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# Capital movements *and external* financing

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This article explores the causes, consequences, magnitude and forms of a phenomenon which is of fundamental importance in the current scene and has enormous implications for the Latin American economies: the growing pace of international capital movements. Many billions of dollars are shifted across national borders by satellite, and a small part of this amount has become the basic element in Latin America's external financing. This financial globalization has its roots in the accumulation of enormous tied liquid surpluses, the generalized liberalization of capital accounts after the collapse of the Bretton Woods frontiers, and the impact of the technological revolution in the fields of informatics and communications. The growing size and importance of the financial markets and external imbalances of the main countries makes necessary a new international monetary system which is not yet clearly defined but undoubtedly involves the free circulation of great masses of liquid assets of increasingly diverse forms: the financial "products" which are traded on the transnational money markets. In recent years, these resources have helped to relieve the Latin American external sector and to supplement the region's domestic saving. The unpredictable and precarious nature of these capital flows, however, makes it advisable to take advantage of the current availability of these funds in order to effect changes which will increase national saving and to use it to raise the productivity and competitiveness of the economies of the region.

# I

# Cross-border capital movements

In recent decades cross-border capital movements have grown with the same dazzling speed of the satellites that transport them. They amount to hundreds of billions of dollars per day and trillions of dollars per year, registered by the electronic language they are expressed in as purchases and sales of increasingly diverse financial assets. They are financial "products", as the market operators like to call them, and just as in the trading of physical goods these products are made increasingly differentiated in order to keep up the competitiveness of their "producers" in the money markets.

Dizzy though the magnitude and abstract diversity of their forms may make us, we must do all we can to understand the causes and consequences, the magnitude and the different forms of this fundamental element in the functioning of today's economy.

Let us begin with a brief look at the past. How did we arrive at the great international mobility of capital which is the basis for the growing trend towards financial globalization? We see that the main causes are the accumulation of big surpluses of liquid assets, the generalized relaxation of controls over capital, and the impact of the technological revolution in informatics and communications. This process has led a group of distinguished French economists of the regulationist school (the "interventionist" school, Latin American neoconservatives would say) to describe financial globalization as "the obligatory adventure" (Aglietta and others, 1990): an adventure which leads both private and public agents to do their best to enjoy its advantages and steer clear of its risks, competing in the short term for high returns and opportunities for obtaining capital inflows.

The recent history of international capital movements and their relation with the financing of balance-of-payments deficits begins with the Bretton Woods Conference, held even before the end of the Second World War. We may recall in passing that the fiftieth anniversary of this momentous meeting took place just a few months ago, strangely enough without much celebration.

The Bretton Woods agreements sought to lay the bases for a system of international economic relations that would effectively further world economic development after the war. The personalities with real bargaining power who sat down at the Bretton Woods negotiating table had vivid memories of two traumatic experiences that took place in the first half of the century. On the one hand, there was the devastating crisis caused by the sudden bursting of an enormous financial bubble and its rapid transmission from one country to another, partly because of the lack of orderly international monetary safeguards. On the other, there were the disastrous political and economic consequences of the war reparations imposed on the losers. In order to solve these two shortcomings the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (the World Bank) were set up. Because of the opposition of the U.S. Senate, it did not prove possible to establish the third leg of the tripod: i.e., a world trade organization (subsequently imitated to some extent by GATT and revived in a different form in the Uruguay Round).

The most novel and important body set up at Bretton Woods was undoubtedly the International Monetary Fund. Among the main objectives of the Articles of Agreement setting up the Fund was that of furthering favourable conditions for full employment by promoting the non-inflationary growth of the world economy and trade through a multilateral international payments system and strong restrictions on exchange rate freedom. (The World Bank was to provide resources for the reconstruction of war-devastated countries, especially in Europe, without distinction between victors and vanquished, in parallel with the Marshall Plan).

The power relations prevailing at the end of the war and the rules laid down at Bretton Woods led to the *de facto* and *de jure* establishment of a hegemonic type of international monetary system: hegemonic because in that system the United States economy acted as the driving force for the capitalist half of the world and the U.S. dollar was the international exchange and reserve currency.

It is an unquestionable fact that during the quarter of a century after the Second World War the world experienced the longest period of growth with stability registered in modern history. The economic evolution of that quarter-century is reflected in an average cumulative annual GDP growth rate of nearly 5%, with international trade growing at a rate of around 8% and annual rates of inflation below 2 - 3%, while economic cycles were smoothed out by Keynesian-type policies. These conditions –as we know from the lessons of real life and the interpretation of them given by Raúl Prebisch– prevailed in the industrialized countries of the centre but trickled down only very meagrely to the underdeveloped countries on the periphery.

Be that as it may, these growth rates made possible the accumulation of formidable physical and financial resources which changed the face of the central market economies (it may be noted in passing that the socialist countries also seemed to grow considerably during this quarter-century). Side by side with production and trade, the accumulation of financial surpluses also grew, and capital markets developed at both the national (in the central countries, of course) and international level.

