The Return of Private Capital to Latin America: The Facts, an Analytical Framework and Some Policy Issues

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This paper discusses the massive and rather surprising return of private capital flows to Latin America. This is both a very new and a very old phenomenon. It is very new in that, only three years ago (when the focus was mainly on foreign exchange constraints and the region's debt overhang) such a massive return of private capital into Latin America seemed totally unlikely to most policymakers, market actors and observers. It is a very old phenomenon, however, because private capital has flown in great abundance to the region on many previous occasions since the early 19th century.

We will first analyse the international context of shifting private capital movements in which this phenomenon is taking place. Then we will examine in some detail what and how much is happening to private capital flows to Latin America. As this phenomenon is so recent, it seems essential first to understand, as far as possible, its magnitude and characteristics. This is not an easy task, due to the limitations of existing data and data collection. The next section will attempt to explain recent developments, focussing both on supply and demand factors. We will then try to develop an analytical framework for evaluating the effects of these flows on Latin American countries looking at empirical evidence. The final section presents conclusions, preliminary policy suggestions and some suggestions for further study.

I. THE INTERNATIONAL CONTEXT AND PRIVATE CAPITAL FLOWS TO LATIN AMERICA

International trends

The return of private capital flows to Latin America needs to be understood

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in the context of major changes in capital movements at a global level. During the 1980s, financial markets have been characterised by: 1) their growing integration amongst different countries, market segments, institutions and financial instruments; 2) liberalisation; and 3) the spread of innovative financing instruments and techniques.

These trends are related first to the deregulation of financial services in areas such as prices, interest rates, fees and commissions, a policy trend which began in earnest in the 1980s, and is now almost complete in industrial countries. Furthermore, the restrictions on the range of activities of financial institutions have also continued to erode, both through market practice and through legislative and regulatory action. Indeed, in the three major economies with traditionally segmented systems – Canada, Japan and the United States - there have been moves toward a relaxation of functional barriers. Movement towards geographic integration of financial markets has been particularly marked in recent years within the European Community, especially in the context of the 1992 Single Market programme. Indeed, as the IMF reports,[2] many market participants in Europe (both EC member and non-member countries) view the overall process of European integration as the single most important influence on their activities and strategies for the 1990s. Within the EC, the integration of financial services has been accompanied by discussion of more integrated supervision and regulation, particularly in the field of banking. However, progress in the latter, in certain key sectors such as securities, has been relatively slow, which could perhaps be a cause for concern.

It should be stressed that other factors have also contributed to the globalisation of capital markets. These include important technological advances in telecommunications and computing, which both accelerate and reduce the costs of international operations and the exchange of information. Also, the sharp current account imbalances in major industrial countries during the 1980s led to large flows of funds from surplus to deficit countries, and especially to the USA; this latter trend seems to be diminishing somewhat as Germany's current account surplus disappears and the US current account deficit declines somewhat.

Finally, there are two somewhat related trends, which seem important to highlight in this context. One is the far more rapid growth of securitised forms of lending (such as bonds) than of bank loans (see Table 1). The second is that institutional investors (such as pension funds, insurance and mutual funds), have played an increasingly dominant role in world capital markets.

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2 IMF, "International Capital Markets, Developments and Prospects", World Economic and Financial Surveys, Washington, D.C., May 1991.

Such investors have a greater ability to analyse in depth the changing conditions in different markets than individual investors. This has led many of them to a greater geographical diversification in their investments, with the aim of improving their profits, and diversifying their risks.

TABLE 1 BORROWING ON THE INTERNATIONAL CAPITAL MARKETS

(Amounts in Billions of Dollars)

INSTRUMENTS	1982	1984	1987	1988	1989	1990	1991
Bonds	75.5	111.5	180.8	227.1	255.7	229.9	297.6
Equities	n.a.	0.3	18.2	7.7	8.1	7.3	21.6
Syndicated loans	98.2	57.0	91.7	125.5	121.1	124.5	113.2
Note issuance facilities	5.4	28.8	29.0	14.4	5.5	4.3	1.8
Other back-up facilities			2.2	2.2	2.9	2.7	4.5
Total securities and committed facilities	179.1	197.6	321.9	376.9	393.3	368.7	438.7

Source: OECD Financial Market Trends, February 1992, and previous issues.

Table 1 reflects the evolution of the international capital markets since 1982. A first trend to observe is the very rapid increase in total global borrowing, from $179 billion in 1982 to $439 billion in 1991. A particularly large increase (of almost 20%) occurred in 1991, after a contraction in 1990, related to a significant reduction in some of the Japanese bonds. A second trend to observe is the increased importance of bonds in total borrowing. Bonds represented around 42% in 1982, and have increased their share to around 67% in 1991. This increase in the share of bonds in total borrowing has been accompanied by a decline in the share of syndicated loans. This was caused mainly by the attitude of leading international banks against extending new loans other than to prime borrowers. This attitude reflects greater emphasis on containing asset growth within boundaries set by new capital adequacy requirements and on improving the quality of loan portfolios. By contrast, the past and the future situation of the international securities markets is clearly more favourable. Market observers point to the fact that, on a global level, the availability of funds remains ample. According to the

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OECD [3] this positive underlying trend in international securities markets is strengthened by two factors: first, the process of asset diversification may intensify since several "emerging" segments of the euro-bond market have reached the critical size which justifies a heavier weighting in institutional investors' portfolios. Secondly, the maturing of the euro-bond market implies an increase in bond redemptions, which provides investors with an increasingly large source of liquidity that needs to be profitably re-invested.

If euro-commercial paper lending and other non-underwritten facilities are added, total borrowing on international capital markets increased from $392 billion in 1987 to $518 billion in 1991. The share of developing countries in this total borrowing, though still relatively low, increased significantly during the past three years, up from 5.0% of the total in 1988 to 8.1% in 1991. Indeed, the overall recourse to private international markets by developing

TABLE 2 LATIN AMERICA AND THE CARIBBEAN: NET CAPITAL INFLOW AND TRANSFER OF RESOURCES

(Billions of Dollars and Percentages)

	(1) Net capital inflow	(2) Net payment of profits and interest	(3) = (1) – (2) Transfer of resources	(4) Transfer of resources – (%) Exports of goods and services
1975	14.3	5.6	8.7	21.2
1980	32.0	18.9	13.1	12.5
1981	39.8	28.5	11.3	10.0
1982	20.1	38.8	–18.7	–18.2
1983	2.9	34.5	–31.6	–30.9
1984	10.4	37.3	–26.9	–23.7
1985	3.0	35.3	–32.3	–29.7
1986	9.9	32.6	–22.7	–24.0
1987	15.4	31.4	–16.0	–14.8
1988	5.5	34.3	–28.8	–23.4
1989	9.6	37.9	–28.3	–20.8
1990	18.4	34.4	–16.0	–10.6
1991	36.0	29.3	6.7	4.4

Source: UN ECLAC Preliminary Overview of the Economy of Latin America and the Caribbean 1991. December 1991, Santiago, Chile.

