

**INTERNATIONAL CAPITAL FLOWS TO
LATIN AMERICA**

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LC/L.351
March, 2000

This document was prepared by Stephany Griffith-Jones, Fellow of the Institute of Development Studies of the University of Sussex, as part of the project "Growth, Employment and Equity: Latin America in 1990s" (HOL/97/6034). The author wish to thank Barbara Stallings for very valuable suggestions. The author is also extremely grateful to Jenny Kimmis and Jacques Cailloux for their help and insightful comments and to Guillermo Mundt for providing very useful data. The views expressed in this document, which has been reproduced without formal editing, are those of the author and do not necessarily reflect the views of the Organization.

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SUMMARY

Capital flows returned to the Latin American in the 1990s after nearly a decade-long of the so-called debt crisis that featured a negative transfer of resources. These new capital flows were closely related to the economic reform process in the region. On the one hand, the reforms were a source of attraction for foreign investors. On the other hand, they helped the reforms succeed by relieving the external constraint that depressed growth during the 1980s.

Nevertheless, the new inflows also created problems. While average inflows in the 1990s were very similar to the amounts received before the debt crisis, their volatility was much greater. This volatility was the source of serious problems for the region, since the reversion of flows when investors lost confidence led to deep recessions.

Given this problem of volatility, foreign direct investment – which tends to be more stable as well as to be accompanied by other benefits, such as access to technology and markets – came to be particularly valued in recent years. This was in contrast to short-term portfolio flows, which embodied the volatility problem.

It will be important in the future for governments and international bodies to design policies to limit the volatility of short-term flows and to encourage long-term capital.

I. INTRODUCTION

Between 1990 and 1997, Latin American countries experienced a huge increase in the volume of private capital inflows they attracted. Net private flows to the region reached a record US\$88 billion in 1997. It is, however, interesting that the 1997 peak level of private flows reached a similar level (both in real terms and as percent of GDP) as the peak of inflows during 1981, when bank lending that had begun in the mid-1970s reached its maximum level. After 1997, inflows began to decline as a result of the international crisis that began in Asia.

The significant increase in the volume of private flows to Latin America during the 1990s can be explained by both domestic and international factors. Clearly, the extensive structural reforms carried out by the majority of countries in the region did much to encourage the return of private capital. More balanced macroeconomic policies, such as the elimination of budget deficits and tighter monetary policies, were also crucial to the process. The reforms served both to ease the entry of foreign capital and increase the creditworthiness of Latin American borrowers.

External factors have also been extremely important (see Calvo, Leiderman and Reinhart, 1993). First, in the early 1990s, the recession in the industrialized countries and the reduction of U.S. interest rates were important contributory factors in the influx of foreign funds to Latin America. This implied that any change to this situation, such as a rise in U.S. interest rates, could contribute to a reduction of capital flows to the region, as happened in 1994. Second, financial liberalization in industrialized countries and the growing international diversification of the portfolios of institutional investors also served to encourage the flow of capital to emerging markets generally, including to Latin America (Griffith-Jones, 1998). Third, contagion from crises in other countries or even other regions has become an increasingly important phenomenon in the 1990s.

The significant increase in the volume of flows to Latin America in the 1990s, itself a reflection of the increasing integration of global finance, was accompanied by very high volatility of those flows. Indeed, the pattern of surges and reversals not only has been repeated over time but has become more frequent in recent years. Two recent crises, the Mexican peso crisis of 1994-1995 and the international financial crisis of 1997-1999, brought violent swings in the levels of capital flows to Latin America. The peso crisis led to significant but fairly brief reversals of portfolio flows to the region in 1995, while the international financial crisis that began in Asia led to major declines in capital flows to Latin America and a currency crisis in Brazil. At the time of writing, it is yet unclear how long the relative drought of capital flows to

Latin America will last, though there are hopes and some evidence that their recovery will be more like 1995-1996 than 1983-1989.

The high volatility of international capital flows to the region is important because, while foreign capital inflows can improve growth and investment levels in recipient countries and thereby help achieve development goals, reversals associated with volatile flows are extremely damaging. Financial crises, and reversals of financial flows, have a serious negative impact on the real economies of affected countries, leading to loss of output and increased poverty levels. Furthermore, volatility itself (of capital flows and of macroeconomic variables) is damaging to investment, growth, and employment.

One of the effects – and, indeed, one of the aims – of the reforms in Latin America, as well as elsewhere, has been to attract more capital flows. Often one of the indicators used to measure success of reforming economies has been whether they attract more capital flows in the post-reform period. This analysis was based on the assumption that the more capital flows of any type a country could attract, the more beneficial this was for growth and development.

The highly problematic experience with capital flows in the 1990s, and much of the recent literature on the subject (Radelet and Sachs, 1998; Rodrik 1998; Bhagwati, 1998), raise the clear possibility that, for certain categories of capital flows (easily reversible ones) and especially if those flows enter on a very large scale, their long-term net growth and development benefits may be negative. While the high costs of reversals of these flows are evident, the benefits of inflows are less clear. At the same time, there is growing empirical evidence (Borensztein, de Gregorio and Lee, 1995; Ffrench-Davis and Reisen, 1998) that foreign direct investment (FDI) contributes to long-term growth. This is for three reasons: a) it is on the whole more stable; b) it is complementary to domestic investment, both in production and through positive spill over effects; and c) it stimulates growth through the embodied transfer of technology and efficiency, as well as facilitating access to foreign markets.

If correct, this analysis implies a complex relationship between reforms, capital flows, and growth. Reforms in general, *ceteris paribus*, tend to attract more capital flows of all categories. It would seem that specific reforms – such as a certain type of capital account liberalization – tend to contribute more to attract larger amounts of potentially volatile capital flows, which can often undermine rather than contribute to the additional growth that other reforms, --such as trade liberalization-- are generating in the economy. At the same time, other reforms – such as privatization and labor market reforms – help to attract FDI, which seems to have clear net beneficial effects on growth. Also, on the positive side, it may be the case that those countries that have implemented "second generation" reforms (including aspects such as development of long-term capital markets and proper regulation of the domestic financial sector) in addition to a "first generation" of liberalizing reforms, may be somewhat less vulnerable to large reversals of capital flows. Above all they may recover access to capital and credit markets somewhat more easily. Indeed, it is also interesting to note that the international debt or financial crises originated in Latin America in the early 1980s (before the reforms), while in 1997-1999 the international financial crisis originated in other parts of the world. Less encouraging is the

fact that Latin American countries are still being hit fairly severely by currency crises and contagion, in spite of their important efforts at structural reform and at improving macroeconomic policies.