As the size of the financial markets grew, however, there was also increased tension on various links of the systems that regulated them, and paradoxically, one of the links that was weakening was the U.S. dollar itself, on which the whole system set up at Bretton Woods was based.

With regard to this systemic weakening process and the dangers it involved, mention must be made of two serious warnings given by mature and far-sighted economists. The first was the proposal, made by Keynes at the Bretton Woods Conference, to anchor the system to a non-national means of payment, itself anchored to gold, which would be traded among governments through an international payments union or clearing house. As we all know, this proposal was not accepted at Bretton Woods. Instead, the members of the Conference adopted the proposal put forward by Mr. White, the United States representative, to set up an international stabilization fund with foreign exchange and gold contributed by its members. This fund would grant short-term credits to countries which had temporary payments deficits in return for general undertakings to move towards monetary convertibility and free trade, and more specific undertakings not to devalue save in exceptional and structural circumstances, subject to the prior agreement of the fund.

A small digression is in order here with respect to Keynes. An economist of the time (see Davidson, 1991, pp. 85-104) recalled that in 1941 –the year of the Atlantic Charter– Keynes had written that to believe in the existence of some automatic adjustment mechanism which would maintain equilibrium if only faith were placed in *laissez-faire* methods would be a doctrinaire illusion that ignored the lessons of past experience and was not supported by any sound theory.

The international monetary system which was finally established did in fact have the U.S. dollar, tied to a certain weight in gold, as its central currency, with the exchange rates of all the other currencies tied to parity with the dollar. For a long time, this made possible a hegemonic and hence stable system: hegemonic, because it was organized on the basis of a single country with the privileges (including seigniorage) and responsibilities of the leader and centre of the system; stable, as long as that country had a strong and dynamic economy and acted responsibly by applying a prudent and anti-cyclical monetary policy.

It is worth recalling that it was also agreed at Bretton Woods to allow the maintenance of restrictions on capital movements, for fear of the imbalances they could cause. As we shall see, with the passage of time these restrictions were gradually relaxed by governments or were simply overtaken by market developments.

The second warning was the far-sighted perception of Robert Triffin, who warned as from the early 1960s that the established system would inevitably end in a crisis, since the dollar standard would face a dilemma similar to that suffered by the pound sterling when it was the leading currency: i) domestic inflation (due to excessive currency issue in order to meet demand from the rest of the world), which would then spread internationally; or ii) deflation in order to avoid a payments deficit through a mechanism similar to the gold standard, which would also spread internationally, with the danger of setting off a crisis involving competitive devaluations, as in earlier traumatic episodes.

This warning by Triffin, which was widely accepted in academic circles with influence on the U.S. Government of the time, soon coincided with other phenomena in the real world. On the one hand, in

Europe (which had by now been reconstructed and was on the way to economic union) there was pressure for an end to the hegemony of the U.S. dollar, from which the U.S. transnationals were deriving benefits. We may recall De Gaulle's demands for a return to the neutral discipline of the gold standard, at a time when Europe was growing rapidly and the share of the United States in the world product and international trade was markedly declining, although it continued to be the most powerful economy in the world.

On the other hand, since the early 1960s offshore financial markets had been arising which offered not only tax havens but also havens for capital which were free from regulations and from the control of national monetary authorities.

Among these financial markets, a prominent place began to be occupied by what were to become known as the "Euromarkets". The story is that these originally arose in London, thanks to the ingenuity of City bankers who wanted to "launder" Soviet foreign exchange. Because of the British reputation for seriousness and good management, these markets attracted financial capital from other countries, since they offered higher interest rates, did not demand identification from depositors, and there was no regulation in them as regards assets and liabilities.

Quite apart from the tax advantages, the more favourable rate represented by the LIBOR, the confidential way in which transactions were carried out and the lack of regulations began to attract funds from investors and intermediaries of the most diverse origins and locations (including the big United States banks) to the Euromarkets. To the U.S. Government, this represented incipient capital flight. From that time of the mid-1960s onwards, a little-remembered period began which was a kind of rehearsal for the great surge that was to come later. The big banks –i.e., the market– sought to extend their frontiers by means of their London branches, taking advantage of the permeable nature of national financial borders. The U.S. Government, for its part, struggled to control these movements, which were difficult to identify and supervise.

These tensions, together with the changes occurring in the fields of production and trade, led to pressures (many of them speculative) for the devaluation of the U.S. dollar with respect to the strong European currencies. As we all know, the decision was finally taken to do away with the convertibility of the U.S. dollar in terms of gold –an obligation assumed by the United States in the Bretton Woods agreements– and to devalue the central currency of the system. Even these momentous measures did not satisfy the market, however, and it was finally necessary to knock down the wall against competitive devaluations which had been erected at Bretton Woods, thus passing from an era of fixed or semi-fixed parities to one of flexible exchange rates, which the following two decades were to place on record as a period of tremendous exchange rate volatility.

