debt relief and concessional aid. We then interacted the dummy with debt variables to determine whether the relationship would change. The result indicates that debt has a negative impact that disappears as the "country effects" are introduced. The dummy is not in itself significant in any of the cases. However, its interaction with the debt variables yields a rather positive effect for the debt relief and multilateral assistance granted to HIPC countries, which suggests a positive impact of these programs over the period in question.

The earlier regressions do not factor in the possibility of the temporary shocks that affect all countries in any given period.[17] To control for these possible effects, we prepared a third set of regressions in which we included time dummies. The results show that this approach yields the most accurate results.

As can be seen from columns 5 and 6, debt has a negative impact on the human development index and this persists even when the "country effects" are factored in. The variable that distinguishes HIPC countries is not statistically relevant, thus suggesting that the debt relief programs did not significantly modify the behavior of the human development index. However, when this variable interacts with others, the negative impact of debt on the HIPC countries is reversed. This suggests that the negative impact of debt on human development is mitigated in countries that benefited from debt relief. Multilateral assistance also has a positive impact on this group of countries.

This result indicates that the various debt relief and multilateral assistance initiatives launched in the 1990s had a positive effect,

Figure 6.2. Fixed effects: The impact of country-specific factors



especially in mitigating the negative impact of indebtedness on human development. However, it is important to note that, despite the positive impact of these debt relief programs that this empirical study has identified, the differences in the human development index remained, as described in the preceding section.

In order to explain this apparent paradox, we sought to determine whether there are country-specific elements that may explain these differences. In the estimates, it is possible to isolate the fixed effects in order to analyze the impact of country-specific factors on the index. Figure 6.2 illustrates those fixed effects. The results speak for themselves: HIPC countries tend to have not only a greater negative fixed effect, but also a more dispersed effect.

This is corroborated in Table 6.3. On average, HIPC countries had a negative "country" effect of 2.08 percent in 1990, whereas non-HIPC countries had a fixed positive effect of 1.04 percent. This result is important because it suggests that, notwithstanding the debt relief programs, country-specific elements in each HIPC country are responsible for the persistence of differences in human development. These country-specific elements may be evidence of unsound policies, as Easterly (1999) concludes. Consequently, in

Table 6.3. Country-specific fixed effects on the human development index

	HIPC	*Non-HIPC*
Average	−.0208043	.0104021
Standard deviation	.0251852	.0100374
No. of countries	21	42

order for aid and debt relief programs to have their hoped for impact, efforts would have to be made to reduce these negative impacts. Otherwise, their effectiveness would be limited.

4. Conclusions

The problem of high debt levels and their negative impact on economic and social development has been widely studied in recent years, especially since the debt crisis of the 1980s. Although various debt reduction initiatives and concessional aid programs have been undertaken, doubts exist as to their effectiveness because the performance of the countries that have received aid has not improved significantly.

This chapter has looked at the relationship between indebtedness and human development, as well as at the effectiveness of concessional aid and debt relief programs. It was found that, in general, higher debt levels had a negative impact on the human development index and that debt owed to international development institutions did not have a significant impact on this indicator. However, debt relief and concessional aid programs for countries that are currently eligible for the HIPC initiative have been successful, especially in reversing the adverse impact of heavy indebtedness on human development. In addition, multilateral assistance for this group of countries has had a favorable impact.

Despite the positive results of debt reduction programs, this study has found that the gap in human development has not narrowed between countries that have benefited from these programs and those that have not. One possible interpretation is that there are specific characteristics in each country, including unsound economic policies, that explain the persistence of these differences. It was found that, whereas the fixed effect of non-HIPC countries is positive by 1 percent, the fixed effect of HIPC countries is negative by 2 percent.

This has important implications, since any debt reduction strategy could be inefficient and not have any impact on human development if these country-specific fixed effects are not addressed. The current debt reduction initiatives that the World Bank and the International Monetary Fund have launched (expanded HIPC) should take this reality into account, so that beneficiary countries can take full advantage of these new initiatives.

Methodological appendix

In order to measure social performance in the different countries, we constructed an index based on the Human Development Index developed by the United Nations. This index measures performance in three areas: health, education, and well-being. Each area receives one-third of the weighting.

Health is measured by life expectancy at birth. Education is measured by two variables: adult literacy (carrying two-thirds of the weighting) and school enrollment in the education system (with one-third of the weighting). Lastly, well-being is measured by the logarithm of gross domestic product (GDP), measured in international US$ (i.e. adjusted for Purchasing Power Parity).

In each one of these four areas, we proceed to develop an index for each country, calculated as follows:

$$\text{Index}_{\text{Countryi}} = \frac{\text{Value}_{\text{Countryi}} - \text{Value}_{\text{Lesser}}}{\text{Value}_{\text{Greater}} - \text{Value}_{\text{Lesser}}}$$

The global index is then arrived at by multiplying each individual index by its weighting.

The difference between the United Nations Human Development Index and the index developed here is that it was not possible to obtain the figures for total school enrollment in the education system and, consequently, the adult literacy rate was used.[18] We included 63 developing countries for which comprehensive data from 1970 were available.[19] Of this group of countries, 21 are eligible for the HIPC initiative.[20]

Data on gross domestic product, debt, education, and health were obtained from the World Bank (PNUD 1999). Since 1975 the World Bank has published figures of GDP only in international dollars. Consequently, in order to begin the series from 1970, the growth rates calculated by Summers and Heston (1991) were used.

Notes

1. See, for example, Sachs (1989) and Manzano and Rigobón (2001). For a general description of the literature on this subject, see Agenor and Montiel (1999).
2. See Dooley (1986), Kletzer (1988), as well as Agenor and Montiel (1999).
3. See Agenor and Montiel (1999) for a description of the Brady Plan and its macroeconomic impact.
4. An extensive literature has been generated on this subject following the Asian crisis of 1997. For a collection of works on the subject see Fernandez-Arias and Hausmann (2000).
5. Qualifying for the HIPC are those poor countries that are eligible only for highly concessional aid from the International Development Association (IDA) and the International Monetary Fund's Poverty Reduction and Growth Facility.
6. For a detailed description of the HIPC, see the HIPC web page: http://www.worldbank.org/hipc/.
7. World Bank, HIPC web page: http://www.worldbank.org/hipc/.
8. Behrman, Duryea, and Széky (1999) suggest that household investment in education (i.e. the level of schooling attained) declines when macroeconomic conditions are adverse.
9. World Bank, HIPC web page: http://www.worldbank.org/hipc/.
10. See note 19 for the list of countries surveyed.
11. This phenomenon is observed by Easterly (1999) and led to his study.
12. See PNUD (1999) and the appendix to this chapter.
13. In 1970, the human development index of the HIPC countries represented 47.4 percent of the index of the non-HIPC countries. In 1997, it represented some 48.0 percent.
14. See the methodological appendix for a more detailed description.

15. The World Bank's Special Assistance Program for Low-Income Countries in Africa and the IMF's Enhanced Structural Adjustment Facility (subsequently referred to as the Facility for Growth and Poverty Reduction) were announced in the late 1980s.
16. Barro and Xala-i-Martí (1995).
17. For example, the increase in oil prices in the 1970s and the debt crisis of the 1980s.
18. We also used secondary school enrollment as an estimate of total enrollment in a smaller sample (43 countries) and obtained similar results.
19. Algeria, Argentina, Benin, Botswana, Brazil, Burundi, Cameroon, Central African Republic, Chad, Chile, Colombia, Democratic Republic of Congo, Costa Rica, Côte d'Ivoire, Dominican Republic, Ecuador, Egypt, El Salvador, Fiji, Ghana, Guatemala, Guyana, Haiti, Honduras, India, Indonesia, Jamaica, Kenya, Republic of Korea, Lesotho, Madagascar, Malawi, Malaysia, Mali, Mauritania, Mauritius, Mexico, Morocco, Nepal, Nicaragua, Niger, Nigeria, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Republic of the Congo, Senegal, Sri Lanka, Sudan, Swaziland, Syria, Thailand, Togo, Trinidad & Tobago, Tunisia, Turkey, Uruguay, Venezuela, Zambia, and Zimbabwe.
20. Benin, Burundi, Cameroon, Central African Republic,Chad, Côte d'Ivoire, Ghana, Guyana, Honduras, Kenya, Madagascar, Malawi, Mali, Mauritania, Nicaragua, Niger, Republic of the Congo, Senegal, Sudan, Togo, and Zambia. Not all of these countries have been formally declared eligible for the program, but are candidates. See the HIPC web page: http://www.worldbank.org/hipc.

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7

Intra- and Extraregional Foreign Direct Investment in Latin America

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1. Introduction

This paper analyzes the subject of foreign direct investment (FDI) into Latin American countries. One main task is to demonstrate how important FDI is as a financing source in the region. This is not obvious, since the actual financing provided by FDI depends on company decisions to source their funds, rather than just on the existence of FDI itself. (For example, the acquisition of a local firm by a multinational enterprise [MNE] can be paid through issue of new shares in the MNE, without any cash at all entering the host country.) The analysis also focuses on the growing phenomenon of intra-Latin American foreign direct investment, which is a complement to the FDI coming into the region from the United States and other industrial countries. Although direct investment from one Latin American country to another is still a fairly small part of total FDI in the region (see Table 7.1), it has been growing quite rapidly since about 1990, and it may form an important part of the business activity that is controlled by Latin American interests.

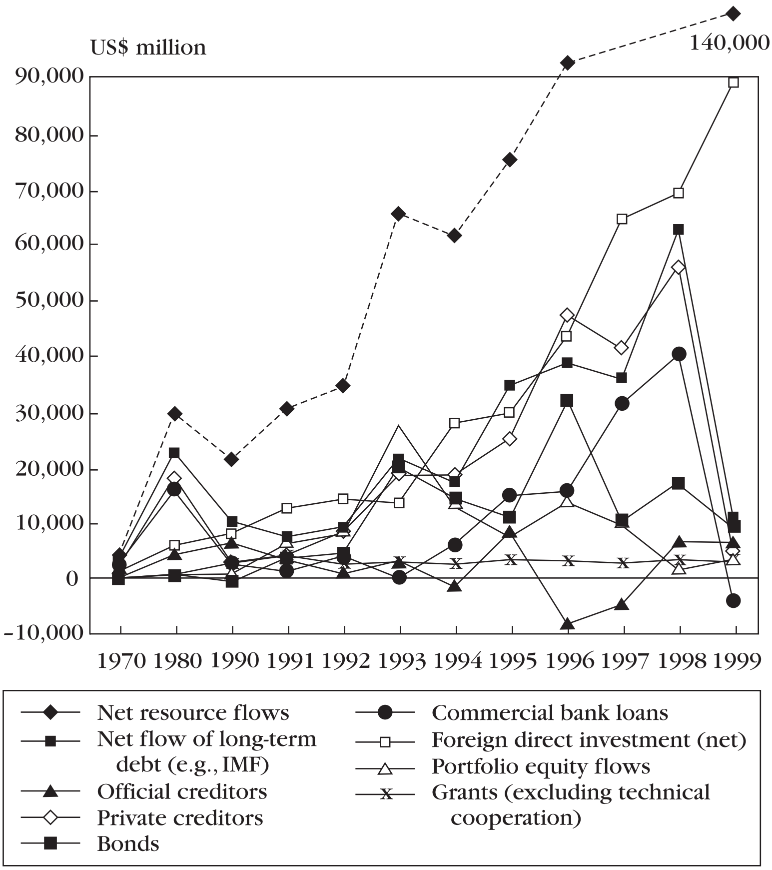
Foreign direct investment in Latin America became the dominant form of foreign finance in the early 1990s, after commercial bank

Table 7.1. Foreign direct investment in Latin America by source and destination country, 1997

	Destination								
Source	*Argentina*	*Bolivia*	*Brazil*	*Chile*	*Colombia*	*Mexico*	*Peru*	*Venezuela*	*Total*
Argentina	–	265	590	180	–	–	–	936	1,979
Bolivia	–	–	–	6	–	–	–	–	6
Brazil	380	–	–	–	–	–	–	115	495
Chile	221	–	1,337	–	1,315	–	139	154	3,166
Colombia	–	–	–	–	–	–	–	7	7
Costa Rica	–	–	–	–	–	–	–	–	2
Mexico	232	–	20	–	–	–	–	1,802	2,222
Peru	–	–	–	–	–	–	–	100	100
Venezuela	118	–	–	9	271	–	–	–	398
Latin America and the Caribbean	*951*	*265*	*1,947*	*195*	*1,586*	–	*139*	*3,293*	*8,376*
European Union	2,006	–	3,429	1,756	1,724	–	–	1,502	10,417
Japan	54	–	1,117	22	13	612	–	34	1,852
United States	1,701	n.a.	7,138	926	746	5,596	241	668	21,539
Total	8,094	731	19,650	5,219	5,703	12,831	1,785	5,536	60,450

Sources: ECLAC database developed by the Unit on Investment and Corporate Strategies, Division of Production, Productivity and Management, on the basis of information from international financial publications, including *América Economía, Expansión, The Wall Street Journal, Estrategia, Diario Financiero, Survey of Current Business,* and *Latin Finance.* Also OECD, *Foreign Direct Investment Statistics, 1999.*

Figure 7.1. Foreign financing in Latin America, 1970–1999



lending dropped off dramatically during the 1980s debt crisis. Figure 7.1 shows the broad categories of foreign financing in Latin America over the past three decades. Note that commercial bank lending was the preferred form of obtaining foreign funding in Latin American countries up to the mid-1980s, when direct investment began to grow importantly. Then in the 1990s, as more and more Latin American firms entered the international capital markets to issue debt and equity, this portfolio investment became a major source of financial inflows that continues today.

Foreign direct investment is quite different from other forms of financial flows, because it implies *control* over the business activity being financed. That is, companies undertake foreign direct investment when they want to establish their own factories, mines, offices, or other business activities in a target country. This is very different from a local firm seeking out foreign funding through bank borrowing or issuing bonds or even equity shares (such as American Depository Receipts, or ADRs). Foreign direct investment thus implies foreign control over the resulting business activity. And this control generally brings with it the transfer of managerial skills and product and/or service technology to the receiving country. Interestingly, however, the *financing* of the FDI may come from local or foreign bank borrowing that may be used to pay for the investment. So, FDI does not necessarily imply new foreign funding when it occurs—although very often that financing is obtained abroad. In sum, foreign direct investment is a business strategy for entering or expanding in a foreign market, and it may or may not involve new financial flows from abroad.[1]

Foreign direct investment takes place for different reasons than more liquid investments such as bank lending or purchase of bonds, which respond to interest rates (or expected rates of return in general), without any concern for managerial control.[2] There are three reasons for FDI to take place:

1. to serve a desirable market through local production or just a local marketing presence by the investing company;
2. to obtain resources such as oil, copper, or coal, or even resources such as technology or other skills that are not available elsewhere;
3. to take advantage of low-cost production that can be used to serve markets elsewhere (also called offshore assembly or *maquila*).

