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

From: Fragile Finance: Rethinking the International Monetary System
FONDAD, The Hague, January 1992, www.fondad.org

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

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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