3 OECD, "Financial Market Trends", No. 51, February 1992.

countries rose in 1991 by nearly 50% (to $42 billion), the highest level in absolute nominal terms since the early 1980s.[4] Particularly noticeable in this expansion was the very strong growth in borrowing by a number of Latin American countries, which we will discuss next.

Dramatic change of direction and increase of flows

As is well known, in the 1980s, net resource transfers to Latin America and the Caribbean (LAC) were strongly negative (see Table 2). One of the key reasons for this was a sharp fall in private flows to the region, caused mainly by a large decline in private bank lending, that had reached such high levels till 1982. Indeed, according to El- Erian,[5] the total amount of voluntary loan and bond financing flows to Latin American countries during the whole 1983-88 period was considerably smaller than that for 1982 alone.

Starting in 1989, and continuing in 1990 and 1991, there has been a dramatic increase in voluntary new private flows to Latin America and the Caribbean. According to ECLAC, (see again Table 2), net total private flows

TABLE 3 PRIVATE CAPITAL FLOWS TO LATIN AMERICA AND TO SELECTED LATIN AMERICAN COUNTRIES

(Amounts in Billions of Dollars)

	1989	1990	1991
Argentina	1.4	0.5	5.1
Brazil	0.2	0.4	11.6
Chile	1.1	2.0	1.7
Mexico	0.7	8.4	16.1
Venezuela	1.0	1.8	4.8
Regional	0.6	0.2	0.8
Total	5.0	13.4	40.1

Source: Salomon Brothers, op. cit.

4 OECD, op. cit.

5 See M.A. El-Erian "Restoration of Access to Voluntary Capital Market Financing". IMF Staff Papers, Vol 39, No. 1, Washington D.C., March 1992.

TABLE 4 TYPES OF PRIVATE CAPITAL FLOWS TO LATIN AMERICA (1991)

(% of type of flow)

	Total	Argentina	Brazil	Chile	Mexico	Venezuela	Regional
Borrowing							
Bonds, Private Placements & Medium-Term Notes	100.0	13.0	41.2	2.3	54.1	6.9	–17.4
Commercial Paper	100.0				24.1	4.9	71.0
CDs	100.0	27.2	69.1		3.7		
Trade Financing	100.0		65.8		34.2		
Term Bank Lending	100.0	4.2	70.0	13.7	10.6	1.4	
Sub Total	100.0	8.8	42.7	3.3	38.6	4.7	1.9
Portfolio Investment							
Funds	100.0	7.4	16.2	3.4	12.5		60.4
ADRs [1]	100.0	12.9			87.1		–0.0
Sub Total	100.0	11.6	3.7	0.8	69.9		13.9
DFI [2]							
Cash Inflows from Privatisation	100.0	39.1			60.9		
Other DFI	100.0	9.1	12.4	10.5	52.6		15.4
Sub Total	100.0	16.7	9.2	7.9	39.3	15.4	11.5
Other Flows	100.0	15.9	84.1				
Sub Total	100.0	15.9	84.1				
Grand Total	100.0	12.7	29.0	4.2	39.9	7.2	7.0
% of GDP		7.6	2.7	5.8	5.9	10.0	

Note: 1 ADRs = American Depository Receipts
2 DFI= Direct Foreign Investment

Source: Table elaborated by Alicia Rodriguez on the basis of data in Salomon Brothers, 1992 Emerging Markets, op. cit.

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to LACs have increased almost sevenfold since 1988. As a result of this dramatic increase, and, to a lesser extent a decline in net payments of profits and interest, 1991 was the first year since 1981 that the net transfer of financial flows reversed direction and turned positive. Thus, the net outward flow of $16 billion in 1990 was transformed into a new inflow of nearly $7 billion in 1991 (see again Table 2). This represented a turnaround of $23 billion in the net transfer in one year, an amount equivalent to 15% of the region's exports of goods and services.

As can be seen in Table 3, Salomon Brothers [6] even estimates a somewhat more rapid increase than ECLAC, with private capital flows to Latin America calculated to have increased eightfold between 1989 and 1991 and by almost 200% in 1991 alone, reaching over $40 billion.

Country distribution

For 1991, according to Salomon Brothers, there was quite a large concentration of private flows to the two largest countries in the region (Brazil and Mexico), which received almost 70% of inflows (see Table 4). For Mexico (which accounted for 40% of total flows to Latin America in 1991), this represented around 6% of its GDP, while for Brazil it represented 2.7% of its GDP.

In 1991, inflows to Venezuela (at $4.8 billion) are estimated to have reached 10% of the country's GDP, whilst inflows to Argentina reached 7.6% of GDP and to Chile 5.8% of GDP (see again Table 4). The country composition was somewhat different in 1990, when the largest flows went to Mexico and Chile, the two countries which, according to Salomon Brothers, received above 75% of total inflows to Latin America. In 1990, inflows to Chile represented 7.4% of the country's GDP and inflows to Mexico 3.6%.

It is very interesting that, in 1991, not only Chile and Mexico (who had pursued prudent macroeconomic policies and had reduced their debt overhang significantly in the late 1980s) had access to private capital markets, but also countries like Brazil, where important macroeconomic imbalances and a large debt overhang still persisted. However, the terms on which Brazilian borrowers have access to the capital markets are somewhat less attractive. We will return to this issue later on.

Types of flows

It is important to emphasise that the increase in net capital flows to Latin

6 Salomon Brothers, "Private Capital Flows to Latin America: Volume Triples to $40 billion in 1991", February 12, 1992, New York.

TABLE 5 TYPES OF PRIVATE CAPITAL FLOWS TO LATIN AMERICA (1991)

(% of total flows)

	Total	Argentina	Brazil	Chile	Mexico	Venezuela	Regional
Borrowing							
Bonds, Private Placements & Medium-Term Notes	21.2	21.6	30.2	12.0	28.7	20.2	–53.1
Commercial Paper	6.3				3.8	4.3	63.7
CDs	1.6	3.4	3.8		0.1		
Trade Financing	4.2		9.4		3.6		
Term Bank Lending	5.9	1.9	14.1	19.3	1.6	1.2	
Sub Total	39.1	27.0	57.6	31.3	37.8	25.7	10.6
Portfolio Investment							
Funds	3.7	2.2	2.1	3.1	1.2		32.0
ADRs [1]	12.3	12.5			26.8		
Sub Total	16.0	14.6	2.1	3.1	28.0		32.0
DFI [2]							
Cash Inflows from Privatisation	8.8	27.0				74.3	
Other DFI	26.0	18.7	11.1	65.7	34.2		57.4
Sub Total	34.8	45.7	11.1	65.7	34.2	74.3	57.4
Other Flows [3]							
Argentina	1.6	12.6					
Brazil	8.5		29.3				
Sub Total	10.1	12.6	29.3				
Grand Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: 1 ADRs = American Depository Receipts
2 DFI = Direct Foreign Investment
3 Identified by the countries' Central Banks.

