Per Jacobsson Lecture

The Recent Surge in Private Capital Flows to Developing Countries

Is It Sustainable?

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Foreword

Guillermo de la Dehesa, Chief Executive of Banco Pastor, Madrid, delivered the second of the two Per Jacobsson lectures held in 1994. The title of his lecture was "The Recent Surge in Private Capital Flows to Developing Countries: Is It Sustainable?" The lecture was held on October 2, 1994 at the Juan Carlos I Exhibition Center Auditorium in Madrid. Sir Jeremy Morse, Chairman of the Per Jacobsson Foundation, presided over the meeting, the proceedings of which are presented in this publication.

The Per Jacobsson lectures are sponsored by the Per Jacobsson Foundation and are usually held annually. The Foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English, French, and Spanish and are distributed by the Foundation free of charge. Through the courtesy of other institutions, other language versions are also issued from time to time. Further information may be obtained from the Secretary of the Foundation.

Contents

Opening Remarks

Sir Jeremy Morse

Ladies and gentlemen: Welcome once again to one of our Per Jacobsson lectures. We have started a little late, because people are taking time to find the auditorium, but I think we should begin our program now.

The welcome comes from the Per Jacobsson Foundation represented on the podium by Jacques Polak and myself. I would like, first of all, to thank our Spanish hosts. I would particularly like to thank the Asociacion Española de Banca Privada (Spanish Association of Private Banks), whose president José Luis Leal Maldonado is here with us today, for the arrangements that have been made for us to have this hall and for the reception afterward. And second, I would like to thank the staff of IFEMA (Madrid Trade Fair Organization) for their help in setting up this lecture.

It is not my practice to introduce the speaker at length, because you have in the program an account of his career. It will immediately strike you what a broad background he has to be one of our lecturers—combining the Bank of Spain, three different ministries, including being the Secretary of State for Economy and Finance at a crucial time in the deregulation of the Spanish economy, and a strong academic involvement in writing and speaking.

The subject he is going to speak on, "The Recent Surge in Private Capital Flows to Developing Countries: Is It Sustainable?" is a very promising one. Of course, it is historically fascinating—after the debt crises that we have been through in our life time of the developing countries and also Eastern Europe in the 1930s and again in the 1980s—to discuss the present surge of flows back to these countries, but it can always be further discussed with pleasure because it is such an open question. It is about the private markets, and to measure what will happen and what is happening is a real test. So we look forward greatly to your talk, Guillermo, which I now ask you to deliver to us.

The Recent Surge in Private Capital Flows to Developing Countries: Is It Sustainable?

Guillermo de la Dehesa

It is for me a great honor and a pleasure to deliver the Per Jacobsson Lecture not only in the year in which we celebrate the fiftieth anniversary of the Bretton Woods Conference but also at the first meeting of the Bretton Woods institutions to be held in my country and my home town.

I thank Sir Jeremy Morse and Jacques Polak for giving me such a challenging opportunity and for suggesting to me such an important and stimulating subject.

I. Anatomy of the Surge

In the last four years, there has been a large surge in long-term private financing flows to developing countries, following nearly a decade of relative stagnation. Net private long-term flows amounted to US$150 billion in 1993, increasing by 53 percent over 1992, and 2.7 times since 1990. Total private flows from 1990 to 1993 accounted for US$380 billion, most of which were in the form of foreign direct investment (FDI) and bonds (Table 1).

I wish to thank Guillermo Calvo, Jorge Mariscal, Pedro Noyola, and Rafael Repullo for their comments. Manuel Guitián and Jacques Polak not only made important contributions to the lecture but they also improved it through careful and patient editing. I also wish to thank Alberto Pico for help in the search for bibliography.

Table 1. Private Flows to Developing Countries
(In billions of U.S. dollars)

	1990	1991	1992	1993	1990–93
Bank loans	20.9	26.9	17.0	18.7	83.5
Bonds	6.1	12.4	23.7	59.5	101.7
Equity	1.3	5.4	9.3	11.8	27.8
Funds	3.5	1.1	1.4	4.1	10.1
FDI	22.8	33.1	44.0	56.5	156.4
Total[1]	54.6	78.9	95.4	150.6	379.5
Total, net[2]	30.8	45.1	68.6	106.6	251.1

Sources: International Monetary Fund, *Private Market Financing for Developing Countries*, various issues.

[1]Unfortunately, data for portfolio flows are only available in gross terms and FDI is in net terms (see methodological note at the end of the lecture) so they should not be added together, but these are the most suitable data available.

[2]Derived from International Monetary Fund, *Balance of Payment Statistics Yearbook.*

Size and Geographical Distribution

These very impressive nominal figures become less spectacular in real terms, of course. When properly deflated, today's flows are only slightly higher than they were in the early 1980s, although they exhibit a very different composition, as will be shown later. Nevertheless, the resumption of private market flows is excellent news for many developing countries that had for so long been excluded from the international capital markets and had received almost exclusively official flows. Only since 1991, for the first time since 1982, have private flows exceeded official development finance; in 1993, private flows were twice the level of official flows.

Most of the increase in private flows has been directed to a relatively small number of developing economies (Table 2). The 12 economies that received more than US$10 billion each during the period 1990-93 accounted for 78 percent of the total. Together with 4 others that received more than US$5 billion each, the combined share of this group in the total reaches 83 percent. The group includes 9 Asian, 5 Latin American, and 2 European economies.

Mexico and China have been, by far, the largest recipients of capital flows (about US$50 billion each). But, in relative terms, taking into account the population of each economy, the major recipients per capita in the last four years have been Singapore with US$6,400 per inhabitant, Hong Kong with US$2,300, Hungary with US$1,200, Malaysia with US$1,000, and Argentina with US$800. Singapore and Hong Kong are special cases for two reasons: first, they should be considered as developed and not as developing economies and, second, their inflows reflect also the strength of their financial markets that intermediate and channel those flows to other countries, mainly to South Asian countries and China. For instance, the Chinese authorities have chosen to list firms in Hong Kong rather than access international markets directly through issues of American depository receipts (ADRs) or global depository receipts (GDRs); therefore, the distinction between inflows to China and those to Hong Kong is blurred.

Table 2. Major Recipients of Private Capital Flows, 1990–93
(In billions of U.S. dollars unless otherwise noted)

							Share of Total *(In percent)*	
	Total	Loans	Bonds	Equity	Funds	FDI	Portfolio flows	FDI flows
Mexico	52.8	2.8	22.8	9.3	0.3	17.6	66	33
China	49.2	10.1	4.5	3.0	1.1	30.5	38	62
Argentina	24.5	0.4	8.6	3.5	0.1	11.9	51	49
Korea	22.9	9.2	12.2	0.6	0.9	0.0	100	0
Indonesia	22.3	12.6	1.3	1.6	0.3	6.3	73	27
Malaysia	19.2	3.5	1.2	0.4	0.3	13.8	28	72
Turkey	19.0	7.1	8.2	0.3	0.1	3.3	83	17
Singapore	18.2	1.5	0.1	1.2	0.0	15.4	15	85
Thailand	18.1	8.3	3.0	0.9	0.1	5.8	68	32
Hungary	14.7	0.6	8.1	0.2	0.2	5.6	62	38
Brazil	14.4	0.4	12.3	0.1	0.1	1.5	90	10
Hong Kong	13.6	4.8	6.2	2.6	0.0	0.0	100	0
Venezuela	9.5	2.4	4.0	0.3	0.1	2.7	72	28
Chile	5.4	0.7	0.7	0.4	0.4	3.1	43	57
India	5.4	0.9	1.3	0.5	0.1	2.6	52	48
Philippines	5.3	0.7	1.3	0.6	0.0	2.6	51	49

Sources: International Monetary Fund, *Private Market Financing for Developing Countries*, various issues.