Indeed, once the wall of fixed parities and the Bretton Woods agreements themselves had been demolished at the beginning of the 1970s, the lack of a new order was of fundamental importance in allowing the oil crisis to have such a damaging effect on the world economy. This opened up a long cycle of serious external imbalances and of stagflation in the central countries which lasted until the early 1980s.

The central countries then began to restore the balance of their economies after a severe recession and to bring down inflation, but growth rates were much slower than in the golden age of the post-war period. Nor was the new stability very reliable, as was shown, among other indicators, by the volatility of exchange parities and international interest rates. As for that far-off objective of full employment, which initially formed part of the basic articles of the Fund, the central countries seemed to have lost the battle in view of the apparently complete validity of the Philips curve, since high "natural" unemployment coincided with the "monetarist" response to inflation.

Today, the level of unemployment is one of the main concerns of the developed countries, to such an extent that in its latest assessment of the world economic outlook (IMF, 1994) the IMF itself wonders whether the increase in unemployment is really reversible, because it considers that the economic and social costs of the present levels of unemployment, whether structural or cyclical, are enormous (*Ibid.*, p. 39). Our own view is that the current unemployment problem is basically of a structural and micro-economic or technological nature, and there is no way that it can be solved –either in those countries or in our own region– by monetarist-type policies, even with well-aimed fiscal corrections. But that is another matter.

Looking at the 1970s and 1980s from our standpoint (that of Latin America and Argentina) gives a clearer idea of the origin and outcome of the debt crisis. Thus, as from 1973 this continent of variable and volatile exchange rates, with financial markets free of all regulation and supervision (the Euromarkets, now extra-territorial entities), began to receive the enormous surpluses produced by the oil price shock, which gave rise to fabulous amounts of resources in countries with very little capacity to absorb them. The petrodollars thus swelled the international liquidity flows at a time when the central countries were in the midst of long years of stagflation. There was a glut of liquidity, and this naturally threatened world stability.

In this period the international banks –praised by the IMF in its official reports and also by the international economic press– helped to solve the difficult problem of recycling the petrodollars in the form of cheap, easy loans which, among other things, led to the over-indebtedness of almost all the countries of Latin America. Not all the blame attaches to the supply side, of course: blissfully irresponsible demand also contributed to the debt overhang.

In the Latin American setting, the debt crisis had its roots both in the great disorder reigning in the international monetary system in the 1970s and in the short-sighted or irresponsible attitudes of some borrowers. This is the root cause of the inequitable treatment meted out in respect of the debt problem, which was finally settled in practice with the "lost decade" and the cleaning-up of the balance sheets of the big transnational banks. This is an important matter, as we shall see, because just as in the second half of the 1970s there was an abundance of foreign capital available to Latin America, so now in the early 1990s there is also an abundance of foreign capital, although it may take a different form. This latter feature may be very important, so while it may be bold to draw analogies, it would be equally imprudent not to draw them.

To sum up: Big financial surpluses were built up during the two decades of rapid world economic growth. The capital markets became stronger, just like the other markets. International financial markets sprang up which were free from regulations and controls. The "walls" set up at Bretton Woods to maintain a more or less regulated international monetary order were first weakened and then demolished. Balance of payments and current account imbalances became more marked and took on the form of a veritable shock with the sudden rise in oil prices. Thus, major institutional changes in international financial markets coincided with rapidly increasing amounts of liquid resources available for intermediation. At the same time, the world economy entered into a period of high volatility as regards the two main international money prices: interest rates and exchange rates.

In order for this explosive growth of the funds in increasingly unfettered international circulation to become a real revolution, all that was needed was a technological ingredient, and this appeared with the great leap forward in informatics and communications. These funds could now circulate worldwide in their most abstract form –almost without metals, physical currency or papers– in real time, through the satellites linking the financial markets of the world 24 hours a day.

Parallel with the above phenomena, all over the world the capital accounts controlling the movement of foreign exchange across national borders were gradually being deregulated. We may recall that a number of important countries –such as France, Japan and others– freed their capital accounts only half a decade or so ago. Today, however, the liberalization of capital movements is practically complete, at least in the market economies.

Here we end this rapid review of the events leading up to the present-day international monetary and financial system. This system –still in course of formation, to be sure– is increasingly based on free foreign exchange markets, with floating less and less strictly applied. The fact is that it is difficult to impose prudential limits in a huge market where there are private actors so powerful that they often twist the arms of the strongest Central Banks. This capital is largely moved through banks or in association with them –leverage– and the diversification of the instruments involved keeps them out of reach of national monetary authorities, as is shown by the evolution of the banking supervision agreements of the Basle Committee. [1]

[1] On this subject, see Cornford, 1993.

# II

## The forms and magnitude of international capital movements

We shall now try to outline the forms and magnitude of international capital movements, before dealing with the systemic consequences of their liberalization and expansion in the present-day world.

The first thing that strikes one when looking at the evolution of these markets is that in only a couple of decades international capital movements have increasingly begun to go beyond the limits of international trade, foreign direct investment and the traditional bank deposits and loans. The capital markets –national and international– now cover an extremely wide and growing range of financial assets. Analytically, these can be divided into five main groups: trade-related operations, foreign direct investments, bank loans, portfolio investments, and miscellaneous other operations.

