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

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Optimism has replaced pessimism for many people in Latin America, as the region has seen notable improvements take place in the past few years, and particularly in 1991. Budget balances have been improved, the printing of money moderated, inflation reduced, and projects better evaluated. But there are also many persistent problems. Private and public investment is low and public wages are far below market levels. Poverty and income concentration continue to increase in many Latin American and Caribbean countries (LACs), to worse levels than before the debt crisis of the early 1980s. Despite clear improvements, therefore, crucial problems remain.

The financial arena has seen significant changes, as documented by Stephany Griffith-Jones in a competent and well-balanced fashion. A large number of Latin American countries have seen a sharp rise in their access to segments of the international capital markets. Foreign savings have become available to them and the region has experienced rapid growth of international financial activity in 1991.

Two questions are raised by this phenomenon, both relevant to developed as well as developing countries:

1. What is happening with overall savings, not only financial savings, but total savings of the world and the national savings of developing countries?
2. How much new productive capacity is being created and what is happening with the rate of use of existing capacity?

These issues must be explored, since financial development is not a gain in itself; it is a means of lubricating and accelerating real economic growth in any country, i.e. increasing investment and productivity, fuelling the capacity to consume, and creating possibilities for higher wage-levels and the provision of productive employment.

In Latin America, the 1970s and 1980s provided examples of both good and bad financial reform. In some cases, increased financial activity was associated with increased economic growth, a rise in investment and better quality of investment. In others, financial reform was connected with diminishing national savings and low rates of investment, along with a decline in the use of capacity. For many years, several LACs operated below the production frontier. That is quite inefficient (see several articles in Ffrench-Davis, 1983), implying that effective ex post productivity is lower than the potential.

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Stephany Griffith-Jones and John Williamson have provided relevant and well-argued insights into these vital issues. But I would like to concentrate on what I consider to be some crucial features of 1991.

I think the fact that Latin America does not find itself in the European financial area, but in the US area is very significant. It is true that world financial markets are becoming ever more integrated, but they are not fully integrated in the sense of having 'one price'. There is a large gap between the price of money in Europe and North America: interest rates diverge widely, and, ex post, the gap has not been closed by exchange rate movements. The external interest rate faced by Latin American countries is not the 9.5 per cent prevailing in Europe but the 3.5 per cent or 4 per cent LIBOR in US dollars. This, and the current low demand for funds in the United States, has important implications for Latin American countries. Both investment and consumer lending in the United States were abnormally low in 1991. This meant that a large volume of funds became available to Latin America and other regions.

Changes in some of the domestic economies of Latin American countries complemented this trend. These included privatisation (in several cases involving a very high rate of return in the short run), low prices for foreign funds, together with high returns in the domestic stock exchange. These have been perceived by economic agents as trends which would continue for some time; combined with low demand in the United States, they generated a remarkable flow of funds towards Latin America.

On the domestic scene, what has resulted? First of all, foreign exchange constraints have been reduced or eliminated. Until 1990, lack of external finance was the dominant constraint on economic activity in several countries, keeping them far below the production frontier.

Since 1991, however, Latin American countries could increase actual GDP faster than their productive capacity, because they had underutilised capacity. So, in spite of low domestic investment, the relaxation of the foreign exchange constraint allowed the GDP to move up. Some countries show increases in GDP as high as 5, 6 or 8 per cent, notwithstanding low investment. Actually, it is not that low investment suddenly became highly productive, but simply that previously the available capacity to generate income had been constrained by a shortage of foreign exchange. But money flows in 1991 have been much greater than the foreign financing actually consumed in the domestic economies of Latin American countries. Thus roughly one-half of the net inflow of capital, totalling $40 billion, has been used to build up reserves.

What does this imply? That the absorptive capacity of domestic economies was limited. Nonetheless, capital kept flowing. Why? Not because Latin America needed more capital for macroeconomic balances, but because short-

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run interest rate differentials or profit rate differentials were wide. So these signals of the market kept drawing capital into Latin America. In such circumstances, what happens? Large reserve accumulation leads to pressures for exchange rate appreciation.

If we look at the 18 main Latin American countries, therefore, we see that in 1991, 15 currencies appreciated in real terms – by between 1 and 20 per cent – compared with the average for 1990. Most of these currencies continued to appreciate during the first half of 1992, in spite of efforts by several governments to prevent this so as to sustain the rise in exports, which was based on low rates of exchange. But the official efforts were no match for the effects of the markets.

