Comment on "The Return of Private Capital to Latin America," by Griffith-Jones

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Griffith-Jones' paper discusses Latin America's restoration of access to private capital flows – a process characterised as "massive and rather surprising" and which raises public policy issues of both country-specific and systemic nature. In line with the paper's coverage, my comments are organised along three related topics: (i) the facts; (ii) the causes; and (iii) the policy implications. An underlying theme throughout the comments is the sustainability of the market re-entry process – an important issue in the context of this workshop's broader deliberations on the functioning of the international monetary system.

The facts

The paper admirably documents the large magnitude of private capital flows to Latin America, and the dramatic speed of the turnaround from the credit-rationing regime. The process – which is best viewed within the overall evolution of the "international debt strategy" – may be considered to have started in earnest just three years ago with the Mexican Bancomext bond issue. Since then it has expanded in several ways, including to encompass: (i) a broader range of countries; (ii) a growing investor base; (iii) greater private sector participation on the recipient end; and (iv) a multitude of financing instruments such as external bond and equity placements, foreign direct investment inflows, flows to domestic equity markets, and capital repatriation. International bank lending, the "locomotive" in the pre-1982 episode of large-scale voluntary flows to Latin America, is the notable exception. The large inflows have been accompanied by an improvement in terms, as illustrated in the lengthening of maturities and reduction in interest rate spreads for bond placements by Latin American countries with recent debt servicing problems.

Overall, therefore, there is support for Griffith-Jones' view that the process has become more extensive in nature. Nevertheless, it is still limited and

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1 These comments represent the views of the author and do not necessarily represent those of the International Monetary Fund.

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touches directly only a portion of developing countries with recent debt servicing problems. Indeed, many developing countries outside Latin America continue to have limited access to international capital market funding. Moreover, and this is also a matter of concern for industrial countries, the linkages across investors and across financial instruments warrant consideration of possible systemic risks in this phase of the international debt strategy. In this context, the paper correctly points to the importance of compiling comprehensive data – the foundation to analytical work and adequate policy response.

The causes

Two related groups may be identified in an analysis of factors behind the restoration of access to private capital flows. The first pertains to the efforts of the re-entrant countries themselves; the second concerns the international environment. Discussion of these factors also sheds light on the sustainability issue.

In discussing the efforts of the re-entrant developing countries, one cannot over-emphasise the importance of sustained economic adjustment and reform policies. Such policies allow for a reduction in country transfer risk which, in turn, provides for a consolidation of access to debt flows and foreign direct and portfolio investments. Accordingly, Griffith-Jones' emphasis on supply enhancement measures is well placed. To result in higher investment and sustained economic growth – the critical determinants of medium-term creditworthiness – these measures must be consistent with internal and external financial stability (i.e., a viable balance of payments position and low and stable domestic inflation).

The process of market re-entry must also be supported by appropriate debt management policies covering both the "old stock" and the "new flows". Here, Griffith-Jones's focus is on appropriate utilisation of existing debt management options including collateralised debt and debt service reduction exchanges for old debt (so-called "Brady-bonds") and credit enhancements for new debt. This focus may be contrasted to the approach taken in Williamson's paper, where the emphasis is on the need for institutional change in the form of an "International Debt Restructuring Agency" [2]. This agency would be charged with revising the terms of contracts, triggered by pre-specific events.

As noted by Griffith-Jones, officially supported debt and debt service reduction instruments provide for a flexible approach to restructuring of

2 See Williamson's paper "International Monetary Reform and the Prospects for Economic Development" in this book.

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existing indebtedness consistent with debtors' longer-term debt servicing capacity, while safeguarding access to new flows. It is not clear whether a new agency would add much to the existing restructuring options. Indeed, an "institutionalisation" of the process through the creation of what is effectively an international bankruptcy mechanism may, at this stage of the debt strategy, have direct costs in terms of discouraging new flows. Alternatively, the agency's effectiveness may be undermined as creditors react by seeking seniority status relative to its procedures through the inclusion in loan contracts of specific waiver clauses.