Operations connected with the financing of international trade naturally develop in line with the evolution of trade in goods and services, which has grown only slowly in recent years: only a little more than world output. Over this same period, foreign direct investment –which was concentrated among the countries of the North in the 1980s– has increased in the case of some developing countries, both in Asia and Latin America. As is well known, in recent times foreign direct investment in Argentina has been closely linked with the privatization process.

There has also been an increase in recent years in sales of bonds and securities guaranteed by the State or backed up by more or less "gilt-edged" assets; in portfolio investments in shares or other high-liquidity assets; and in speculative inward and outward movements having no connection with any operations in the fields of production, investment or trade.

There has been a striking proliferation of "financial products", especially futures, options and all sorts of derivations of them. Sophisticated financial engineering is used to take advantage of institutional and technological changes. Competitiveness causes the operators to be measured by the yardstick of their ingenuity in devising new "products" to be traded on international financial markets.

The measurement of international capital flows raises very complex problems which are reflected in the well-known statistical discrepancies of the balance of payments figures registered and published by the International Monetary Fund. These discrepancies reflect the growing stock of external financial assets recognized by the issuing countries but not registered in the statistics of the countries whose residents acquire them. In order to get an idea of the volume of resources which are not registered or measured, it may be noted that in the last decade the statistical discrepancy has averaged some US$50 billion per year.

The difficulties in measuring and balancing the capital accounts led the Board of the IMF to set up a Working Group, headed by Baron Godeaux, to assess the statistical practices relating to the measurement of international capital flows and, in particular, the main sources of the statistical discrepancy. The report presented by this group notes that the liberalization of capital markets, financial innovations and changes in investors' preferences have made it very difficult to measure portfolio investments; that full information is not available on offshore financial centres, and that there are big concealed capital flows connected with the traffic in drugs and arms.

These observations not only mean that these data on capital movements should be viewed with caution, although they are the only ones we have: they also give an idea of the difficulties that governments face in trying to supervise such movements.

In spite of the difficulties of measurement, however, there are other data which enable us to get an idea of the magnitude of international capital flows. Let us begin with the most conventional movements: those of private bank credit. In the 1980s, total world cross-border bank loans grew by 280% to over US$8 trillion. During this period, the total assets of United States banks doubled, while those of Japanese banks trebled. For purposes of comparison, it may be noted that over the same period the world GDP at current prices grew by 120% (but only by 35% at constant prices), and at the end of the decade world trade amounted to US$3.6 trillion: i.e., less than half the amount of cross-border bank loans, which in turn formed only a part of total international capital movements.

For Latin America and the Caribbean, foreign loans grew much less than these amounts during the 1980s (only 45%), and they were concentrated in the later years of the decade. It may be recalled that during the "lost decade" the banks practically made loans only to refinance arrears of interest: that is to say, to improve the appearance of their own balance-sheets. Moreover, in recent years their voluntary loans have not been significant in absolute terms or in comparison with other items on the capital inflow account.

Let us go on to look at another traditional market: that of bond sales. Here, a striking feature is the increase in the share of the developing countries in international bond issues. Developing country bond issues increased practically seven-fold over the last five years, amounting to over US$30 billion in 1993, although even so they represented only 10% of total world international bond issues in that year. Latin America, however, which had sold only US$830 million in bonds in 1989, sold over US$20 billion in 1993.

A great deal has been said about the really astounding growth of one sector of the international capital market: that of foreign exchange transactions. Figures have been mentioned in this respect which leave one's head reeling, both because of their magnitude and the vast differences they reflect: thus, they are estimated at between fifty and a hundred times the total value of world trade in goods and real services. Even so, a recent IMF report (IMF, 1993a) notes that although both the size of the foreign exchange market and the number of private operators capable of injecting very large sums into it are obviously much greater now than in the past, both of them have probably been underestimated.

By way of example, another segment of the capital market provides a good illustration of the speculative ingredients which characterize it. This segment is the market for "derived" products (futures, options, swaps), which has registered explosive growth. According to estimates given in another IMF report (IMF, 1993b) this market grew from US$1.6 trillion in 1987 to US$8 trillion in 1991 (i.e., as much as the entire international banking market). Thus, it increased from the equivalent of 35% of the United States GDP to the equivalent of 140% of it.

An interesting example of the complexity of these derived products is that of futures contracts on interest rates. In 1987, these amounted to US$500 million in respect of contracts in U.S. dollars and US$141 million in other currencies, but in 1991 the figures were US$1.5 billion in U.S. dollars and a similar amount in other currencies. The important points to note are the size of the increase and the change in the composition by currencies. As Carlos García Tudero noted, these resources have ceased to play their original role of hedging risks and have increasingly come to play a speculative role.