Source: Table elaborated by Alicia Rodriguez on the basis of data in Salomon Brothers, 1992 Emerging Markets, op. cit.

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America and the Caribbean has not been due mainly to a return of bank lending, but due to the region's re-entry to capital markets, (especially bonds, private placements and medium-term notes), portfolio investments, and foreign direct investment. In this context, it is noteworthy that the process of the region's market re-entry has been done via a wide range of financing instruments, and involves a wide range of markets, investors and lenders.

Table 5 offers a breakdown of private flows to Latin America in 1991. We can see that 39% of the total flows ($15.7) took the form of borrowing, most of this being in the form of bonds, private placements and medium-term notes. Borrowing was a particularly important source of funds in 1991 for Brazil (see again Table 5). Furthermore, as can be seen in Table 4, in 1991 a very high proportion of short-term flows to Latin America (via for example CDs and trade financing) went to Brazil.

Another important category in 1991 was foreign direct investment, which, at $14 billion, represented almost 35% of total flows into the region. Direct foreign investment is reported to have been a particularly high proportion in Venezuela (where it went mainly for privatisation), Chile (for new investments) and to a lesser extent Argentina (mostly for privatisation, but also in a smaller proportion for new investment (see again Table 5)). Portfolio investment flows represented a smaller share – 16% – of private flows in 1991, with fairly significant proportions in Mexico and in other Latin American countries. In previous years, 1989 and 1990, Mexico and Chile were the Latin American countries that obtained a particularly large share of portfolio investment in Latin America [7]. Indeed, it was a Chilean firm, CTC (Chilean Telephone Company) which was the first Latin American company that sold shares on the New York Stock Exchange since 1963, via American Depository Receipts (ADRs).

Also of interest in this context is the Telmex (Mexican Telephone Company) privatisation, which involved the issuance of some $2.3 billion on several equity markets. This equity offering is reported [8] to be the sixth largest placement of shares in the world (in nominal values).

Length of period and cost

As regards the length of time for which these capital flows are entering, it is encouraging that for some countries, such as Mexico and Chile, and to a

7 P. West "El regreso de los paises latinoamericanos al mercado internacional de capitales privados." Revista de la CEPAL, Santiago de Chile, September 1991.

8 See El-Erian, op. cit.

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lesser extent Venezuela, 1991 was characterised by increased levels of longer-term capital flows.

Thus, for Chile, over 65% of the private flows entering in 1991 was via direct investment, all of which was for new investment. For Mexico the figure was almost 35%. Furthermore, Mexico established a new benchmark and reportedly broke a psychological barrier with a ten-year, $150 million Euro-bond issue for NAFINSA (the national development bank). However, on average, Mexican international bond issues have not improved their maturities that much. According to the IMF,[9] for secured issues, average maturities went up only from a 5 year average in 1989 to a 5.5 year average for 1991 (see Table 6); for unsecured issues in the private sector, there has been a more important lengthening of maturities, (from 2 to 4.4 years), but they are still fairly short.

On the other hand, public sector unsecured issues saw their average maturity decline slightly. (Significantly, however, spreads have come down markedly in Mexico, especially for unsecured public issues (see again Table 6)).

TABLE 6 AVERAGE TERMS ON INTERNATIONAL BONDS (MEXICO)

	1989		1990		1991	
	Spread [1]	Maturity (Years)	Spread	Maturity (Years)	Spread	Maturity (Years)
Secured issues	165	5	304	4.4	150	5.5
Unsecured issues						
Public sector	820	5	379	4.9	246	4.2
Private sector	800	2	613	3.6	542	4.4

1 Spread = premium in basic points, defined as the difference between the bond yield at issue and the prevailing yield for industrial country government bonds in the same currency and of comparable maturity.

Source: IMF

9 World Economic and Financial Survey, 1991, op. cit.

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Aside from direct investment, some bonds and possibly some portfolio investment, the majority of private capital flows to the region has been short-term, especially in short-term money market instruments, where local Latin American interest rates tend to be significantly higher than in the USA. Thus, many American, Latin American and European investors and lenders have been attracted to CDs, Treasury bills, bonds and commercial paper that offer yields at two to four times LIBOR for short-term investments. Table 7 shows estimated benchmark real domestic interest rates and compares them to US$ LIBOR.

TABLE 7 BENCHMARK REAL DOMESTIC INTEREST RATES, 1990-1991

	1990	1991
Argentina (Intercompany lending rate)	47.4%	22.0%
Brazil (Monthly rate - LTN/BBC)	25.4%	32.4%
Chile (90-365 day real annual deposit rate)	9.5%	5.5%
Mexico (28 day CETES rate)	34.7%	15.9%
Venezuela (91 day zero coupon rate)	33.8%	35.5%
US$ LIBOR (6-month average)	8.4%	4.4%

Source: Salomon Brothers, based on national and international sources.

The dramatic drop in short-term US real interest rates during 1991 to a level which (by 1980s standards) was very low, drastically increased the attractiveness of Latin American investment instruments with far higher yields.

It is interesting that US investors, faced with lower interest rates at home, have increased their investments in Latin America by so much, even though

European interest rates are far higher than US ones. This shows that world financial markets are still not fully integrated.

As Kuczynski[10] correctly suggests, the fact that in 1991 private capital inflows took place even into countries such as Peru which were suffering from significant financial and other problems, suggests that the external forces of funds, driven by sharply lower interest rates in the US markets, were a very powerful explanation of such short-term flows. As we will discuss in more depth in the next section, other factors (including not just high Latin American interest rates but also better economic prospects in the region) have also played a major role.

Sources of funds

It is also encouraging that the investor base of flows going to Latin America has broadened significantly, particularly in 1991, now including money managers, pension funds, mutual funds, insurance companies, finance companies, as well as Latin American investors, the latter either returning capital home or investing in other countries in that region. Furthermore, multinational companies are increasing their direct investments in the region. According to the World Bank, Mexico and Brazil were the top two destinations for investment in developing countries, in the period 1981 to 1991. The prospect of trade integration between Latin American countries, the US and Canada, is further encouraging the formation of strategic alliances between US and Latin American companies.