The policy implications of these more complex relationships have to be more nuanced than were those emerging from the conventional analysis in the past, which was based on the almost theological assumption that international capital and credit markets were always efficient. The new realities seem to imply the need for far more careful and possibly more limited capital account liberalization until policies are in place, both nationally and internationally, to avoid recurrent costly currency crises. They also imply the need to combine domestic financial liberalization with simultaneous regulation of the financial sector. For small open economies in a world of volatile capital flows, new forms of regulating the domestic financial sector may be appropriate, which may include larger protective cushions than in developed economies for example, higher capital adequacy ratios for banks, as well as introduction of counter-cyclical elements into the regulatory process, to moderate boom-bust patterns of behavior (Ocampo, 1999). It may also imply the need for accelerating and deepening reforms and policies (such as privatization, labor market reforms, and especially more investment in human capital and infrastructure) that encourage more FDI. These measures at the national level need to be complemented by international measures that encourage greater stability in capital flows to developing countries.

The importance of policies at the national and international levels to encourage far greater stability in capital flows is particularly important for reforming economies. There seem to be two stages in the implementation of reforms. The first stage – linked to rationalization of existing capacity – leads to high unemployment and inequality, even when there is rapid growth. Only in the second stage is new investment undertaken, which leads to improvements in employment and equity (see Moguillansky and Bielschowsky, 2000). To reach the second stage, stable capital flows are not only important to help finance the new investment (and, if in the form of FDI, to facilitate embodied transfer of technology), but also to avoid the major disruptions to output and investment that sharp declines or major reversals of capital flows can cause. Financial and currency crises not only seriously restrict availability of credit and foreign exchange for both working capital and investment; they may also undermine for a relatively long period of time the confidence of both domestic and international investors, as we discuss in more detail below.

In assessing the impact of foreign financial flows on Latin America, it is crucial to look both at the broad pattern of total flows and at the composition of inflows, their conditions, and their volatility. This paper begins by looking at the general pattern of financial flows to Latin America over the last three decades and how the recent trend in flows fits into that overall picture of high volatility. It then examines the links between capital flows and growth. It goes on to look at each major category of flows – foreign direct investment, portfolio flows, and bank lending – examining the trends of the flows and the terms and conditions on which they enter the region. It concludes with some policy recommendations.

II. THE VOLATILITY OF CAPITAL FLOWS TO LATIN AMERICA

Measuring the volatility of international capital flows as a percentage of GDP to various regions between 1970 and 1992, Hausmann and Gavin (1996) found that developing countries in general experience greater volatility of capital flows than industrialized countries. In Latin America, the study found that the standard deviation of capital flows as a share of GDP was 2.8 for the 1970-1992 period, while the corresponding figure for the industrialized countries was only 1.7 (see table 1).

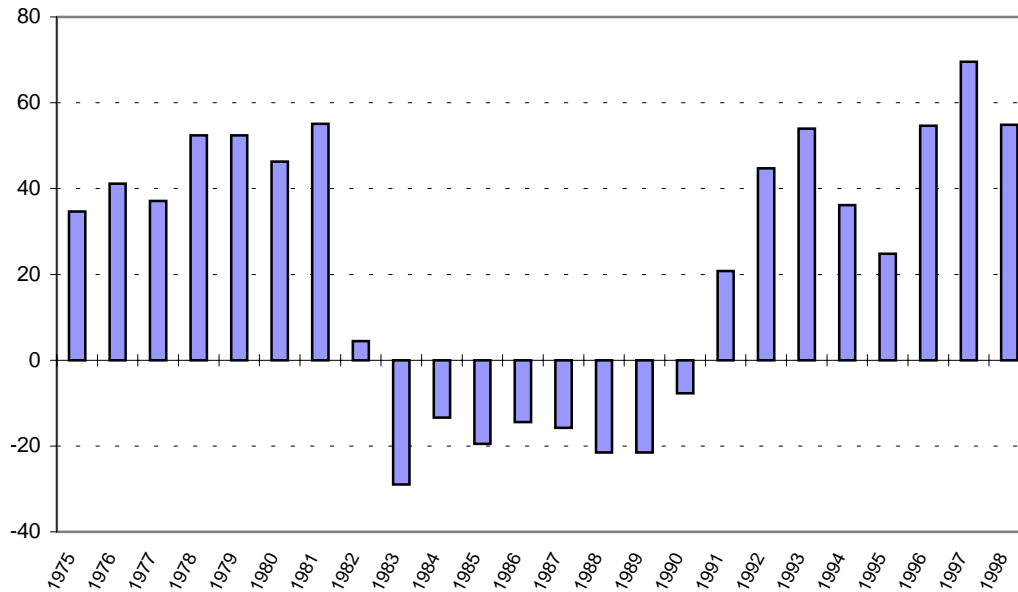
Table 1
VOLATILITY OF CAPITAL FLOWS AND GDP IN SELECTED COUNTRIES, 1970-92

Standard Deviation	Latin America and the Caribbean	Sub-Saharan Africa	Middle East and North Africa	East Asia	Industrial Countries
Capital flows as percent of GDP	2.8	4.4	6.1	1.5	1.7
Real GDP growth	4.7	5.3	7.9	3.0	2.2

Source: Hausmann and Gavin (1996)

Figure 1 shows net private capital flows to Latin America in constant 1990 U.S. dollars between 1975 and 1998. Private flows were very high in the 1976-1981 period; they became negative between 1983 and 1990; they grew rapidly till 1993, before falling in 1994 and 1995, due to the peso crisis. In 1996 and 1997, net flows picked up again. By 1998, as a result of the Asian crisis and its spread, capital flows declined again. Between 1975 and 1998, it is therefore possible to define three sub-periods (1975-1981, 1982-1990, and 1991-1998); the first period has positive net inflows, the second is the “lost decade” of the debt crisis, and the third is the return of capital flows in the 1990s.

Figure 1
LATIN AMERICA AND THE CARIBBEAN: NET CAPITAL FLOWS, 1975-1998
(billions of 1990 U.S. dollars)^a



^a Data were deflated by the U.S. consumer price index.

Source: ECLAC, on the basis of IMF data.