In the face of the soaring growth rate of the financial derivates market, the IMF technicians reflect the concern felt by the monetary authorities of the developed world. In the report already referred to (IMF, 1993b) they note that although the participants in derivates markets are exposed to the same kinds of risks as in other financial markets –credit, market, liquidity, legal and political risks– there is concern that the speed at which these markets have developed and the complexity of many of the instruments traded may have increased the management risk: that is to say, the risk of speculative diversions of funds by operators (as in the recent crisis of the tradition-steeped Barings Bank), which have given rise recently to various novels and films.

Let us now move on to another important indicator on the current nature and dimension of the capital markets. As is well known, institutional investors are among the most important sources supplying these markets with funds. One of the main groups among these investors is that made up of the pension funds of various developed countries. According to a World Bank expert (Davis, 1993), in 1988 the total net investments of United States pension funds came to US$726 billion. This represented nearly 50% of total personal saving in that country and 35% of its GDP. The corresponding figures for the United Kingdom were 71% and 41%, respectively.

In the same year, the total assets invested by United States pension funds amounted to the dandy little sum of US$16.5 trillion, representing 13.5% of total personal U.S. assets. Although at that time only 4% of that total was invested abroad, it should be noted that in 1980 the corresponding figure was only 1%. This points to a tendency among institutional investors which may be very important for the countries of the region.

Although the speculative ingredient in investments cannot be precisely measured, some economists have tried to make an estimate, if only by indirect means. Thus, Tesar and Werner (1993, p. 20) found that the gross volume of share investment flows was much greater than the net flows, and this difference was greater in United States foreign investments than in that country's domestic investments. In other words, in the portfolios of United States investors, their investments on foreign stock exchanges are less stable –more speculative?– than their investments inside their own country.

This feature should serve as a warning in respect of the nature of the foreign capital flows which have contributed so much to the booming emerging stock markets, including those of several Latin American countries. It probably also helps to explain why these flows go down in line with increases in short-term interest rates in the United States. The boom in these flows coincided with a downward trend in interest rates in that country, while their stagnation or decline fitted in with policies of higher interest rates on the part of the Federal Reserve.

The behaviour of those responsible for channelling savings towards domestic or foreign investments confirms the propensity of savers, except in unusual circumstances, to invest within their own countries rather than actively seeking higher returns abroad. Indeed, this raises a paradox with regard to the international transmission of savings, which is a central issue in international monetary theory, the traditional assumption of which is that international capital flows reflect the efficient reallocation of savings and the rational diversification of portfolios among opportunities and locations offering different risks and yields.

In an effort to avoid over-simplifications which can be very costly in real life, and from an indisputably neoclassical and conventional viewpoint, Lucas (1990) points out that the followers of the equalizing theory of the simplest trade and growth models apply the law of diminishing returns to infer that the marginal product of capital is greatest in the poorest economies. Thus, he says, conventional neoclassical theory holds that if the market forces are allowed to operate freely, new investments will go preferentially to the poorest countries (or regions), until wages and capital yields equalize.

This is what Lucas says. Latin American experience shows that either the theory is faulty or freedom of the market is a mere utopia, however, because the truth is that capital tends to circulate preferentially among the richest countries, regions and agents, and only trickles down to the poorer countries or regions for speculative reasons or in search of higher yields. We have had this experience in recent times in Argentina, both internally and externally: internally in the case of the regional promotion efforts and externally in most of the privatization operations.

I should like to make a slight digression at this point. Capital that brings us external savings on terms in keeping with our investment needs is always welcome. But we must learn to grow thanks to our own resources, as Ferrer would say. The most recent neoclassical theories on economic growth –from Solow to Romer– hold that the accumulation of physical capital is not of itself sufficient to ensure the long-term growth of an economy. Solow gave emphasis to an unexplained "residue", after studying the growth of the United States economy over a century. Romer brought in the concept of endogenous growth, emphasizing above all the role played by the accumulation of human capital (a term which humanist Raúl Prebisch found repugnant).

Other highly respected economists of the Northern school (Barro, Mankiw and Sala-i-Martin, 1992) maintain that capital is only partially mobile, since it can finance "accumulation of physical but not human capital". In the same study, they develop a model whose application leads them to conclude that the main message in their work is that the quantitative impact of the [international, interregional, interpersonal] mobility of capital is only slight; if there are certain types of capital, such as human capital, which cannot be financed with resources from world markets, then open economies will converge only a little faster than closed ones.

This is just one result, which can in no way be interpreted as an invitation –on the part of those authors or the person quoting them– to adopt strategies based on closed economies. From the highest theoretical level, however, it does take away some qualms about the seriousness of the sins of trade protection (when applied in a measured and harmonious manner, of course). Proof of this are the cases of Japan and the new little "Asian tigers" or the great Chinese "tiger".

# III

## The causes and systemic consequences of international capital movements

Let us now return to the main line of reasoning of these paragraphs by looking first at the causes and systemic consequences of international capital movements and their relation with current account or saving/investment imbalances or gaps and then going on to examine the recent experience of Latin America.