Composition

There have been two major shifts in the composition of private flows in the last four years, compared with flows in earlier periods. First, FDI has been almost as important as total portfolio flows and, within portfolio investment, nonbank flows have been much more important than bank loans, as shown in Table 1. Second, private borrowers have predominated over sovereign borrowers. The former have accounted for nearly 60 percent of the total private capital inflows in the last few years, while they were a clear minority in the 1970s and 1980s.

Although the rise in portfolio capital inflows has been important, the surge in FDI during the 1990s has been even larger. In real terms, net direct investment flows to developing countries have been almost two and a half times as large as on average in the 1980s. Again, as in the case of portfolio investment, this flow of FDI has gone to a relatively small number of countries in Asia, Latin America, and Europe. Fifteen countries received 82 percent of all FDI in developing countries between 1990 and 1993, with the first five (China, Mexico, Malaysia, Singapore, and Argentina) receiving 56 percent of the total.

The simultaneous upturn in both direct investment and portfolio capital flows is in sharp contrast to the experience of the 1970s, when the surge in portfolio finance, and specifically bank lending, had been accompanied by a steep decline in direct investment.

Sources

A third new and important element in this recent surge has been the broadening of the investor base. Before 1992–93, developing countries attracted very limited investment from institutional investors in industrial countries, such as pension funds, mutual funds, and insurance companies. In some countries, in Latin America in particular, recent inflows mainly reflected flight capital repatriation by wealthy individuals, as well as activities of hedge funds and highly leveraged speculators. Since 1992, some U.S. and European pension and mutual funds have increased their share of developing country investments to sizable percentages.

At the end of 1993, the average share of emerging markets in total investment of the institutional investor portfolios exceeded 10 percent, up from only 2.5 percent in 1989. Regional and national mutual funds have been very important vehicles for promoting investor knowledge and familiarity with emerging markets.

Institutional investor preferences still differ among the main industrial countries. U.S. investors favor Latin American and Asian issuers, U.K. investors tend to invest in Asia, German investors focus principally in Eastern Europe, and Japanese investors like to invest most in East and Southeast Asian markets.

As already mentioned, the repatriation of flight capital has remained an important element in the increase in net private flows to developing countries, mainly in Latin America and in some highly indebted countries in other regions. This is also a very positive aspect of the recent surge in private inflows, for two reasons: first, because it shows that a reversal of capital flight is possible once internal and external conditions are favorable; and, second, because in many developing countries it reversed the net transfer of resources abroad brought about by capital flight in excess of the growth of external debt, which had resulted in a net decline in their imports and had posed a constraint on their growth. Although accurate estimates are very difficult to make, developing countries may well have lost some US$300 billion in the 1970s and 1980s because of capital flight.[1] As already noted, in 1990–93 private capital flows to developing countries reached close to US$400 billion. A simple comparison of these two figures not only indicates that the size of the capital flight reversal has been very important, at least in the major recipients of those flows, but also that, most probably, new investors have been attracted by developing countries.

II. Factors Behind the Surge

What were the reasons for such a large increase in private flows to these countries? Some were external and some internal to these countries.

[1] Claessens and Naude (1993).

External Factors

The main external factors were, first, a sharp reduction, the largest since the 1960s, in short-term interest rates both for dollars and for other major currencies that lowered the external debt service of developing countries and helped improve their solvency and their credit rating. This allowed them to conclude negotiations with their creditors and to reduce their fiscal imbalances. It also provided new incentives to increase their borrowing.

Second, the recession experienced by the industrial countries, together with the drop in short-term interest rates, lowered the relative return on their domestic capital and real estate investments. This provided an incentive for industrial country investors to move to developing, mainly emerging, economies with higher returns and improved solvency, and for developing country investors to start repatriating flight capital.

Third, the recession in the industrial countries coincided with larger current account deficits in many developing countries, both in Asia and Latin America, either because of a deterioration in their terms of trade due to the fall in the price of petroleum and other commodities or because of the different economic cycles among developing and developed countries or because of larger imports of intermediate and capital goods necessary to modernize the production structure after many years of low investment rates. These current account deficits have prompted large capital inflows to finance them.[2]

Fourth, the increasing competition and globalization in international markets have led some manufacturing and service companies in the industrial countries to relocate their activities in emerging countries with lower labor costs.

Finally, the liberalization of domestic financial markets in industrial countries has made it possible for developing country sovereign borrowers and private companies to tap these markets. Regulation S and Rule 144A in the United States are good examples of this trend.

[2] Calvo, Leiderman, and Reinhart (forthcoming).

Internal Factors

The internal reasons have been related not only to the size and the level of industrial and financial development of emerging countries but mainly to the conduct of their economic policies. The large differences in the flows of capital to different countries are a clear sign of the importance of these internal factors.

The 16 economies with the largest inflows have, with very few exceptions (such as Brazil until very recently), reached a reasonable degree of macroeconomic stability, have adopted successful price stabilization programs based on sound fiscal policies, have introduced institutional reforms liberalizing factor markets (notably, capital and labor), have reduced trade and investment barriers and, finally, have made important moves toward the privatization of state assets and the deregulation of financial markets. All these internal measures have increased both the credibility of their policies and the rate of return on their assets and investment projects. But a few countries that have not introduced the necessary fiscal adjustment but restrained internal credit or increased domestic interest rates have also attracted large, albeit very speculative, capital inflows. Only under a regime of exchange rate stability is this possible.[3] That is, in some of these cases a lack of economic policy credibility due to not fully credible price stabilization or trade liberalization programs did not prevent higher nominal returns on domestic financial assets from prompting too large capital inflows.

The predominance of external factors, internal structural factors, or pure interest rate considerations have had different kinds of effects on the volume, the composition, and the persistence of the private capital flows, as well as on the domestic economy of the recipient countries.

When the predominant factors have been external, capital inflows have tended to be short term and highly reversible and to produce domestic overheating. When internal structural reasons have predominated, not only has there been no overheating but capital inflows have contributed to achieving macroeconomic stability and have tended to be sustainable. Finally, when the only internal reasons have been attractive high interest rates derived

[3]Schadler, Carkovic, Bennett, and Kahn (1993).

from inconsistent policies, capital inflows have tended to be speculative and reversible, have had little effect on domestic investment and growth, and have resulted almost exclusively in an increase in foreign currency reserves.[4] Such an increase in official reserves also has some positive aspects for countries that follow a fixed exchange rate policy, since it enhances the credibility of their stabilization policy.[5]

III. RESPONSES TO THE SURGE

Pros and Cons of the Surge

As a general rule, capital inflows help to supplement domestic saving and, thus, to increase investment and to foster economic growth, but they can also have destabilizing effects in the short run.

Capital inflows increase the availability of capital, reduce its cost, and allow domestic investors to fund their investment decisions and domestic consumers to smooth out their consumption over time.