All of these reasons are relevant to the FDI that takes place in Latin American countries, although historically the second and third reasons have been relatively more important in comparison with FDI into industrial countries, where the market-serving reason generally dominates.

2. Historical view of FDI in Latin America

Before focusing specifically on foreign direct investment, consider the broader array of international financial activity in the region over time. In Latin American economies, international business has played a major role since the creation of independent nations. Most of the region broke away from Spain between 1810 and 1825; Brazil gained independence from Portugal in 1822. Indeed, probably the first major type of international business in the region was financing of Latin American governments for the wars of independence during 1810–25. Most of this debt was in the form of bonds issued in the London market—and most of it defaulted during the crash of 1825–6 in Europe[3] (not wholly unlike the situation in the 1980s, except for the form of the debt).

Even before the move to independence, the Latin American colonies of Spain and Portugal were heavily involved in international business in the form of exchange of raw materials, such as gold and silver exported from Latin America, for products from Europe, such as clothing, iron, and manufactured goods. The production of minerals and metals was generally undertaken through Crown-chartered companies, which operated only in the Latin American country in question. Thus, this would technically not be considered as foreign direct investment, since the companies operated only locally in Latin America, and involved investors from Europe but not parent operating companies.

The raw materials and commodities bias still characterizes trade today between these countries and the United States and the European Union. For most of the past two centuries Latin American primary products, especially metals and agricultural products, have been extensively traded in exchange for European and later US manufactures (Bulmer-Thomas 1994). And likewise, foreign direct investment into Latin America has flowed relatively more into these industries rather than into the more technology-intensive manufactures.

This process of highly "dependent development" with respect to trade flows was paralleled by one of more independent interaction between borrowers in the region and lenders in Europe for much of the nineteenth century. Table 7.2 outlines the major long-term

Table 7.2. Long-term capital flows into Latin America in the 1800s

Source and date	*Long-term bond issues*	*Foreign direct investment*
1822–5 United Kingdom	£21 million by London banks for various Latin American governments	More than 40 joint stock companies formed to extract raw materials in the region
1825 France	FF30 million issued by the government of Haiti on the Paris stock exchange (Bourse)	
1826–50 United Kingdom	£18 million by London banks for various Latin American governments	No new joint stock firms founded to operate in Latin America
1851–80 United Kingdom	£130 million by London banks for various Latin American governments	Railways built in several countries, including Peru and Brazil
1870–9 France (annual average)	FF1.5 billion issued by various Latin American governments on Paris Bourse	FF32 million of private sector shares and bonds issued on Paris Bourse
1881–1900 United Kingdom	£105 million net increase in Latin American bond issues on London Stock Exchange	£147 million FDI in railways during 1880–90; other private stock and bond investment rose by £256 million during 1880–1900
1880–1900 France	FF2.1 billion issued by various Latin American governments on Paris Bourse	FF2.3 billion of private sector shares and bonds issued on Paris Bourse

Source: United Nations (1965), pp. 5–12.

capital investments in Latin America during that century. Foreign direct investment began as early as the mid-nineteenth century, with projects in mining and also development of infrastructure such as railways and then telegraph/telephone systems (Wilkins 1970; Miller 1993). However, most of the financing flows were related to bond issues and to bank financing in the nineteenth century.

In the twentieth century Latin America became a major trading partner for the United States, providing natural resources and low-cost assembly of manufactures such as clothing and electronic products (Wilkins 1974). Often, the production of the natural resources, such as oil, copper, bauxite, and bananas, attracted foreign direct investment to build and operate the large-scale mines or plantations that produced competitive outputs for international sales (principally in the United States). Other natural resource exports, such as sugar, coffee, and cocoa, were largely produced by local companies and exported to international markets.

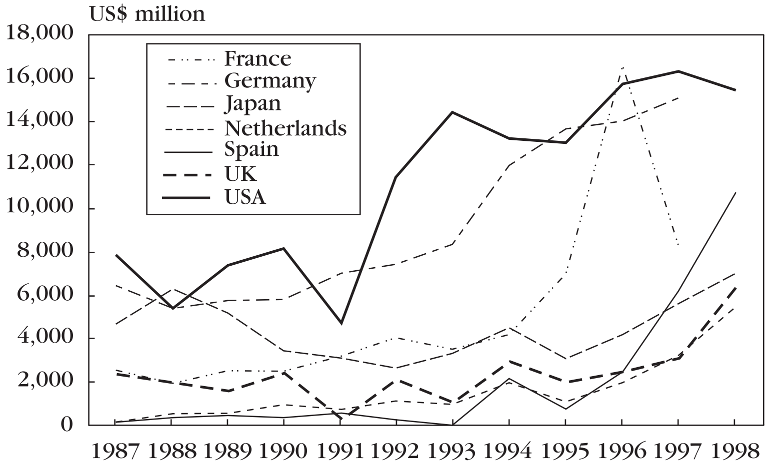
The markets of Latin American countries attracted some limited foreign direct investment to serve local demand, but this was largely attracted to the big three—Argentina, Brazil, and Mexico—until the past three decades. This market-seeking FDI was typically in manufactures that required relatively small capital commitments, such as production of processed foods and some low-tech machinery and electrical goods (Grosse 1989).

There was an interesting shift of FDI, in terms of the value invested, away from natural resources and toward manufacturing in the 1970s, as governments became much more protective of those resources, including nationalizing foreign firms in the oil, copper, bauxite, and other sectors. This wave resulted from the ECLAC-based development strategy of inward-looking industrialization launched in the 1950s by Raul Prebisch (Prebisch 1950) and others.

During the 1980s, in the "lost decade" of the external debt crisis, FDI generally grew slowly in the region, still favoring manufacturing over extractive ventures, although the mining ventures tended to be enormous and often outweighed many smaller manufacturing investments. And this direct investment inflow was positive, in contrast to foreign bank lending, which turned into a net outflow for most of the decade, as banks sought to recoup some of their nonperforming loans to Latin American borrowers.

The wave swung away from manufacturing toward services in the 1990s, as the world economy became dominated by this sector. As part of the broad move to economic opening in the region, a widespread sell-off of state-owned enterprises led to FDI in telecommunications, electric power generation and distribution, and financial services, among others. These infrastructure investments were few in number relative to manufacturing investments, but again enormous

Figure 7.2. Foreign direct investment in Latin America by source country, 1987–1998



in size. The privatization of Telebras into a dozen phone companies in Brazil alone attracted more than US$19 billion of FDI into that country in 1998.

The source countries from which FDI has moved into Latin America have shifted over recent years, with the United States-based companies facing growing competition from European and Asian rivals. The "Spanish re-conquest" of the 1990s was especially notable, with large and numerous acquisitions of telephone companies, of electric power companies, of banks, and of other kinds of firms in several sectors. In terms of home-country size, Spain played a highly disproportionate role in the growth of FDI into Latin America during the 1990s. Figure 7.2 shows the shifting pattern of home-country FDI flows into Latin America over time.

Today Latin America is the fourth-largest region in the world in measures of international business, trailing the United States and Canada, the European Union, and East Asia. In 1999, incoming foreign direct investment was over US$75 billion, while the international trade of Latin American countries amounted to over US$300 billion.

3. Financing sources of FDI in Latin America

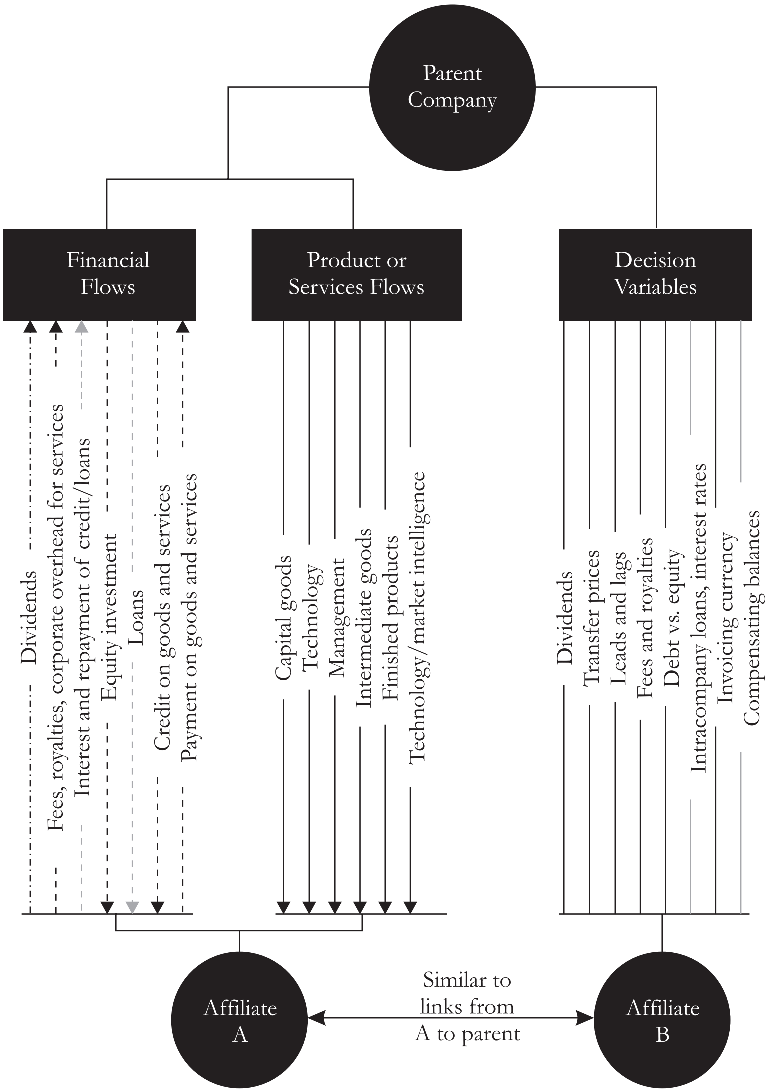
One of the curious aspects of foreign direct investment is its tenuous link with foreign financing. Indeed, if it were not for the many related flows of technology, management skill, exports, and other interactions with the global economy, foreign direct investment would appear to be a poor substitute for bank borrowing or bond issuance as a source of capital. Consider the ways in which foreign direct investment implies financial flows, as shown in Figure 7.3.

The initial funds inflow may be minimal, since the payment for ownership of the FDI project can be made through locally borrowed funds, or new issue of shares in the foreign firm, or many other ways that do not necessarily bring in new foreign capital. However, the related flows are multiple and may be quite large. Typically, FDI leads to additional inflows of products and services from the home country. When the FDI is for offshore assembly or for acquiring a scarce raw material, then it generates substantial exports flows from the host country. Affiliates of foreign parent companies often take loans from the parent, buy technology and business services from the parent, and generally buy and sell intermediate products and services within the multinational corporate network.

FDI really is much more a strategic issue than a financial one. Still, given the impact of FDI on financial flows, it is useful to explore some of these flows empirically. Although data are not available for all investor countries, the largest one (the United States) has produced detailed financial information about FDI activity around the world since 1976. Based on this information as compiled by the US Department of Commerce, we can begin to get an understanding of the financial impacts of foreign direct investment in Latin America.

The US data are disaggregated into sources of funding (intra-company loans; reinvested earnings; equity injections from the parent—the total called "net capital outflows") and distributions of revenues (dividends; interest paid abroad; royalties and fees—added to reinvested earnings this is "net income"). On the funding side, reinvested earnings have been the largest source of increased FDI into the region. Intra-company loans make up a fairly small part of the total,

Figure 7.3. Financial flows related to foreign direct investment



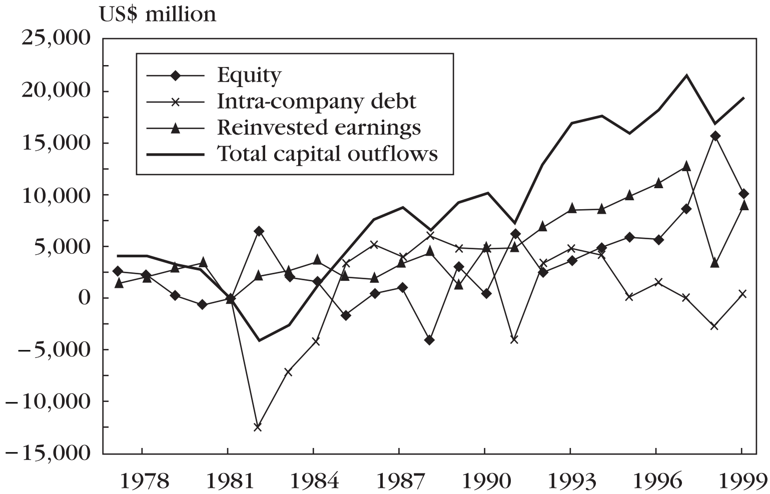
and equity capital injections are fairly variable, sometimes figuring quite importantly in total FDI and at other times declining to low levels. External sources of funding, such as borrowing from banks domestically and/or abroad, constitute a major source of funding. This funding does not appear in the measures of FDI, because it constitutes debt rather than equity.

Unfortunately, it is not possible to subdivide the outside borrowing further, to see where loans were sourced, either in the host country or elsewhere in the world. If bank borrowing were primarily local, then less capital inflow would occur to the host country. If bank borrowing were primarily from international sources, then the financing inflow to the Latin American countries would be higher. It is simply not possible to find this answer with the available secondary data. Discussions with MNE financial managers in Latin America lead to the conclusion that most borrowing by existing foreign investment affiliates is done in the local market. This is logical, because the firms want to approximately balance out their local assets with local liabilities in that same currency, and thus reduce their exchange risk. One added consequence of local borrowing by MNE affiliates is that interest and principal repayments remain in the host country and do not cause funds outflows.

Considering the intra-company financial flows, Figure 7.4 shows the relationship of equity flow, intra-company loans, and reinvested earnings as funding sources for Latin American affiliates of US MNEs. "Capital outflows" is the terminology used to reflect the flows that are considered direct investment from the parent company to the affiliate.

Reinvested earnings almost always top the list of sources of increase in direct investment in the region, though during the late 1980s intra-company debt was the preferred instrument for FDI, and at the end of the 1990s new equity investment was the leading source instrument. Intra-company debt was probably preferred in the mid and late 1980s because it produced a repayment flow of interest and principal that companies wanted to insure despite the weak economic conditions in the region (which sometimes led to government limitations on profit remittances, for example). In the late 1990s new equity jumped dramatically, most likely because of

Figure 7.4. Sources of increases in foreign direct investment in US multinational enterprises in Latin America, 1977–1999



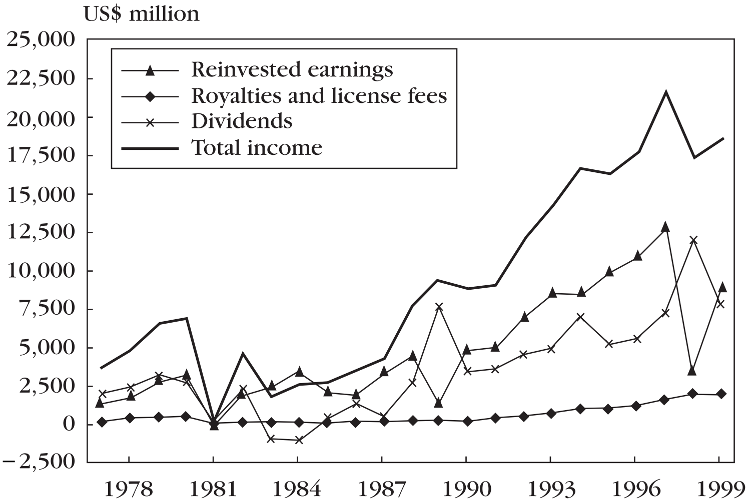
Source: US Department of Commerce website, "U.S. Direct Investment Abroad," www.osec.doc.gov.

