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Capital flows:
lessons from the
Chilean experience

Eduardo Aninat

Minister of Finance of Chile.

Christian Larraín

International Finance Coordinator, Ministry of Finance, Chile.

This article examines the capital regulation system used in the Chilean economy in recent years. It begins by describing the factors determining international capital movements in recent times and the role of the financial system in the intermediation of such flows. It then considers the Chilean policy on the regulation of capital flows, which seeks to solve the problem of how to reconcile the reduction of inflation with the maintenance of a real exchange rate compatible with export competitiveness. The policy instruments used include intervention by the Central Bank, which is reflected in a strong increase in the international reserves, together with open-market money sterilization operations. In view of the limitations of this strategy, the process has been accompanied by gradual real devaluations of the peso. In addition, since mid-1991 Chile has applied non-quantitative controls on capital which seek to discourage the entry of short-term resources. Another salient feature of Chilean capital regulation policy has been the adoption of a more flexible approach to capital outflows. The article concludes that this policy has favoured the attainment of high rates of domestic saving and helped to reduce the vulnerability of the Chilean economy. Other important factors in these achievements have been the austere fiscal policy applied and the application of suitable requirements of a prudential nature to the banking system.

I

Background

Now that more than a year has passed since the devaluation of the Mexican peso and the so-called "tequila effect" which affected the economies of the region to different degrees, the recessionary and inflationary effects of that situation, linked with a sudden reversal of international capital flows, still cause problems for some countries.

It is generally agreed that those capital flows have favourable effects, such as supplementing domestic saving –which is usually low in developing economies–, diversifying risks and minimizing the costs of adjustments due to discrepancies between income and expenditure.

However, experience shows that in the absence of policies that favour the preservation of the fundamental macroeconomic balances ("fundamentals")[1] through suitable regulation, the entry of heavy international financial inflows can have harmful effects on the performance of the recipient economy. In particular, the experience of the two-year period 1994-1995, which affected some countries of the region particularly strongly, shows that the reversal of these flows can also involve significant costs in terms of reduced activity and increased unemployment and inflation.

Chilean economic history itself bears witness to lax management of capital flows, in a context of financial liberalization, during the period 1979-1982. This had clearly harmful consequences in the form of a sharp appreciation of the currency which distorted the allocation of resources between tradeables and non-tradeables and the availability of funds for financing investment, among other aspects.

We thus see that the free circulation of international financial resources has both positive and negative effects. The challenge facing public policies is to strengthen the positive effects without compromising the macroeconomic balances, by keeping the fundamentals at their trend values within a regulatory scheme which guarantees the stability of the financial system while allowing it to play a heightened intermediation role.

This challenge became even greater in the early 1990s when there was a strong flow of capital to the emerging economies, including Chile. In the Chilean case, the application of an active policy of regulating international capital movements has made it possible to keep up a successful economic performance (table 1). Even in 1995, when Latin America's overall growth sank to approximately 0%, the Chilean economy turned in favourable results, reaching for the first time in three decades a rate of GDP growth (8.5%) which was higher than the rate of inflation (8.2%). The prospects for 1996 are that both growth and inflation will be around 6.5%.

This article describes the scheme of regulation of international capital flows used in the Chilean economy during the 1990s, and some lessons regarding policy are drawn from this experience.

TABLE 1
Chile: Macroeconomic results
(Percentages)

	Real GDP growth	Inflation	Unemployment	Investment as % of GDP
1987	6.6	21.5	9.3	22.2
1988	7.3	12.7	8.1	22.8
1989	9.9	21.4	6.3	25.5
1990	3.3	27.3	6.0	26.3
1991	7.3	18.7	6.5	24.5
1992	11.0	12.7	4.9	26.8
1993	6.3	12.2	4.6	28.8
1994	4.2	8.9	5.9	26.8
1995 [a]	8.5	8.2	5.4	27.6
1996 [b]	6.5	6.5	...	...

Source: Central Bank of Chile.
[a] Preliminary figures.
[b] Estimates.