Nevertheless, capital inflows may also have undesirable effects on the economy. First, they tend to result in an appreciation of the real exchange rate, a consequent reduction in competitiveness and a larger deficit in the trade and current accounts, thus forcing the recipient countries to an internal adjustment to regain competitiveness. The reason is simple: if the increase in domestic absorption induces large spending in the nontraded goods sector, its relative price will increase, the real exchange rate will appreciate, and resources will shift toward that sector, resulting in a smaller traded sector and, consequently, a bigger trade deficit.[6]

In principle, there is a logical tendency for capital inflows to raise current account deficits in order to facilitate the transfer of the goods and services that are the material counterpart of these flows. But, in reality, capital account surpluses have more than compensated for the current account deficit, leading to an increase in foreign currency reserves.

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[4] Schadler, Carkovic, Bennett, and Kahn (1993).

[5] Dooley, Fernández-Arias, and Kletzer (1994).

[6] Calvo, Leiderman, and Reinhart (1993).

Capital inflows perceived to be of a speculative or destabilizing nature, or those that overheat the economy, lead the monetary authorities to purchase part of the inflow, which results in an increase in reserves and the money stock. To avoid the latter effect, they also tend to sterilize some of them by selling public securities.

These highly speculative or reversible capital inflows can also have adverse effects on internal credit expansion and the domestic banking system. Those inflows not used directly to finance imports or investment are intermediated through bank deposits, usually one of the most attractive investment for short-term inflows because of their high nominal returns. These new deposits might induce banks to expand their risk by increasing their short-term loans to the domestic private sector, which then ends up borrowing in excess. This increases the likelihood of a financial crisis not only because of the probability of a future increase in nonperforming loans but also because of the high reversibility of the capital flows.[7]

Policies

The adverse side effects of the surge in capital inflows in the receiving economies, in particular, the real exchange rate appreciation, have led to different policy responses by developing countries. The main economic policy dilemma posed by capital inflows is between price stabilization and competitiveness: appreciation of the exchange rate helps price stabilization but hurts competitiveness.[8] In principle, the possible responses can be to let the exchange rate to appreciate, to accumulate reserves, or a mixture of both.

Some countries have introduced exchange controls or taxes on short-term borrowing from nonresidents (Chile, Colombia). Their effects however, have been short lived, since economic agents have found ways to avoid these measures, through over-invoicing and under-invoicing imports and exports, using parallel financial markets or other means.[9]

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[7] Calvo, Leiderman, and Reinhart (1993).

[8] Larrain (1994).

[9] Mathieson and Rojas-Suárez (1993). See also Guitián (1993).

Other countries have used export subsidies to compensate exporters for the real exchange rate appreciation. But this policy goes against the rules of the General Agreement on Tariffs and Trade (GATT) and tends to induce retaliation. Some other countries have liberalized imports (Mexico, Chile, Thailand, and so on) to increase efficiency, promote competitiveness, and reduce the monetary effects of increased reserves.

Fiscal restraint has also been used by some countries (Thailand, Argentina, Mexico, Chile), in order to dampen inflationary pressures and thus to minimize real exchange rate appreciation. When inflows are large and persistent, this is probably the most efficient response, especially if it is limited to cutting expenditure, since increasing taxes reduces the absorption capacity of the private sector.

The most widely used policy response has been recourse to sterilized intervention, by the sale of government debt in exchange for foreign currencies and securities. Evidence of this response is found in a clear degree of comovement between official reserves and capital inflows in most of the receiving countries. The net effect of sterilized intervention should be an increase in nominal and real domestic interest rates, a reduction in aggregate demand, and a lower appreciation of the real exchange rate. Nevertheless, sterilized intervention may carry a fiscal cost through the difference between the higher interest rate of the government debt issued to sterilize and the lower return on the investment of the international reserves. Governments and central banks are, thus, acting as financial intermediaries that lend cheap and borrow dear. Annual estimates of this fiscal cost for Latin American countries range from 0.25 percent to 0.50 percent of GDP.[10] In the end, the success of sterilization depends on the breadth and liquidity of the domestic securities market.

Another danger of sterilizing is that massive "open market" operations placing treasury debt instruments tend to increase domestic nominal interest rates, which in turn induces further capital inflows, thus setting off a vicious circle: the more sterilization, the more capital inflows and the more need for sterilization. Malaysia and Colombia are good examples of this risk.

[10]Leiderman and Reinhart (1994).

Nonsterilized intervention, that is, simply buying the foreign currency inflow in exchange for money creation could well be an alternative, but this course of action risks high inflation later, which, apart from resulting eventually in a loss of competitiveness can also increase the vulnerability of the banking system, as mentioned earlier.[11]

The policy of allowing an appreciation of the nominal exchange rate to try to insulate the impact of the inflow on domestic monetary policy has been used less often by the countries affected, except by Chile and Mexico. Although it is a very obvious response, its likely impact on competitiveness has made the authorities of developing countries rather reluctant to use it.

Furthermore, when capital inflows take the form of short-term bank deposits, or when there is a fear of their quick reversal, monetary authorities have used marginal reserve requirements on short-term deposits (Chile and Malaysia) or limited swap facilities (Indonesia) to avoid interest and solvency risks in the banking system.

Regional Experience

The two regions, Latin America and Asia, which have been the main beneficiaries of the recent surge in capital inflows, show important similarities as well as differences in the composition and macroeconomic effects of those inflows.

The resulting global surplus on capital account has been similar in the two regions, although with large disparities among countries. In both regions, there has been a considerable degree of intervention by the monetary authorities, resulting in large increases in international reserves, and in both areas there has been a boom in the domestic stock markets, with large increases in their dollar-based returns.

The macroeconomic effects of the capital inflows have been different in the two areas. In Latin America (except Brazil), the appreciation of the real exchange rate has been much larger than in Asia, where Korea, Indonesia, and Thailand actually achieved a real depreciation in spite of the inflows. This seems to be the result of several factors. The capital inflows seem to have been

[11] Calvo, Leiderman, and Reinhart (1993).

channeled more toward consumption in Latin America, mainly at the beginning of the surge, and relatively more toward investment in Asia. In Latin America the average level of investment over GDP has been stagnant at around 16 percent (though in Mexico and Chile it has increased) and private consumption as a ratio of GDP has risen 2.5 points, while in Asia the average level has risen from 25 percent to 28 percent.[12] Also, public consumption, which is usually more biased toward nontraded goods, has played a greater role in Latin America (except in Chile) than in Asia, where the response to larger inflows has been more in fiscal expenditure contraction. Finally, sterilization policies have been more successful in the Asian countries (most notably in Singapore), achieving a deceleration of monetary growth and, consequently, limiting the impact of aggregate demand on the price of nontraded goods.

The most important difference between the two regions has been in the composition of the inflows. As shown in Table 3, bonds (42 percent) and equity (12 percent) have been a much more important source of financing in Latin America than in Asia, where loans (30 percent) have been the predominant form of portfolio investment. In the Asian countries, 43 percent of total inflows was channeled through direct investment, while in the Latin American countries the FDI share was 38 percent. The difference in composition may explain the lower real appreciation of the exchange rate in the Asian countries, where, probably, investment in traded goods grew faster than consumption of nontraded commodities.