As we have already seen, the main causes of the extraordinary growth and rapid global integration of international capital markets as a system in the recent history of the world economy are basically: i) the rapid accumulation of surpluses in the first quarter of a century after the war; ii) the collapse of the "wall" erected at Bretton Woods and the generalized removal of exchange controls and other impediments to movements of capital among market economies; [2] and iii) the technological advances made in the fields of informatics and computation.

Another systemic approach to the growth of international capital markets is to be seen in balance of payments theory. It is well known that there is a macroeconomic accounting identity between the current account and capital account balances. In other words, a current account surplus or deficit is balanced with a capital account deficit or surplus in the balance of payments (with an "Errors and omissions" item to cover statistical discrepancies). Another theoretical approach to the interpretation of these external inflow and outflow accounts identifies the current account balance as the difference between the total saving of a nation and its rate of investment.

An interesting observation is made in a study on the spread of global financial integration and its consequences (Artis and Bayoumi, 1989). These authors suggest that modern theory on the balance of payments in integrated capital markets should extend the theory of individual consumption and saving to the economy as a whole. This approach represents the application of the theory of the primary function of national and international financial markets, which is to channel the resources of agents possessing a surplus –families, firms and governments which spend less than they earn: i.e., save–, to agents who do not have a surplus because they spend more than they receive: i.e., who dissave.

Naturally, the consequences are very different, depending on whether the use made of the external savings is efficient or not: in other words, whether they are used for reproductive investment which will generate future compensatory income, or for present consumption. This is why there are danger signs in many of the Latin American countries –and especially in Argentina– on account of the high propensity to consumption displayed in two recent periods of abundant inflows of external capital: bank capital in the second half of the 1970s and mainly non-bank capital in more recent years.

We have our own view of the present financial world, both inside and across national frontiers. Whatever the validity of neoclassical balance-of-payments theory or of the identity of total saving and total investment, in actual fact for some time now the world has been witnessing a process of growing and dizzyingly fast financial mobility, with a high proportion of speculative capital whose connection with real investment may be weak or distant. It is a kind of process of collective saving which operates at a very high speed, like the communications satellites that transmit the capital, practically without having any contact with the Earth, and whose profits swell a form of saving which is not channelled to reproductive investments.

Various authors have found that the correlations between saving and investment become less marked when fixed investment is used instead of total investment. There are any number of empirical studies which show that, despite the high international mobility of capital, total net saving and investment

[2] Frenkel (1989) considers that the barriers to international capital flows are so low that it can be said that financial markets are virtually completely integrated not only among the great industrial countries but among smaller countries too.

flows continue to be markedly insular: that is to say, they stay within the borders of each country, especially in the case of the most industrialized countries. This is the same analytical conclusion that had been reached by Tobin (1981).

Let us now look at some of the main systemic consequences of international capital movements, as reflected in a very interesting IMF study (Goldstein, Mathieson and Lane, 1991). Although its analytical bases correspond, as might be expected, to a view of the world from the North, this study nevertheless contains items applicable to the experience of Latin America and Argentina.

According to conventional theory, the integration of capital markets generates gains in terms of efficiency because it facilitates the transmission of saving to the most profitable or productive investments. In practice, however, the structural changes in international financial markets, while undoubtedly facilitating the circulation of savings, have proved to be an additional source of uncertainty, not only as regards the links between the financial markets of the various countries, but also regarding their effects on monetary and fiscal policies.

These consequences of the international mobility of capital occur in different ways, depending on whether the countries have a leading or subordinate position in the world economy. Thus, the United States has been able to finance heavy fiscal and current account deficits for a long time now –over ten years–, absorbing endogenous and exogenous shocks in this way. We will merely note that among the endogenous shocks of a financial nature were a number of generalized bank upsets such as those generated by the debt crisis, the portfolios of bad debts of petroleum and other firms, and the real estate crisis of the late 1980s, with its sequel of widespread bankruptcies of savings and loan institutions. Among the main exogenous shocks is the climate of highly volatile exchange rates and interest rates which has prevailed during the last few years.

In contrast –to take an example which we all know very well– almost all the Latin American countries have been obliged to make violent recessionary adjustments to deal with systemic shocks such as those experienced in the early 1980s due to the rise in real international interest rates and the decline in commodity prices.

To take a more global view, it may be said that the central countries take better advantage of what the above-mentioned study so rightly called the international public good of world economic stability, which, by the very fact of being an international public good, raises the need for policy coordination among the countries whose domestic policies most affect the behaviour of the international economy.

Let us now look at another source of systemic shock. Fundamental changes in interest rates and exchange rates affect the investment decisions and portfolio preferences of the operators with the greatest influence on the movement of national savings across frontiers. As the IMF technicians note, this gives rise to legitimate concern among the monetary authorities of the central countries as to whether the existing institutional arrangements can cope efficiently with the new volume of transactions and effectively handle the risks created by crises of liquidity or solvency. We became familiar with these concerns in the protracted debt renegotiations, and they have emerged once again in the North with respect to the possibility that speculative operators may come to dominate transactions in the foreign exchange and securities markets, thus fostering a perilous increase in the price volatility of a wide range of financial assets.