□ The authors wish to express their gratitude for the valuable comments of Ricardo Ffrench-Davis and Heinz Rudolph.

[1] This concept covers both the solidity and stability of these balances and the correspondence of key relative prices with their medium-term trend values.

II

The factors determining international capital movements in the 1990s

1. Conceptual aspects

International capital inflows play a decisive role in the economic development process. Among the functions traditionally ascribed to them, one of the most important is that of mobilizing capital to the developing countries, which enables them to supplement their domestic saving, raise their levels of investment, and stimulate their growth. The mobility of capital also favours the diversification of risks and makes it possible to minimize the cost of intertemporal adjustments due to discrepancies between income and expenditure.

However, certain imperfections in the functioning of capital markets may give rise to externalities and result in disparities between private and social values. The fundamental theory of the economy of well-being –that every competitive balance leads to a Paretian optimum– is based on two key assumptions: first, that the information must be exogenous, i.e., it must not be affected by the actions of any of the agents in the market, and second, that the market must be supplied with a full range of products. These assumptions are clearly not fulfilled in the case of financial markets, because supplying information is one of their essential functions. Moreover, some risks may remain outside the coverage of insurance, and there are no great incentives for banking establishments to provide long-term finance (Stiglitz, 1993).

A characteristic feature of financial markets is that lenders and investors basically consider the profitability they hope to obtain, undervaluing the total surpluses generated by the enterprise they are considering financing. Consequently, projects which offer the highest expected profitability for the lender may not coincide with the projects that give the biggest yield, but they will nevertheless be financed. Likewise, if the information is faulty the financial markets may not be balanced. In these markets, those who are willing to pay more may not be the same as those who represent the biggest expected return for the lender. Indeed, the profitability may fall if interest rates are raised, as the probability of insolvency will also tend to rise. As a result, credit may be rationed: even when there is excessive demand for credit, lenders can avoid raising interest rates by making adjustments in the amounts involved.

These imperfections in financial markets have clear repercussions on the international mobility of capital, since they hinder enjoyment of the potential benefits of resource flows. Firstly, as far as the role of external saving is concerned, conditions may not always be ideal. Countries may replace domestic saving with external saving, and investments may not always be efficient, or may not be sufficiently concentrated in tradeables to generate the necessary foreign exchange flows (Devlin, Ffrench-Davis and Griffith-Jones, 1994). Capital inflows naturally tend to lower interest rates and stimulate domestic spending. The portion that goes to tradeables tends to settle in through a larger current account deficit. However, there is also excessive demand for non-tradeables, giving rise to a tendency towards real currency appreciation, a larger non-tradeables sector, a small tradeables sector and a large trade deficit.

Secondly, with regard to the diversification associated with the free mobility of international financial assets such as portfolio investments, it should be noted that these flows are characterized by their sudden reversals. Unlike other forms of capital –such as foreign direct investment, loans from international financial institutions or long-term bank loans– portfolio investments inherently involve the risk of sharp short-term reversals. This volatility can give rise to big fluctuations in exchange rates, interest rates, or both at once. The unpredictable nature of their effects on prices can discourage domestic and foreign investors from increasing their investments in the country, and if the fluctuations in interest rates or exchange rates are very pronounced, they may affect the economy as a whole (Devlin, Ffrench-Davis and Griffith-Jones, 1994).

These elements can also serve to impede the inflow of compensatory capital to such an extent that severe economic adjustments are needed because of discrepancies between income and expenditure, forcing developing economies to pay heavy costs when they run into adverse external conditions. For such economies, whose international reserves run out easily, any external upsets which reduce the flow of capital will immediately force cuts in domestic expenditure, in an effort to restore the balance-of-payments equilibrium. Production will almost certainly go down, depending on the irreversible elements which exist, in view of the natural rigidities which impede the reallocation of resources, thus setting off a tendency towards a drop in investment.

These factors were observed in all their magnitude during the recent crisis associated with the "tequila effect", which hit Mexico and Argentina particularly hard.