Table 2 shows the mean, standard deviation, and coefficient of variation for each of the sub-periods based on the data provided in figure 1. These calculations show that the volume of capital flows to Latin America were of about the same magnitude in the 1990s in relation to the previous inflow period, but they were more volatile. Thus, the mean was about the same in 1975-1981 as in 1991-1998, but the standard deviations for inflows were 8 and 17, while the coefficients of variation were 18 and 37, respectively. This meant that the surges and declines that were far more frequent in the 1990s than in the 1970s and 1980s. On the positive side, the recoveries of flows after crises seem also quicker (see figure 1).

Table 2
CHARACTERISTICS OF CAPITAL FLOWS TO LATIN AMERICA, 1975-1998

Period	Mean ^a	Standard Deviation	Coefficient of Variation
1975-81	45.6	8.1	17.8
1982-90	-15.4	9.6	-62.3
1991-98	44.9	16.7	37.1

^a Billions of 1990 dollars.

Source: Author's calculations based on data in figure 1.

It can be hypothesized that technological and institutional developments, which may reflect secular trends, explain the increase in volatility of capital flows during the 1990s. Clearly the development of information technology has increased the speed with which capital can flow in and out of countries and, more generally, the speed and ease with which financial transactions can be made and reversed. Furthermore, it has been argued that the growing importance of institutional investors together with the increasing international diversification of their assets, the risk and reward structures of delegated portfolio fund managers, and the growing appetite for liquid, transferable securities that can be easily sold may also be contributing to the increased volatility of capital flows to developing countries.

One factor is the sheer massive scale of institutional investors' assets, which surpass US\$40 trillion (see Griffith-Jones, 1998 and World Bank, 1997). This contrasts with the relatively small size of many recipient markets. This asymmetry highlights the potential for volatility as marginal portfolio adjustments by institutional investors can lead to massive changes in the level of capital flows to individual countries. According to BIS (1998) estimates, a hypothetical shift of 1 percent of equity holdings by G-7 institutional investors would be equivalent to over 66 percent of the Latin American equity markets.

A second factor is linked to risk/reward structures of fund managers and, in particular, to the frequent evaluation of fund managers' investment performance against market benchmarks or against peer performance. As a result fund managers fear underperformance, because it can imply loss of business and therefore lower fees; this discourages positions different from benchmarks or from the average of their peers. There is evidence that these incentives contribute to herding, and therefore to high volatility of capital flows.

A third, broader factor may be linked to the fact that capital market financing is more rapidly affected by changes in market sentiment, as securities investors have looser relationships with borrowers and are more influenced by daily price movements – as they mark to market their assets – than are commercial banks (BIS, 1999). This would help explain why fund managers withdrew earlier than commercial banks in East Asia (BIS, 1998). Evidence on this point is not totally clear cut, however, as various types of intermediaries – especially large ones – have adopted similar risk management systems. Nevertheless, the fact that different actors (e.g., banks, pension funds, and mutual funds) have highly correlated strategies may contribute to an aggravation of capital flow volatility and of the scale of asset price movements. Combined with the asymmetries of scale between global assets and the size of Latin American economies, this opens the possible danger that in the future high capital flow volatility will remain or even increase, particularly if effective measures are not taken nationally and internationally to counteract this volatility.

III. THE LINK BETWEEN CAPITAL FLOWS, INVESTMENT AND GROWTH

The volatility of capital flows is important because it can have serious negative effects on the real economies of recipient countries. Economic downturns and particularly financial crises, which often result from or are aggravated by volatile financial flows, have a negative impact on growth and often result in reduced investment in both physical and human capital. The experience of Mexico during the peso crisis of 1994-1995 showed how a financial crisis can result in serious disturbances to production and investment. Mexican GDP fell by 7 percent in 1995, many firms had to close, investment and consumption levels fell dramatically, and the country's banking system was severely weakened.

Table 3 shows that volatility of capital flows is not only higher in Latin America than in developed economies, but its cost is also higher. The table compares the cost in terms of lost output of banking and currency crises in emerging economies to industrialized economies. In general, resolution costs of banking crises in industrialized countries have been held at under 10 percent of GDP, whereas in several emerging market countries, particularly Latin America, the costs have been much larger (IMF, 1998).

Table 3
COSTS OF CRISES IN LOST OUTPUT RELATIVE TO TREND

	Number of crises	Average recovery time (years) ¹	Cumulative loss of output per crisis ² (percentage points)	Crises with output loss ³ (percent)	Cumulative loss of output per crisis with output losses ⁴ (percentage points)
<i>Currency crises</i>	158	1.6	4.3	61	7.1
Industrial	42	1.9	3.1	55	5.6
Emerging market	116	1.5	4.8	64	7.6
<i>Currency "crashes"⁵</i>	55	2.0	7.1	71	10.1
Industrial	13	2.1	5.0	62	8.0
Emerging market	42	1.9	7.9	74	10.7
<i>Currency and banking crises⁶</i>	32	3.2	14.4	78	18.5
Industrial	6	5.8	17.6	100	17.6
Emerging market	26	2.6	13.6	73	18.8

¹ Average amount of time until GDP growth returned to trend. Because GDP growth data are available for all countries only on an annual basis, by construction the minimum recovery time was one year.

² Calculated by summing the differences between trend growth and output growth after the crisis began until the time when annual output growth returned to its trend and by averaging over all crises.

³ Percent of crises in which output was lower than trend after the crisis began.

⁴ Calculated by summing the differences between trend growth and output growth after the crisis began until the time when annual output growth returned to its trend and by averaging over all crises that had output losses.

⁵ Currency "crashes" are identified by crises where the currency component of the exchange market pressure index accounts for 75 percent or more of the index when the index signals a crisis.