Table 3. Private Capital Flows to Asia and Latin America, 1990–93

	Asia *(In billions of U.S.dollars)*	Share of Asia in Total *(In percent)*	Latin America *(In billions of U.S. dollars)*	Share of Latin America in Total *(In percent)*
Bank loans	55.6	30.4	6.6	5.6
Bonds	30.9	16.9	49.8	42.5
Equity	12.5	6.8	14.0	12.0
Funds	4.3	2.3	1.8	1.5
FDI	79.3	43.4	45.0	38.4
Total	182.6	100.0	117.2	100.0

Sources: International Monetary Fund, *Private Market Financing for Developing Countries*, various issues.

[12] Calvo, Leiderman, and Reinhart (1993).

Finally, external factors seem to have had, on average, a greater impact on Latin American than on Asian inflows. The deterioration of the terms of trade has been larger in the Latin American countries and the role played by the swing in the private capital account of the U.S. balance of payments (in the form of increased outflows and reduced inflows) has affected Latin America more than Asia, as the Japanese balance of payments did not go through the same kind and amount of swing. A number of econometric studies found a weight of between 30 percent and 60 percent for external factors in the case of Latin America[13] and only between 20 percent and 25 percent in the case of Asia.[14]

IV. Sustainability of the Surge

Recent Experience

In the first half of 1994, external conditions have become dramatically less favorable. Most industrial countries are getting over the recession and some, such as the United States, are growing faster than expected. Short- and long-term interest rates are up in the United States, and long-term interest rates are going up in Europe as well. As a consequence, the return on financial assets is increasing in member countries of the Organization for Economic Cooperation and Development (OECD) and some investors are shifting their portfolios back to domestic markets. In a few major developing country borrowers, internal conditions have also deteriorated because of certain unfavorable economic and political conditions.

The impact of these developments on the sustainability of the capital inflows is shown in Table 4, which compares flows received by developing countries in the second half of 1993 with those received in the first half of 1994. For the time being, the impact seems to have been small. The share of developing countries in total international bond flows has diminished by 4 percentage points, but it has gained almost 5 percentage points in total equity issuance and more than 8 percentage points in total bank loan

[13]Calvo, Leiderman, and Reinhart (forthcoming). See also Bercuson and Koenig (1993).
[14]Calvo, Leiderman, and Reinhart (forthcoming).

commitments. Within this global picture, the negative impact has been felt especially in Latin America. Asian countries have been able to maintain a rather stable flow of equity and bonds, and the flow of bank loans has almost doubled. Latin American countries have experienced a reduction in flows in each of the three categories, though mainly in bank lending.

Table 4. Private Flow Sustainability in Developing Countries
(In billions of U.S. dollars unless otherwise noted)

	Second Half 1993	First Half 1994
Bank loans	10.0	11.4
Share of global commitments (*in percent*)	15.9	20.7
Asia	7.0	9.2
Latin America	1.5	0.2
Bonds	37.2	26.2
Share of global issuance (*in percent*)	15.9	12.0
Asia	14.9	13.0
Latin America	15.8	8.8
Equity	7.6	6.8
Share of global issuance (*in percent*)	19.6	24.2
Asia	4.1	3.8
Latin America	3.1	2.1

Sources: International Monetary Fund, *Private Market Financing for Developing Countries*, various issues.

As far as FDI is concerned, the comparative situation is similar. China, Thailand, Malaysia, and Indonesia have had record increases in FDI in the first six months of 1994. In Latin America the increase has been lower, but present expectations created by the North American Free Trade Agreement (NAFTA) and future expectations arising from the development of the Southern Cone Common Market (MERCOSUR) may help maintain a reasonable flow of FDI over the coming years.

The different performance of the two regions conforms well to the previous assessment that external factors played a larger role in the surge of capital inflows in Latin America than in Asia.

Prospects

What will happen in the near future? Net private capital flows to developing countries in the rest of the 1990s will of course continue to reflect the saving and investment balances in both the developing and industrial countries. For the time being, it is clear that since the mid-1970s saving rates in both the industrial and developing countries have declined, and they have continued to fall in the early 1990s. At the same time, demand for investment has been growing and is likely to continue to grow in the near future exacerbated by the reconstruction of Central and Eastern Europe and the opening to the world markets of very large countries, such as China and India.[15] This suggests that without measures to stimulate either private or public sector savings in both industrial and developing countries, high real interest rates—especially on long-term instruments—and a very selective "private capital crunch" will continue as the main characteristic of the 1990s for some developing countries.

In this general context, portfolio flows might prove more sustainable than conventional wisdom foresees and, in contrast, direct investment flows may become less sustainable than conventional wisdom predicts.

On portfolio flows, the recent strong demand for developing country securities may have reflected the growing conviction of investors that the overall risk of a portfolio can be reduced by adding developing country securities even if these assets are riskier than those of industrial countries. Why? This is because returns on developing country securities have been found to have very low or negative correlations with returns in the United States and other industrial country markets. And even more, returns among different developing countries tend to be also relatively uncorrelated. As a matter of fact, the volatility of returns in developing countries has been higher (in equities) and lower (in bonds) than in OECD countries. The only exception to this low correlation has been the recent bond crisis where returns in many developing countries rose in parallel with returns in industrial countries, notably returns in Latin America and the United States. The reason could have been the massive and indiscriminate sale by many

[15]Chuhan, Claessens, and Mamingi (1993).

highly leveraged hedge funds of developing country securities to cover losses in other markets. It has also happened, against conventional wisdom, that the market volatility of developing country stock prices has increased once their markets have opened up to foreign investors and have increased their international investor base.

On the other hand, conventional wisdom suggests that longer-term considerations play a more dominant role in direct investment than in portfolio flows. Therefore, in principle, direct investment flows should tend to be more stable than other capital flows. But present capital inflows contain some elements that may reduce the time horizon of direct investment. First, the reinvestments of earnings of foreign affiliates that are not well captured by balance of payment statistics and that are supposed to be a major source of sustainability appear to move procyclically, so that a reduction in domestic growth in developing countries reduces affiliates' earnings and, accordingly, their reinvestment flows. Second, a large part of the direct investment flows has been related to privatization, and privatization programs are slowly coming to an end in many developing countries. Third, in many developing countries, part of the direct investment surge may merely have consisted of a one-time stock adjustment of foreign investors' portfolios as a response to the larger opportunities derived from the removal of legal restrictions on nonresident ownership of domestic assets.[16] In sum, broadly speaking, FDI may not be less volatile on a year-on-year basis for a given country than other capital flows, at least in the near future. The volatility of any particular type of capital inflow is more likely to be generated by changes in the institutional structure of a country's financial markets than by the characteristics of any particular flow.[17]

Differences with the Past

The issue of sustainability of capital flows has been extremely important since the abrupt interruption of the capital inflows of the 1970s ended in the debt crisis of the 1980s.[18] Nevertheless,

[16] Goldstein and others (1991).

[17] International Monetary Fund (1994, forthcoming).