2. The role of the financial system in the intermediation of capital movements

At the microeconomic level, an inflow of capital into the country will increase the volume of funds handled through the financial system and hence the volume of domestic assets and liabilities.

Experience shows that in a financial system which has been only recently liberalized to operate under market conditions, where supervision is still in the process of adapting to the new conditions, and which is receiving heavy capital inflows, interventions in the exchange market which are not fully sterilized expose the banking system to bigger credit risks because of the expansion of its assets. It has been noted that a rapid increase in loans by the banks is usually accompanied by a relaxation of the standards of loan risk assessment. Such an increase is usually concentrated in a few sectors, and any reversal of the cycle is usually accompanied by a deterioration in the risk level of the investment portfolios of financial establishments (Gavin and Hausmann, 1995).

Moreover, in the economies most seriously affected by the spread of the Mexican crisis, the low quality of the bank assets limited the possibility of applying adjustment policies based on increased interest rates in response to the loss of confidence in the local currency. Thus, an indirect effect of a sudden rise in short-term interest rates was an increase in the unprofitable assets of the banks. Since the loans supplied by local banks are a fundamental source of finance in emerging economies, it is almost sure that any sustained rise in interest rates will have a strongly contractive effect, will lead to a deterioration in the average quality of debtors, and will encourage adverse selection practices, thus undermining the solvency of the institutions concerned. In such circumstances, the Central Bank will have less leeway for resorting to increases in interest rates (IMF, 1995).

3. International capital movements in the 1990s

According to preliminary estimates prepared by international organizations, in 1995 Latin America's net financial resource transfer balance was negative for the first time since 1990: -10.6 billion dollars (ECLAC, 1995; IMF, 1995). It is interesting to note, however, that the upward trend in international capital inflows already began to reverse in 1994, which means that other factors must be added to the Mexican crisis in order to explain the behaviour of these resource flows. It may be noted that positive transfers to the region amounted to US$ 11.5 billion in 1994 and US$ 34 billion in 1993. These figures exclude extraordinary balance-of-payments finance, which came to US$ 29.1 billion for Argentina, Mexico and Nicaragua together.

Some of the factors which help to explain the big increase in the flow of capital to emerging countries between 1991 and 1993 also help in understanding the change in the behaviour of capital movements in 1994 and 1995 (Corbo and Hernández, 1996). In 1994, the speed-up in growth and the rise in interest rates in the United States, together with an adjustment in the financial conditions of various important industrialized economies, caused investors to reorder their global portfolios to the detriment of the emerging economies (Griffith-Jones, 1994). When, in addition to the foregoing factors, we remember that the effects of the Mexican crisis undermined investors' confidence in the soundness of the region's economies and the solidity of its macroeconomic fundamentals, it is easy to understand why the transfer of funds to Latin America was negative in 1995.

Notwithstanding the foregoing, however, a number of changes have shaped a new institutional scene and decisively influenced the way capital has responded in the 1990s to the financial conditions of the developed countries or to basic macroeconomic imbalances in the emerging economies. In the first place, the liberalization of capital movements in most of the latter has meant the growing integration of their markets into the global financial markets. Secondly, the weight assumed by financial securities in international finance has meant that syndicated bank loans are giving way to stocks and bonds as the preferred instruments for capital transfers to emerging markets (Hale, 1995). Thirdly, the increase in institutional investors has meant that capital flows to emerging economies are now determined by considerations of liquidity and profitability rather than by long-term banking relations (IMF, 1995).

These changes in the environment have had at least two important consequences. On the one hand, the liberalization of cross-border transactions and the gradual integration into global capital markets have allowed firms and individuals in the largest emerging economies to gain access to low-cost transactions on the international banking and capital markets, not just at the wholesale but also at the retail level. If residents have doubts about the sustainability of the exchange-rate policies of their country, they can adjust the currency denominations of their financial assets quickly and cheaply (IMF, 1995).