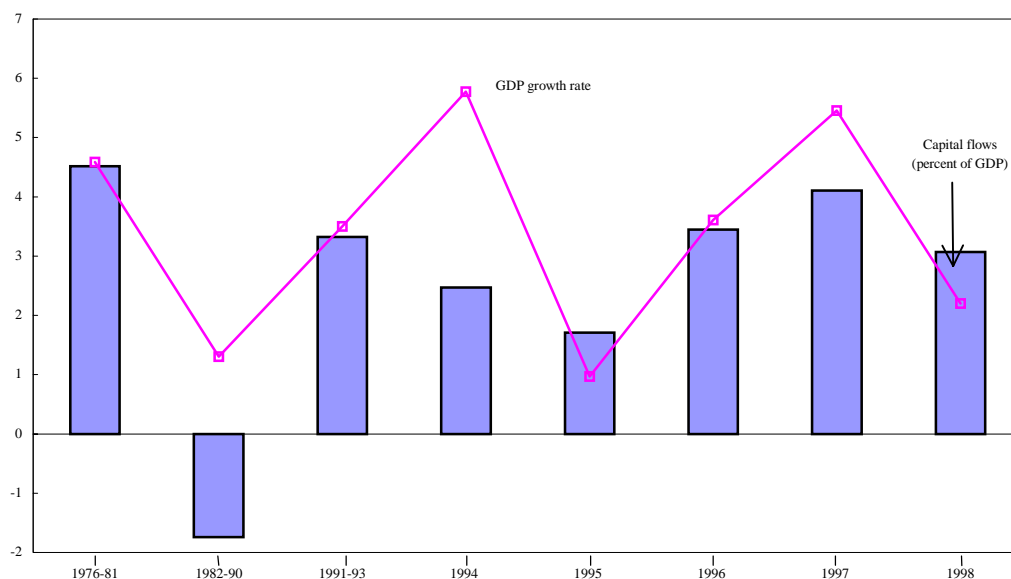
⁶ Identified when a banking crisis occurred within a year of a currency crisis.

Source: IMF (1998).

Highly volatile capital flows, and the costly currency and banking crises that are often associated with them in developing countries, can have a serious negative impact on growth rates. Between the mid-1970s and the present, not only have capital flows to Latin America been highly volatile, but GDP growth in the region has also been highly volatile. Latin America as a whole has experienced more and deeper recessions than most other regions of the world (Hausmann and Gavin, 1996).

Figure 2 plots the data on capital flows to Latin America as a share of GDP against the growth rate of GDP in Latin America over the same period. It shows that there is a very strong correlation between the growth rate of GDP in Latin America and capital inflows to the region. During the inflow period 1976-1981, the region grew at an average rate of around 4.5 percent per year, while receiving capital flows at a similar share of GDP. During the period of capital scarcity, between 1982 and 1990, growth fell to less than 1 percent per year, while capital flows to the region became negative at -1.7 percent of GDP. During the 1990s, GDP growth and capital inflows have continued to follow a very similar pattern. Both capital inflows and growth rose considerably in the years immediately preceding the Mexican peso crisis, with GDP growth peaking at 5.8 per cent in 1994; growth fell sharply in 1995, while capital flows also fell as a result of the peso crisis and its spillover effects in Argentina and Uruguay. There was then a marked parallel recovery in both capital inflows and growth during the 1996-1997 period, when GDP growth in the region averaged 4.4 percent, before the decline in both flows and growth that have resulted from the international financial crisis.

Figure 2
LATIN AMERICA AND THE CARIBBEAN:
NET CAPITAL FLOWS AND GDP GROWTH RATES, 1976-1998
(percent)



Source: ECLAC, on the basis of official data

The relationship between GDP growth and capital flows is partly non-causal, as both are affected by other economic variables. Fluctuations of GDP growth in Latin America are a result of a number of factors, both domestic and external, of which volatile capital flows is only one, though clearly a very important one. Moreover, the causality between flows and growth to some extent runs both ways as high rates of growth are one of the factors that attract foreign finance to developing economies. Nonetheless, the relationship between GDP growth and capital flows in Latin America, clearly illustrated in figure 2, is very striking. It is safe to conclude that capital inflows contribute to higher levels of growth, and that the sharp reductions or reversals in flows (especially if they lead to balance of payments and financial crises) have a strong contractionary impact on the region's economies.

The effect of changes in levels of net capital flows on the expansion of GDP occurs in the first instance via the impact of flows on imports, although a number of other mechanisms – such as variations in levels of domestic bank lending – are also important. Thus, large inflows enable higher imports, which first permit an increased use of existing productive capacity that, facilitated by higher aggregate demand, leads to growth of output and employment. In a second moment – if capital flows continue, spare productive capacity is used up, and confidence of private actors increases – flows may increase levels of investment, which would increase the likelihood of leading to more sustainable growth (Corden, 1990).

In this scenario of sustained growth, all sorts of positive effects of the capital flows could interact with positive impacts from the reforms. These include the transfer of more efficient embodied technology that increases productivity, as well as more dynamic responses from entrepreneurs, who see their efforts at investing and innovating rewarded by higher profits and growth.

There is also a less rosy and unfortunately more common scenario. When capital flows decline or are totally reversed, this leads in the first instance to a sharp contraction of imports (as exports are slower to respond); the contraction in imports leads to a fall in growth (see figure 2). These links operated particularly clearly for Latin America in the 1983-1989 period, when the sharp reversal of capital flows and the large increase in debt servicing were major factors explaining the dramatic fall in imports (of around 40 percent in the first instance), which was a major factor in explaining Latin America's extremely poor growth performance during those years. The sharp declines or reversals of flows in the 1990s also led to lower imports and lower growth.

As Devlin, French-Davis and Griffith-Jones (1995) argued, several pre-conditions need to be met for capital flows to produce sustained growth, that is for a virtuous “debt cycle” to take place. These include: a) a high proportion of the inflows should go into investment; b) the additional investment should be efficient; c) a large proportion of the increased investment should go into tradeables, so as to help create a trade surplus that would help service the flows in the future, and d) creditors and investors must be willing to provide stable and predictable capital flows on reasonable terms. As experience has shown, these conditions are difficult to meet simultaneously in practice. Furthermore, after the East Asian crisis we have learned that there is

an additional condition that needs to be met for capital flows to contribute to sustainable growth, which is that increases in investment, particularly in exports, should not be in sectors where there is risk of global overproduction (Kaplinsky, 1998).

It is unfortunately both difficult and rare, at least in recent Latin American economic history, for large surges of capital flows to lead to sustained growth. This may relate to the fact that the above listed pre-conditions are difficult to meet. Furthermore, some of the effects on the domestic economy induced by the initial surge of capital unfortunately make it more difficult for flows to be maintained and to contribute to sustainable growth (Reisen, 1999).