[18] Claessens, Dooley, and Warner (1993).

the present situation of the developing countries is very different from that at the end of the 1970s. First, in that period, their favorable situation was due to favorable terms of trade developments that enhanced their export performance. The aggressive commercial bank lending between 1979 and 1981 was based on the expectation that that situation would continue. But this expectation did not materialize and that is why the reversal in lending was so abrupt. Today, developing countries have been able to cope with adverse terms of trade shocks and yet maintain export growth by diversifying their export base.[19]

Second, in the 1970s most borrowing countries sought balance of payments finance for the government or government-controlled entities rather than to finance domestic projects. The sovereign lending boom was closely linked to the "inward-looking" (except in a few Asian countries) development policies pursued in developing and centrally planned economies, with very high levels of state intervention in the economy and with "financial repression." Under this system, interest rates were kept low and financial markets were assigned a limited role in allocating resources across the economy, since financial resources were channeled directly by official decision through subsidies, special credit allocation, and other means.

Today, on the contrary, most developing country borrowers have opted for open, market-oriented policies whereby the state leaves a far greater role to the market to make economic decisions and where a greater integration in the world economy is sought by adopting export-oriented growth strategies and reducing restrictions to trade in goods and services. The World Bank and the IMF have played an important role in encouraging and stimulating this change of policy. Even the most dynamic emerging countries in Asia, which had been maintaining for many years high degrees of state direction, financial repression, and exchange restrictions, are making cautious steps toward liberalization.[20]

The introduction of economic reforms has removed subsidies, price controls, and special credit allocations in most developing countries. Reforms in the financial sector have also been very important by bringing about competition among financial

[19]Calvo, Leiderman, and Reinhart (1992).

[20]Organization for Economic Cooperation and Development (1993).

institutions, liberalization of interest rates, reduced barriers to entry, better financial infrastructures, and upgraded technology in stock exchanges and in payments and settlement systems.

Third, as pointed out earlier, an important shift from sovereign borrowers to private borrowers and from bank lending to bonds, equities, and, above all, FDI makes the present situation sounder.

In the 1970s, lending to private borrowers was constrained for two reasons: Except for multinational subsidiaries, audited financial information was scarce and lending to borrowers other than government did not reduce sovereign risk, since credits to private and nonfinancial companies did not escape rescheduling when the country could no longer meet its external obligations.

Today, a growing number of investors and intermediaries are active in emerging markets and have developed an infrastructure that makes it possible to research and disseminate information, thanks to a strong local presence of professionals who understand local markets and their practices. Better knowledge of those markets has diminished the importance of country risk. Private borrowers and investors are now capable of operating in rather adverse "country risk" environments.

The current situation is very different from the one prevailing in the 1970s, when a small number of sovereign borrowers interacted with a comparatively small number of banks with a large concentration of risk in those countries. Today, there are a large number of investors, mostly institutional but also individuals and companies, interacting directly with a very large number of private borrowers or through investment banks operating in many countries. The process of international asset diversification is having far-reaching consequences for developing countries.[21]

Fourth, most developing countries have today a lower level of foreign debt than in the 1970s and have accumulated a substantial amount of foreign currency reserves to be used if necessary. Thus, investors have somewhat more comfort than in the past. The dominant form of private capital inflow this time is a domestic currency claim on domestic debtors, whether the government, banking institutions, or nonbanking institutions. The dollar value of these positions depends on the debtor governments' commitment to defend the exchange rate for their currencies. In many cases, there

[21]Organization for Economic Cooperation and Development (1993).

are strong commitments to maintain it, and, in general, reserves are now larger when needed to defend the exchange rate policy.[22]

Finally, political and macroeconomic stability is today much stronger than it was in the 1970s.

In sum, the objective situation and conditions of developing countries and of international financial markets have changed dramatically in the last two decades and now the prospects of a sudden reversal of capital inflows is much less likely and their level of vulnerability is lower.

Nevertheless, it has to be recognized that, at least to some extent, the exceptionally strong expansion of capital flows to emerging countries represents a portfolio stock adjustment by the main investors to new opportunities in countries with high economic potential and with sound and recent economic reforms. Thus, once the current rush to diversify is completed, growth may continue but at a slower pace. Moreover, the recent surge of capital flows has not been restricted to countries with strong economic adjustment programs. Falling dollar interest rates have reduced dramatically secondary market discounts and in many cases have brought them to zero. Therefore, it seems plausible that rising dollar interest rates could reverse this situation. Finally, the progressive liberalization of capital movements will generate outflows from developing countries as their investors try to diversify their portfolios as well.

Policies to Increase Sustainability

In the last analysis, the durability and sustainability of the recent inflows will depend on the internal policies of the developing countries themselves. A reversal of capital inflows can be avoided provided durable internal factors, such as long-term real profitability, improved competitiveness, and sound economic policies, outweigh the impact of adverse external factors.

To create a proper context of sustainability, the first policy step is to make sure that the capital inflows finance a rise in investment spending, which is the only way to generate new resources to finance the service of the capital inflow in the future.

[22]Claessens, Dooley, and Warner (1993).

On the macroeconomic front, internal policies should aim to improve the resource generating capacity of the economy. The more a developing country is able to promote internal saving and investment, the more foreign capital inflows it will attract and the more flight capital will be repatriated. For that, it is necessary to create a favorable macroeconomic investment climate, assuring investors that their capital will be safe from large swings in inflation, taxes, and exchange rates. In general, developing countries can offer higher returns than industrial countries. Therefore, their main objective should be to enhance their advantages by creating a framework of increased credibility and investor confidence.

The most efficient way to achieve this objective would be to introduce fiscal and structural policies aimed at eliminating distortions. Tightening fiscal policy is the best way to contain inflation and avoid real exchange rate appreciation. To the extent that the inflows are attracted by an unsustainable mix of tight credit and lax fiscal policies, reducing fiscal expenditure will help to avoid excessive demand for nontraded goods and will save resources that can be invested by the private sector.

Monetary policy can also play an important role in restoring competitiveness, by restraining credit expansion in relation to the growth of money demand and containing the price and exchange rate effects of the capital inflow.

Nevertheless, while domestic credit and fiscal restraint are usually required in the presence of large capital inflows, they provide primarily short-run solutions. If the capital flows persist, more fundamental changes in the economy are required to restore the balance. These changes must include some means to enhance the adaptability of the economy through greater flexibility in the markets of factors of production.

Therefore, another efficient response to capital flows shocks is the establishment of factor market flexibility, both for labor and capital.[23] In a situation of equilibrium nominal wages, exchange rate appreciation will result in too high a wage level. Wage flexibility will be needed not only to restore the balance but also to avoid any negative impact on employment. The same can be said about the need for labor mobility among traded and nontraded

[23] Guitián (1994a).

good sectors or for a flexible, market-determined, not government-directed, allocation of capital.

At the sectoral level, there is a need to establish an appropriate domestic institutional framework to channel these flows. In some cases, this implies building a proper financial system from scratch. In other cases, it entails improving government regulation of the financial sector, mainly its prudential and supervisory functions over the banking system and the stock market, to avoid financial crises when inflows are not channeled to the right investors or are channeled to consumption. In yet some other cases, it will be enough to improve custodial arrangements, systems for clearing and settlement, compulsory information and documentation, and a better control over any form of market manipulation.

On the microeconomic front, the best approach is to reduce or eliminate barriers to foreign investment that, very often, explain most of the differential risk premiums among developing countries. These liberalizing measures should include the introduction of an unrestricted access of foreigners to domestic assets to avoid risk premiums that are captured not by the recipient country but by the foreign investor and the abolition of ownership restrictions on remittances, as well as restrictions on foreign exchange and on capital structures. Another important barrier is the taxation of capital gains, which should not exceed that in the industrial countries, to avoid a lower after-tax return. Taxes on capital gains should always be lower than those on repatriated dividends.[24] It would also help if regulators and supervisory agencies in industrial countries were to relax some of the uneconomic and severe restrictions on the share of assets that institutional investors can hold abroad or in developing countries.