On the other hand, the current incorporation of the emerging economies into the global capital markets has made them more vulnerable to external events, such as changes in the cycles of the industrialized economies and problems in any of the major financial markets. Although recent experience shows that the problems of any important economy spread regionally and globally, it should be emphasized that once the initial panic has been brought under control markets do discriminate, albeit imperfectly, in the light of the solidity and stability of the economies' fundamental variables.

In general terms, countries with low rates of saving, big current account deficits, weak banking systems and heavy short-term indebtedness have suffered heavier external pressures than countries with solid and stable fundamental variables. In the final analysis, the leeway for applying economic policies that let these variables get out of line has narrowed very considerably, so that the present challenge is to keep economies in balance before investors oblige the authorities to adopt more costly solutions. This points to the need for policies which regulate capital movements and thus permit efficient management of the macroeconomic and financial risks associated therewith, yet without giving up their benefits.

III

Policies applied in the Chilean economy for regulating international capital movements

The renewed flow of capital to the emerging economies has had favourable repercussions on levels of activity and investment in them, but, on the other hand, has given rise to pressures which have affected the money supply and caused trends towards appreciation of the currency.

The banking system, for its part, has been at the centre of the crisis associated with the "tequila effect", inasmuch as it has had to absorb the effects of the interest rate rises needed to defend the value of the national currency. Financial liberalization, together with capital inflows that have not been subject to proper supervision, has proved to be fertile ground for future banking crises (Rojas-Suárez and Weisbrod, 1995).

In the case of Chile, measures to promote and diversify exports lie at the centre of the development strategy. A key variable in this respect has been a stable exchange rate compatible with medium-term external equilibrium. The ongoing reductions in inflation have also played an essential role in the Chilean development process, since it is generally recognized that lower rates of inflation favour efficient resource allocation and stimulate the competitiveness of the economy.

TABLE 2

Chile: Net capital movements
(As a percentage of GDP)

	1991	1992	1993	1994	1995	1990-1995
Net capital movements	2.3	6.7	6.0	8.9	1.7	6.0
Foreign direct investment	1.2	1.5	2.5	3.4	1.5	2.3
Medium- and long-term	-0.2	0.7	1.1	2.6	-0.3	0.9
Short-term	1.3	4.5	2.4	2.9	0.5	2.8

Source: Central Bank of Chile.

In 1990-1995, the average annual net flow of capital into Chile was 6% of GDP (table 2). The flows of foreign direct investment and medium- and long-term capital not only represented over 50% of net capital inflows during that period but also registered an upward trend over time. It is worth noting that foreign direct investment gradually increased year by year, amounting to 3.4% of GDP in 1994.

In Chile, this led to a policy dilemma: how can reductions in inflation be reconciled with the maintenance of a real exchange rate compatible with a balance-of-payments current account deficit that is sustainable in the medium term?

In 1995, the Chilean economy, like other countries in the region, also registered a decline in the net inflow of capital, which came to 1.7% of GDP. Within this figure, foreign direct investment amounted to 1.5% of GDP. Although this investment registered a 19% increase over the previous year, this growth was offset by the decline in inflows of portfolio capital in the first three quarters of the year. Medium- and long-term loans, for their part, suffered a drop of -0.3%, mainly because of prepayments of US$ 1,391 million of external debt to multilateral agencies by the Government and Central Bank.

Notwithstanding the foregoing, the interesting feature of the Chilean case is that its economy has not been affected much in terms of its macroeconomic results. Furthermore, the prospects for 1996 indicate that there will be a net recovery in the inflow of capital, both as regards foreign direct investment and portfolio capital.

The strategic objectives of the capital movement regulation policy applied in the Chilean economy are, on the one hand, to avoid the disturbances that capital inflows can cause in expenditure, inflation and the exchange rate and prevent these variables from being unbalanced or diverted from their medium-term trends and, on the other, –an objective which has always been a central element in the management of the economy– to take the necessary steps, through suitable prudential regulations and active follow-up action, to prevent any risk that the growing intermediation of capital by the banks might affect the solvency and stability of the financial system. All this is designed to guarantee efficient coverage of the credit and financial risks involved in banking operations.