Large surges of capital flows tend to contribute to overvalued exchange rates, whatever the exchange rate regime adopted. This overvaluation discourages investment in tradeables, and especially in exports, which are meant to be one of the most dynamic sectors in a reformed economy. There is also evidence that overvalued (as well as volatile) exchange rates discourage all investment. More broadly, volatility in key macroeconomic variables – not only exchange rates but also domestic credit levels, asset values, interest rates and the rate of growth itself – have a negative effect on investment levels via business expectations, as they increase uncertainty about future profitability of investment. As investors have the option of delaying investment until more information arrives, there exists an opportunity cost of investing now rather than waiting (Dixit and Pindyck, 1994). Therefore, increased volatility in macroeconomic variables, which augments uncertainty, requires a far higher expected rate of return in order to justify investment. As a result, increased macroeconomic uncertainty reduces the level of private investment, as various empirical studies have shown. This is negative for future growth.

For obvious reasons, overvalued exchange rates encourage growth of current account deficits. As this trend continues, and as foreign exchange liabilities (especially short-term) increase, the likelihood increases of a reversal of capital flows and a currency crisis. Such a currency crisis (or a major over-shooting of the exchange rate, to imply a devaluation much larger than required by fundamentals) will increase the risk of a banking crisis in Latin America. Both phenomena have tended to cause short-term declines in output and to discourage investment, which discourages future growth.

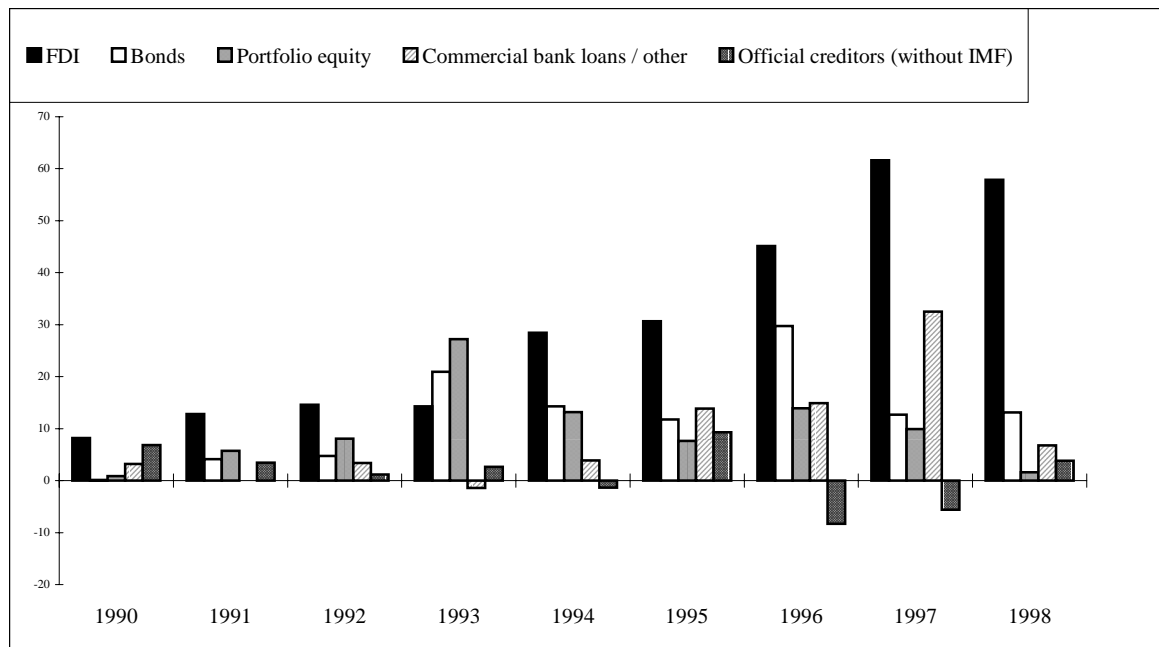
Another negative interaction between capital flows and sustainable growth operates via the impact on the fiscal balance and public investment (Fitzgerald, 1999). With a surge of short-term capital inflows, there is a change in market perceptions about what they will accept as a sustainable public debt ratio. As this increases, the “permitted” fiscal deficit can rise quite sharply for a transition period, given the space opened by the higher debt ratio and higher expected growth rate. Once foreign creditors and lenders see the cumulative effect of their individual decisions, however, sentiment can change suddenly, possibly even to a lower public debt ratio than before the initial favorable change of perception. The market then requires that a large fiscal surplus be generated to finance repayment of existing debt stock to reduce the debt ratio. As taxes are difficult to increase rapidly and current spending is difficult to cut, public investment tends to be the main adjustment mechanism. Sharp fluctuations in public investment are very negative, as efficiency is lost both when projects are started too rapidly and ongoing ones

are frozen or delayed once started. Also the volatility and resulting inefficiency of public investment negatively affects private investment because there often are strong complementarities between them.

A final, external reason that it is difficult for surges of short-term capital to contribute to sustained growth is related to the volatile nature of capital flows themselves. Rather than faithful companions, capital flows are fair weather friends. Their love of a country may quickly change, due to a deterioration in key variables (such as current account deficits, fiscal deficits or the ratio of short-term foreign liabilities to reserves) that they themselves partly contributed to create or because of external factors, such as variations in developed countries' interest rates (Mexico, late 1994) or contagion from currency crises in other emerging markets (Brazil, early 1999).

A key determinant of capital flow volatility is the term structure of net inflows. Figure 3 shows the breakdown of private capital flows to Latin America between 1990 and 1998 into foreign direct investment, portfolio flows, and other investment. The latter is largely made up of bank lending and other investment flows such as trade credits. The figure shows that both portfolio flows (bonds and equity), which tend to be more liquid, and bank lending, around 50 percent of which was short-term in this period, have been more volatile during the 1990s than foreign direct investment.

Figure 3
LATIN AMERICA AND THE CARIBBEAN: COMPOSITION OF NET CAPITAL FLOWS, 1990-1998
(Billions of U.S. dollars)



Source: World Bank (1999) and ECLAC (1999).