Added to the market's influence, there was the justified concern with reducing inflation. When you have a large inflow of dollars, and the day-to-day market is pressing for appreciation, it is hard to supersede this short-run market trend because it contributes to reducing inflation. The most relevant question we should ask, however, is: how much of this appreciation is a movement towards equilibrium or away from equilibrium?

One could argue, following Stephany Griffith-Jones, that part of this might be a movement in the correct direction. Obviously, the debt crisis of the 1980s led to significant real depreciations, which were needed after the appreciations of the 1970s, when abundant and cheap bank loans had caused most Latin American currencies to appreciate. In the 1980s, the trend was reversed, and sharp depreciations resulted. Chile, for instance, more than doubled the real exchange rate between 1982 and 1986. In both decades, there seems to have been an overshooting (from a long-run perspective) of exchange rate adjustments, dictated by short-run policy needs.

At the present time, therefore, there is some room for appreciation without the danger of future imbalances. However, following Stephany Griffith-Jones and Mohamed El-Erian, one must follow with great care how this develops in the future. What will happen with current account deficits, with real exchange rates and what will be the response of exports?

For tradeables do not include only exports, but also importables. In 1991, many Latin American countries reduced restrictions on imports, in most cases correctly. But one has to take into consideration what happens in the real economy in order to conduct an efficient restructuring. If a country is appreciating the exchange rate, pari passu, while reducing import barriers, it will be giving two negative signals for import-competing industries which may result in a strong negative adjustment. Every economy will adjust to market signals, but the crux of the matter is that it should adjust in the direction of creating more capacity, of being more productive, of encouraging people to invest more and better. If a country reduces tariffs and appreciates the exchange rate at the same time, it runs the risk that the positive incentives to exports are smaller than the negative incentives to imports. Fiction? No, it is the history of the 1970s, of the countries that instituted strong import liberalisation policies together with exchange rate appreciation. Chile and some other Latin American countries provide clear examples. (Ffrench-Davis, 1983).

So, in evaluating the welfare effects of financial flows, it is very important to examine what is happening in the real world, because what matters in the end is the performance of the real world, the effort to produce more with a higher level of efficiency and equity (ECLAC, 1992). Efficient financial markets are crucial to this effort. Now, what to do when a given country or region faces a revived access to capital flows but these new flows are partly associated with recession in the United States and abnormally high returns in Latin American countries? Then, it becomes necessary to manage or influence capital flows in such a way that they contribute to future stability.

Macroeconomic management, and exchange rate policy in particular, are crucial for stability to be sustainable. This explains why several countries in Latin America have been trying to influence, to some degree, the composition of capital inflows, so that they are tied to the (long-term) investment process. The Griffith-Jones paper stresses this. Encouragement should be given to long-term flows associated with the investment process – direct foreign investment, imports of capital goods, and so on.

This is one component of capital movements. Given their volume, it can be said that it is not the part that creates the appreciating trends. These are more closely linked with the short-run flows which result from short-run interest rate or profit rate differentials.

A second element is, and Mohamed El-Erian emphasised this, the matter of domestic surveillance of financial markets. It is true that most of the flows are conducted by private agents. Some people may think, as they did in the 1970s, that this eliminates the risk of mistake. But history proves that this is a gross error; imbalances can be created by both the public and private sectors. Look, for example, at Chile in the 1970s. Chile had a budget surplus and was reducing public sector debt. Nonetheless, the deficit on its current account had climbed to 18 per cent of GDP by 1981. There was a surplus in the public sector, but a deficit exceeding 18 per cent in the private sector. This was the result, among other variables, of wrong prices (an appreciated exchange rate), large supplies of loans by banks, and generalised myopia on the part of lenders and borrowers.

The surveillance of domestic capital markets needs a rebalancing, and several of our economies should be subjected to careful monitoring, with more emphasis on keeping close track of the quality of the performance of the financial markets. Some countries have been very careful and tough on this matter. In others, part of the job is pending.

The other element is macro-management: how to conduct this so that the

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capital flows don't disturb the performance of the real sector, especially via their influence on the exchange rate. Here, I think, there is an unavoidable trade-off: we have to choose either to regulate the exchange rate and exert some control on short-run capital movements, or to let the capital inflows determine short-run exchange rates and then go through more radical shifts in the balance of payments and macroeconomic cycles. History, and present events, very clearly signal that one has to make a choice.

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Floor Discussion of the Griffith-Jones Paper

Is Latin America's boom sustainable?