An interesting issue is whether a large proportion of the capital flowing into Latin America is from Latin American investors repatriating assets previously held abroad. As can be seen in Table 8, estimated repatriation of capital flight in 1990 reached $7 billion (for five major countries in the region). This would represent around 40% of total capital inflows into the whole region during that year (see again Table 2). For 1989, the proportion would be similar. This would seem to give some credibility to the perception of those observers who believe that more than 50% of the capital entering Latin America is from Latin American investors. However, it would seem [11] that a growing proportion of capital flowing into the region originates from sources outside the region, as the potential and profitability of such flows becomes more widely known.

10 P.P. Kuczynski "International Capital Flows into Latin America: What is the Promise?" World Bank Annual Conference on Development Economics, 1992.

11 Interview material.

In any case, the return of capital previously fled is an important and positive trend emerging since 1989. According to Chartered West LB estimates for five major Latin American countries (Mexico, Chile, Venezuela, Brazil and Argentina), there was a total net capital repatriation for 1989-90, of $10.5 billion, which is in sharp contrast with the 1987-88 period, when there was a capital flight of $8.0 billion, implying a turnaround of $18.5 billion in a short period.

As can be seen in Table 8, between the years 1989 and 1990, the situation was quite heterogeneous across these five countries. Mexico, Venezuela and Chile saw important levels of repatriation, while Brazil and Argentina experienced capital flight. Indeed, Brazil – once regarded as an example of a country which avoided capital flight – was consistently losing capital between 1983 and 1990. By contrast, Mexico – a country which traditionally had large capital flight – has had a massive return (estimated at $10 billion) in the 1989-90 period. The Mexican government estimates that a further $5.5 billion returned in 1991. Of the five, the only country that has had a significant net repatriation of capital for the whole 1983-90 period is Chile. This seems to have been due both to so-called economic fundamental factors (strength of macroeconomic policy, good relations with external creditors, private sector orientation, low inflation, positive real interest rates and a welcoming attitude to foreign direct investment) and institutional factors (debt conversion and dollar-swap mechanism). It is noteworthy that the appearance of more

TABLE 8 ESTIMATED CAPITAL FLIGHT (–) REPATRIATION (+), 1983-90

(Amounts in Billions of Dollars)

	Argentina	Brazil	Chile	Mexico	Venezuela	Total
83	–1.7	–4.3	+0.2	–1.8	–4.5	–12.1
84	+0.9	–6.4	+1.2	–3.1	–1.6	– 9.0
85	+0.4	–1.3	+1.0	–4.1	+0.4	– 3.6
86	+1.6	–0.4	+0.6	–2.1	+1.2	+ 1.0
87	–1.8	–1.0	+0.2	–1.6	+0.9	– 3.2
88	+0.8	–1.5	–0.6	–5.3	+1.8	– 4.7
89	–1.3	–1.7	0.0	+5.2	+1.2	+ 3.4
90	+0.3	–1.0	+1.4	+5.5	+0.7	+ 7.0
1983-90	–0.7	–17.6	+4.1	–7.3	+0.2	–21.3

Source: Chatered West LB, op. cit., Developing Country Investment Review, London, March 1991

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sustainable stability given by a successful democratic government (in 1990) led, in that year, to the highest capital repatriation of the period for Chile (see again Table 8). It is important to stress that, at least in the Chilean case, a return to democracy has had a favourable effect on capital repatriation.

II. CAUSES OF LARGE PRIVATE INFLOWS INTO LATIN AMERICA

It is important to understand the causes of large private inflows into Latin America, not only because it is of interest in itself, but also because it would throw light on two relevant policy issues. One is whether the phenomenon is likely to be sustained on such a scale. The other is whether other countries (in the rest of Latin America, in the rest of the developing world and in Eastern Europe) could be equally or at least partly as successful as some Latin American countries in attracting new flows.

One set of factors relates to overall supply conditions. We have already mentioned two key supply factors that have encouraged flows to Latin America; these are the rapid growth and globalisation of world capital markets (especially of bonds and equities) and the dramatic decline in US dollar short-term interest rates. Continued recession or slow growth in the US and Europe further discourage investment there, as do serious debt problems in important sectors like real estate in those countries. The decline in budget deficits in certain countries (e.g. in the UK) in the 1980s also implied smaller demand from traditional alternative investment sources (e.g. gilts) [12]. A reduction in the US budget deficit could have a similar effect.

More generally, it should be stressed that net private capital flows to the Latin American region do not and will not just depend on conditions and policies in those countries, but also on the savings and investment balances in the rest of the world, interest rate differentials, and efficiency and stability in international financial and capital markets.

Before continuing our analysis, it seems worthwhile to stress that it is nonetheless very encouraging that certain LAC countries have regained access to international financial and capital markets at a time (1990/91) when several international factors (declining German current account surpluses, increased demands from EE and CIS, fragility of some international banks) were either problematic and/or highly uncertain.

We will now examine the factors which attracted flows specifically to certain Latin American countries.

Clearly, improved domestic policies and economic prospects in Latin

12 Financial Times Pension Fund Investment, May 7, 1992.

American countries played a key role in attracting new flows to some of the biggest countries in the region, as did other important factors which we discuss below.

Improved domestic policies and prospects

There is consensus that the primary condition for access to foreign flows (as well as encouragement of the return of flight capital by nationals) is the reduction of existing domestic financial imbalances due to improved budgetary performance and prudent monetary policies. Amongst the relevant factors are reinforcement of fiscal revenue effort and positive real interest rates. Secondly, policies that enhance the supply response of the economy are clearly important, including that of production of tradeables. As, for example, the Chilean experience in the 1980s clearly shows, a competitive exchange rate plays a key role in promoting production of tradeables. A third area where domestic policies seem important is improving economic efficiency through structural reforms, such as trade liberalisation, tax reform, rationalisation of legal and other procedures ruling foreign investment, etc.

It should, however, be emphasised that some of these structural reforms, and especially trade liberalisations, have high initial costs, especially if carried out very rapidly and during periods of foreign exchange security, as is well illustrated by the Chilean experience of the 1970s. Latin American countries have also made particularly significant efforts to relax limitations on foreign ownership as a way of attracting foreign direct investment. As N. Lustig [13] emphasises with respect to Mexico, "after 1982 it was no longer possible to wait for foreign investment to follow growth. Foreign investment had to come before growth was in place. It became a needed ingredient for growth...". Therefore major efforts were made to attract it.

Two types of measures that have clearly encouraged foreign capital inflows are: privatisation (and the high rates of return associated with it) and development of the domestic capital markets, especially, but not only, the stock exchanges.

However, there are two areas which, though not so frequently stressed in the academic literature,[14] seem important factors in explaining both foreign

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13 Lustig, N. "Mexico's Integration Strategy with North America" In: C. Bradford (ed.) "Strategic Options for Latin America", OECD Development Centre and IADB, Paris, 1992.