A clear regulatory framework of international standards for company accounting and investor protection would also help to attract investors. Developing countries should also try to increase the international tradability of their securities to lower their own required return, since systemic risk can decline if a stock with much country-specific risk is internationalized.[25]

Furthermore, it is very important to make information internationally available, not only about the general economic situation

[24] Claessens and Gooptu (1993).

[25] Eun, Claessens, and Jun (1993).

of the issuing country but also about its current financial position and its policies to attract foreign investors. It is necessary to have credit ratings and to channel worldwide as much information as possible about the country and its companies, to give clear and selective information to potential investors and to try to minimize "contagion effects" from other countries in different situations.

In the last instance, the perception of creditworthiness held by the foreign investor plays an important role in determining the availability, the sustainability, and the cost of capital to developing countries. The perception of a deterioration of a country's creditworthiness can lead to an abrupt stop of capital flows that may be very difficult to reverse, as the experience of many countries from 1982 to 1990 showed. Usually, creditworthiness takes a short time to be lost and a long time to be re-established.

What is even more important to avoid or at least smooth today, given the high integration of capital markets, are contagion effects.[26] A creditworthy country can lose access to international capital when other countries with a similar external debt position or in the same region start experiencing external payments difficulties. The latest financial crisis has shown how contagion occurs not only when information about borrowers' current financial position is lacking but also when adverse economic news is such that all similar borrowers are viewed as equally likely to be affected. This is the case in the present bond crisis that has affected not only developing countries but industrial countries as well. The present deeper integration of financial markets enhances the contagion effects. Sometimes contagion effects may work the other way in the sense that financial markets follow "fashions" that can help attract inflows to countries that have not attained the same level of creditworthiness as others. Once investors "discover" a new emerging market, capital tends to flow to that country in amounts that bear no relation to the country's creditworthiness. But, even in this case, attempts should be made to avoid contagion effects, since the risk of reversal of fashions is very high.

Finally, speaking about capital flows and developing countries when we are celebrating the fiftieth anniversary of the Bretton Woods institutions leads me to say a few words about them in the

[26]Claessens and Gooptu (1993).

context of this lecture. How can the World Bank and the IMF help the sustainability of present private capital flows and their extension to other developing countries? The World Bank could help by giving financial support to economic and financial reforms, as well as to regional cooperation and integration, to enhance broader participation of developing countries in the global economy. It could help further by enhancing the role of the private sector, which is clearly proving to have the largest potential to promote investment, stimulate growth, and create jobs in developing countries, and, finally, by supporting private investment decisions and the development of private markets in these countries.

The IMF could help in three ways. First, by adapting its code of conduct to the globalization of capital markets and the liberalization of capital movements. The IMF has played a key role in liberalizing exchange systems and in opening the world economies to the free trade of goods and services. But its code of conduct still permits countries to restrict international capital movements in response to balance of payments pressures. That may have made sense 50 years ago, but in a world where those movements have been liberalized de jure or de facto, the relevance of this provision may be called into question. The distinction between the liberalization of the current account and the capital account made sense 50 years ago, but the argument hardly holds today now that current accounts are broadly opened and capital basically flows freely.[27] Second, the IMF should increase its lending potential to help countries cope with larger swings in global capital flows. Third, now that the globalization of capital markets links national monetary policies ever more closely, the IMF through its surveillance activities should try to ensure that national monetary policies remain compatible with global financial stability.[28]

In conclusion, in a world environment of freedom of capital movements and of increasing competition for long-term private capital, developing countries will be subject to severe economic discipline by potential investors. Only those countries that can show a consistently solid record of macroeconomic stability, creditworthiness, and long-term financial profitability will be able to

[27] International Monetary Fund (1991).

[28] Guitián (1994b).

attract a sustained flow of long-term private capital flows, no matter how favorable or unfavorable the external factors.

Only through these kinds of policies would capital inflows lead to higher growth in developing countries and the convergence of world income.

A Note on the Methodology

A distinction needs to be made between gross and net capital flows. Net capital flows arise only when there is an imbalance between national saving and investment within a country, that is, a net flow is the financial counterpart to the transfer of real resources through a current account imbalance. Gross capital flows do not need to involve a transfer of real resources when they are mutually offsetting, but even then can be very important in improving the liquidity of portfolios and in diversifying risks, since they allow individuals and firms to choose the preferred forms of assets and liabilities that they hold and issue. Most gross capital flows arise as portfolio managers attempt to improve the composition of their existing portfolios (to diversify risk or reduce tax burdens) rather than to enlarge them.

On the other hand, capital markets can respond to shocks through capital flows, through a change in asset prices, or through a combination of the two. There can be a trade off between asset price adjustment and net capital flows in helping to restore capital market equilibrium. As markets become more integrated and portfolios more internationally diversified, asset price changes are likely to substitute increasingly for net capital flows to restore market equilibrium. This shows the danger of using only the volume of capital flows to measure the degree of financial market integration.

The measurement of capital flows is also extremely difficult, because not all transactions involve an exchange of financial instruments for money (for instance, the reinvestment of earnings in an enterprise owned by a foreign direct investor) and there are valuation problems derived from exchange rate or asset price movements and because of lack of some flow data, especially short term.

The conventional although imprecise way to measure net capital inflows is through the balance in the current account of the balance of payments. Except for errors and omissions, the capital account surplus equals the gap between national saving and national investment. Therefore, increases in capital inflows can be identified with larger current account deficits.

I have used for this lecture the capital flows statistics published by the IMF in the yearly report, *Private Market Financing for Developing Countries.*

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SIR JEREMY MORSE: Thank you very much, Guillermo, for that lecture. We now come to the question and answer section. You can send up a written question, but I prefer to take questions from the floor.

Our speaker gave us a very broad picture, as one might expect from the title. He analyzed for us the flows, the external and the internal factors, their blend, and their effects on different parts of the world. He made the proper division between the cyclical factors, the once-for-all factors behind the surge, and the long-term factors. Then he gave us a realistic—but quite encouraging—view of the sustainability of these flows. He ended with his prescriptions—primarily for the developing countries but also addressing the industrial countries and the international institutions. I am sure that when we come to reading the text those closing words will ring very proudly.

Questions and Answers

Following the formal presentation, Mr. de la Dehesa answered questions from the audience.

I have two questions. First, I wanted to know what the breakdown between equity and bond investment is in emerging markets. And second, since the sensitivity to currency risks is different for equity and bond investors in emerging markets, are interest rate changes arising from sterilization measures a serious risk for host countries?

MR. DE LA DEHESA: On your first question: In Latin America, bonds have represented 42 percent and equity 12 percent. In Asia, the biggest part—30 percent—has been loans, with bonds 17 percent and equity 7 percent. On your second question: In the last few years currencies in developing countries have been more stable. Therefore, the currency risk has been lower in most developing countries than before. Probably the major swings in exchange rates in the short term have happened in some industrial countries rather than in developing countries, with the exception, of course, of Brazil or countries with high rates of inflation. As to the interest rate risk, I don't think that has been up to now a major impediment for foreign investors. On the contrary, the interest rate differential has been pretty large and has attracted most of this capital. But, as I mentioned in my lecture, it is true that some countries that did not follow proper macroeconomic policies still attracted a large volume of foreign capital; in those countries the risk was much higher. But in most of the countries that I am referring to the interest rate risk was not a major threat.