Institutional strengthening may be of greater relevance in the case of foreign direct investment. This source of inflow has tended to attract relatively little – albeit increasing – attention in the literature, including in Griffith-Jones' paper. Yet, it is a source of external savings that offers the prospects for "servicing" requirements that are most closely linked to the performance of the underlying investment – a phenomenon that enhances developing countries' growth prospects and places a larger direct responsibility on adequate investment feasibility and appraisal work by foreign investors. Recent international initiatives include the establishment of the Multilateral Investment Guarantee Agency. As in other areas, a delicate balance has to be struck between providing adequate institutional support and limiting moral hazard risks associated with implicit or explicit official insurance schemes.

Turning to country-specific measures, there is a growing consensus on the limited effectiveness of ad hoc incentive schemes in promoting long-term productive foreign direct investment. Experience shows that ad hoc provision of generous investment incentives (such as tax holidays, duty rebates, etc.) generally constitutes a poor cost-effective approach for promoting such investments. Rather, the emphasis must be on ensuring the consistency and sustainability of the enabling environment through appropriate economic and financial policies.

Griffith-Jones' paper makes an important distinction between endogenous, country-specific factors which explain the re-entry to capital markets, and factors that may be deemed essentially exogenous from the viewpoint of developing countries. While these factors have contributed to higher inflows, they have added volatility to the process of restoration of access to private capital. The reduction in short-term nominal yields on U.S. dollar denominated short-term financial instruments is viewed as contributing to investors' search for higher returns in Latin American countries. This has been accentuated by the on-going process of integration and internationalisation of national financial markets.

In addition to shedding light on the magnitude of flows, the structural changes in financial markets also hold the key to explaining the rapidity of the turnaround. The integration of market segments within and among industrial

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countries (and a few developing countries) has dramatically increased the mobility of financial flows and shortened the response time for these flows. This also provides the potential for an equally rapid U-turn, particularly in the context of an increase in nominal short-term yields in industrial countries. Accordingly, an important issue for an appropriate functioning of the international monetary system is the extent to which the large flows to Latin America reflect adequate investor evaluation of improvements in country fundamentals – an issue that, as noted below, is influenced by perception of implicit or explicit safety net mechanisms extended by the official sector. The weaker the linkage to recipient country fundamentals, the larger the scope for disruptive outflows, with potential negative contagion effects on other areas of the economy.

The policy implications

Having reviewed briefly the factors behind the restoration of access to private capital flows, let me now turn in earnest to the third topic – the related policy issues. Analysis of these matters need to extend beyond the coverage of the paper. This is best illustrated by organising the comments into three groups covering: (i) re-entrant developing countries; (ii) other developing countries, particularly those with recent debt servicing problems; and (iii) industrial countries. Together, they shed light on the sustainability of the re-entry process and its implications for the functioning of the international monetary system.

As noted by Griffith-Jones, the return of voluntary capital flows raises several policy issues for re-entrant countries. These include: how to manage the process in order to minimise the risk of a "re-exit"; how to contain the potential adverse impact on domestic financial balances; and how to maximise the positive externalities, particularly for domestic financial markets. These issues are of special importance to Latin American re-entrants for which markets have already discounted future policy adjustments and commercial bank debt reduction packages.

Analysis of the experience of relatively well-established re-entrants (e.g., Mexico) [3] clearly points to the need for a judicious policy mix that builds upon the factors that contributed to the re-entry – viz., (i) prudent macroeconomic policies that alleviate short-term financial pressures; and (ii) restrained borrowing, combined with well-timed placements of benchmark issues in various capital market segments and avoiding implicit or explicit government debt guarantees of private sector borrowing. Griffith-Jones'

3 See, for example, El-Erian, "Mexico's External Debt and the Return to Voluntary Capital Market Financing", IMF Working Paper, WP/91/83, Washington D.C., August 1991.

analysis goes beyond these factors to advocate direct intervention to reduce the share of volatile flows. While some of the proposed measures appropriately strengthen the prudential regulatory and supervisory regime in developing countries, their overall impact would be limited in the absence of a change in the parameters that induce the flows in the first place. Moreover, fine-tuning of policies to differentiate the treatment of different types of capital flows is inherently difficult. Accordingly, the policy emphasis must remain on securing the economic and financial fundamentals that provide for greater efficiency in the use of the capital inflows and reduce exposure to sudden reversals in flows. In addition – and this is an issue that deserves attention in discussions of consolidating the restoration of access to private flows – there is a case for increased use of available risk management instruments to reduce vulnerability to external shocks. Thus, countries' improved creditworthiness also provides access to cost-effective market-based hedging tools that limit the impact of unanticipated adverse developments in commodity prices and international interest rates. [4]