14 Amongst those stressing the direct link between debt reduction and new capital flows, see M. Dooley, "Market valuation of external debt", In: J. Frenkel, M. Dooley and P. Wickan (eds.), "Analytical Issues in Debt", IMF, Washington, D.C., 1990; and S. van Wijnbergen, "Mexico and the Brady Plan", Economic Policy, April, 1991; Sachs, Krugman and others have argued in the similar way.

capital inflows and return of flight capital. One is economic growth or the prospect of increased growth. The former was initially illustrated by the Chilean case and the latter illustrated by the Mexican case, where prospects of growth are not only bolstered by recent figures, but also very crucially by the prospects of the NAFTA with the US and Canada. Furthermore, in 1991, for several Latin American countries, growth prospects both improved and were seen to improve significantly. However, there still remain serious problems, partly inherited from the 1980s, such as relatively low levels of investment and a highly skewed distribution of income. A second additional factor is political stability, preferably in the context of a relatively consensual and democratic political process. The increase in capital inflows into Chile during the first year of democratic government provides evidence for the importance of this factor.

Restructuring of existing debt

Nowadays, there is also agreement in the economic literature that for many countries it is a pre-condition for renewed capital flows that the "old debt overhang" has to be eliminated or significantly reduced. There is now strong evidence (for example from Mexico) that, at least for some countries, there can be a strong complementarity between some debt reduction (as in Mexico via its Brady deal) and increased capital inflows. As had been hoped by the Mexican government, [15] the indirect positive effects of Mexico's Brady deal became more important than the direct effects. The multi-annual Mexican Brady deal, which not only reduced debt service but also shifted amortisations forward for an important number of years, reduced uncertainty and provided confidence. This contributed to indirect benefits (including significantly increased capital flows and return of flight capital), which are estimated – at least in the short-term – to have been more important than the cash-flow effects of the Brady package.[16]

In the case of Venezuela, there is preliminary evidence that its Brady deal has also contributed to increased capital flows. The case of Chile is somewhat different, as its debt overhang was dealt with through pure market-based techniques (mainly via debt-equity swaps) and – in 1990 – a more conventional rescheduling of commercial debt. However, also in this case, the

15 See, P. Aspe, "The Renegotiation of Mexico's External Debt", In: M. Faber and S. Griffith-Jones (eds.), "Approaches to Third World Debt Reduction", IDS Bulletin, Vol 21, No. 2, Sussex, April 1990.

16 For a more detailed discussion, see S. Griffith-Jones, "Is there still a Latin American debt crisis?", Paper prepared for CEPAL, 1991.

reduction of the debt overhang (together with rapidly-growing exports) was an important factor in encouraging new private flows.

However, it should be mentioned here that, rather surprisingly, countries like Brazil and Argentina, which had not reached an agreement with the commercial banks, and (in the case of Brazil) had not yet put "their macroeconomic house in order", have also had access to new capital flows since 1991, though on less attractive financial terms. It is interesting that these new private flows may, in the case of Brazil, contribute to a reduction in the debt overhang, thus reversing the causality observed in other countries. Indeed, the sharp increase in Brazil's foreign exchange reserves in 1991, partly caused by these large inflows, may help the Brazilian government put together a Brady type debt reduction package, since part of these reserves could be used to pay for collateral required by banks for this purpose.

These flows seem to have come in partly [17] on the expectation that Brazil and Argentina will follow the same positive path as Chile, Mexico and Venezuela (a sort of positive regionalisation of expectations). They are also partly linked to the high creditworthiness of companies who are allowed unrestricted access to foreign exchange and have shown a good payment record in the past. However for companies in those countries to borrow significant amounts and at cheaper and longer-terms, it seems an important pre-requisite that the countries' macroeconomic situation improves and that the debt overhang has some kind of definite settlement.

Nevertheless, it is important to stress that the "quality" of the companies attracting the flows (whether public or private, or – as often occurred recently – in the context of privatisation), is a very significant element in attracting new flows. Large well-known creditworthy companies, especially if they are exporters, will find this task much easier. It seems that it is the size and reputation of the companies, rather than particular sectors, which attract foreign flows. Indeed, foreign flows have been attracted by companies in sectors as diverse as oil, paper, tourism, banks, telecommunications and copper mining. Perhaps the major common feature is their ability to generate foreign exchange income via sales.

It is unclear whether small countries in the region (with fewer and less well-known companies in that category) will be able to attract the same scale and type of new private inflows that are now coming into Mexico, Chile, Venezuela, Colombia and possibly Argentina and Brazil. Their task is made even more difficult if they still have an unresolved debt overhang, as several (e.g. Ecuador) do. In this sense, it seems important that: i) they get, where necessary, greater levels of debt reduction than those countries which can

17 Interview material.

already attract new flows; ii) they get strong support from the IFIs in reaching a favourable debt settlement (as commercial banks may be less keen in those cases to do so, and as they may require more debt reduction); iii) they continue to have significant access to official flows; and iv) special efforts are made by IFIs and industrial governments to help those countries to attract private flows.

Reduced transaction costs

Perhaps somewhat less important, but also of significance, is the fact that there has been a reduction in transaction costs for developing countries when entering international capital markets, especially that of the USA. The 1990 approval of "Regulation S" and "Rule 144A" has reduced transaction costs and liquidity problems for LAC countries tapping US markets.[18] Regulation S exempts securities from registration and disclosure requirements (with costs for first time LDC issues estimated formerly in the order of $500.000 to $700.000). Simultaneously, the adoption of rule 144A reduced the loss of liquidity associated with "private placements" (in the past buyers of securities through private placements had to hold them for at least two years after the initial offering). Since 1990, "qualified institutional buyers" (e.g. entities managing and owning at least $100 million in securities) have had the two-year holding requirement relaxed.

According to reports, these changes have also reinforced the possibilities offered by the American Depository Receipts (ADR) programme without meeting the full costs of offerings/listings. This has helped LAC countries (e.g. Chile, Mexico, as described above) to place shares on the US market.

Also, access to bond markets for LAC countries has been facilitated by market-credible credit ratings, thus reducing investors' costs, and allowing access to new segments of the international capital markets, with Mexico receiving its first credit rating by Moody's in December 1990. The ceiling rating for Mexican debt was set at Ba2, just below investment grade, but there seem to be good possibilities for an upgrading. Indeed, it could be argued that the market is already giving investment grade to Mexico and the credit ratings are lagging behind.

These improvements in access to US capital markets should also be accompanied by similar (or equivalent) changes, if necessary, in European and/or Japanese markets. Some steps have already been taken. For example, in June 1991, the Japanese authorities lowered the minimum credit rating

18 G. Pfefferman and A. Madarassy "Trends in Private Investment in Developing Countries", Discussion Paper, IFC Washington, D.C., 1992.