Note: "Equity" includes "Intra-company debt" during 1977–81.

the major privatizations in which US companies bought controlling ownership of many formerly state-owned Latin American enterprises, as well as acquisitions of existing Latin American firms that had troubles owing to the "tequila" crisis and its aftermath during 1995–9.

Although not related to direct investment inflows, the uses of earnings by MNE affiliates in Latin America are also a key component of the financial flows related to direct investment there. The activities of MNEs in overseas affiliates produce product and service sales, purchase of inputs to produce these outputs, technology and management skill transfers to operate the affiliates, and finally distribution of the funds generated from these activities. The funds are paid as profit remittances (dividends) to the parent company, as interest payments for intra-company loans, as fees and royalties for services provided by the parent company (such as technology transfer), and as reinvestments in the affiliate. Figure 7.5 depicts these uses of funds by US affiliates in Latin America since the 1970s

Figure 7.5. Uses of earnings by US multinational enterprises in Latin America, 1977–1999



Source: US Department of Commerce website, "U.S. Direct Investment Abroad," www.osec.doc.gov.

(although interest payments are not included, since those data were not provided by the US Commerce Department).

This figure shows that more earnings were reinvested than distributed to the home office in the aggregate for most years since the late 1970s. Dividend payments outstripped reinvested earnings in just a few years (in the late 1970s and in 1989 and 1998), perhaps owing to heightened investor doubts about the economic future of the region in those years. Overall, income tended to be distributed fairly evenly between reinvestment and all other uses during 1977–99.

One should conclude from this reasoning that FDI is *not* a simple financial flow that can be harnessed for autonomous economic development. Rather it is an indicator of a complex web of financial, ownership, trade, technology, and other intangible links between firms operating in one country and related firms in another. De facto in Latin America over the past three decades, most of the earnings of multinational firms' affiliates have remained, reinvested in the host country. The burden of "repaying" the capital that is invested is clearly not as severe as the burden of repaying foreign debt, even when debt may often be renewed (FDI is permanent, with no final maturity date and with no required interest payments). Even this commentary about repayment misses the point that FDI generates continued inflows of knowledge, skills, and other intangibles, as well as often linking the firm to exports and imports to other parts of the world.

4. Focus on Latin American firms' FDI

Although intra-Latin America FDI is much smaller in scale than the FDI entering the region from the United States, Europe, and Japan, it is nevertheless important, and it is growing rapidly in size. This section turns to the phenomenon of cross-border expansion by Latin American firms—that is, intraregional FDI.

Reasons for Latin American firms going international

The most common reason for firms from Latin American countries to go abroad is—just as for firms from the leading industrial countries—to seek foreign markets. This has been the starting point for expansion by such giants as Petrobras, Televisa, Polar, Concha y Toro, and Perez Companq, and also for smaller firms seeking to expand their market horizons.

Another reason for expansion into other Latin American countries is the search for raw materials (for example, oil in the case of YPF's expansion into Bolivia and Ecuador). This strategy is much less common among Latin American firms than among industrial country firms in Latin America. The reasons are multiple, but probably the main one is that overseas raw materials investments in mines, oil wells, and other extractive ventures tend to be quite capital intensive, and this capital is relatively scarce in Latin America in comparison with the industrial countries. Hence, the more active multinational oil companies across borders in Latin America are Exxon

Table 7.3. Latin America's largest 25 multinational enterprises

Rank	*Company*	*Country*	*Sector*	*Sales (US$m.)*
1	Pemex	Mexico	Petroleum/gas	27,267.0
2	PDVSA	Venezuela	Petroleum/gas	27,256.0
3	Petrobras	Brazil	Petroleum/gas	14,903.8
4	Telmex	Mexico	Telecommunications	7,871.7
5	CFE	Mexico	Electricity	7,562.0
6	Eletrobrás	Brazil	Electricity	7,162.6
7	Petrobras Distribuidora	Brazil	Petroleum/gas	6,196.0
8	Cifra	Mexico	Retail Stores	5,178.8
9	Ipiranga	Brazil	Petroleum/gas	4,723.5
10	Exxel Group	Argentina	Holding	4,700.0
11	Odebrecht	Brazil	Holding	4,503.3
12	Cemex	Mexico	Cement	4,298.0
13	Vale do Rio Doce	Brazil	Mining	4,252.5
14	Ecopetrol	Colombia	Petroleum/gas	3,943.6
15	CBD	Brazil	Retail stores	3,626.6
16	Alfa	Mexico	Holding	3,626.2
17	Furnas	Brazil	Electricity	3,607.6
18	Grupo Carso	Mexico	Holding	3,597.3
19	Femsa	Mexico	Beer/soft drinks	3,373.4
20	Varig	Brazil	Airlines	2,997.3
21	Copec	Chile	Petroleum/gas	2,889.5
22	Panamco	Mexico	Beer/soft drinks	2,773.3
23	Ceval	Brazil	Foods	2,746.5
24	Codelco	Chile	Mining	2,730.2
25	Sabritas	Mexico	Foods	2,638.0

and Shell, rather than Pemex and PDVSA. Likewise, the more active copper companies in the region are Phelps Dodge and Rio Tinto, rather than Codelco.[4]

The largest Latin American direct investors tend to be the largest Latin American companies, as in the rest of the world. Table 7.3 lists the 25 largest companies in Latin America, excluding subsidiaries of non-Latin multinational firms such as Shell and General Motors. The companies that dominate this list are similar to the ones that lead the Fortune 500, namely oil and auto companies and other heavy-industry giants. They are not necessarily as active in overseas markets as some smaller manufacturing firms from the region, but they have the most impact in terms of employment, funds flows, and so on.

Indeed, Latin America's largest multinationals can be seen as falling mainly into one of two groups: members of *grupos económicos,* family-based conglomerates that have existed as business leaders in Latin America for many years (such as Grupo Diego Cisneros and Grupo Carso), and state-owned (or formerly state-owned) enterprises, mostly in infrastructure and raw materials (such as Telmex and Petrobras).

Bases of Latin American MNE competitiveness

The Latin American firms that undertake FDI have to contend with the same factors that confront MNEs from other regions, namely entrenched local firms, regulatory barriers, and competition from other MNEs. The main competitive strengths of Latin American firms that enable them to expand successfully through FDI are as follows:

- *Relationships with key customers.* As with MNEs elsewhere, existing customer relationships enable the firm to build sales and maintain market share owing to the "captive" sales to loyal clients. Of course, this varies across industries and situations, but the producers of industrial products and business-to-business products and services are likely to be able to establish these kinds of relationships. In Latin America the relationships tend to be within-country ones, and so the most practical means of expanding across borders has been through acquisition of existing local firms or through joint ventures in which the local firm supplies the local customer relationships.
- *Local distribution channels.* This competitive advantage exists in the home markets of Latin American MNEs, where they establish and then dominate local distribution relative to smaller firms and outside MNEs. As with the previous competitive advantage, when entering foreign markets Latin American MNEs can obtain this same advantage only by acquiring or linking with a local firm that has the channels in place.

- *Relationships with governments.* This is a clear competitive advantage of the state-owned MNEs such as Petrobras and Codelco in their own countries, but it may also be an advantage for private sector firms that have developed close relations with governments (especially for former state-owned firms such as telephone companies, electric power companies, and other utilities). Enersis from Chile prided itself on having a better ability to deal with host governments in negotiations for electric companies being privatized, compared with its US and European rivals in the same bidding contests.
- *Management skill in restrictive, small market economies.* The skills developed from operating successfully in relatively small, restricted national markets should present an advantage to a Latin American firm in comparison with industrial country MNEs that have more experience in more open and larger markets. This advantage has been asserted by Latin American MNEs, though it is not clear that it can sustain competitive attacks from other MNEs with additional competitive advantages.

Although the competitive advantages of Latin American MNEs that help them to establish themselves in foreign markets are important, they should be viewed in light of the competitive advantages possessed by rival firms from industrial countries (particularly proprietary technology, management skills, and financial capital) and by local rivals in host countries (such as relations with the local government, and established customer relations and distribution channels in the host market). It may be more logical that Latin American MNEs would be inclined to link up with local or other foreign partners to obtain those advantages—and this is certainly a major form of cross-border expansion that these firms do utilize. For example, the Chilean electric power company Enersis (since acquired by Spain's Endesa) entered power distribution and generation in Argentina, Peru, Colombia, and Brazil through joint ventures with local partners that had capabilities such as government relations and local distribution channels and with foreign partners that had capital and technology (Grosse and Fuentes 1999).

The weaknesses of Latin American MNEs are seen clearly in the context of the Spanish "re-conquest" of the 1990s, in which a dozen major Spanish firms entered the Latin American markets and bought out smaller local firms, often in capital-intensive businesses such as telecommunications and electric power. Spanish MNEs with greater financial resources entered and purchased leading electric power companies such as Enersis (by Endesa) and Colbun in Chile and Coelbe and COSERN in Brazil (by Iberdrola), telephone companies (mainly by Telefónica de España), the largest private oil company, YPF (by Repsol), and numerous banks (by Santander and by Banco Bilbao-Vizcaya). Another handful of major Spanish companies bought insurance companies (Mapfre), tobacco companies (Tabacalera), and hotels (Melia) throughout the region. The Latin American firms may have been at least as well managed as their Spanish acquirers, but they were unable to put up the same level of financial backing as the larger European firms.

With respect to technology and foreign distribution in industrial countries, Latin American firms have tended to be bought out by larger and more skilled competitors. Despite truly notable exceptions such as Cemex and Televisa from Mexico, which both operate major, successful affiliates in the United States, most Latin American firms do not have their own production presence in industrial countries. And, with very few exceptions, Latin American companies do not lead global competition in high-tech sectors; rather they buy technology from the global leaders. Latin America's leading firms exhibit major weaknesses in these two types of competitive advantage as they move toward the goal of establishing long-term global competitiveness.

Ways in which Latin American firms go abroad with FDI

To benefit from their main competitive advantages, and to avoid putting themselves in weak positions in overseas markets, Latin American MNEs tend to use joint ventures and other alliances as entry vehicles to foreign markets, and to enter sectors that favor the same kinds of advantages that they possess at home. So, for example, the Argentine conglomerate Perez Companq has moved into Chile and Brazil with strategic alliances in the energy sector. Chile's

Grupo Luksic has similarly moved into Argentina and Peru through joint ventures with local partners there.

Chilean firms in sectors that were privatized earlier in that country have moved overseas into other privatization situations and have made successful bids for electric power companies, water services, and even airlines (LanChile). The Argentine privatized oil company YPF, before being bought out by Spain's Repsol, expanded elsewhere in Latin America by bidding successfully for the Bolivian national oil company and for exploration rights in Ecuador, in addition to forming a joint venture with Petrobras in Brazil.

Most South American multinational firms have expanded first into other countries of that region, before widening their horizons to include the United States, Europe, and other industrial markets. Multinational firms from Mexico, in contrast, have often gone first to the neighboring US market before ever looking to expand into Latin America.

Reasons Latin American firms have "gone international" in recent years

It should be noted that intraregional FDI developed rapidly in the 1990s, owing not only to the strategic interests of the firms and the strengths of the investor companies, as noted above, but also to the regulatory conditions in the region, which have improved dramatically since the debt crisis of the 1980s. Government policy throughout Latin America, and especially in Chile, Mexico, Argentina, and Colombia, has been altered to the point where it is almost an unrecognizable reverse of the inward-looking policy framework of the previous 30 years. Table 7.4 sketches a simple overview of this situation, in which both intraregional and outside FDI have boomed in the past decade.

The policy changes are particularly striking in the Andean Pact countries and Mexico, which were most restrictive in the earlier period. The business environment is arguably most changed in Argentina, which moved from extreme interventionism under the military governments up until 1985, and then to almost diametrically contrasting openness beginning under Raul Alfonsin's government and accelerating under the government of Carlos Menem.

Table 7.4. Foreign direct investment regulations in Latin America

Country	*1976*	*1986*	*1996*
Argentina		Approval needed for FDI over US$20 million; utilities and banking generally limited to local firms	No restrictions; national treatment of foreign firms
Brazil		FDI banned in airlines, media, energy, PCs; foreign exchange controls on remittances; joint ventures only in telecoms, banking, and mining	FDI banned in airlines, media, fishing, gasohol; other sectors fairly open
Chile		No restrictions; national treatment of foreign firms	No restrictions; national treatment of foreign firms
Colombia	Ancom Decision 24 rules	Ancom Decision 24 rules	Few restrictions; mostly national treatment of foreign firms
Ecuador	Ancom Decision 24 rules	Ancom Decision 24 rules	Some limits on fishing, airlines, energy, and telecom; other sectors open
Mexico		Majority Mexican ownership required; 40% maximum foreign ownership in some sectors; no foreign ownership of banks, oil, media; no foreign exchange controls	Restrictions on oil, power, and media; elsewhere national treatment of foreign firms
Peru	Ancom Decision 24 rules	Ancom Decision 24 rules	Some border-area limits; otherwise, national treatment of foreign firms
Venezuela	Ancom Decision 24 rules	Ancom Decision 24 rules	Restrictions on oil, media, other natural resources; other sectors open

Source: Economist Intelligence Unit/Business International Corporation, *Business Latin America,* various issues.

Notes: These regulations do not identify an additional major limitation on FDI in the 1970s and 1980s, namely that electric power, telephone services, many airlines and banks, and other utilities were operated by state-owned monopoly enterprises in most of Latin America. With the privatization policies of the 1990s, most of these sectors have been opened up to domestic and foreign private sector investment.

Ancom Decision 24 is the Andean Pact's Foreign Investment Code. It requires fade-out of foreign ownership to a maximum of 49% in 10 years; disallows royalty payments to parent companies; limits intra-firm loans; limits profit remittances to 20% of registered capital.

Lessons for Latin American firms undertaking direct investment abroad

The firms that undertake foreign direct investment from one Latin American country to another should take both positive and negative lessons from this strategy. On the positive side, diversification of business activities brings with it a reduction in the risks associated with economic cycles and other macroeconomic problems that may occur in the home country. Even so, because of the "contamination effects" of regional macroeconomic swings, intra-Latin America FDI does not really escape this problem nearly as well as FDI into other parts of the world.