History has taught us, Shahen Abrahamian observed, that financial markets are prone to cycles of boom and bust. Is the euphoria over Latin America's recent return to western capital markets justified therefore? A note of caution could be found in the very site of this discussion, where the notorious 'tulip mania' had once almost bankrupted Holland's economy.

"At the end of the seventeenth century," Abrahamian reminded the gathering, "Holland was the scene of the first great speculative craze in Western European history. It was a purely private, market-driven phenomenon. There were no Keynesian policies, no import substitution policies, no planning involved; it was a globalised, integrated market economy much more so than today. And this tulip mania nearly bankrupted the whole economy."

Today's capital flows to Latin America should therefore be carefully looked at in terms of sustainability, he argued. The sources of these flows – $40 billion in the last year alone – had still not been adequately explained. He felt that the new money gushing into the region was simply being pulled by high interest rates and the expectation that these high rates would be held up.

"Money is coming in because the exchange rate is going to be held up," he contended, "and the exchange rate is being held up because money is coming in. This is a recipe for a bust, quite clearly!"

Other participants shared this fear. Tom de Vries pointed to the strong link between US monetary policy and capital shifts to Latin America.

"When US interest rates were low in the 1970s," he observed, "bank capital flowed to Latin America; when US interest rates became high in the 1980s, capital stopped flowing; and now, when US interest rates in real terms are about zero, capital has started flowing again." Private banker Frans van Loon, saw it differently. The explanation, he said, lies in "the growing efficiency" of the Latin American financial markets.

"In the day-to-day perspective of banking," he said, "the resurgence or improvement of efficiency in banking business – in terms of what is being done with domestic savings, with payment systems and with allocation through the banking system – in Latin America is very notable." According to Van Loon, one has to look at the new flows in the context of the

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complementary capability of the domestic money and capital markets.

"It is only through the improvement of those markets that international capital transfers can play their proper role," he argued. He also pointed to a completely different reason for bankers' interest in the 'newly-emerging markets': the 'lousy situation' in the financial markets of the industrial countries.

"Business in the OECD itself, in the supposedly efficient markets, has not been all that attractive," he said. "Margins have been very low, and there have been very serious debt problems. Banks haven't really gone bankrupt because of the debt crisis in the developing countries; they have gotten into trouble because of huge problems with real estate, agriculture, tycoon lendings, things like that, in the industrial countries. The real big scandals, difficulties and inefficiencies in the financial world in the past years have not been in the developing countries, but in the OECD: the savings and loans crisis in the United States, the collapse of Japanese brokerage firms, the BCCI scandal, etcetera. That's where the real big losses in the financial system have been actually incurred."

Stephany Griffith-Jones welcomed the search for additional explanations of the capital flows into Latin America because she, too, was anxious about their sustainability. "In particular," she said, "I think of the very large privatisations, large increases in stock exchange and prices of shares, and in general the whole area of development of private capital markets that Van Loon talked about. I think this is also interesting because it gives us a hint that some of these flows may be once-and-for-all flows, for example the private flows linked to massive privatisation processes in the last years in Argentina; a lot of money came in to take advantage of that. Some of the foreign direct investment flows, related to creation of new capacity, may turn out to be more sustainable."

Separation of 'good' from 'bad' flows

There was general agreement that some flows are good, while others are less desirable. Ariel Buira emphasised that one should look where the money goes, make sure that the new flows are not used to finance budget deficits, and find out whether the private sector receiving the flows allocates them in a productive way. The difficulty however is: how to separate the good flows from the bad ones.

This poses a dilemma, Shahen Abrahamian noted. To get good flows in, one needs liberal, market-friendly policies, but to keep the bad ones out, some interventionist measures are required. Griffith-Jones thought this problem could be solved by separating them adequately through indirect instruments such as taxation, reserve requirements, etcetera. But going beyond that, she

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warned, is very complex because you end up giving misleading signals and trying to control the over-reaction of financial markets.

Other participants countered that any form of government intervention would hinder "good" money flows. According to Mitsuhiro Fukao, Japan provided an example of this.

"Right after the war a small company called Sony tried to get the transistor technology rights," he related, "but the Japanese Ministry of International Trade and Industry (MITI) held up the approval for some time, because they thought it was a bad project."

Griffith-Jones dismissed this example. She argued that the intervention policy of the Japanese Ministry of International Trade and Industry had greatly contributed to the economic success of Japan. "Japanese government intervention could be an example for other developing nations," she insisted.