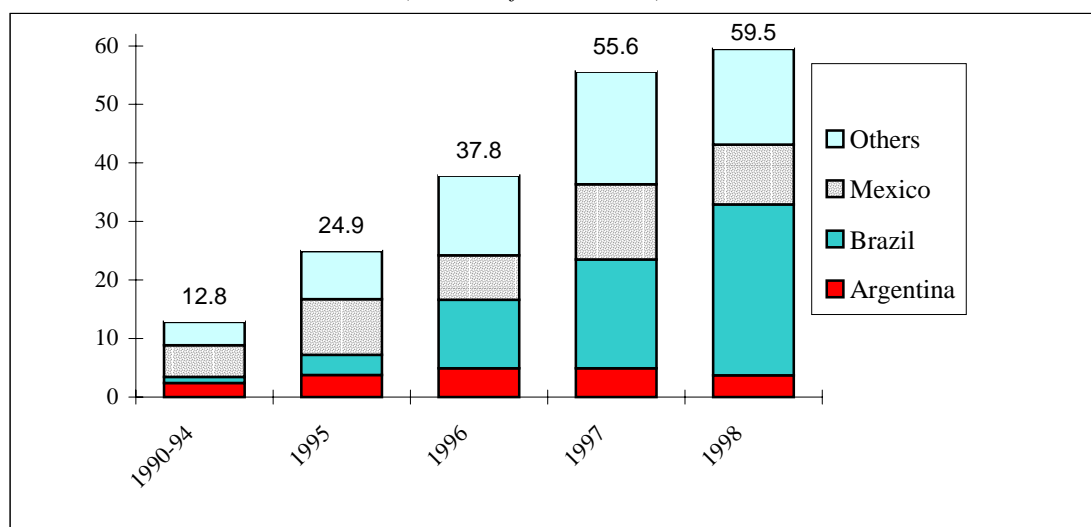
Figure 3 shows that net portfolio flows rose significantly between 1991 and 1993. In this period, Latin America relied heavily on these portfolio flows. This pattern changed after 1994, as a result of the peso crisis in Mexico. Portfolio flows declined, while FDI flows remained steady. In 1996, portfolio flows showed a significant recovery and remained fairly steady through 1997. FDI flows continued to increase steadily, constituting a growing share of total flows to the region. In 1997 FDI made up 61 per cent of net capital flows to Latin America, portfolio flows and bank loans represented 43 per cent, while other net investment was negative.

IV. COMPOSITION OF CAPITAL FLOWS TO LATIN AMERICA

1. Foreign Direct Investment

Global levels of FDI flows increased significantly during the 1990s, reaching nearly US\$400 billion in 1997. In recent years, the distribution between countries has been shifting with developing countries receiving an increasing proportion of these flows and Latin America's share increasing to around 44 percent to developing countries in 1997. In 1997, Latin America and the Caribbean received FDI flows of US\$56 billion, rising to US\$60 billion in 1998. This figure represents a significant increase compared with the levels of FDI flows in previous years (see figure 4).

Figure 4
LATIN AMERICA: NET FOREIGN DIRECT INVESTMENT FLOWS, 1990-1998
(billions of U.S. dollars)



Others: Bolivia, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.

Source: ECLAC, on the basis of official and IMF figures.

In addition to the increasing levels during the 1990s, another important feature of FDI flows to Latin America was their stability during periods of turmoil as is evident by looking at figure 3. Whereas portfolio flows and bank lending were very sensitive to market disruptions and therefore extremely volatile, FDI remained stable throughout the turbulent 1990s. Not only was FDI more stable in itself, but it also helped to stabilize the current account by expanding capacity

in the tradeable goods sector. In 1997, FDI represented around 60 percent of total private flows to the region, and this figure increased in 1998 to around three fourths of total flows. FDI as a proportion of total flows to Latin America had reached similar levels in 1995, following the peso crisis.

Returning to the distribution of FDI flows within the region, figure 4 shows the increasing importance of Brazil as a recipient of FDI inflows during the 1990s. In 1996, Brazil took over from Mexico as the main recipient of FDI in Latin America. In 1997, Brazil received 30 percent of FDI flows to the region, followed by Mexico and Argentina, with 19 percent and 10 percent respectively; Chile, Colombia, and Venezuela also received around 10 percent. These six countries, together with Peru, were the most important FDI recipients in the region.

The three main mechanisms for FDI inflows are the acquisition of private assets, the privatization of state assets, and investment in new assets (ECLAC, 1998). In the first half of the 1990s, the privatization of state-owned enterprises was the main avenue for FDI inflows to Latin America. Then, in the period 1994-1996, an increasing proportion of FDI inflows were dedicated to new investment, with the restructuring and modernization of existing foreign-owned companies in the region as well as of recently privatized state industries. In 1997, the transfer of assets, both public and private, again took over as the primary reason for FDI flows to Latin America. This trend was particularly strong in the larger economies, such as Brazil, Argentina, Mexico, Colombia, Venezuela and Chile. In those countries where the privatization process was in its later stages, such as Argentina, Chile, Mexico and Peru, the sale of private assets was more important than the privatization of state firms.

The United States has been the source of the largest proportion of FDI flows to Latin America in recent years, followed by Europe. Regional trading agreements have encouraged FDI flows to the countries of the region involved, such as NAFTA (Mexico) and MERCOSUR (Brazil and Argentina). In Mexico in the early 1990s, there was a boom in foreign direct investment following the announcement and ratification of the NAFTA agreement, together with the far-reaching economic reforms in that country. Later in the decade, Brazil took over in importance as economic reforms and the privatization process brought FDI flooding in.

Privatization has been an extremely important source of revenue for Latin American countries; between 1985 and 1992, more than 2,000 publicly-owned firms (such as public utilities, banks and airlines) were privatized throughout the region (ECLAC, 1998). Early privatizing countries included Chile and Argentina, while Mexico and Peru have also carried out major privatization programs. More recently, Brazil has become the region's most important privatizing country; in 1998, Brazil received privatization receipts of around US\$6 billion (including from the sale of Telebras).