Another systemic risk is the possibility that a financial crisis may be sparked off due to "contagion" with fears of dubious validity. Money –especially speculative money– is at once bold yet easily scared. The perception that the liquidity or solvency of an important borrower has deteriorated can set off a domino effect in international financial circles. This already happened with the Latin American debt crisis, and it is one of the interpretations of the Great Crisis of the 1930s, which is remembered as being like a powder train running from Wall Street to almost every corner of the world.

Finally, we would like to refer to a view expressed in the study in question which deserves to be taken into account when analysing the medium-term prospects for international capital flows. The long-standing decline in rates of saving in both industrialized and developing countries (where net saving went down from 17% to 10% of GDP between 1973 and 1988), together with the growing demand for world savings (due to the recovery of the central economies and developing countries, the retooling of the Eastern European economies, the great Chinese and Indian market, etc.), suggest that if there is not a significant increase in rates of saving, one of the features of the 1990s may be high interest rates, especially for the long-term instruments most closely linked with investment demand. We may recall the difficulties of the U.S. Federal Reserve in bringing down long-term interest rates and the need to resort to substantial increases in short-term rates.

We may add that as long as international exchange rate volatility continues –and it seems to be persisting– the exchange rate risk premium (with which we are all too familiar in Argentina) will be an important source of differences in real interest rates on financial markets. This means that it would not be prudent to underestimate the real cost of capital inflows in these and coming years, nor the level of profitability it is necessary to attain in order to pay them.

# IV

## The external financing of the region

Let us now move on to the external financing of Latin America. As we all know, the region has suffered from a chronic problem of external finance constraints, whose structural roots were clearly and perceptively described by Raúl Prebisch. I think, however, that Prebisch himself would correct that part of his diagnosis dealing with the behaviour of trade and investment –i.e., the real economy– by adding to it the features or distortions of financial globalization which we have tried to set forth in the preceding pages.

Even though some countries of the region have gradually been overcoming their disadvantageous place in world trade as commodity exporters, the external sector continues to be the soft underbelly of our economies. This situation has been aggravated in recent years by the sharp fluctuations in international financial flows. Generally speaking, at least since the mid-1970s, the evolution of the Latin American economies has been dictated not only by the terms of trade and world economic activity but also by the abundance or scarcity of external capital.

Before trying to make an analysis of this situation –which must necessarily be an interim analysis, for history continues to be full of surprises– let us recall some numerical data on three aspects: i) the balance of payments, and especially its current and capital accounts; ii) net resource transfers, and iii) net capital movements.

Between 1976 and 1982 –the years of indebtedness, due at first to the receipt of net loans but later to credits that merely served to stave off the crisis for a while– the region had heavy and rapidly growing current account deficits (soaring from over US$11 billion in 1976 to over US$40 billion in 1982). The crisis and subsequent adjustment caused a rapid reduction in these deficits, however. In 1983 the total deficit dropped to only a fifth of the year before, and with some fluctuations this level was maintained up to 1990. In 1990, however, the deficit jumped back to nearly US$20 billion, and by 1993 it was more than twice this figure.

The mirror image of these current account movements was to be seen in the capital account, which was strongly positive up to 1981, negative up to 1990, and markedly positive since then. We may recall that in 1976 the net capital inflow was US$16 billion but rose to US$37 billion by 1981 (although this latter figure already included debt rollovers). Two years later, the account registered a deficit of nearly US$24 billion, and this phenomenon lasted eight years before it was reversed. In 1991 there was a net inflow of US$25 billion, rising to nearly US$50 billion in 1992, and it was only slightly less in 1993. Thus, in the second half of the 1970s (thanks to abundant bank credit) and again in the last two years (this time thanks to non-bank financing) inflows on the capital account exceeded the current account deficits and permitted the accumulation of reserves and an increase in expenditure.

Another way of getting an idea of these changes is to use the well-known concept of net resource transfers, defined as the net capital inflow (short- and long-term capital, unrequited official transfers, and errors and omissions), less payments of profits and interest. [3] For Latin America as a whole, this transfer

[3] For the World Bank (1993, p. 25), total net transfers are calculated by deducting from total net resource flows the total amount of interest payments, reinvested profits and remittances of profits, with the use made of IMF credits being excluded from the total net resource flows. In this article, however, the ECLAC definition and estimates are used.

was positive during the years of true indebtedness, averaging US$15.8 billion per year between 1974 and 1981. It became markedly negative in 1982, however, and remained so through 1989 (at around US$23 billion per year). In 1990 the negative balance went down to US$9 billion, and since then transfers have been very positive: US$5 billion in 1991, US$20 billion in 1992, and US$15 billion in 1993. [4]

Let us continue to look at the figures reflecting the position of the Latin American external sector during the last twenty erratic years, when it has been so dependent on capital inflows and outflows. In this exercise, we shall base ourselves on an excellent ECLAC study on international financial flows, which we shall also use freely in our analysis (ECLAC, 1994). [5] We shall look this time at net capital movements. Between 1977 and 1981 there was an average capital inflow of US$30 billion per year, with a peak of over US$40 billion in 1981. The figure dropped abruptly to half this level the following year and averaged only a little over US$8 billion between 1983 and 1989. Thereafter, however, inflows –and returns– rose rapidly from US$21.5 billion in 1990 to over US$62 billion in 1992.