Ariel Buira agreed that intervention may be opportune, for instance, in keeping bad flows of money out. An example was the Mexican central bank's policy of discouraging very-short-term flows or 'hot money' coming in.

"We do this by widening the band for exchange rate fluctuations," he explained, "so that they don't know at what rate they will come out after two or three days and that may make it uninteresting to come and arbitrage the interest rate."

Buira cautioned that this strategy was of questionable effectiveness. He said central bank officials from Spain had repeatedly told him that, in a largely integrated market, measures can only limit capital inflows for a short period of time. "After a while, the market finds ways of getting around your measures. The Spanish experience tells us there isn't really much you can do to stop it, which brings us to the question of the need for better government supervision and regulation that Griffith-Jones brought up."

Jack Boorman, amongst others, stressed the importance of letting the market itself do the job of separating good and bad flows. According to him, default and failure are the natural separating mechanism.

"The point is," he said, "that in a world of micro-lending to a diversity of entities, if risk is being priced right, there ought to be failure. We should not prevent failure, for it is a very healthy feedback. More failure, more losses in the US banking system would have woken people up a lot earlier, and the same thing is true for Latin America: failure would be healthier than government supervision."

However, many participants felt that market forces and failure alone were not sufficient. They pointed out that private borrowers and lenders today remember that when things turn out bad in the end there is always the government to bail you out. So they don't take all the risks into account when considering the transfer of capital. Gerald Helleiner suggested, therefore, that capital flows should be subjected to monitoring and surveillance in a

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similar way as is done with money flows related to the drugs trade. He felt there was now a "vacuum we no longer can afford".

Agreeing, Henrik Fugmann proposed that this vacuum be filled by a better supervisory framework. Private banker, Van Loon, supported this view, noting that there was a dangerous gap between the lending and securities business.

"For every loan to a Latin American country," he observed, "we must keep a good portion of our loan as reserves, but if bonds or equity are bought, there is no such requirement." Further control and supervision should not just be addressed to the banks only, but to the whole system of international financial transfers, he argued.

Need for information and guidelines

There was general agreement that the markets should be made to work better and do their job properly, through improvements in the exchange of information on the risks involved in transferring capital to certain countries. Stimulating the availability of "real, reliable open information" was, in Van Loon's view, the best way of improving risk calculation. Present-day information technology makes it easy to exchange information quickly and amply, he noted. But, while recognising the role of monitoring and surveillance systems, he warned against their prominence being increased. "Millions of micro-decisions can do a better job than a few centralised supervisory entities," he said.

But, John Williamson pointed out, while agreeing with Van Loon's general proposals, there is also the need for some macroeconomic guidelines by which such information can be judged. Policymaking cannot be left to a "million" private micro-decisionmakers. "Governments do have an advantage in thinking about macroeconomic questions," he noted, "because that is what they are paid to think about. One shouldn't just leave it to the market, because individuals there make money by spotting a trend before others do, and they don't take macro-sustainability into their considerations."

Clearing up the old debt

Giovanni Andrea Cornia raised the question of what was happening to the old debt and asked what influence the new flows were having on current debt reduction strategies. He felt that old debt had not yet been effectively reduced.

Van Loon countered, "The large scale securitisation of the old debt – all the Brady deals – has been one very important stimulus to the capital markets' activity and particularly the securitised lending that we see now in

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Latin America." Although Griffith-Jones shared Van Loon's view, she agreed with Cornia and the others concerned about the large debt overhang still troubling a number of developing countries. As Drag Avramovic pointed out, "there are 120 indebted countries who still can't borrow." Observing that, unfortunately, Griffith Jones' analysis was not applicable to most other parts of the world, Percy Mistry challenged the notion of the globalisation of the world financial system.

"The global system has fractured itself into three North-South zones, a dollar zone, an ecu-deutsche-mark zone and a yen zone," he stressed. "And there are parts of the world which are not really articulated within any of these. Africa for instance has become part of the charity zone, not part of the ecu-deutsche-mark zone. When we talk about globalisation of the monetary system and of the international financial markets you have the distortion that 150 countries, not 120, have just dropped off the map."

John Williamson argued that these 120 countries might not be such a big issue if India and China were not among them, since both those countries, containing huge sections of the world's population, were "on the wing of market-creditworthiness."

Griffith-Jones had focussed on Latin America, she explained, because that was where the most rapid changes were taking place. But, she said, "perhaps one should have another conference on the poorer countries and their problems, and how they relate to the monetary and financial issues we are discussing."

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