Have you found a direct relationship between increasing capital flows abroad and the falling investment in military expenditures following the end of the cold war?

MR. DE LA DEHESA: I think it is well known that in order to avoid the so-called capital crunch—although that issue is somewhat debatable—one of the major ways to reduce public deficits in industrial countries would be to reduce military expenditure in developing countries as well. So I would agree with you that the reduction of military expenditures will permit the reduction of fiscal imbalances in developing countries and will allow the private sector to invest and also attract more foreign flows.

You said that the total over 1990–93 of these flows was US$380 billion. Of that, for Central and Eastern Europe, the total over exactly the same period was only US$15 billion. Five years ago, people thought that number would be very much greater. Can you give us your views on why it has appeared to be so small so far, what might change it, and how it might change?

MR. DE LA DEHESA: There are two factors. One is competition for flows, and it looks as if Asian countries are growing at such a fast rate that the opportunities are much larger. The same is true for Latin America. Growth in Latin America is far greater than in Central or Eastern Europe. This is a very important reason, because Central and Eastern Europe are both still in a transition period of restructuring their economies, while in Asia and Latin America market economies have been functioning for quite a long time. The other reason is investors' preference for particular regions. U.S. investors like Latin America, some countries of Southeast Asia, and now China. Japanese investors prefer Asia, and only German investors still have a preference for Central and Eastern Europe. The German flows have been much smaller because most of these have gone to eastern Germany. But I think that in the future there will be a change in those flows. Hungary, for instance, is already among the 16 countries that received more than US$5 billion in the last four years, but the rest of Eastern Europe received, as you said, a very small proportion. So probably as Hungary and maybe the Czech Republic advance in the process of transition, followed perhaps by Poland, and one day Russia and other republics of the former Soviet Union, the countries of Central and Eastern Europe will join the receivers of capital inflows. But for the time being investors' preferences lie in Asia and Latin America.

How can capital inflows be stable when foreign institutional investors invest in traded securities with short-term gains in mind? Would it not be desirable to throw some sand in the wheels and, as Tobin suggested, tax these short-term capital flows?

MR. DE LA DEHESA: This has been done by Chile, for instance. Chile has tried to avoid large capital inflows because of their highly speculative nature. But, as a matter of fact, most developing countries are hungry for capital, so up to now the pros of the capital inflows have been much larger than the cons. Therefore, I think it would be too early to start throwing sand in the wheels when you are receiving such an inflow. It is true that some of the inflows are more speculative than others and can have a quick reversal, but at the same time the inflows—even if they are very liquid—increase internal credit through the banking system and internal investment by domestic investors. The problem is are they going to be reversed quickly or not? And for that the best answer is to have the proper internal macroeconomic policies.

In connection with the development of flows into equity markets in emerging countries, do you see a need to improve the transparency of the local equity markets in various countries? Would that not be an important incentive if some of the procedures that are standard in the developed countries were also introduced in the emerging markets?

MR. DE LA DEHESA: I think that this is a very important issue and I mentioned it in my speech. If all developing countries could have the same international standards for auditing disclosure, I am sure the flows would be much larger and this I think is a very important step to be taken for those capital markets that have not yet done so. I also think that the establishment of many investors locally in those countries is helping a lot to achieve this goal.

While your lecture has amply covered the measures to be taken about inflows, it is the subsequent outflows that leave developing countries up the creek in difficulty. Could you amplify? And then a more general question. You have made no mention of foreign direct investment in Africa. What prospects *do you see for Africa and for South Africa in particular as far as foreign direct investment is concerned?*

MR. DE LA DEHESA: Africa has been a little bit left out of most private flows. Official flows are large in Africa but private flows are almost nonexistent or very small—a few flows into Nigeria and now into South Africa and a fewer smaller countries. But you spoke about the outflows. Capital flight has been very large in Latin America for many years, and always responding to bad economic policies. And even when they introduced capital controls—as most countries in Latin America did in the 1960s, 1970s, and 1980s—the capital flight was unstoppable. You cannot stop outflows by introducing controls. You can do so only by improving your internal policies.

As regards the future of foreign direct investment in Africa, I think that there is a large potential, because some of the African countries have very important commodities to export and they can attract projects for the development of these commodities—production and distribution. Yes, quite a large foreign direct investment is possible.

In some countries like India it is now debated what to do with the inflows. There seems to be much more than the government can cope with and part of the reason is that they add to the reserves and the government has to issue currency, which is inflationary. Do you think that to some extent this matter can be tackled by allowing the foreign institutional investors to import gold in the countries and sell it in the market rather than giving foreign exchange to the government and then use the sale proceeds to invest in the capital market to take care of the inflationary impact of the institutional investors' inflows?

MR. DE LA DEHESA: That is a very interesting proposal, but personally I doubt that in such a huge country as India the present capital inflows—which are not astronomical—can produce a high level of inflation. Either the central bank in India is not stabilizing enough or it is just intervening and gaining reserves and increasing the monetary base or I cannot understand how the capital inflows can be inflationary in India. So I doubt the existence of the problem you envisage.

Do you think that countries that recognize the importance of mobilizing their own savings for investment in equities and debt will attract more capital flows from the outside than those neglecting domestic capital creation?

MR. DE LA DEHESA: Of course, this is the main issue. The level of savings in some Asian countries is so large that they will soon be capital exporters. Some already are capital exporters. So they have such a high level of savings that not only do they attract capital for some specific industries or companies but they also export capital, so the net flow in some of these countries is very low. That shows you how the key to attracting more capital is to have at home a very high level of saving and investment. The more you can produce at home, the more attractive it will be for the foreigner.

I was just wondering how you assess the possibility or the prospect of global savings being sufficient to meet the future demands of all the developing countries, the countries in transition, plus the shortage of savings in industrial countries that are running government deficits. I would have thought that would be one of the most severe problems to be considered in assessing the future sustainability of capital flows.

MR. DE LA DEHESA: I explained in the lecture that, in order to avoid a capital crunch and high world interest rates, it would be very important that industrial countries reduce their fiscal deficits. And now the prospects for that reduction are much better because the economies of these countries are recovering. As you know, the cyclical component of fiscal deficits in most OECD countries, including your country (Canada) is very large, but now that your country is in the top league of growth it will generate much more revenue and will be able to cope with the fiscal deficit in a much quicker way. Otherwise, as long as there is a global savings and investment imbalance and interest rates go up, the main countries to suffer will be those—and there are many OECD countries—that have very large debt-to-GDP ratios. It will then be much more expensive to finance those ratios. Thus, it is to the benefit of both industrial and developing countries to try to maintain a lower rate of interest.

You mentioned that lower rates of interest and economic recession among industrial nations were one of the key explanations of larger flows. Assuming that in the coming years we see a rising rate of interest and that economic recovery is confirmed, what is your estimate of the impact (in terms of amounts and spreads—quantities and prices) on the flows to emerging countries?