1. Macroeconomic aspects

As already noted, the central aim of Chilean macroeconomic policy has been to avoid the distortions that capital inflows may cause in inflation and the exchange rate.

The fundamental instrument in Chilean anti-inflation policy is management of the short-term interest rates offered on Central Bank securities. This instrument, together with fiscal policy, helps to keep aggregate expenditure and production in line with a rate of real growth of the product that is sustainable in the long term (in the light of the growth rates of the labour force, investment and productivity).

This approach has permitted the Chilean economy to bring down inflation gradually but steadily, attaining single-digit inflation in 1995 for the second year running.

The growing openness of the capital account and the consequent integration of the country's financial market into the global markets has reduced the leeway for interest rate policy by narrowing the difference between the domestic and external rates.[2]

[2] In countries with a flexible exchange rate, appreciation of the nominal exchange rate in periods when there are heavy inflows of capital can insulate the economy from the monetary and credit effects of such flows. However, abrupt movements in the real exchange rate can impose severe adjustments, especially if the appreciation is reversed when the capital is withdrawn.

TABLE 3
Chile: External accounts and capital flows

	Current account deficit[a]	Net international reserves[b]	Exports of goods (*billions of dollars*) Total	Exports of goods (*billions of dollars*) Excluding copper
1987	3.9	8.0	5.2	3.0
1988	0.7	10.6	7.0	3.6
1989	2.7	10.4	8.1	4.1
1990	2.0	17.6	8.3	4.5
1991	-	19.3	8.9	5.3
1992	1.7	21.1	10.0	6.1
1993	4.8	21.4	9.2	6.0
1994	1.4	25.9	11.6	7.4
1995[c]	-0.2	22.0	16.0	9.6

Source: Central Bank of Chile.
[a] As a percentage of GDP.
[b] As a percentage of exports of goods and non-factor services.
[c] Preliminary figures.

TABLE 4
Chile: Cost of external credit subject to compulsory reserve requirement[a]
(Annual averages)

	LIBOR	Up to 1 year	Up to 3 years
1991	6.1	7.9	6.8
1992	3.9	5.8	4.7
1993	3.4	5.1	4.1
1994	5.1	7.5	6.0
1995	6.1	9.1	7.3

Source: Central Bank of Chile.
[a] Also includes tax on interest.

In this context, if it is decided to apply a policy of systematic reduction of inflation through interest rate management, it will be necessary to use a variety of tools in order to achieve a progressive decline in inflation without affecting the medium-term equilibrium exchange rate. With this aim, Chile has applied a combination of policies involving four main elements: intervention with sterilization; gradual real revaluations; disincentives for the entry of short-term capital, and more flexible regulations on capital outflows (Ffrench-Davis, Agosin and Uthoff, 1995).

Central Bank *intervention* has been reflected in a big increase in the international reserves (from US$ 3 billion in December 1989 to US$ 14.8 billion at the end of 1995). Increases in the money supply associated with the purchase of foreign exchange on the market can lead to levels of liquidity higher than those needed to comply with the official goals in terms of activity and inflation (table 3).

In order to *offset* the monetary effects of the accumulation of reserves, the Central Bank of Chile has resorted to sterilization through open market operations. However, it is well known that this may be limited in its capacity to eliminate the effects of intervention. Insofar as the sale of Central Bank debt paper helps to augment the difference between domestic and external interest rates, full and prolonged sterilization may distort domestic rates enough to attract more capital and, still worse, increase the share accounted for by short-term capital. Sterilization also has quasi-fiscal costs due to the difference between the interest rates obtained by the international reserves and the rate paid by the Central Bank on domestic sales of its financial instruments.