As the ECLAC study in question notes, over the last two years net resource transfers represented 2.7% and 1.9% of the regional GDP, respectively, after having registered an average negative level of 3.7% during the period of crisis and adjustment (1983-1989).

The recent history of the region tells us that in the second half of the 1970s most of the Latin American countries failed to take advantage of the availability of external financing to increase their total rates of saving and to channel such saving towards investments in the production of tradeable goods. If this new wave of capital inflows is not used either in order to promote domestic saving, increase reproductive investment and retool the economy in order to make it more internationally competitive, then it is likely that just around the next corner lies a further rude awakening: a fresh hangover from a new financial bender.

It is not that we are pessimistic, by temperament or by ideology. We are merely following the lessons of recent experience and the definition given by the orthodox economist Lucas (1990), for whom capital flows are simply loan contracts or IOUs: a poor country acquires capital from a rich one in return for a promise to establish a flow of goods in the opposite direction for a time (which may be eternal), in the form of payments of interest or remittances of profits.

In the years of the adjustment, interest payments (both actually paid and merely due) were the slipknot of the external noose around the region's head. We should therefore make sure this time that the new capital flows we are now receiving are used to transform our economies and make it possible to generate surpluses to cover future payments of profits and interest, so as to form a virtuous circle of rewarding indebtedness and not sink into another long and cruel adjustment crisis.

Capital inflows are not unalloyed elements of gain and advantage for those who receive them. We have already seen that they very often have unwanted macroeconomic effects, such as forcing up the real exchange rate, with its contrasting effects on imports and exports, leading to a big rise in the trade deficit. This happened in the earlier years of indebtedness, and it is beginning to happen again now. When a country finances its trade or current account deficit with inflows of foreign capital, it runs the risk that a significant reduction in those inflows can set off a speculative attack on its currency which may lead to a balance of payments crisis.

Another macroeconomic danger has been identified by two authors who could never be accused of following a heterodox line: Cavallo and Cottani. In an analysis which seems highly justified, they wrote that when a country accumulates reserves, the government usually allows the currency to appreciate, thereby reducing the fiscal impact of its own debt service commitments. This appreciation also incentivates private agents to offer credits or deposits in dollars. If external problems arise, the government puts off adjustment of the exchange rate because of its own exchange rate exposure and that of the private sector. When it finally devalues, the government has to deal with its own losses and those of the private banks of the country. The result is greater inflation, fed by the expansion of the money supply, and less economic stability (Cavallo and Cottani, 1989).

[4] Data based on ECLAC figures (ECLAC, 1993a and 1993b) in constant 1987 dollars.

[5] We also took advantage of the excellent study by Devlin, Ffrench-Davis and Griffith-Jones (1994), which we were able to read in manuscript form through the kindness of one of the authors.

History and theory both teach us that economies which want to grow and develop must take advantage of moments of abundant capital inflows in order to improve their international specialization. This is particularly true of developing countries, which, in order to grow, must improve their unfavourable place in the international economy and reverse the consequences of what Prebisch called the unequal distribution of the fruits of technical progress.

Countries which do not export the products of their industrial capacity –an industrial capacity which must be increasingly technified and diversified– not only lose out in the distribution of the benefits of international trade, due to the well-known phenomenon of the ongoing decline in the terms of trade, but also run into periodic bouts of external bottlenecks in their economies. A fundamental element for judging the advantages and disadvantages of the exogenous and endogenous factors which attract abundant capital over short spaces of time is therefore the extent to which these factors help to meet the true challenge of development: that of creating a solid virtuous circle which will make it possible to increase saving, invest it in activities of high economic and social productivity, and improve the external competitiveness of the economies concerned.

To sum up, then: the illusion or monetary mirage of easy external financing had a disastrous outcome with the debt crisis of the 1980s. In order to make sure that something similar does not occur with the abundant financial resources that the region has been receiving from abroad in recent years, and in order to ensure that they do indeed make an effective contribution to the development of the various countries of the region, two essential conditions must be fulfilled.

First, the level of those resources must be maintained for as long as is necessary to avoid the generation of premature balance of payments problems. Second, the use made of them must be socially efficient: that is to say, a bigger domestic saving effort must be made in order to increase the range and quality of our countries' production and improve their place in the international economy. Present-day history shows that this is a viable and successful strategic option. Countries which do not pursue it vigorously and tenaciously will continue, with greater or lesser ups and downs, to be bogged down in the long-standing crisis of peripheral capitalism analysed in the last works of Raúl Prebisch.

(Original: Spanish)

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