As regards lessons to be drawn for other developing countries, the experience of the Latin American re-entrants clearly points to the potential for a virtuous cycle of higher investment, growth and private inflows. Policy reforms can trigger private sector financial responses which, if well managed, facilitate the broadening of the economic adjustment and reform effort. This consideration assumes an added degree of importance in the context of indications of larger competing claims on world savings and prospects for increased regionalisation – issues that are addressed in Sengupta's paper. [5]

The third layer concerns industrial countries. Here there is need to go beyond the widely accepted principle of a stable macroeconomic environment discussed by Griffith-Jones. Financial market regulators and supervisors face an important challenge: how to meet genuine prudential concerns for protecting the integrity of their financial systems while implementing sufficient regulatory flexibility to (i) avoid undue credit rationing and excessive borrowing costs for developing country borrowers; and (ii) allow market discipline mechanisms to operate effectively.

This is not a new challenge. Similar issues arose in the context of the design and implementation of measures to strengthen the international debt strategy to include market-based debt and debt service reduction instruments for bank claims. At that time, regulators worked closely with debtors and

4 Such instruments are discussed in Mathieson, Folkerts-Landau, Lane and Zaidi, "Managing Financial Risks in Indebted Developing Countries", IMF Occasional Paper No 65, Washington D.C., 1989.

5 See Sengupta's paper "Aid and Development Policy in the 1990s", in this book.

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creditors to clarify, inter alia, the application of regulatory rules and, where appropriate, provide guidelines on the treatment of specific issues as they arose. While I do not have time to discuss in depth some of the policy issues that arise in the re-entry phase of the debt strategy, it is worth mentioning five related elements that influence the nature of private market flows to developing countries: (i) the approach to refining procedures of loan-loss regulatory provisioning regimes applicable in industrial countries to bank claims to provide for timely graduation of developing countries with recent debt servicing problems; (ii) the approach to determining risk weights for computing banks' adherence to regulatory capital adequacy requirements; (iii) host country authority over the establishment of financial institutions from developing countries; (iv) use of cut-off credit rating standards for mobilising funds on industrial country securities markets; and (v) actual or implied official insurance schemes covering suppliers of resource flows to developing countries.

Clearly, the objective is to establish the enabling environment in which well-formed market participants allocate resources to activities with the highest risk-adjusted expected returns, while minimising the possibility of disruption to financial markets. Policy analysis and deliberations in these areas are complicated by several issues. First, while there is no strong evidence to suggest that a single factor has contributed, per se, to undue credit rationing or ineffective market discipline, the issue also needs to be approached using a general equilibrium-type analysis – i.e., investigate the extent to which the factors interact. Second, some prudential requirements at the national level reflect agreements on the harmonised implementation of multilateral frameworks – as in the case of the Capital Adequacy Accord. Agreements on such framework are difficult to fine-tune. Third, the approach to bail-out mechanisms for creditors and debtors has to take account of what is essentially an intangible element – contagion effects of financial failures. It is difficult to assess the potential cost of such contagion. The greater the concern for limiting contagion, the larger the likelihood for the de-facto provision of relatively broad bail-out schemes. These considerations must be counterbalanced with the possibility of increasing moral hazard risks, and the related scope for public sector liabilities on account of safety net provisions. Finally, financial markets themselves may be prone to overreaction. Indeed, some observers have expressed concern about the current volatility in bond and equity markets. Such market instability may warrant in some cases somewhat slower regulatory policy relaxation in certain areas (e.g., provisioning and capital adequacy cover). But this is not a costless process. There are trade-offs for the functioning of the international monetary system in terms of efficiency losses associated with misallocation of loanable funds.

Concluding remarks

In concluding, allow me to thank Griffith-Jones for providing a rich documentation of the process of Latin America's restoration of access to private capital flows. Her paper provides a good basis for discussing general policy issues that influence the functioning of the international monetary system. Adequately addressing these issues requires close monitoring of developments and coordination among policymakers in industrial and developing countries. Discussions in this type of forum offers the prospects for strengthening the analytical foundation for meeting the policy challenges ahead.

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