The process has been accompanied by gradual *real revaluations* of the peso, which have made it possible to relieve the quasi-fiscal pressures deriving from the entry of capital. In January 1992 the "dólar acuerdo" (an official reference value) was revalued by 5% and the floating range of the dollar on the formal exchange market was expanded to 10%, whereupon the exchange rate for the "dólar observado" or "observed dollar" (another official reference value) abruptly fell by 9% (i.e., almost to the bottom of the floating range) due to the revaluation and the flexibilization of that range. Later on, at the end of 1994, the "dólar acuerdo" was revalued by a further 10%.

Since mid-1991 Chile has also been applying *non-quantitative capital controls* (after the style of Tobin, 1978), thus discouraging the inflow of short-term capital. The main mechanism used for this purpose has been a 30% compulsory reserve on the foreign indebtedness of banks and businesses, whose validity lasts only one year (table 4). This compulsory reserve makes it possible to expand the leeway of monetary policy for controlling expenditure through interest rates and reducing the negative impact of sterilization on the inflow of capital. It is interesting to note that the composition of net resource flows into the Chilean economy has changed in the 1990s in the sense that the share accounted for by long-term capital has increased, which is partly attributable to these controls on capital inflow.

Another distinctive feature of Chilean policy on the regulation of capital movements since 1991 has been the measures taken to make the regulations on *capital outflow* more flexible and facilitate the early repatriation of funds in order to relieve the monetary and exchange-rate pressures associated with the inflow of foreign exchange. To this end, pension funds have been authorized to make investments abroad, subject to a limit which has been gradually raised, amounting to 9% of each fund's resources in 1996, while the range of instruments authorized for such investments has also been broadened.

The regulations on direct investments abroad by Chilean residents have also been made more flexible. Previously, Chapter XII of the Central Bank's regulations laid down that foreign exchange for investments abroad must be purchased on the formal foreign exchange market –where the main agents are the banks–, subject to Central Bank authorization. In April 1991, however, this rule was changed to permit the purchase of foreign exchange on the informal market, without any requirements other than that of informing the Central Bank.

With regard to the financial system, a Bill is under consideration to amend the law on banks so as to permit the extensive internationalization of the Chilean banking system, both through cross-border transactions and by direct investments abroad by banks, through branches or subsidiaries (Larraín, 1995). In addition, laws were recently promulgated which permit the existence of mutual funds specializing in offshore investment funds. These regulations aim to stimulate capital outflows and further diversify the risk spectrum of the Chilean economy.

This process has been based on a high rate of domestic saving, backed up by a policy of fiscal austerity, and on the resources of the private pension fund system (Uthoff and Titelman, 1996). It has thus helped to reduce the upward pressures on interest rates due to sterilization, by discouraging the entry of short-term capital, and to lessen the vulnerability of the economy to reversals of external capital movements. According to preliminary estimates, by 1995 the rate of saving as a percentage of GDP would be 27.4%, of which 27.6% would correspond to domestic saving (table 5). In 1990-1995 external saving averaged around 2% of GDP. For its part, fiscal policy has systematically turned in surpluses. In the years in question fiscal saving averaged 4.4% of GDP per year, with an average global surplus of 1.8% of GDP.

TABLE 5

Chile: Domestic saving and fiscal surplus

(As a percentage of GDP)

	Domestic saving	Public saving	Fiscal surplus
1990	24.2	2.5	0.8
1991	24.1	3.7	1.5
1992	24.8	4.9	2.2
1993	23.9	4.8	1.9
1994	25.4	4.8	1.7
1995 [a]	27.6	5.5	2.6

Source: Central Bank of Chile.

[a] Preliminary figures.

2. Financial aspects

Unlike what happened in other countries of the region, the Chilean banking system was not affected by the reversal in capital flows. Although it is true that this was due largely to the fact that neither macroeconomic stability nor growth suffered adverse effects, it is also true that the "depth" and solvency of the financial system have contributed to a sound process of intermediation of capital flows and the maintenance of suitable credit standards for ensuring that the expansion of loan operations is in keeping with the growth of the fundamental variables of the economy.