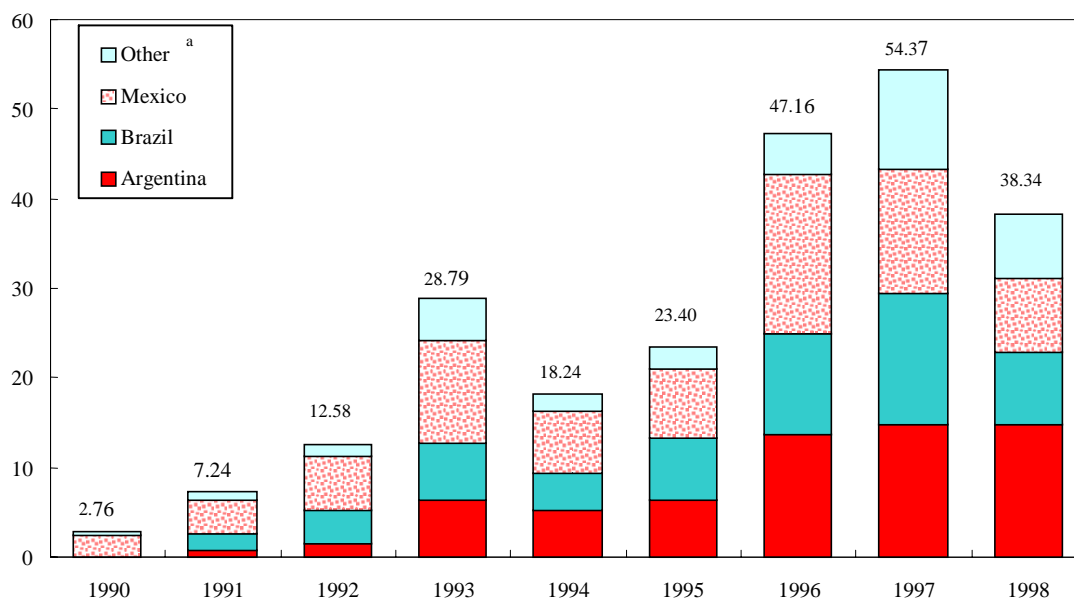
Brazil's privatization program has been part of a "second wave" of privatization in Latin America, which involved the sale of state assets, often through concessions, allowing private sector activity in areas previously considered preserves of the state. Examples include the opening of new markets, such as that for mobile telephones, and private investment in sectors such as mining and petroleum. Foreign investment in these sectors has often taken the form of

joint ventures with local companies. While this type of investment does not increase the productive capacity of the recipient country, it does serve to improve the quality of services (mainly in energy, telecommunications, and transport) and increase competitiveness. Privatization, in general, also acts as a springboard for further FDI flows.

2. Portfolio Investment

Before 1989, Latin America and the Caribbean only had limited access to the international bond market. Since then, however, the region has enjoyed extensive access to this market, and the importance of bond financing as a source of external finance to Latin America has risen significantly. Figure 5 shows that the volume of international bond issues in Latin America and the Caribbean rose from US\$2.8 billion in 1990 to a peak of US\$54.4 billion in 1997, before falling in 1998.

Figure 5
LATIN AMERICA: INTERNATIONAL BOND ISSUES, 1990-1998
(billions of U.S. dollars)



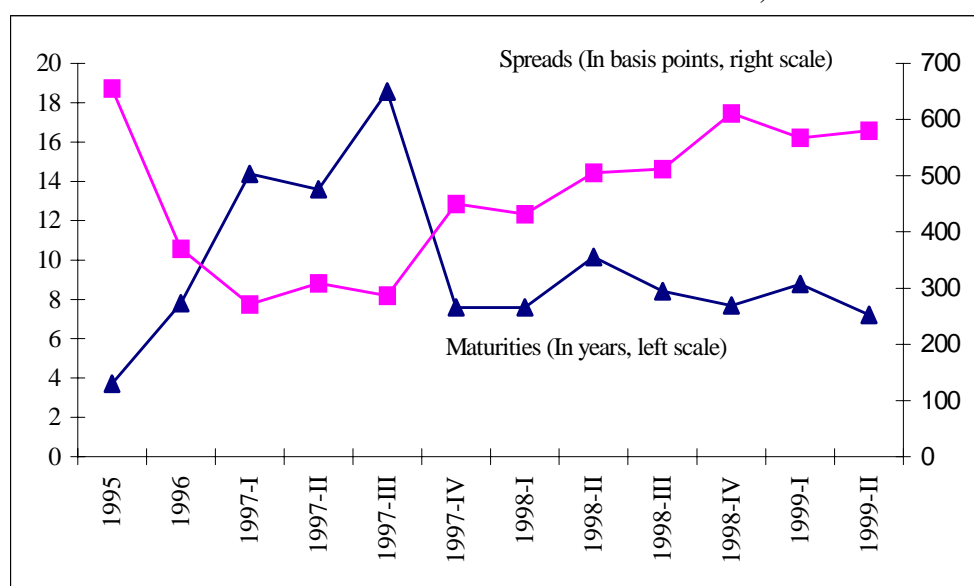
^a Bahamas, Bolivia, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Guatemala, Jamaica, Panama, Peru, Trinidad and Tobago, Uruguay, and Venezuela.

Source: ECLAC, on the basis of official and IMF figures.

Figure 5 shows that international bond issues by Latin American countries fell off during the peso crisis in 1994 and 1995, before rising again rapidly to record levels in 1996 and 1997, but falling in 1998, a trend that is expected to continue. The countries most active in the bond market have been Mexico, Brazil, and Argentina followed by Venezuela, Chile, and Colombia. In 1997, Argentina and Brazil issued bonds amounting to around US\$15 billion, Mexico US\$14 billion, and Venezuela US\$5.5 billion.

In addition to the growth in the volume of bonds issued in Latin America, the size of new bond issues also increased during the 1990s. Bond financing is relatively expensive for Latin America; bond margins for Latin America have been high, particularly in Brazil and Argentina. Moreover, spreads, which had been falling since the peso crisis, rose sharply as a result of the international financial crisis, with spreads on Venezuelan and Brazilian bonds most affected. This trend increased following the Russian devaluation and debt moratorium in mid-August 1998. Figure 6 shows how the international financial crisis affected the conditions facing international bond issuers in Latin America.

Figure 6
LATIN AMERICA AND THE CARIBBEAN: TERMS AND
CONDITIONS FOR INTERNATIONAL BOND ISSUES, 1995-1999



Source: ECLAC, on the basis of official and World Bank figures.