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standards for public bond issues on the Samurai market (from single A to triple B). In Switzerland, steps are being taken to abolish minimum credit requirements.

Possibility of customising financial instruments

One option for improving access to capital markets, especially by countries at a stage when they are fully re-establishing (or establishing) their reputation in those markets, is to provide explicit credit enhancements via collateralisation. This can be done, for example, on the basis of existing assets, such as deposits abroad, or expected streams of receivables – such as Telmex's attracting investors by providing them a claim on payments due to it by the US company AT & T on account of international communications. Another technique recently used by LAC borrowers has been enhancement by early redemption options, and particularly by a "put option" which provides the holder the discretion to resell (put) the bond to the borrower at a predetermined price.

Such mechanisms have been used innovatively in recent years by Mexican, Venezuelan and other LAC companies. Their use could be broadened, if necessary, to companies and countries that need to offer this type of "comfort", and to investors who still are somewhat worried about credit and transfer risk. However, possible costs of extensive use of this mechanism need to be carefully evaluated, and should be a cause of some concern. These costs include, in particular, the reduction of flexibility for the country and the company of use of future income, as well as costs associated with legal and technical arrangements. These should be compared with the advantage of initially helping restore market access and of possibly obtaining funds cheaper than would have been otherwise possible. More broadly, the proliferation of explicit or implicit government guarantees should be avoided, unless they are essential.

Other structural elements

As regards foreign direct investment there seem to be additional, more structural elements, which influence its level apart from the factors outlined above. A 1992 IFC study [19] concludes rather categorically that recent research suggests that the traditional determinants of FDI levels, such as labour costs and country risk have become far less important than in the past. On the contrary, structural factors – such as the availability of an educated

19 G. Pfefferman and A. Madarassy "Trends in Private Investment in Developing Countries", Discussion Paper, IFC, Washington, D.C., 1992.

and highly skilled work-force, market size, quality of infrastructure, level of industrialisation and the size of the existing stock of FDI, as an indicator of the quality of the business climate in the country – play an increasingly important role.

III. SUGGESTIONS FOR AN ANALYTICAL FRAMEWORK FOR EVALUATING THE EFFECTS OF THE RETURN OF PRIVATE CAPITAL FLOWS TO LATIN AMERICA

Undoubtedly, the fact that private capital is flowing back to certain major countries in Latin America is a very positive trend, reflecting international recognition of those countries' improved growth performance, international competitiveness and declining inflation. Both policymakers and major social actors in those countries clearly deserve praise for having achieved the important turnarounds in their economies that have encouraged renewed access to private capital markets so soon after the major debt crises of the 1980s.

While welcoming these trends, however, certain policy questions need to be asked. Are the current high levels of net private flows to those countries likely to be sustainable for a long period? Are the terms, in relation to maturities, costs and guarantees (particularly of borrowing) not too onerous for the recipient economies? Are the risks taken by lenders/investors eventually not going to become too high? Are the external resources being productively invested in the country? Is a sufficiently high proportion of this investment in foreign-exchange-generating economic activity that will help service the debt or generate other flows from abroad? Are these large flows not having undesirable (besides clearly desirable) macroeconomic effects on recipient economies? What measures are being taken by governments of recipient economies to counteract such problematic effects, and how effective are they? It seems rather urgent to conduct fairly detailed empirical research which will provide a more solid basis for answering such questions.

On a more positive note, questions need to be asked by other developing countries as well as East European countries and CIS Republics about the lessons that can be learnt from Chile, Mexico and others on how they can regain or gain access to international private capital markets? Is it likely that other countries (in Latin America, but also in poorer parts of the world, like in Africa) can gain/regain access to new private flows? Or are there structural reasons which make it more difficult? If so, what can be done, within and outside those countries, to help them gain access to private capital markets?

What role should be played by guarantee mechanisms, for example via the World Bank and/or regional banks to encourage new private flows to the

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poorer, less creditworthy countries?

Returning to the Latin American countries that have regained market access, policy questions need to be asked both in the countries from which the flows originate and those in which they are received. At one level: what can be done to improve and make sustainable access to developed countries' flows by such countries? What can be done especially in improving access to flows that are more long-term and have lower, as well as less-variable, costs? At another level: should regulators and supervisors in developed and developing countries increase their monitoring, supervision and regulation, especially with regard to the new categories of flows that are coming in, such as, for example, portfolio investment? How best can a balance be achieved which satisfies the needs of prudence without unduly constraining access to LDCs?

The need to ask this type of question arises both out of economic history and out of economic analysis. Writers such as Bagehot, [20] as far back as 1873, and, more recently, Kindleberger, [21] have pointed out that private capital markets tend to be characterised by successive periods of over-lending and under-lending, often resulting in costly financial crises. Kindleberger, op. cit., analyses the pattern of boom (usually in times of upward movement in the business cycle) and over-contraction of lending, usually in times of slow-down of economic activity, and has illustrated this pattern with historical examples, going as far back as the South-Sea Bubble. Marichal and others [22] have depicted the five great debt crises as resulting from the earlier lending booms which occurred in Latin America since Independence: in the mid-1820s, the mid-1870s, the early 1890s, in the 1930s and in the 1980s.

A particularly useful framework of analysis for current new flows is suggested by a recent paper of Corden, and by John Williamson's comments on it, [23] which focusses on the lessons offered by the lending booms in the 1970s and the debt crises of the 1980s. Using empirical analysis, Corden examines the phenomena of increased spending in developing countries

20 Bagehot, W. (1873), "Lombard Street: A Description of the Money Market", J. Murray, London, 1917 (reprinted edition).

21 Kindleberger, C., "Manias, Panics and Crashes: A History of Financial Crises", Macmillan, Basingstoke and New York, 1978.

22 Marichal, C., "Historia de la deuda externa de America Latina", Alianza Editorial, Madrid, 1988.

23 M. Corden, "Macro-economic Policy and Growth: Some Lessons of Experience", J. Williamson "Comment on Corden's paper", both In: World Bank, Proceedings of the World Bank Annual Conference on Development Economics 1990, Washington, D.C., 1990.

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whether for consumption or investment, caused mainly by ready availability of funds from world capital markets. He stresses public spending booms, but recognises that private sector booms have similar effects in practice (as illustrated by the Chilean experience in the 1970s and early 1980s).

Two effects of the booms need to be carefully distinguished. The first is the Keynesian effect, which is reflected in higher demand for locally-produced goods and a reduction of the foreign exchange constraint, in a short-term rise in the growth rate. To the extent that the increase in demand (and the inflows of capital) is temporary, this Keynesian boom is temporary. Not only the rate of growth of output initially rises, but to the extent that the boom was financed by foreign flows, spending can grow even faster. Once – and if – a debt crisis starts, investment and growth of output fall (often drastically), debt service payments rise very fast, and the rate of growth – or the level of national income – falls even more. Usually in the first phase, there is an appreciation of the exchange rate, as the capital inflows create a "Dutch disease" type of pressure, often welcomed by governments, understandably anxious to lower inflation or avoid its increase.