The diversification benefit is a financial one, whereas the negative side of FDI for Latin American firms is the competitive aspect. Unless Latin American firms can develop and maintain competitive advantages that really do enable them to outcompete rivals, then the FDI strategy will not be sustainable. So, if the firm's main strength is knowledge of competing in small and restrictive markets, this strength is becoming less and less relevant in the more open twenty-first century. And, if the firm's strength is in dealing with the government, this strength is difficult to duplicate in other countries, and it is becoming less viable as governments assign a greater role to the private sector for investment and operating decisions in the economy. The challenge will be to build and maintain competitive advantages that are sustainable, such as customer relationships and dominance of channels of distribution; not to speak of the traditional strengths of industrial country MNEs—technology and marketing skills.[5]

The greatest challenge to Latin American MNEs may very well become the decision on how to insert the firm into the global network of alliances and organizations that are coming to dominate international business. Since virtually no firm, whether based in the United States or in Bolivia, can compete at the global level without a strong network of partners and allies, the threat to Latin American firms is not different from the threat to US firms. But, given their smaller average size, the Latin American firms will have to be more agile in finding sustainable positions in the global competitive environment.

5. Conclusions on the direction and impact of FDI in Latin America

FDI will continue to be a major financing source in Latin America during the decade ahead, along with portfolio investment in stocks and bonds issued by Latin American firms. The precise amount of funding brought into the region from FDI projects depends greatly on the particular project, but overall it appears that FDI provided a large percentage of total financial resources in the region during the past decade.

FDI really should not be viewed as a financial flow but rather as a bundle of technical, managerial, and financial resources that are linked to international companies. The value of FDI to a recipient country is much greater than whatever financial inflow it may directly produce. For example, since Intel's initial US$500 million direct investment in Costa Rica, it has not invested large sums of money on a repeated basis, yet the exports produced by that project now provide more income to Costa Rica than do exports of any of its traditional products such as coffee, bananas, and sugar. Furthermore, the jobs created by the project are not just traditional low-skill jobs, but include high-tech engineering and management positions. In sum, the FDI project is far more than just a capital inflow.

Clearly, these impacts of job creation, technology inflows, product and input trade, and other activities linked to FDI make it appropriate for governments to design policy environments that try to optimize the benefits that may be produced. Indeed, much of the debate since the 1990s about dealing with multinational firms has shifted from an earlier focus on regulation and limitation to FDI promotion and encouragement of more extensive and more linked activities in host countries (Wint and Wells 2000). The goal is to channel FDI and foreign firm activity in general to those areas that produce the most benefits for the host country.

The problems associated with FDI fall largely in the realm of international relations, in that the governments of Latin American countries must deal with international companies whose ultimate decisionmakers reside elsewhere. And the extensive linkages of these firms to the rest of the global economy tie Latin American countries more tightly to that environment, subject to the financial volatility that the global economy has been producing since the mid 1990s.

Notes

1. Without going into minute details, FDI may readily be paid by having the foreign investor take out bank loans locally in the host country, so that ownership shares of the venture go to the foreign company and financing comes from the local financial market. More typically, this funding is found outside of the host country, but not necessarily through any issue of new equity in the capital markets. It may come from the parent firm's retained earnings or from bank borrowing abroad. Increases in foreign direct investment typically come predominantly from reinvested earnings of the affiliate.
2. This is a huge distinction. As just one example, consider a direct investment project in an emerging market to assemble clothing or electronics products for sale in industrial countries. The FDI will respond not to local interest rates or cost of capital, but rather to the ability of the firm to minimize production costs in that location, with funding typically from abroad and markets served abroad as well. This example just serves to emphasize the major difference in motivations for direct investors versus portfolio investors and foreign lenders.
3. This situation is described in Marichal (1989), pp. 12–67.
4. Recently, however, Grupo Mexico beat out Phelps Dodge in a bid to acquire Asarco, making Grupo Mexico now the world's third-largest copper producer behind Codelco and Phelps Dodge.
5. It is not likely that Latin American MNEs will become leaders in developing new technology or marketing skills overnight, so their most logical strategies will be to build the other kinds of competitive advantages, and to ally themselves with foreign MNEs when the technology or marketing capabilities are necessary for success.

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8

Financing for Development in Latin America: A View from the Private Sector

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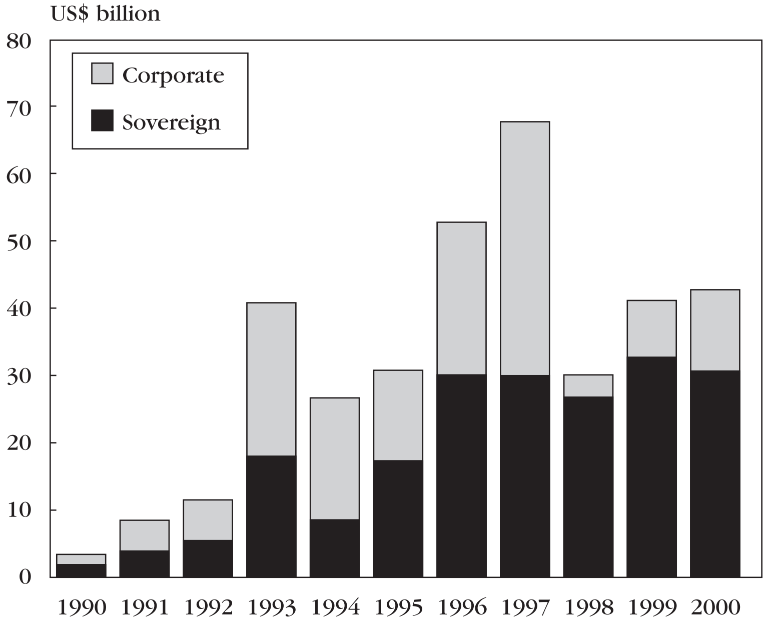
1. Recent developments in bond financing in emerging markets

The increasing importance of bond financing to emerging markets

In spite of volatile macroeconomic and external financial conditions, private debt flows have continued, providing substantial positive net financing to emerging countries, albeit with short interruptions, in the past decade. As countries have increasingly turned to the markets, bond issuance has become a regular source of financing for emerging countries. In fact, net external bond issues increased 13-fold between 1990 and 1999. Net external bond financing accounted for about one-fifth of net private external financing for emerging countries, including foreign direct investment (FDI), in the 1995–9 period.

Emerging markets' net external bond issues reached US$42 billion in 1999, from US$3 billion in 1990, with a noticeable increase starting in 1993 as corporate bond issuance in Latin America and Asia picked up (see Figure 8.1). However, net external bond financing to emerging markets is still 30 percent below the peak recorded in 1996–7. In fact, net capital inflows to emerging economies are still about 40 percent below the peak recorded in 1996–7.

Figure 8.1. Net bond financing to sovereigns and corporates in emerging markets, 1990–2000



Source: Goldman, Sachs & Co.
Note: Data for 2000 as of September.

Why capital flows will not recover to 1996–7 levels

The confluence of uniquely favorable conditions brought about a surge in net capital inflows to emerging markets in 1996–7. Without a doubt, far-reaching stabilization efforts and structural reforms and the completion of commercial bank debt restructuring agreements favored a spectacular boom in net capital inflows to emerging economies to a peak of US$360 billion in 1996–7 from US$160 billion in 1991–2 (Table 8.1). Since then, net capital inflows shrank to US$170 billion in 1999, recovering to US$225 billion in 2000. Despite this recent recovery, there are three reasons we believe that net capital inflows will not recover to the record levels of 1996–7.

Table 8.1. Net capital flows to emerging markets, 1992–2001 (US$ billion)

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000f*	*2001f*
Current account balance	−79.3	−119.5	−74.2	−93.3	−94.7	−62.9	−55.9	22.7	65.5	−3.3
Capital account balance	137.3	182.2	142.1	210.8	205.3	125.8	88.2	41.3	31.7	111.4
Net flows from non-residents	*163.4*	*228.4*	*259.5*	*259.8*	*369.8*	*345.6*	*229.7*	*168.3*	*225.4*	*236.2*
Private	138.4	179.7	254.7	244.1	367.8	292.9	174.4	155.3	205.5	226.3
Equity investment	98.4	134.7	186.0	137.2	199.1	167.2	166.1	172.4	179.5	173.5
Debt-creating flows	40.0	45.0	68.7	106.9	168.7	125.7	8.3	−17.1	26.0	52.8
Bond financing	11.3	40.9	26.9	30.8	53.2	67.7	30.3	41.5	42.2	45.0
Official	25.0	48.7	4.8	15.7	2.0	52.7	55.3	13.0	19.9	9.9
Net flows by residents	*−26.1*	*−46.2*	*−117.4*	*−49.0*	*−164.5*	*−219.8*	*−141.5*	*−127.0*	*−193.7*	*−124.8*
Change in reserves	58.0	62.7	67.9	117.5	110.6	62.9	32.3	64.0	97.2	108.1
Memorandum items										
Net bond financing										
% of net flows	6.9	17.9	10.4	11.9	14.4	19.6	13.2	24.6	18.7	19.1
% of net private flows	8.1	22.8	10.5	12.6	14.5	23.1	17.4	26.7	20.5	19.9

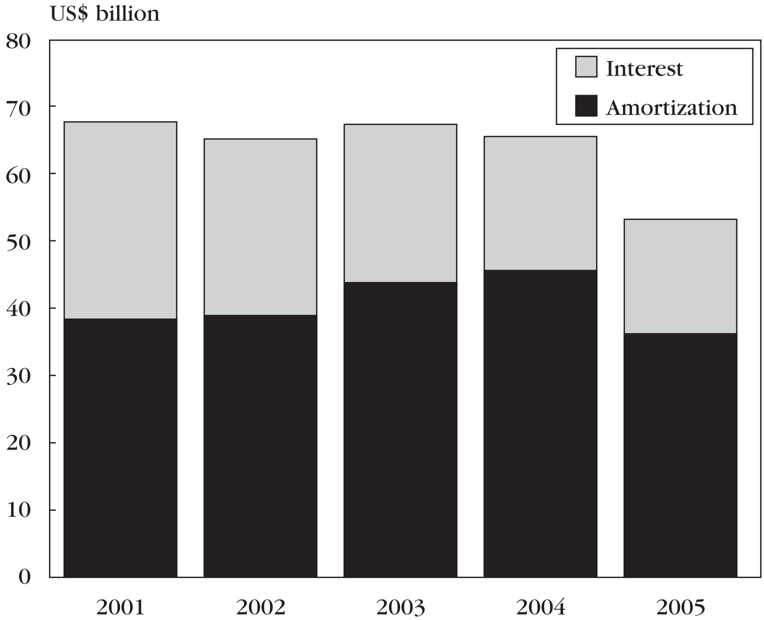
Sources: International Monetary Fund, Institute of International Finance, and Goldman Sachs estimates and projections.
Notes: Figures for 2000 and 2001 are forecasts. Net flows by residents corresponds mainly to accumulation of assets abroad by residents; includes errors and omissions.

1. Since 1995, the current account deficit in the United States increased four-fold to about US$430 billion in 2000. Given that capital flows are governed by risk and return considerations and that both have been generally better in the United States than elsewhere, it follows that the United States has crowded out higher risk financing to emerging markets. Even if lower growth rates reduce the current account deficit in the United States, we believe that such funds are more likely to return to "Euroland" instead of going to emerging markets.

2. Over the past two years or so, the three largest central banks (the Federal Reserve, the European Central Bank, and the Bank of Japan) have tightened monetary policy. For example, during this period the Fed raised Fed funds rates 200 basis points (bp). Such a reversal in the stance in monetary policy has had two strong and detrimental effects on emerging market financing. The first effect is that commercial banks accelerated net repayments of some US$100 billion in loans in 1998–9, following a cumulative increase in net exposure of US$235 billion in 1995–7. Unless monetary policy is eased substantially in the next two years, we do not expect bank lending to increase beyond a small increase in trade financing in tandem with growth rates in global trade volumes. The second effect is that the credit crunch and subsequent losses in emerging and developed credit markets alike significantly reduced the number of leveraged players in emerging markets, including hedge funds and proprietary desks. This significantly reduces market liquidity and the number of eligible investors for new emerging market bond issues.

3. Overall, investors' perception of risk in emerging markets (and most acutely in Latin America) has increased since the Asian crisis. We attribute this to four reasons. First, investors learned the hard way that, at times, countries do and will continue to default on their external debt obligations. Second, the development of a new international financial architecture and its demands on foreign creditors have added an unwelcome element of regulatory uncertainty. Markets price risk well, but they cannot price regulatory uncertainty. Third, even after sizable adjustments and a massive oil windfall, the gross external financing requirements of Latin America remain a staggering US$210 billion (11.7 percent of regional GDP). Put dif-

Figure 8.2. Scheduled debt service of emerging markets' bonded debt, 2001–2005



Source: Goldman, Sachs & Co.
Note: Stocks as of end-September 2000.

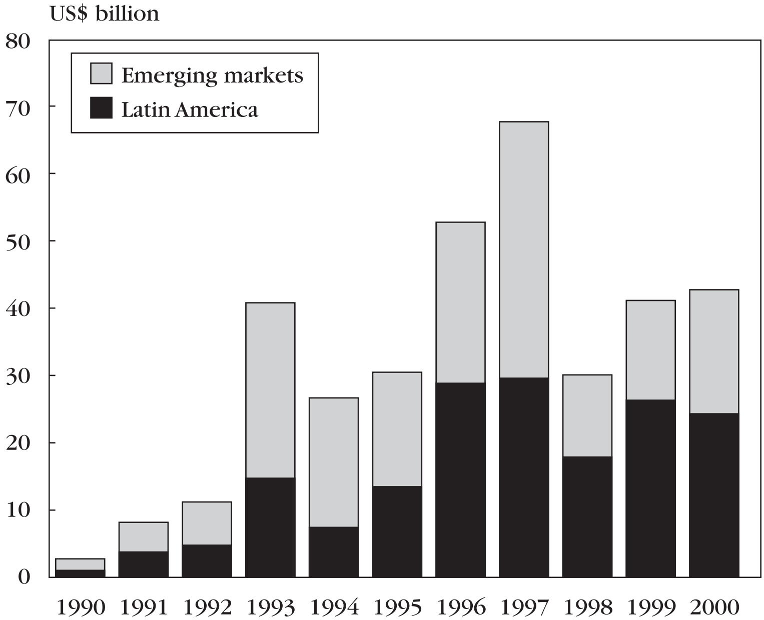
ferently, the scheduled external debt service payments of Latin America for 2001 were more than twice the region's total exports of goods and services, thus making the region particularly vulnerable to a credit event in case of a sharp deterioration in terms of trade (i.e. a drop in commodity prices) and/or capital inflows. Fourth, we believe that political risk in Latin America has increased substantially, being acute in some countries and mild in others.