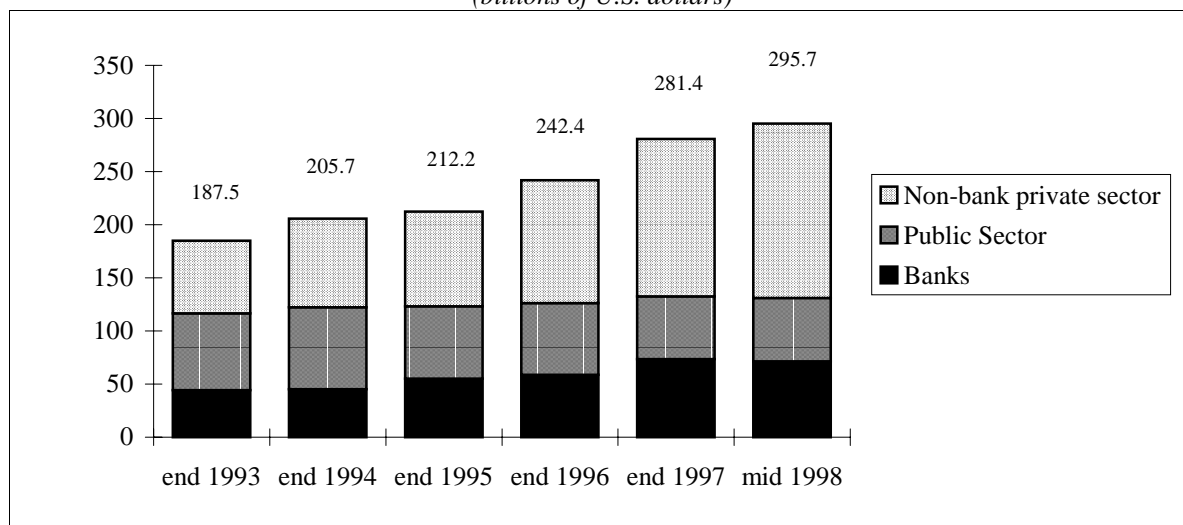
The crisis has also reversed the previous improvement in the average maturities of Latin American bond issues. Average maturities had remained steady at around 3-4 years from 1989 until 1995, before increasing significantly to 8 years in 1996, and again to 15 years in 1997. This was seen as a very positive shift as the longer maturities reduced the potential volatility of bond flows, which make up a large share of total flows to the region. As we can see in Figure 6, maturities fell in the last quarter of 1997 to 7.6 years and remained at about that level. On the previous trend of rising maturities of Latin American bonds, it is worth noting that the share of bonds issued with options had also increased in the same period. Since options allow the lender to pull out before the official maturity date, the apparently less potentially volatile bond flows may have actually been little better than in previous years. The impact of bond options has been particularly dramatic in the case of Brazil, where the share of bonds issued with options increased sharply after 1996. Furthermore, the Weston Group has estimated that of US\$7.5 billion due in 1999, almost half (around US\$3 billion) will originate in the exercise of put options (Financial Times, March 18, 1999).

International share issues have also been an important source of capital for Latin American countries in the 1990s, although to a much lesser extent than bond issues. Share issues rose from US\$4 billion in 1991, to nearly US\$5 billion in 1994 (ECLAC, 1999). Issues fell sharply as a result of the Mexican peso crisis however and unlike bond issues recovered only gradually, failing to reach pre-crisis levels.

3. Bank Lending

The importance of bank lending in total private capital flows to Latin America is significantly less in the 1990s than it had been in the 1970s. Figure 7 shows the steady growth in the outstanding claims of BIS reporting banks to Latin America from around US\$200 billion in 1993-1994 to US\$295.7 billion in mid-1998. The financial turbulence following the Asian crisis did not stop the growth of outstanding claims of BIS reporting banks to Latin America in the first half of 1998. However, IMF figures suggest that while foreign banks may have been increasing their exposure to Latin America during the first half of 1998, net bank lending flows to the region were in fact negative for the second half of 1998.

Figure 7
LATIN AMERICA: INTERNATIONAL BANK LENDING BY TYPE OF BORROWER, 1993-1998
(billions of U.S. dollars)



Source: BIS (various).

The share of short-term claims (up to one year) on Latin America increased somewhat during the 1990s, from around 37 percent in 1991 to around 55 percent in the first half of 1998. This rise can mostly be accounted for between 1991 and 1993, when the share rose to about 50 percent. The share of short-term claims on lending to Latin America compares quite well to the share for lending to Asia, where the figure remained at over 60 percent between 1992 and 1997. As regards the sectorial composition of claims, there has been a gradual shift away from interbank lending and in favor of direct non-bank exposure.

V. CONCLUSIONS

Capital flows to Latin America have reached very high levels in the 1990s. Except for FDI, which has been a growing proportion of flows to Latin America and has provided a source of stability to the region, all other capital flows to the region are very volatile. Not only are their levels volatile, which is the most problematic feature, but their conditions (both in terms of maturity and cost) also fluctuate strongly. Furthermore, some of the fluctuations in conditions (e.g., maturity) are difficult to detect statistically, as formal maturities may remain the same, but de facto ones can fall due to financial engineering mechanisms such as put options.

Private capital flows to Latin America are much more volatile than capital flows to developed countries. This volatility of capital flows, transmitted to volatility of macroeconomic variables, is very negative both for growth and investment. A number of mechanisms explain the negative link between volatility and growth; the main long-term one seems to be that the increased uncertainty caused by volatility significantly undermines private-sector confidence and therefore discourages investment.

It would be desirable if capital flows were more stable, as this would allow virtuous interactions to develop. If capital flows in for a significant period, and it finances efficient investment with an important proportion in tradeables, it will generate sufficient growth, savings and trade surpluses to allow for the servicing of the inflows in future years. Such a virtuous circle worked well for example in the United States in the nineteenth century.

A virtuous circle of relatively stable capital flows would be particularly valuable and essential for reforming economies, where new and increased investment is essential to allow the economy to adapt to important changes in relative prices and in the overall context of economic policy and to generate increased growth. In contrast, very volatile capital flows, by increasing uncertainty and causing currency and banking crises, may be particularly harmful for reforming economies. By undermining the ability of the economy to generate the increased growth that could result from the reforms, there is the risk that they could even undermine political support for the reform process itself.

At present the outlook for capital flows to Latin America and more broadly to emerging markets is uncertain. Three key questions and concerns arise. First, will capital flows return to the average high levels that prevailed in the 1990s? Second, if so, what will be their composition? Will they be dominated by more stable FDI or by more volatile short-term flows? Third, will capital flows to the region be as volatile as they have been in recent years?

It is crucial that policies be designed – nationally, regionally and internationally – to help attract long-term flows and discourage potentially volatile as well as reversible capital flows. In particular, emphasis should be placed on reforms that encourage more stable flows such as FDI, whereas reforms that encourage more volatile flows should be postponed.

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