The second type of effect of lending booms, which must be carefully distinguished from the former, is on growth of capacity (on the supply side). It is crucial here what proportion of external flows goes to investment in the country, how productive it is, and what proportion of it is – directly and/or indirectly – converted into tradeables. If enough efficient investment takes place and output rises sufficiently (and is converted into tradeables in a large enough proportion), it is more likely that future debt service or other flows generated by the original inflows can be financed without problems.[24] The rise in debt or foreign investment will not have been a problem; indeed, it will have temporarily increased the rate of growth and made the country permanently better off. Surprisingly, what Corden does not mention, is that, if other positive effects are unchained (such as increased productivity of investment and/or increase in domestic saving and investment), the long-term effects on growth can be even bigger and more sustainable.

However, there is also a less rosy scenario. If increased investment proves insufficient and/or inefficient (the latter, either because it was ex-ante inefficient or because unexpected adverse movements of international interest rates, terms of trade or other changes occur) and if not enough production of tradeables is generated, then the initial output growth is followed by a debt problem, leading possibly to reductions in total absorption, below levels that

24 For a more detailed discussion, see S. Griffith-Jones, "International Financial Markets; A Case of Market Failure", In: C. Colclough and J. Manor (eds.) "States or Markets? Neo-liberalism and the Development Policy", Clarendon Press, Oxford, 1991.

can be sustained in the absence of the earlier boom. Thus, the total effect (through time) of such flows on the country's retained income can be negative, even if the effect on output may have been positive initially.

The rosy scenario is more likely to materialise if the modality of flows is better suited for long-term growth. This implies preferably long-term, low cost modalities, or even better mechanisms where outflows are linked to results.

In this context, it is important that LDC borrowers make use of the instruments available on the market which reduce vulnerability to variables such as commodity prices and international interest rates, and that they contribute to the further development of such instruments. Short-term lending at variable interest rates is, on the other hand, particularly undesirable, as the experience of the 1980s so dramatically shows.

Because of the risk of the less rosy scenario occurring, precautions would seem essential – to minimise such risks and to maximise the likelihood that both lenders and borrowers obtain not just short-term but also sustainable benefits from such flows. A strengthening of international public compensatory mechanisms (e.g. via enlargement of the IMF facility for this purpose) could give an additional layer of protection against instability in international variables such as commodity prices and interest rates.

However, it should be stressed that the renewal of private flows to Latin America in the early 1990s has played a key role in helping kick-start economic recovery, in reviving domestic private sector confidence and in increasing government revenues, thus making the funding of urgently-needed social spending possible. The value of this initial, positive Keynesian effect of foreign flows should therefore not be under-estimated, especially in a region emerging from a "lost decade" in terms of growth and development.

IV. CONCLUSIONS AND POLICY SUGGESTIONS

Drawing on this framework, it seems important to stress the following:

1. Regarding the scale of private flows, and especially debt-creating ones, it seems desirable that all involved err on the side of prudence. It is when international private flows represent a very large proportion of developing countries' GDP or (in particular) exports, that their impact on borrowers and lenders are more likely to become problematic.

2. Some type of flows seem more desirable than others, and, where possible, recipient and originating countries' governments should encourage a desirable mix. Foreign direct investment, on the whole, seems more desirable than

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lending: it tends to imply more careful cost-benefit calculation by investors, is more likely to bring additional efficiency gains, and profit-remittances tend to be more closely linked to the success of the project than debt servicing. (However, in some cases the rates of profit remittances may surpass debt servicing. This is a subject where more recent analysis of empirical trends may be required.) Within borrowing, longer maturities are obviously preferable to short-term ones; fixed interest instruments are preferable to variable interest ones, unless expectations of declining interest rates are strong, and – obviously, but often forgotten – borrowing at very high cost may (unless the country has no other option) be less desirable than not borrowing at all.

Most of the private flows of the early 1990s seem to have a better profile than those of the 1970s, in that a higher proportion (e.g. Chile and Mexico) comes as foreign direct investment, and a higher proportion of lending to some countries (e.g. Mexico) comes via fixed interest bonds. Furthermore, as discussed above, the conditions on bonds (particularly for Mexico) have improved rather significantly, especially in terms of the large reduction in risk premiums. In the case of Brazil and Peru, a large proportion of flows seems to come in via rather short-term and high cost lending, which is far more problematic.

This leads to two preliminary conclusions. One is the need for the recipient countries and international institutions such as the IMF and the BIS, to monitor carefully and precisely all capital inflows into different Latin American countries, as well as their conditions. This is no easy task, as some of the flows may not be currently registered, and as there are methodological problems (such as, for example, calculating effective yields on bonds rather than initial yields, which are normally recorded). Efforts need to be made in this direction, to avoid the problems of the 1970s, when information on private flows was so insufficient that it contributed to incorrect decision-making. A second conclusion is that it may be necessary for recipient countries in particular to discourage excessive inflows, particularly of certain types. In this sense, recent measures by the Chilean, Mexican and Brazilian Governments (through different mechanisms) either to discourage all flows or more short-term ones, were clearly well taken. Further measures may be required in those or other countries if capital continues to flow at excessive levels.

As regards type of flows, it has been argued that there is a smaller risk of negative effects if the flows originate from and go to the private sector. In relation to bonds, Tables 9 and 10 clearly indicate that for Mexico (in 1991) and Brazil (1991) most of the bond finance went to the private sector, though in the case of Mexico, the situation was different in 1989 and 1990 (see again Table 9). Though this should provide some comfort, as the private sector is likely to be more efficient than state enterprises, it should be remembered that some of the previous boom-bust lending cycles also involved private actors as both lenders and borrowers.

TABLE 9 MEXICO: ISSUE OF BONDS, BY TYPE OF BORROWERS

	Number of Issues			Amount in %		
	1989	**1990**	**1991 ***	**1989**	**1990**	**1991***
Public						
Sovereign			2			
Banks		4	1	29.9	21.9	5.1
Development banks		2	1		4.4	6.4
Eximbank	1	1	2		6.6	8.9
PEMEX		4	3		11.0	14.0
TELMEX	1	2		47.8	22.6	
CFE		1			10.3	
Sub total	2	14	9	77.6	76.7	34.4
Private						
Banks		1	2		2.2	4.8
Cement	1	1	2	22.4	4.4	29.3
Mining		2			6.6	
Telmex			1		0.0	29.0
Tobacco		1			2.9	
Oil		1	1		1.4	2.5
Steel		1			2.2	
Others		2			3.6	
Sub total	1	9	6	22.4	23.3	65.6
Total	3	23	15	100.0	100.0	100.0

* Till September 1991

Source: Data based on Banco de Mexico information.