For these reasons, net capital inflows to emerging markets likely will stabilize at about US$240 billion a year in the 2001–5 period, well below the US$360 billion peak in 1996–7. This increase will be primarily fueled by a recovery in debt-creating flows, because the expansion of global trade should rebuild the stock of trade debt outstanding. Net bond financing will likely stabilize at about US$45 billion a year in 2001–5, thus covering about 20 percent of emerging markets' financing needs in the medium term. Furthermore, gross bond financing is likely to stabilize at about US$85 billion a year, reflecting higher gross bonded debt issues intended partially to roll over higher scheduled debt service of bonded debt (Figure 8.2).

Latin America attracts most of the bond financing to emerging countries . . .

Latin America is the region that has taken the most advantage of the renewed access to private international capital markets since the early 1990s, attracting about one-half of net bond financing to emerging markets in the 1995–9 period (see Figure 8.3). Furthermore, net

Figure 8.3. Net bond financing to Latin America and emerging markets, 1990–2000



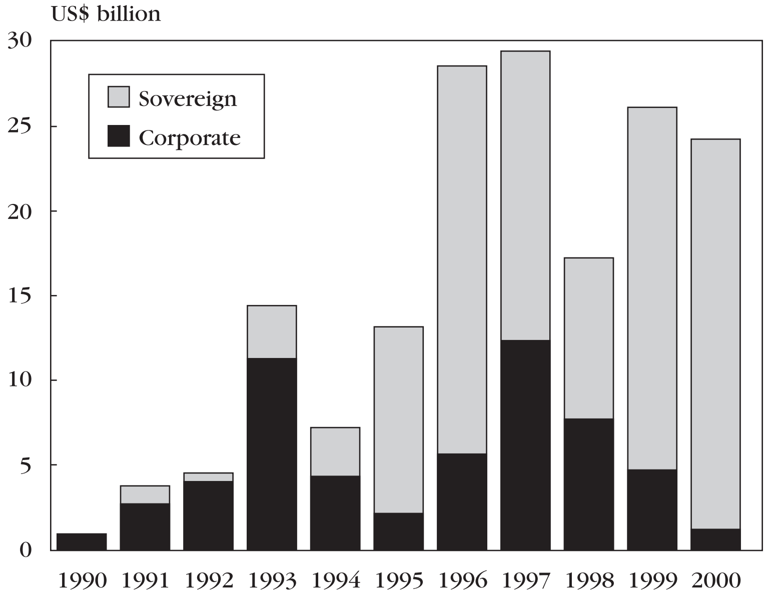
Source: Goldman, Sachs & Co.
Note: Data for 2000 as of September.

Table 8.2. Net capital flows to Latin America, 1992–2001 (US$ billion)

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000f*	*2001f*
Current account balance	–34.8	–46.1	–52.2	–37.1	–38.9	–65.1	–89.5	–56.3	–58.7	–66.5
Capital account balance	57.7	66.8	47.9	60.5	68.3	79.2	70.6	46.0	68.3	76.0
Net flows from non-residents	*68.1*	*81.7*	*64.6*	*84.3*	*92.2*	*117.3*	*115.8*	*81.1*	*97.0*	*92.9*
Private	65.6	50.1	56.2	67.6	81.2	108.8	99.9	67.8	78.3	82.1
Equity investment	19.6	34.4	38.2	32.0	51.1	62.6	51.4	65.7	55.9	55.1
Debt-creating flows	46.0	15.7	18.0	35.6	30.1	46.2	48.5	2.1	22.4	27.0
Bond financing	4.5	14.6	7.2	13.2	28.5	29.6	17.4	26.2	25.6	27.0
Official	2.4	31.5	8.4	16.7	11.0	8.5	15.9	13.3	18.7	10.8
Net flows by residents	*10.4*	*–14.9*	*–16.7*	*–23.8*	*–23.9*	*–38.1*	*–45.2*	*–35.1*	*–28.7*	*–16.9*
Change in reserves	22.9	20.7	–4.3	23.4	29.4	14.1	–18.9	–10.3	9.6	9.5
Memorandum items										
Net bond financing										
% of net capital flows	6.7	17.9	11.1	15.6	31.0	25.2	15.0	32.2	26.4	29.1
% of net private flows	6.9	29.2	12.8	19.5	35.1	27.2	17.4	38.6	32.7	32.9

Sources: International Monetary Fund, Institute of International Finance, and Goldman Sachs estimates and projections.
Notes: Figures for 2000 and 2001 are forecasts. Net flows by residents corresponds mainly to accumulation of assets abroad by residents; includes errors and omissions.

Figure 8.4. Net bond financing to sovereigns and corporates in Latin America, 1990–2000



Source: Goldman, Sachs & Co.
Note: Data for 2000 as of September.

bond financing has become the region's most important source of external financing after net FDI. In 1999, net bond financing represented about 38.6 percent of total net private capital inflows to Latin America, from 19.5 percent in 1995 and 6.9 percent in 1992 (Table 8.2). Net bond financing is expected to total US$26 billion in 2000, or 32.7 percent of total private sector financing to Latin America (Figure 8.4).

It is worth noting that the volume of net capital inflows in Latin America remains highly concentrated in Brazil, Mexico, and Argentina. Although Brazil, Mexico, and Argentina account for about 80 percent of Latin America's nominal GDP, the "big three" absorbed 90 percent of net capital inflows to Latin America in 1999, up from 73 percent in 1996. Furthermore, they absorbed 86 percent of FDI to the region in 1999, up from 67 percent in 1996.

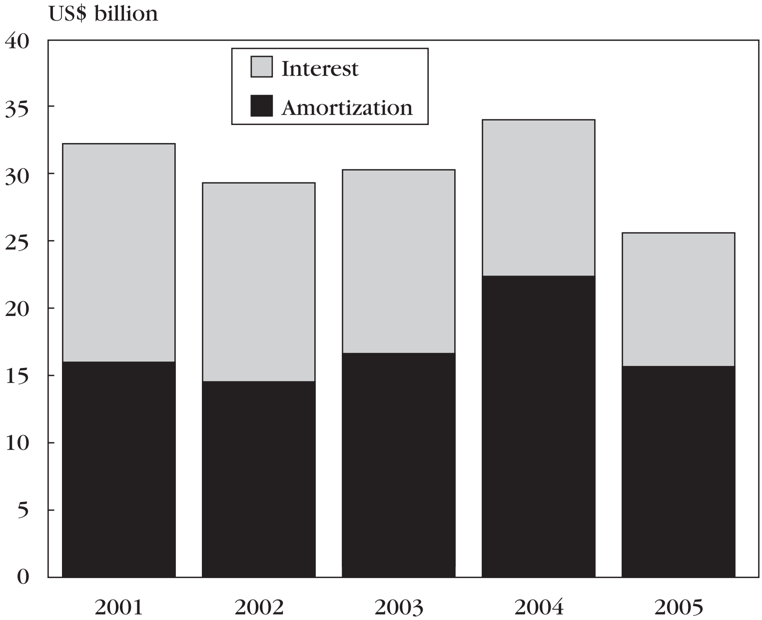
Net bond financing has followed a similar pattern. Brazil, Mexico, and Argentina's share of gross bond financing to Latin America remained at about 88 percent in the 1995–9 period. Of the smaller countries in Latin America, Colombia, Panama, Uruguay, and Venezuela have had permanent access to international bond markets in the past few years. Chilean private sector companies have been much more active than the sovereigns recently. In contrast, the public sectors in Colombia and Panama have increasingly financed their fiscal deficits through net bond issuance, more recently taking advantage of a growing euro market (Colombia). Venezuela has not issued new bonds in the US dollar market since 1997, having tapped the euro market instead. Ecuador and Peru's access to bond financing has been limited in the past few years, although for different reasons. Peru has chosen not to tap bond markets, instead relying on multilateral financing. Ecuador's access to international bond markets was limited by deteriorating macroeconomic conditions and default in September 1999.

. . . but mostly for the wrong reasons

Better fundamentals are in part responsible for higher net capital inflows to Latin America. However, low savings ratios and large external debt service payments are structural reasons for large external financing needs for Latin America. In addition, the average bond maturities in Latin America will rise to US$20 billion a year in 2001–5. If we add the coupon payments, total bond debt service payments will increase to an average of US$30 billion in 2001–5 (Figure 8.5).

Another structural reason for large financing needs is that, being primarily a commodity-exporting region, at times Latin America will need higher external financing to accommodate transitory drops in terms of trade when commodity prices fall. By contrast, non-Japan Asia will continue to be a net exporter of capital, as its current account deficit will amount to US$57.4 billion in 2001. In addition, Asian external debt service payments will remain lower in absolute and relative terms (with the region's external debt service ratio to exports of goods and services remaining below 100 percent).

Figure 8.5. Scheduled debt service of Latin American bonded debt, 2001–2005



Source: Goldman, Sachs & Co.
Note: Stocks as of end-September 2000.

For these reasons, Latin America should continue to be one of the most active regions for bond financing in years to come. Net bonded debt flows should stabilize at about US$30 billion a year in the 2002–5 period, maintaining their share of about one-third of net private financing to the region. Keeping net bond financing at about US$30 billion will necessarily require larger gross bond issues to keep up with a steeper debt service schedule.

2. Recent developments in the structure of emerging debt markets (EDM)

The EDM investor base is changing . . .

High volatility in EDM has often sparked discussions about the sustainability of private debt financing in the medium term and on the viability of the EDM as an asset class to which investors should allocate any share of their fund on a consistent basis. After experiencing large losses from the crisis in Russia, the participation of hedge funds and proprietary desks in EDM has diminished substantially. Lower participation of leveraged players in EDM has resulted in lower volatility but also in lower liquidity in the market. However, dedicated funds, which in general have a longer-term investment strategy, have maintained their participation in EDM.

Non-dedicated (crossover) investors have usually taken an opportunistic view of the EDM asset class, often liquidating their positions when a crisis arose. However, crossover investors have recently started increasing their participation in EDM quite substantially on a more consistent basis as opposed to a purely opportunistic one, particularly on the primary issuance front. The increasing importance of Global Benchmark Indices as a tool for diversifying risk across different asset classes partially explains such behavior. The introduction of the Lehman Universal Index broadens the universe of investment opportunities for US fund managers to include bonds not registered in the United States and denominated in different currencies. It also includes non-investment-grade dollar-denominated bonds, including Brady and other bonds issued by emerging markets.

At 4 percent, the weight of emerging market debt in the Lehman Universal (which includes bonds worth US$6.4 trillion) is much higher than the 0.7 percent in the more commonly used Lehman Aggregate Index (US$5.4 trillion). The EDM investor base in the United States will broaden as fund managers migrate toward the Universal Index. Furthermore, once the use of the Universal Index is fully established, volatility in EDM likely will drop further because fund managers will tend to remain invested in EDM (market-weighting or under-weighting the index), rather than fully liquidating their positions in the event of a crisis.

The EDM investor base has also been broadened as emerging economies have substantially increased their euro- and yen-denominated bond issues. Euro-denominated bond issues have increased to about one-third of total issues since the euro was introduced in early 1999, opening up a market with large potential for emerging market issuers and helping reduce the existing pressure on the US dollar-denominated segment. Euro-denominated bond issues have found demand from institutional and retail accounts across Europe, and from investment funds that follow global benchmark indices in the United States.

. . . and so is the financial architecture for international financial markets

The EDM landscape is also being shaped by recent efforts to redefine the role of the private sector in the architecture of international financial markets. Private sector bailing-in and burden-sharing policies pushed by official creditors and international financial institutions (IFIs) and a further reshaping of the lending practices of the International Monetary Fund (IMF) should have a lasting impact on the market.

Besides increased disclosure and transparency in country risk assessments, the IMF revamped the Contingent Credit Line (CCL) to be its main lending vehicle to cope with future capital account crises in emerging markets. The IMF is also studying whether to lower commitment fees and rates of charges applicable to CCL resources to encourage eligible countries to shift their preference toward the CCL and away from the existing Supplemental Reserve Facility.

Meanwhile, the Fund is modifying the terms and conditions under which other facilities will be used in the future, to discourage countries from requesting new programs for the sole purpose of rolling over obligations to the Fund. The Fund plans to allow countries implementing sound macroeconomic policies, but that are vulnerable to financial contagion, to be entrusted with a greater degree of automaticity for drawing on the CCL with less stringent consultation requirements. This will ensure that withdrawals could be made quickly without sending negative signals to financial markets, thus avoiding a deterioration in the very same confidence that the CCL aims to restore.

Constructive engagement, voluntary approaches, and standstills rule EDM

The changes to IMF lending practices will have important consequences for private investors. Specifically, while the Fund is moving toward segregating its resources to deal with occasional but large financial crises, it will also seek a much larger private sector involvement (PSI) in the resolution of financial crises. Unlike recent packages that offered sufficiently large resources to bail out bondholders (Mexico, Thailand, South Korea, and Brazil), PSI relies as much as possible on market-oriented solutions and voluntary approaches, including comprehensive debt restructuring of private debt to provide adequately financed programs and a viable medium-term payments profile. This includes the possibility that, in certain extreme cases, a temporary payments suspension or standstill may be unavoidable. Furthermore, the IMF will continue providing financial support to a member's adjustment program despite arrears to private creditors. The resolution of bonded debt defaults in Ukraine, Russia, and Ecuador, without the intervention of the IFIs, reflects this new feature in the market.

Implications of the new architectural practices for EDM

Multilateral institutions and officials of the Group of Seven (G7) countries should strive to limit as much as possible the regulatory uncertainty resulting from the current adaptive and, to some extent, discretionary rules of the game for dealing with financial crises in emerging markets. Although information has been made available by the official sector, the fact is that the rules of the game are still unclear for investors, and a firmer framework for crisis resolution and greater consultation with financial markets could drastically reduce regulatory uncertainty and, ultimately, EDM spreads. In this context, we believe that the recent involvement of the IMF in Argentina and Turkey has further moved the framework toward discretion rather than rules.

Lower regulatory uncertainty likely will encourage investors to focus even more on the intrinsic credit quality and policies of the sovereign. It will also help reveal the underlying sovereign risk profile of emerging markets, bringing valuations closer in line with the fundamental macroeconomic policies affecting the credit's intrinsic capacity to pay. These policies will also discourage investors from taking long debt positions on the expectations of a rally upon the announcement of a bailout package to rescue a country in distress.

From the authorities' perspective, we believe that a true and legitimate strengthening of IMF surveillance practices will reduce the scope for crises resulting from bad policies. This is particularly true if financial vulnerability and liability management indicators support surveillance. The restraining effect of these procedures will be stronger the more financial markets add these metrics to their own credit toolbox, and the less politicized and objective policy assessments by the IMF executive board become. It is positive that the Fund will discourage prolonged users from having chronic IMF programs for the sole purpose of rolling over their financial obligations to multilateral institutions. This will force policymakers to implement more quickly the stabilization measures and structural reforms needed to restore fiscal and external solvency.