MR. DE LA DEHESA: It would be very difficult to come up with numbers, but, as I mentioned, between 30 percent and 60 percent of the inflows in Latin America were due to the external factors to which you refer. Therefore, in the hypothetical case that the reversal would be wholly due to these external factors, it would reduce the flows by 30 to 60 percent. But I doubt that it will be that large, because there is some inertia in capital flows, both in portfolio and foreign direct investment. Many of the institutional investors are very much attracted by portfolio diversification. They see that the lack of correlation between returns in industrial and developing countries reduces the risk and increases the returns. Naturally, if interest rates go up in industrial countries, they will also rise a little bit in developing countries. That will offset in part the threat of a quick reversal.

The speaker has addressed the recent surge of capital to developing countries, but some developed countries have had a similar experience—perhaps among them our host country Spain. I would like to ask our speaker whether the experience of Spain in handling its large capital inflows contains any lessons for developing countries?

MR. DE LA DEHESA: I don't know if we in Spain are able to give many lessons but we had the same kind of situation mainly from 1986 to 1991 and especially since we joined the exchange rate mechanism (ERM) in 1989. Once we joined the ERM, the capital inflow became much larger because of the perception that the peseta would not be depreciated. That prompted huge inflows of short-term capital, attracted by the differential of interest rates between Spain and Germany (and other European countries). So this was one of the paradoxes of the ERM—that on account of the stability in the exchange rate the countries with high inflation were attracting large amounts of capital, which distorted the domestic monetary policy and failed to restrain the inflation, while the countries with a very low rate of inflation were losing capital, which increased the deflationary situation of those countries. So how did the Spanish authorities react to that? At the beginning, they sterilized heavily and that, of course, raised domestic interest rates and attracted even more flows. Then the Bank of Spain decided to introduce, temporarily, some measures just to stop this huge amount of foreign inflows. These measures, similar to exchange controls, consisted of taxing the return on public debt bought by nonresidents and imposing a 30 percent deposit on foreign borrowing by residents. That did not work. These measures were lifted after a few months, because by introducing them the Spanish Government lost credibility, so the risk premium went up and again more flows came in through different channels, in spite of the introduction of such limiting measures.

Therefore, one of the lessons that we could offer to developing countries is that in those cases the best way to proceed is for the economy to absorb those inflows in a productive way. If you are able to get your internal demand for investment rising enough, you will be able to absorb these inflows without introducing overheating in the economy. Another lesson would be not to try to use quantitative controls or other measures with similar effect to avoid the inflows, because in the end they undermine the credibility of the country.

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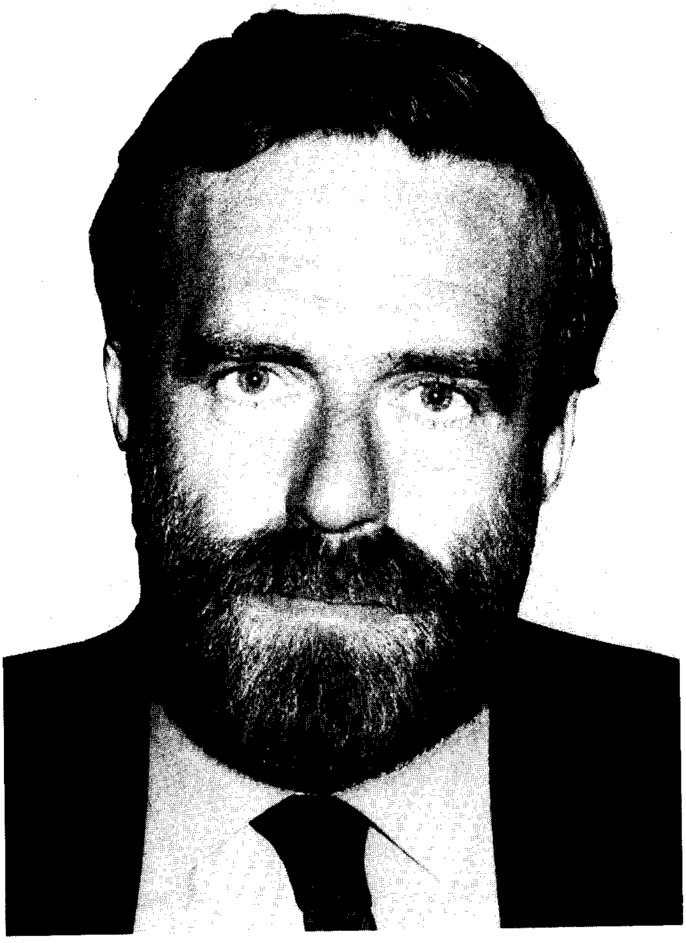
SIR JEREMY MORSE: Thank you very much. A few final words before we go. The first ones must be of thanks to our speaker. It was a very broad subject, which he tackled with a suitable breadth. Then the questions came to him from every possible angle of the subject and from every part of the world and we witnessed a very fine display of answering these questions. Thank you very much indeed.

The full text of the lecture, along with the questions and answers, will be published in a few months, but in the meantime you can get outside a copy of today's lecture amplified by tables. You can also get copies of the Spanish version of last year's lecture by Enrique Iglesias on Latin America and last June's lecture by Alexandre Lamfalussy on central banking in transition given at the time of the Bank of England's tercentenary celebrations. You have also received—with today's program—a sheet that enables you to ask for the full version of today's lecture to be sent to you. We will meet again a year hence in Washington. In the meanwhile, thanks to our interpreters and thanks again to our speaker.



Guillermo de la Dehesa

Biography

Guillermo de la Dehesa has been Chief Executive of Banco Pastor and Vice Chairman of Goldman Sachs Europe since 1988.

In 1991, Mr. de la Dehesa was elected Chairman of the Council of Spanish Chambers of Commerce and Country Chairman of the International Chamber of Commerce in Paris. He is a member of the board of directors of a number of Spanish corporations, including Unión Eléctrica Fenosa and Hullas del Coto Cortés.

Between 1982 and 1988, Mr. de la Dehesa held senior positions in the Spanish Government: He was first appointed Deputy Secretary of Commerce and later Secretary of State for Economy and Finance. In both capacities he played an important role in the deregulation of the Spanish financial markets, drafting new legislation on banking, insurance, auditing, and stock markets, as well as liberalizing interest rates and capital flows. Prior to that he served as manager of the foreign division of Banco de España and Secretary General of the Ministry of Industry and Energy.

Mr. de la Dehesa is also active in the academic world. He is Vice Chairman of the Centre for Economic Policy Research in London and is a member of the Group of Thirty. He has lectured at a number of universities and has published widely in Spain and abroad. He has served as a consultant to the International Monetary Fund on debt management, to the World Bank on trade liberalization, to the governments of Poland and the Soviet Union on privatization, and to Hungary as a member of the Blue Ribbon Commission.

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1966 *The Role of the Central Banker Today.* Lecture by Louis Rasminsky; commentaries by Donato Menichella, Stefano Siglienti, Marcus Wallenberg, and Franz Aschinger (Rome).

1967 *Economic Development: The Banking Aspects.* Lecture by David Rockefeller; commentaries by Felipe Herrera and Shigeo Horie (Rio de Janeiro).

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1983 *Developing a New International Monetary System: A Long-Term View*. Lecture by H. Johannes Witteveen.

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The Recent Surge in Private Capital Flows to Developing Countries: Is It Sustainable? Lecture by Guillermo de la Dehesa (Madrid).

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