The experience in credit and financial risk evaluation in a market economy which has been built up over the years by the Chilean financial system and the presence of a strong and highly-qualified banking supervision body –one of the important lessons of the 1982 debt crisis– have allowed the banking system to act as intermediary for the increasing flow of resources associated with external capital, without any deterioration in asset quality or unsustainable increases in loan operations.

In banking supervision schemes, emphasis must be placed on their prudential nature: that is to say, their capacity to foresee problems and take corrective measures before the problems actually materialize. The Chilean banking legislation contains elements which assist in this: the faculty of supervising assets and reserve requirements; the restrictions and drastic punishments laid down for operations with related parties; automatic mechanisms for adjusting net worth when a bank's capital falls below the minimum levels demanded by the regulator; and faculties for freezing the operations of banking establishments, preventing transfers of funds outside the bank, and restricting the payment of dividends by banks which do not meet the necessary levels of capital (Larraín, 1994).

In order for the market to be able to collaborate in the supervision of financial establishments, it is essential that there should be an insurance system to protect the stability of the payments system and reduce the exposure of the establishments to runs on their funds, although at the same time it is desirable that it should be somewhat limited, in order to give depositors an incentive to evaluate the situation of the banks for themselves. In Chile, there is a total guarantee for sight deposits which is backed up by the Central Bank but which demands that the assets should include certain instruments free of risk (technical reserve); in addition, there is a State guarantee covering up to 90% of the rest of the deposits, up to an amount of approximately US$ 3,000.

Transparency of information is essential in order to avoid any form of "cooking the books" and to allow the market itself to supervise the banks' situation. In Chile, such transparency is an obligation under the law, and the regulator has full access to all the information of the institutions.

IV
Conclusions

The imperfections which are characteristic of the operations of international financial markets, the changes in the nature of capital movements, and the growing integration of the emerging economies into world markets all highlight the importance of a capital flow regulation policy which can cover the macroeconomic and financial risks connected with the entry of external resources, without losing the benefits associated with them.

In the new institutional context which affects international capital movements, the vulnerability of the emerging economies to reversals in capital inflows has been considerably accentuated, thus reducing the margin for error in economic policy management and the leeway for imbalances in the fundamental macroeconomic and microeconomic variables of those economies.

The strategic objectives of the capital movement regulation policies applied in Chile are, on the one hand, to minimize the distortions that such movements can cause in interest rates, inflation and the exchange rate and, on the other, to prevent the intermediation of capital through the banks from leading to an excessive expansion of credit which can affect the stability and solvency of the financial system.

Among the instruments used in this policy are intervention in the foreign exchange market, together with partial sterilization of the monetary effects of such intervention, and moderate real revaluations of the currency to help relieve the costs incurred by the Central Bank in the sterilization process.

Another component in the regulation of capital movements has been the application of non-quantitative controls to discourage the entry of short-term capital. The aim of this measure is not to distort the trend values of the economy, but rather to expand the leeway for monetary policy in order to keep expenditure in line with the potential product.

The policy of permitting more flexible arrangements for capital outflows, especially through direct investments abroad by domestic agents and regulation of the operations of institutional investors, is just as important as the foregoing measures. A prominent feature of this policy is the current Bill to amend the law on banks by considerably expanding the external operations of the financial system and permitting the establishment of mutual funds specializing in offshore investments.

The underlying objective of this regulation of capital movements has been the achievement of high rates of domestic saving, which has helped to reduce the vulnerability of the Chilean economy to external capital movements. In this respect, the application of an austere fiscal policy has also been of crucial importance for absorbing the monetary effects of capital inflows and has helped to keep the rate of domestic saving at a high level.

Finally, a central aspect of the policy has been the maintenance of suitable prudential requirements in order to guarantee the banks' capacity to handle the various types of risks. If the banking system has suitable capacity to handle risks, together with the necessary "depth" and flexibility, and if the supervisory authorities are well-equipped and well-qualified, an internationally active financial system will not be adversely affected by an increase in its role as intermediary.

(Original: Spanish)

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