Another consequence of new architectural designs will be potentially to segment emerging market credits. This is because the new policies will dramatically raise the bar and create incentives for countries to pursue stronger macroeconomic policies, particularly in those cases where transitory shocks worsen liquidity but not solvency positions. Stronger policies will be rewarded with better fundamentals and privileged membership to the CCL "club," both factors contributing to easier market access at lower spreads. By contrast, those with deeper structural problems or weaker governance will likely have less, and more expensive, market access.

3. Sovereign risk in EDM

GS-ESS: A long-term valuation model for EDM

The number and value of bonds issued by emerging markets have surged dramatically over the course of the previous decade. So much so, bonds are now one of the fastest-growing sources of external development financing, being second only to FDI. In addition, their terms have improved owing to increased investor participation in emerging market securities, as well as better long-term economic prospects in a number of countries. However, emerging market sovereign spreads have also undergone marked turbulence, in light of the plethora of financial crises experienced by the emerging countries since the Mexican crisis in 1994–5. These large movements have created attractive opportunities over time, both for buyers as well as for sellers of emerging market bonds, where price movements do not often reflect changes in the countries' ability to pay.

We have developed a model for long-run equilibrium sovereign spreads in emerging market economies: the **G**oldman **S**achs **E**quilibrium **S**overeign **S**pread (GS-ESS). GS-ESS develops a systematic guide to valuing emerging market sovereign spreads over the long run, which captures the impact of macroeconomic fundamentals on the sovereign's ability to pay.[1]

A fundamental model of sovereign risk

Most theoretical models of equilibrium bond spreads start from some specification of the determinants of the probability of default, and tie the probability of default to a spread. In general, the probability of default is modeled as a function of macroeconomic fundamentals. Assuming a risk-neutral lender, spreads could be determined by the following relation:

$$\log \mathbf{SPREAD}_t = \alpha + \beta_i \mathbf{X}_i + \varepsilon_t,$$

where $\alpha = \log(1 + \mathbf{i}^*)$ and $\mathbf{i}^*$ is the risk-free world interest rate, the $\mathbf{X}_i$s are the fundamental determinants of the probability of default, the βs are the corresponding coefficients, and ε_t is an independently distributed random error term. Many variables have been suggested by theoretical studies as potential members in the set of X_is. A simple model of an indebted small open economy suggests that variables reflecting the economy's ability to generate foreign exchange (the external transfer problem) and the government's ability to generate enough domestic resources to purchase the foreign exchange required for servicing its external obligations (the internal transfer problem) should be considered. Economy-wide and public sector flow and present-value budget constraints provide a natural set of variables indicative of the solvency and liquidity of the sovereign.

Results: Guidance for fundamental valuation

GS-ESS uses panel techniques to estimate the long-run fair value for bond spreads. The panel comprises 17 emerging countries, 7 from Latin America, 3 from Eastern Europe, 2 from Africa and the Middle East, and 5 from Asia. The coefficient estimates that we obtain from regressions conducted using panels provide us with an average set of long-run coefficient driving spreads for all the countries. We then apply this same set of long-run coefficients to the different country fundamentals and arrive at the country-specific estimates of the long-run equilibrium spreads.

Table 8.3 presents the results from the panel regression and the pooled mean group (PMG) long-run elasticities.[2] The estimated coefficients correspond to the long-run panel model. All coefficients are associated with theoretically expected signs, suggesting that the explanatory variables all work to influence emerging market spreads over the long run as we think they should. In addition, all variables are statistically significant at the 5 percent level or higher, with the exception of LIBOR, which is significant at the 7 percent level. Even though this variable is not significant at conventional levels, we refrain from excluding it on the grounds of economic theory.

In the last column of this table, we provide an estimate of how spreads would change given a 1 percent increase in each of the explanatory variables. For example, if long-run real GDP growth were to increase by 1 percent, assuming all else is constant, this would reduce the long-run equilibrium spread by about 7 basis points (bp). On the other hand, the marginal impact of a 100 bp

Table 8.3. Long-run model estimates

Variable	*Coefficient*	*Asymptotic t-statistic*	*Impact on spreads from 1% increase in explanatory variables (in basis points)*
Intercept	−439.3	−2.7	
Long-run real GDP growth	−691.3	−5.1	−7
Total amortization/reserves ratio	162.1	8.3	2
Total external debt/GDP ratio	7.5	10.1	7
Nominal budget balance	−34.2	−2.0	−34
Total NFGS exports/GDP ratio	−2.57	−5.8	−3
Foreign exchange real misalignment	210.4	2.2	2
Long-run LIBOR	45.3	1.7	45
Debt restructure dummy	165.0	5.0	165.1[a]

		Significant	*Conclusion*
R-bar squared	.55		
F-statistic	58.019	1%	Explanatory variables jointly significant
Breusch–Pagan LM	2.21	No	Residuals are not cross-correlated

Source: Goldman Sachs estimates.
Notes: Asymptotic *t*-statistics are based on robust standard errors. Long-run real GDP growth refers to trend growth. NFGS refers to exports of non-factor goods and services. This ratio is corrected by transforming exports values by the long-run real exchange rate as measured by GSDEEMER. The Breusch–Pagan LM test is a test for cross-sectional correlation of residuals, distributed chi-square with 1 degree of freedom.
a. If country restructures.

increase in LIBOR is an increase in spreads of about 45 bp.[3] If the benchmark bond used is one that corresponds to restructured debt, the spread will be, on average, 165 bp wider compared with those that have not been restructured.

Using the set of estimated coefficients, we construct a series of predicted equilibrium sovereign spreads and the estimated misalignment series as the difference between the actual and predicted spread. In so doing, we arrive at country-specific misalignments based on the long-run explanatory variables. We report the fitted values in Table 8.4 in the column headed "Current GS-ESS," which

Table 8.4. GS-ESS: Equilibrium sovereign spreads (basis points)

Country	*Name*	*Price 10/11/2000*	*Spread 10/11/2000*	*Current GS-ESS*	*Under(-)/ over(+) valuation*
Argentina	Rep 17	79.75	865	423	−442
Brazil	Rep 27	72.65	808	370	−438
Bulgaria	IAB 11	73.00	768	591	−177
China	Rep 08	98.44	166	131	−35
Colombia	Rep 07	74.00	810	314	−496
Ecuador	30s	36.25	1,374	989	−385
Indonesia	Rep 06	81.00	662	534	−128
Korea	Rep 08	103.88	228	127	−101
Malaysia	9	103.89	220	162	−58
Mexico	UMS 16	112.50	378	324	−54
Peru	PDI 17	60.00	750	491	−259
Philippines	Rep 09	74.38	770	299	−471
Poland	PDI 14	92.00	205	308	103
Russia	28	36.00	1,207	873	−334
South Africa	Rep 09	97.75	361	252	−109
Turkey	30	96.75	629	790	161
Venezuela	Rep 27	97.75	847	388	−459

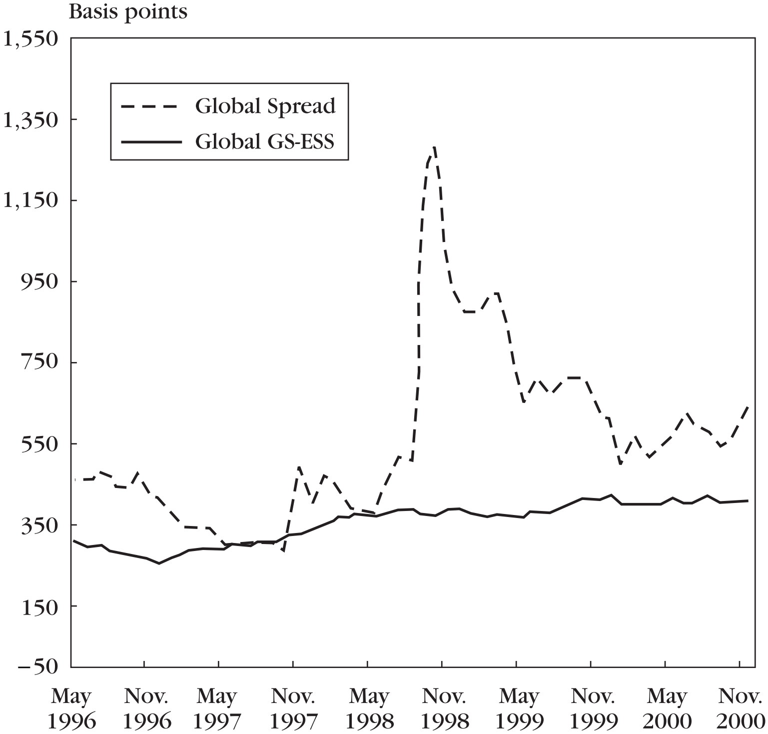
Notes: GS-ESS represents our preferred model of long-run equilibrium sovereign spreads in emerging market economies. A misalignment of 10 bp or less is considered as fair value.

represents the equilibrium sovereign spreads for November 2000. Alongside this column is the misalignment expressed as the basis points deviation of the November 2000 spread from its long-run equilibrium.

EDM spread above long-term fair value

With these results we calculate a market-capitalization-weighted regional and global GS-ESS for a basket of 17 emerging markets hard-currency bonds. This allows us to compare the market-capitalization-weighted actual spread (Spread) with Global GS-ESS, our measure of long-term fair value. We also calculate the regional GS-ESS for Latin America (LATAM), Eastern Europe, Middle East, and Africa (EMEA), and Asia.

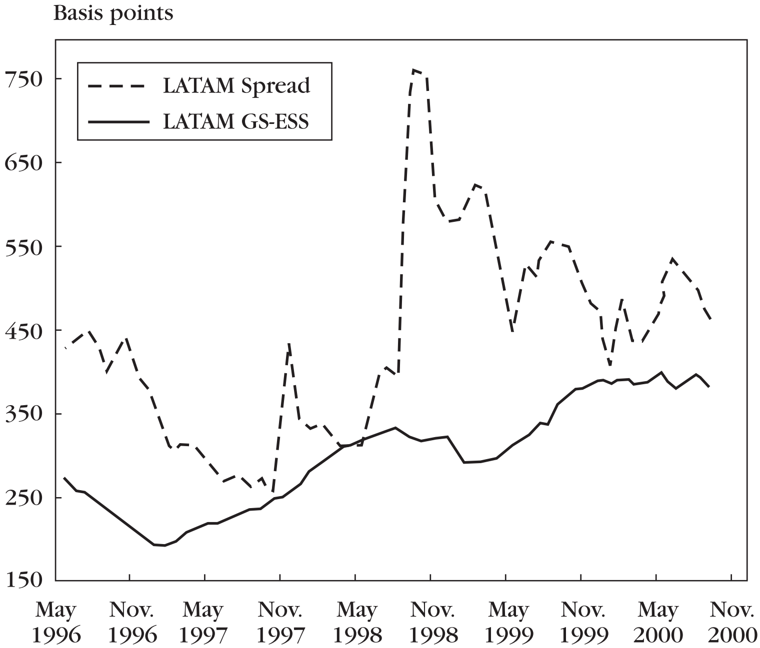
Figure 8.6. Global spreads and the Goldman Sachs Equilibrium Sovereign Spread, 1996–2000



Source: Goldman Sachs estimates.

The general trend over the three months to November 2000 was one in which foreign currency bonds became more undervalued against GS-ESS, our preferred framework for looking at sovereign ability to pay. Figures 8.6–8.10 show the market-capitalization-weighted average deviation from GS-ESS for a basket of 17 emerging markets hard-currency bonds. The graphs show that this weighted-average undervaluation measured by our long-term GS-ESS increased 92 bp over the three months to November 2000. At

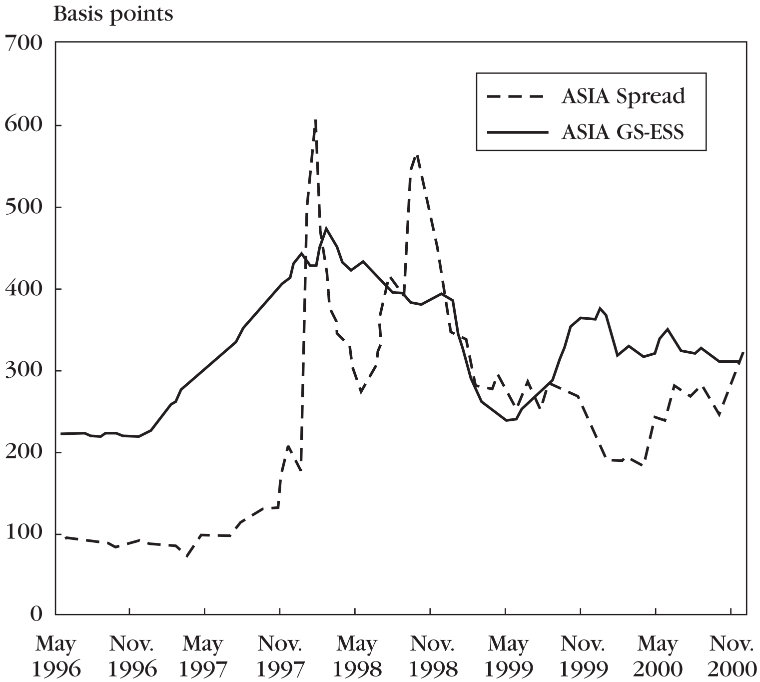
Figure 8.7. Latin America: Global spreads and GS-ESS, 1996–2000



Source: Goldman Sachs estimates.

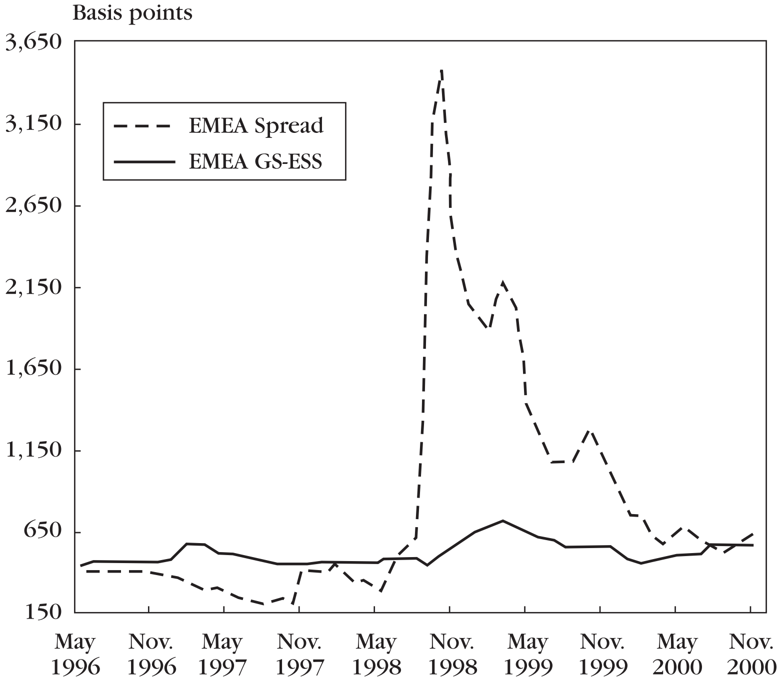
640 bp, the EDM Global Spread in November 2000 was almost 250 bp above what macroeconomic fundamentals warranted (GS-ESS at 400 bp). On average, all of the regions experienced a widening, led by Latin America with 73 bp, Asia with 59 bp, and the EMEA region with 73 bp. As a result, Latin American, EMEA, and Asian spreads are 143, 70, and 12 bp, respectively, above their long-term fundamental equilibrium levels, as measured by GS-ESS.