TABLE 10 – 1991 BRAZIL –

	Issues	Amount ($ Million)	Percentage
Public			
Sovereign			
Banks			
Development bank	1	55	1.61
Eximbank			
PETROBRAS	5	842	24.72
TELEBRAS [1]	2	225	6.61
Sub total		1122	32.94
Private			
Steel	1	200	5.87
Bank	2	130	3.82
Celulose	1	40	1.17
Computers	1	100	2.94
Deriv. Oil	1	50	1.47
Chemical	3	120	3.52
Others	4	186	5.46
Others <$20 m		1458	42.81
Sub total		2284	67.06
Grand total		3406	100.00

1 It is expected that Telebras will start being privatised in 1993.

Source: Data based on Salomon Brothers, 1992, op. cit.

While private actors may be more efficient at taking decisions and managing enterprises at a microeconomic level, governments and public international organisations do have an advantage in analysing trends at a macroeconomic level, and evaluating whether the sum of microeconomic decisions taken by private actors is efficient and sustainable in the present and future. Hence, there is a need for government monitoring, supervision and regulation of private flows.

Furthermore, as regards private investors (especially in bonds) it is interesting that the risk is not wholly taken by them, as most bond issues (particularly to private sector borrowers) are either collateralised by receivables and letters of credit, or have put options; this puts part of the risk on the borrower. Though attractive and ingenious as a mechanism for helping re-entry to capital markets, it implies that investors may not evaluate the risk as fully as they would in other circumstances, and as a result, the supply of finance does not reflect pure market considerations.

More broadly, private lenders and borrowers (and especially large ones) may assume, based on past experience, that there are implicit government guarantees on their flows, further increasing supply beyond 'pure' market levels. This provides a particularly strong theoretical and practical reason for government supervision and regulation at the stage when new flows are expanding, as governments may be dragged in at a later stage anyway to bail out the private sector at taxpayers' expense if things go wrong. Even more generally, it can be argued that because financial markets are prone to over-react in both directions, and this may have severe costs for society as a whole, the need to avoid such market failure justifies the need for regulation and supervision.

3. It is necessary that the projects financed with new flows should be carefully evaluated using cost-benefit techniques, which compare the present value of estimated total costs with revenues, and examine, in particular, the estimated foreign exchange cost-benefit balance of individual projects, as well as the overall sum of costs and benefits for all inflows. As Corden and Williamson, op. cit., correctly point out, due account needs to be taken in such evaluations of the likelihood of future devaluations, if and when the lending boom diminishes.

As risks tend to be distributed in an unclear fashion among private lenders/investors and borrowers, and among private and public institutions (both in originating and recipient countries), it seems important that at least one actor carries out rigorous and careful cost-benefit analysis. In this sense, it would seem desirable that governments in recipient countries either carry out such analysis themselves or verify strictly that the private sector is doing so, and provide the necessary technical assistance if required. It is naturally essential that such evaluations, and other necessary supervisory or regulatory measures (e.g. of local stock exchanges) are not done in a way that would stifle such flows with unnecessary red tape. The need for agility should, however, be combined with a minimum of prudence. Such a balance is not easy, given the speed with which booms of lending/investment originate and

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develop, as well as the large scale on which they often take place. Relevant timely and independent technical assistance (from IFIs, developed country regulators, from other LDC regulators) may be very valuable; rapid exchange of information among regulators of different sectors (banking, securities, others) and different countries may need to be organised on a systematic basis. Regulatory and information gaps need to be filled quickly if the creation of new markets has not yet been accompanied by appropriate supervisory and regulatory institutions.

In the case of developed countries, the need for more appropriate regulation and supervision of flows to developing countries in certain sectors (e.g. insurance companies, pension funds) needs to be put in a broader context of appropriate regulation of all these institutions' investments.

4. Difficult issues of macroeconomic management are raised for recipient countries, especially as regards their level of spending, control of the money supply and level of the exchange rate.

As Williamson and Corden, op. cit., clearly conclude, countries should try to restrict their spending to the level of their permanent income. Equally, they need an exchange rate that is consistent with long-term equilibrium in the balance of payments. However, in practice, these are complex matters, as for example the level of permanent income or of an "equilibrium exchange rate" crucially depends (amongst other factors) on how large and how permanent private capital flows will be, on future evaluation of terms of trade, international interest rates, etc. Again, erring on the side of prudence may be advisable, as regards some counter-cyclical policy and the avoidance of excessive over-valuation.

Further policy-relevant research is required, which analyses the policy dilemmas in the new circumstances (both internationally and nationally), taking into account the far more deregulated international environment and the greater openness and reliance on market forces of recipient economies. Interchange of policy experiences amongst countries, and an analysis of their effectiveness, will be valuable; European experiences, for example in the case of Spain in the late 1980s, may provide interesting lessons for LAC countries receiving massive inflows of capital.

5. Finally, it should be emphasised that creditors and investors do have very good long-term reasons for channelling funds into certain Latin American countries. These have made major and costly efforts at very successfully restoring macroeconomic equilibrium, under very difficult circumstances; they have also introduced a number of structural reforms, which have dramatically increased those countries' ability to augment exports. Partly, as a result of such efforts, growth has increased in some countries (though

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investment levels are still relatively low) and inflation has come down. More importantly perhaps, there is strong consensus within these countries for continuation of such policies.

There is, however, perhaps need for a final word of warning. This is for both lenders/investors to beware of euphoria; also, successful governments in Latin American countries would probably do well to remember Williamson's, op. cit., wise, though apparently conservative suggestion, that all positive shocks should be treated as though they were transitory and all negative shocks as though they were permanent. The most hopeful element about the new situation is perhaps precisely that in many aspects most Latin American governments (though clearly not all) seem to be taking such advice seriously. If this continues, perhaps the new private capital inflows to them may be sustainable in the medium-term, and the "rosy scenario" may materialise, as it has in some selected developing countries, such as South Korea.

Besides prudence in financial and macroeconomic matters, as well as the other elements discussed above, a pre-condition for the "rosy scenario" may be sustained efforts, e.g. by increases in government social spending, in education and health to improve the welfare of the poorest groups in Latin American countries. Besides it being equitable, such measures would both improve political stability and sustainability and contribute to human capital development, essential both for growth and for attracting long-term capital flows. Furthermore, given the current macroeconomic situation, such increases in social spending could be more easily funded in a non-inflationary manner. Indeed, for example, the very fact that international and domestic interest rates are declining for many Latin American governments, as well as the revaluation of their currencies, eases the domestic currency cost for those governments to service their debt, both domestic and foreign. This allows them some room for increasing social spending in a non-inflationary way.

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