Figure 8.8. Asia: Global spreads and GS-ESS, 1996–2000



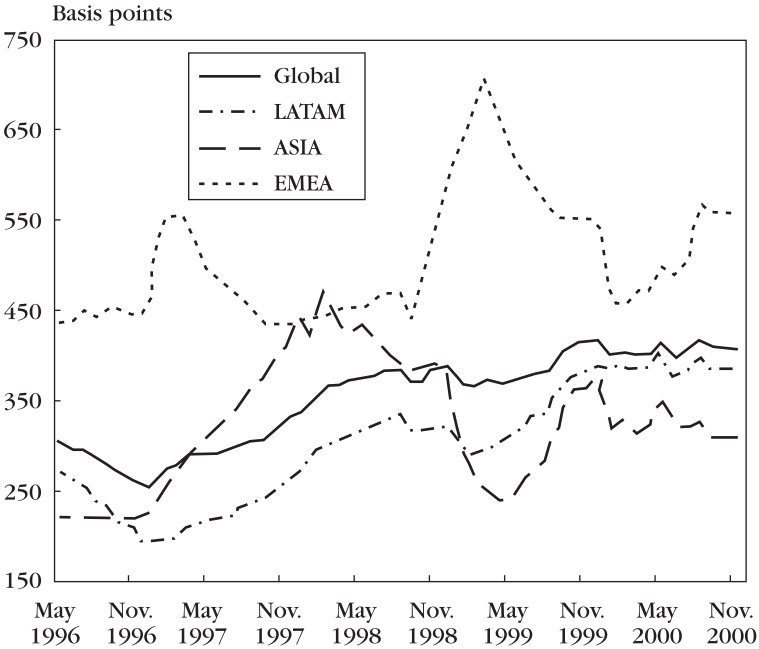
Source: Goldman Sachs estimates.

Figure 8.9. Emerging Europe: Global spreads and GS-ESS, 1996–2000



Source: Goldman Sachs estimates.

Figure 8.10. Global and regional GS-ESS, 1996–2000



Source: Goldman Sachs estimates.

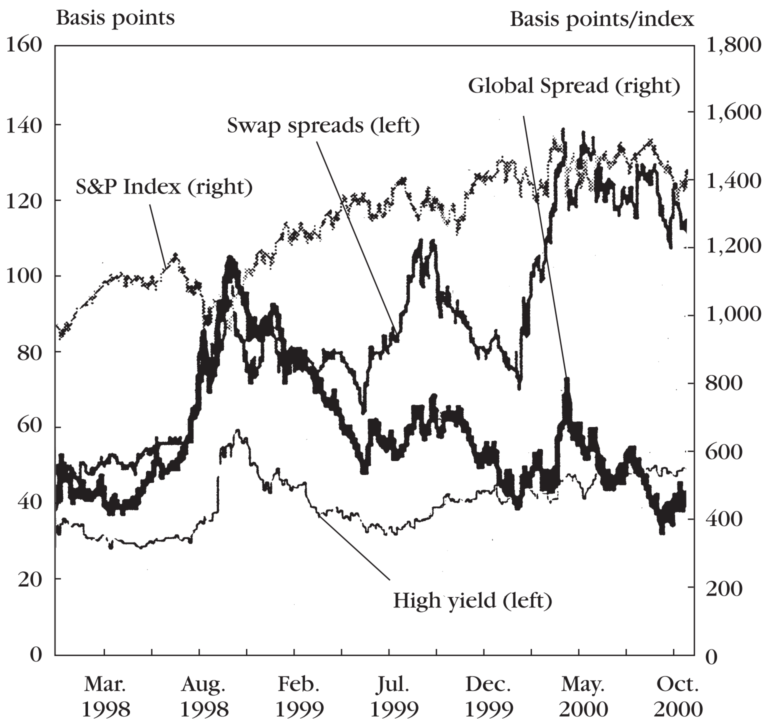
Adjusted GS-ESS: A short-term valuation model for EDM

Market spreads may, and often do, differ from the level of spreads that macroeconomic fundamentals warrant. Such discrepancies arise because spread models based on macroeconomic fundamentals—such as GS-ESS—reflect only the sovereign's fundamental ability to pay. However, other factors do affect spreads, driving them away from their long-term equilibrium levels. For example, equity market volatility, the behavior of swap spreads, and global real GDP growth are all such factors. Adjusted GS-ESS takes such factors into account. Specifically, we estimate the extent to which EDM spreads are driven by considerations beyond the pure "ability to pay" (as measured by our preferred valuation model, GS-ESS) versus the extent to which they are driven by global real or financial factors, thus creating an adjusted bond market equilibrium measure that accounts for short-term factors.

Model specification: Market sentiment and liquidity matter

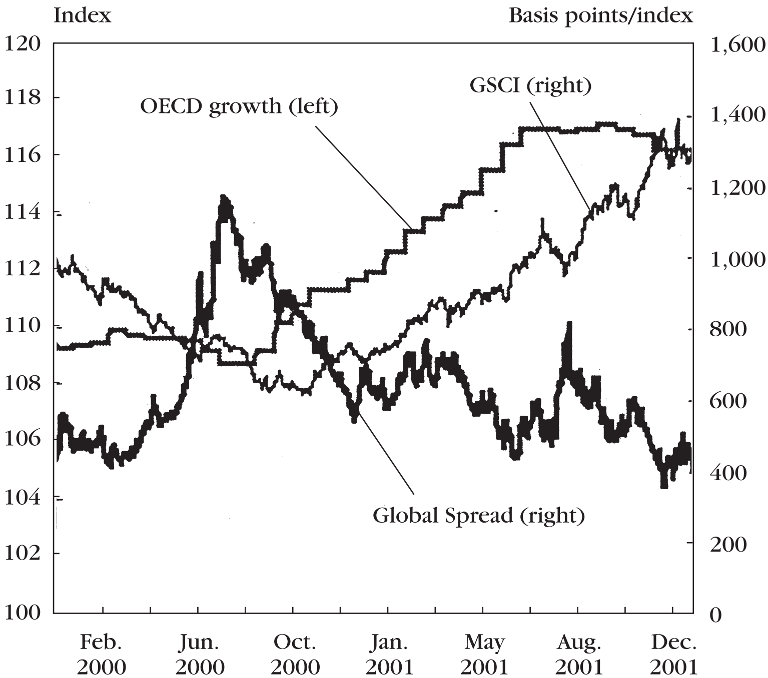
We find that, among economic and financial factors, OECD leading indicators of economic activity and swap spreads are the main drivers of EDM spreads (Figures 8.11 and 8.12). We also find that other indicators such as US equity markets, high-yield bond markets, and commodity prices have a statistically significant relationship with

Figure 8.11. Global financial conditions and spreads, December 1997–October 2000



Source: Goldman Sachs estimates.
Note: S&P Index = Standard & Poor's Index.

Figure 8.12. Global economic conditions and spreads, January 2000–December 2001



Source: Goldman Sachs estimates.
Note: GSCI = Goldman Sachs Commodity Index.

EDM spreads. Our results indicate that variations in global factors, combined with the fundamentals captured by GS-ESS, explain 80 percent of the variation in EDM spreads. Although we stop short of suggesting that this exercise can be used for "predicting" spreads, we believe that our results represent a significant step towards that objective. We adopt a multivariate approach and first specify a model including some of the variables that may be argued to drive EDM spreads. We use the capitalization-weighted index of emerging market bond spreads (Global Spread) described above, noting that it is highly correlated with the Emerging Markets Bond Index (bradies + global) (EMBI+).

Results: Explaining temporary departures from equilibrium

The estimated results for the model are presented in Table 8.5. Note that all the coefficients are associated with the expected signs. In terms of sheer magnitude, the main drivers of total spreads appear to be swap spreads and the OECD leading indicator. For example, assuming all other variables to be constant, for a single basis point increase in swap spreads, total spreads widen over 4 bp. The coefficient associated with the Goldman Sachs Commodity Index (GSCI)

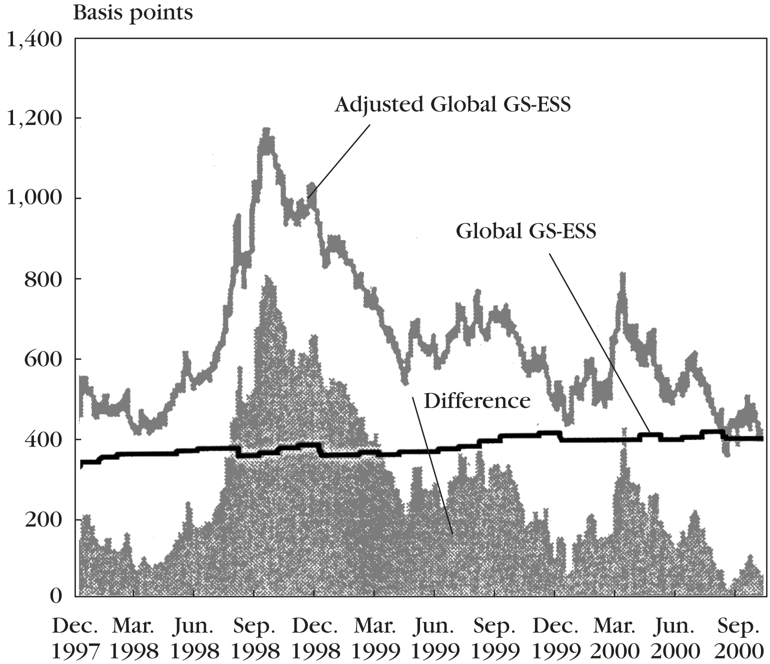
Table 8.5. Short-run model estimates (dependent variable is SPREAD)

	Coefficient	*t-ratio*	*Significance*
Intercept	1677.46	1.40	Low
GS-ESS	1.00	—	—
OECD leading indicator	−7.33	−0.54	Low
10-Year USD SWAP spreads	4.41	3.45	High
Yield on US Corporate B-Grade	1.11	4.36	High
S&P Equity Index	−0.55	−2.22	High
GSCI	−0.28	−8.11	High
R-bar squared		0.82	
	Test		
Serial correlation:	LM(1), LM(2)	1.85, 2.14	Low
Heteroskedasticity		1.92	Low
Functional form	Ramsey's RESET	1.67	Low
Residual normality		2.01	Low
Structural stability	F-test out-of-sample	1.47	Low

Source: Goldman Sachs estimates.

Notes: We used restricted autoregressive distributed lag estimation using monthly data. The coefficient associated with the GS-ESS variable was restricted to unitary. This restriction was not rejected based on a chi-square test (results available upon request). Sample for primary model is from May 1996 to October 2000 (dependent variable being EMBI+). Serial correlation is based on the Lagrange Multiplier test—tests for both first-order LM(1) and second-order LM(2) are presented; functional form refers to Ramsey's RESET test using the square of the fitted values; normality is a test of normality of the residuals based on skewness and kurtosis of residuals; heteroskedasticity is a test of the regression of squared residuals on squared fitted values. All diagnostic tests are distributed chi-square: LM(1) with 1 df, LM(2) 2 df, functional form and heteroskedasticity with 1 df, and normality with 1 df.

Figure 8.13. Global conditions are benign, December 1997–September 2000



Source: Goldman Sachs estimates.

is negative, indicating that an increase in commodity prices narrows total spreads in emerging markets. Finally, the fit of this regression is quite good, implying that over 80 percent of the variation in Global Spread is explained by fluctuations in the explanatory variables.

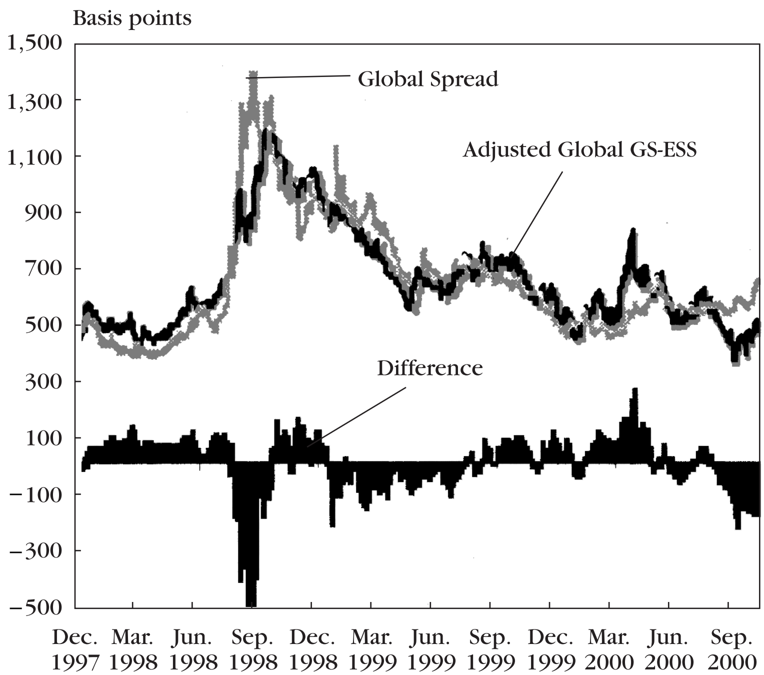
Figure 8.13 shows Global GS-ESS and Adjusted Global GS-ESS, capturing the impact of global financial and macroeconomic conditions on EDM spreads. First, we notice that Adjusted GS-ESS is far more volatile than GS-ESS, because it is driven by volatile global financial conditions. Second, the low spread between GS-ESS and Adjusted GS-ESS (about 50 bp) means that financial conditions have been overall benign to spreads in the quarter to November 2000, explaining Adjusted GS-ESS at 450 bp.

In fact, high OECD economic growth, better commodity prices, and a lingering positive wealth effect (S&P) almost fully compensate for wider swap and high yield spreads. Also notice that, in the past, external financial and macroeconomic conditions have caused Adjusted GS-ESS to deviate significantly from fundamentally driven GS-ESS. Such was the case in 4Q1998, when financial conditions in the United States experienced a significant deterioration.

EDM is also inexpensive against short-run variables

In Figure 8.14 we show Adjusted GS-ESS and Global Spread. According to our short-term valuation model, which takes into con-

Figure 8.14. Spreads are inexpensive relative to Adjusted GS-ESS, December 1997–September 2000



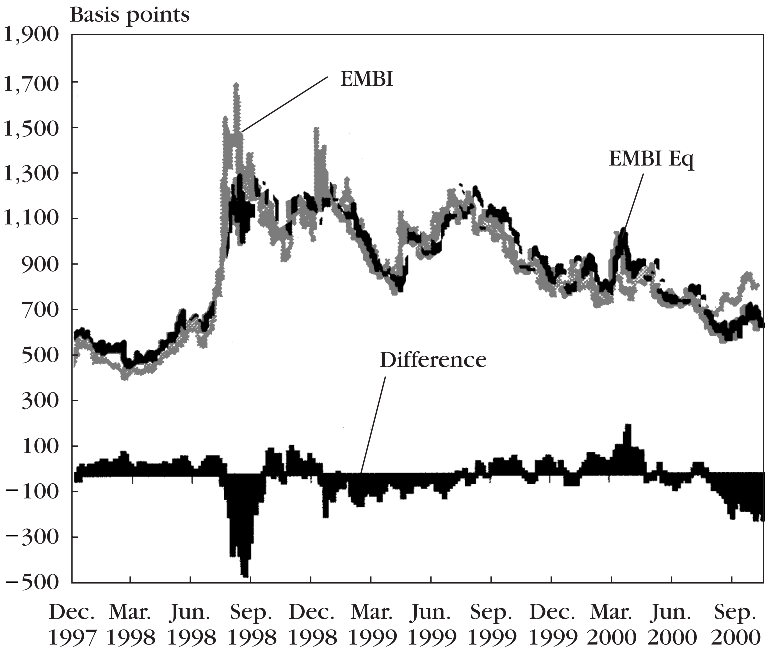
Source: Goldman Sachs estimates.

Table 8.6. GS-ESS and Adjusted GS-ESS

	November 2000	*December 2000*
Weighted average spread	642	
GS-ESS	398	435
EMBI	845	
Adjusted GS-ESS	647	546

Sources: Goldman Sachs estimates; market data.

Figure 8.15. EMBI+ Equivalent Index is inexpensive relative to Adjusted GS-ESS, December 1997–September 2000



Source: Goldman Sachs estimates.

sideration global financial and macroeconomic conditions, Global Spread is inexpensive relative to Adjusted GS-ESS by about 200 basis points (Table 8.6). Thus, EDM is inexpensive not only relative to our current long-run estimates of fair value, but also relative to our short-term estimates of fair value.

To facilitate the comparison with the widely used EMBI+ index, we map our Global Spread series (a weighted average of the 17 countries in our emerging market sample) to the EMBI+ index (Figure 8.15). We call this index the EMBI+ Equivalent Index (EMBI Eq). We also map our Adjusted GS-ESS measure of fair value to make it consistent with EMBI+ spreads. To map our Global Spread series to the EMBI+ index, we first translate the misalignment of the Global Spread series from its equilibrium in terms of standard deviations of the Global Spread variable. We then use the same standard deviation as a representative measure of misalignment of the EMBI+. Because the two series are highly correlated (a correlation coefficient of 0.88), significant deviations from the two series should be only temporary, making this "mapping" a reasonably accurate approximation. According to these calculations, the EMBI+ is about 200 bp undervalued, similar to the result we achieved with the original measure.

4. Conclusion

High-risk premiums in emerging debt: Opportunity or warning?

The overall performance of emerging markets was very uneven in the past decade. Some emerging economies experienced a significant improvement in their overall macroeconomic performance, particularly in the 1990–7 period, with most regions undergoing either a rebound or an acceleration of real GDP growth, lower inflation, better current account positions, and a strong accumulation of reserves, one which in part was made possible by a modest recovery in capital inflows. Notwithstanding such favorable conditions, financial performance was rather mixed or outright disappointing in some emerging countries and regions, which built up severe macroeconomic imbalances. Macroeconomic performance in the emerging world deteriorated in the 1997–2000 period, in part reflecting worsening external conditions that exacerbated most domestic macroeconomic imbalances, forcing severe adjustments in several (and defaults in some) emerging economies.

Historically, volatile economic performance reflects not only the adoption sometimes of unsustainable macroeconomic policies by some emerging countries but the structural frailties that besiege most emerging economies—including low savings and productivity rates. Volatile and somewhat unpredictable macroeconomic performance and policies are the main reason behind the high risk premiums for so long observed in most emerging economies.

We believe that the outlook for emerging economies in the next five years is fair, although some of the largest emerging economies will likely grow less and the consolidated current account positions will not be as good as they were in 2000. We have three reasons for believing that the scope for a consistent tightening of EDM spreads is limited. First, the external and fiscal vulnerabilities of Latin America remain high, even after years of adjustment. Second, liquidity and demand for bonded debt have drastically declined to about one-third of their peak, and this is one of the most severe consequences of the Asian, Russian, and Ecuadorian crises. Third, the perception of default and punitive private sector involvement in financing packages exacerbated the view that EDM has become an unfriendly asset class under the new innovative financial architecture.

Policy changes are needed to allow Latin America to grow faster

To be fair and balanced, the recent default experiences in EDM have led to a better assessment of risk and better discrimination between strong and weak credits. However, the sad part of the story is that a worsening in external financing conditions compounded by traumatic policy experimentation resulted in a more modest outlook for external financing for Latin America, even though flows are likely to continue to recover.

Without stronger capital inflows, prospects for higher real GDP growth in Latin America will be more limited. In turn, the inability to allow the benefits from recent adjustment and reforms to trickle down in terms of growth, employment, and income distribution may in part account for the increase in political risk in Latin America. Under such limitations, we believe that the scope for a reduction in debt and equity risk premiums will be limited or below the full potential of the region, thus putting a ceiling on future performance by Latin American financial markets.

But, rather than lamenting nostalgically about how good the boom years of the mid-1990s were, we believe that government officials throughout the region and in Washington would benefit from taking bolder steps to boost the availability of domestic financing and improve the intrinsic credit quality of countries in the region. We give three concrete examples that could help Latin America reduce its refinancing needs and the cost of capital while at the same time bolstering growth.

1. Latin American countries need to increase their domestic savings ratio to GDP, while further reducing public sector borrowing requirements. This primarily entails a more ambitious reduction of fiscal deficits and lower debt burdens, the latter remaining perhaps too large relative to the stock of domestic financial wealth.

2. Latin American countries need to follow the steps of Mexico and Chile, which have shown how powerful the benefits from freer trade and trade integration agreements are. This would particularly benefit Argentina and Brazil, two countries that remain too closed to trade and that have large external debt service and dividend repayments ahead of them. This implies, at the very least, a unilateral opening up of their economies to trade or, even better, seeking with the US administration a fast track for ALCA, the proposed Free Trade Area of the Americas. In this regard, help from Washington and Brussels in crafting cooperative trade agreements with Latin America would bolster growth, reduce political instability in the region, and drastically reduce the risk of balance-of-payments crises and debt defaults in Latin America. Being able to generate foreign exchange to meet external obligations is still the cheapest form of crisis prevention.

3. Multilateral institutions and G7 country officials should strive to limit as much as possible the regulatory uncertainty resulting

from the current adaptive and to some extent discretionary rules of the game for dealing with financial crisis in emerging markets. Although information has been made available by the official sector, the fact is that the rules of the game are still unclear for investors, and a firmer framework for crisis resolution and greater consultation with financial markets could drastically reduce regulatory uncertainty and, ultimately, EDM spreads.

Acknowledgments

This article draws on the work and views of the entire Latin America Economic Research Group at Goldman, Sachs & Co.

Notes

1. For a complete description of the theoretical and empirical models, see Goldman, Sachs & Co. (2000c).
2. The PMG estimator is applicable to panels where we have cross-sectional variation in the short-run dynamics but long-run commonality in the long-run equilibrium relationship. See Im, Pesaran, and Shin (1998).
3. We report Newey-West heteroskedastic robust standard errors. This means that the errors are corrected for potential biases arising from the possibility that the error variances across each country may not all be the same.

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Report on the Authors' Roundtable Held at Columbia University

María Eugenia Mujica
Institute of Latin American Studies, Columbia University

The Permanent Mission of Colombia to the United Nations and the Institute of Latin American Studies (ILAS) of Columbia University in New York organized a roundtable on "Financing for Development: A Latin American and Caribbean Perspective" on November 15, 2000. The event provided the authors of the book with an opportunity to present their work and to discuss their proposals with an audience of experts on the subject. The roundtable was declared open by Dr. Lisa Anderson, Dean of the School of International and Public Affairs of the University, of which ILAS is a department.

The first presentation was made by Oscar R. de Rojas of the Department of Economic and Social Affairs of the United Nations, who explained the background to and progress made in the preparation of the High-Level International Intergovernmental Event on Financing for Development (now designated an International Conference), scheduled to take place in 2002. De Rojas stated that the subject of financing for development had begun to be discussed in the United Nations more than 20 years earlier as part of the North–South dialogue. However, in view of the subject's sensitivity, the resolution that proposed the convening of an event for its consideration was not adopted until 1997. De Rojas said that the negotiation of the agenda was very difficult. For example, the Ad Hoc Working Group that met in 1998 was able to reach agreement only on very general issues. After that, the General Assembly waited an entire year before taking up the item again. The agenda for the proposed Conference was agreed upon in June 2000 and includes such issues as the mobilization of domestic resources, private international capital flows, trade, and systemic aspects. De Rojas mentioned that other issues for consideration in the agenda are the participation of the Bretton Woods institutions and the World Trade Organization, the various regional perspectives, and the participation of civil society in the process.

After this initial presentation, Jairo Montoya, Director of Multilateral Organizations in the Ministry of Foreign Affairs of Colombia, presented the official position of the Rio Group on the subject of financing for development, a priority issue on the agenda of the Rio Group. Financing for development not only has a political component but is a key requirement for development in member countries. For the Rio Group, it is necessary to reduce the vulnerability of countries to external financial crises and to have early warning mechanisms for their prevention. Montoya stated that the Rio Group adopted a united approach in dealing with the issue in the United Nations, as can be seen in the Declaration at Cartagena de Indias of June 2000.

Ambassador Gert Rosenthal, the Permanent Representative of Guatemala to the United Nations and a member of the Bureau of the Preparatory Committee for the High-Level Event on Financing for Development, discussed the role of the United Nations in this area. He stated that the succession of international financial crises and their repercussions during the 1990s had given a new sense of urgency to the desire of the United Nations to become involved in the field of financing for development. Rosenthal listed the reasons the organization of a high-level event by the United Nations is an excellent idea. These included the fact that the United Nations: (1) has the moral authority and the capacity to bring together high-level government authorities; and (2) can help to create a space in which the Bretton Woods institutions and other actors can coordinate their efforts to mobilize and channel resources into development. Ambassador Rosenthal also outlined a series of seminal ideas that the United Nations could put forward at the event.

The presentation by Arvid Lukauskas of Columbia University centered on trends in investment patterns and capital flows to emerging markets and, in particular, to Latin America. Lukauskas noted the change that took place in the 1990s in the composition of financing for development at the global level, which was most striking in Latin America. While flows of official development assistance have declined, flows of private short-term capital and, to a larger degree, of direct foreign investment account for a much larger share in the breakdown of financing for development.

However, as was noted by a member of the audience and subsequently in the presentation by Enrique García, President of the Andean Development Corporation (ADC), flows of private capital are heterogeneous, asymmetrical, concentrated, pro-cyclical, and volatile. In addition, markets are imperfect, domestic savings rates are very low, and a series of imbalances exists at the domestic level (in information, access to credit, etc.). Consequently, regional development financial institutions are essential in order to ensure that capital flows are more efficient and equitable. The President of the ADC noted that these institutions are currently not only financing projects but also playing several other roles, including: (1) as a catalyst for attracting resources; (2) intermediation in reducing the cost of these resources; (3) anti-cyclical financing; (4) support for the reestablishment of macroeconomic balance; (5) support for the process of state reform; (6) strengthening of financial markets; and (7) promotion of small and medium-sized enterprises. García concluded his presentation by suggesting a number of other innovative roles in non-traditional financing and in the strengthening of capital markets.

The work of José Antonio Ocampo and Manuel Agosín of the Economic Commission for Latin America and the Caribbean was presented by Inés Bustillo, Director of the Washington Office of ECLAC. The authors argued that international financial institutions are not well equipped to deal with financial crises, and that it is therefore necessary to reform the international financial architecture by focusing on the strengthening of mechanisms for the prevention and management of crises. The performance of regional financial institutions must complement the management and prevention of crises. Ocampo and Agosín proposed the following reforms at the international level in the area of crisis prevention: (1) the inclusion of a component in the macroeconomic policies of the industrialized countries to monitor their impact on developing countries; (2) greater policymaking autonomy for developing countries; (3) greater symmetry in the distribution of information; and (4) representation of the developing countries' interest in forums that deal with the question of financial stability. At the national level, the authors called for sound management of economic booms and prudent regulation of capital flows.

On the question of crisis management measures, Ocampo and Agosín stressed the need to strengthen the International Monetary Fund to enable it to function as a central bank during periods of crisis, the need for emergency rules to permit the creation of additional money, and the need for conditionalities to be confined to the traditional spheres of financial and macroeconomic policies. As part of the multilateral regulations, a multilateral arbitration mechanism should be created for the settlement of disputes and collective action provisions should be included in loan contracts to prevent developing countries from being penalized in the form of higher costs for access to resources.

The presentation by Osmel Manzano of the ADC focused on the impact of external indebtedness on economic and social development. According to Manzano and Fidel Jaramillo (who is the coauthor of Chapter 6 but was not present at the discussion), although external debt is not a bad thing in itself, high levels of debt have an adverse effect on development. External financing is not sufficient to guarantee economic growth. The same is true of debt reduction programs. That is because highly indebted developing countries have specific characteristics—Manzano mentioned poor economic policies—that neutralize the positive impact of these programs. Manzano concluded his presentation by appealing to the multilateral aid agencies to consider these particularities in their aid strategies so that countries could benefit from the new initiatives.

Robert Grosse of Thunderbird looked at direct intra- and interregional foreign investment in Latin America. He noted that foreign direct investment has even greater importance than is attributed to it in the traditional models, since in reality it incorporates many more financial and non-financial flows, such as technology transfers, control and ownership, and intra-company exports. Thus, when measuring foreign direct investment, it is necessary to focus not only on the financial aspects but also on those aspects related to the transfer and management of resources. Because of this, he concluded, governments must design policies that seek to maximize the benefits of foreign direct investment in all relevant areas.

The final presentation was made by Federico Kaune of Goldman, Sachs & Co., who looked at private sector capital flows, i.e. from investment banks. Kaune stated that bond financing, despite its greater volatility, was gaining in importance in the total net financing of Latin American economies. Latin America accounts for approximately 50 percent of the world total of bond financing, concentrated mainly in Brazil, Argentina, and Mexico. Kaune argued that the current transformation of the structures of financial markets would lead to a process of market segmentation: only some countries would belong to the select group of "chosen countries" that attract private investment. Consequently, he urged the countries of Latin America to adopt economic policies that would increase sources of domestic financing—domestic saving rates—and improve the credit rating of the countries of the region. He pointed out further that the multilateral financial institutions and the developed countries should reduce their regulatory uncertainty with respect to the financial crises in emerging markets.

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