Growth with stability. Financing for development in the new international context

Growth with stability

Financing for development in the new international context

Economic Commission for Latin America and the Caribbean (ECLAC)

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Foreword

In contrast to its situation during the "lost decade", in the 1990s the Latin American and Caribbean region regained its access to international capital markets. Its return to these markets, in combination with a commitment to achieving basic macroeconomic equilibria, was manifested in smaller fiscal deficits and lower inflation, but the region has recovered only part of the ground it had lost in terms of its pace of economic growth. Thus, the region's economies have not been growing fast enough to strengthen their labour markets or to reduce poverty significantly.

This situation is reflected in the volatility exhibited by sources of external finance other than foreign direct investment and official credit. That volatility, in its turn, is not solely a consequence of the instability that is so typical of financial markets; it is also being exacerbated by the international financial system's serious problems of governance. This state of affairs also attests to the Latin American and Caribbean countries' vulnerability to the financial cycles generated by procyclical macroeconomic policies and to their inability to raise their savings and investment rates enough to achieve higher rates of economic growth. Finally, it is also a reflection of shortcomings in the region's financial development process and the weakness of the countries' mechanisms for regulating and supervising their national financial systems, which has opened the way for unusually frequent financial crises in those systems.

In order to turn this situation around, in this study ECLAC has proposed a strategy for attaining growth with stability based on three

lines of action: strengthening the international financial system's ability to prevent and manage crises and the countries' ability to design more preventive macroeconomic policies to back it up; picking up the pace of export development and improving access to international financial markets; and boosting national savings rates while furthering the countries' financial development so that national resources can be mobilized and channeled into investment.

The original version of this study was prepared by ECLAC as a contribution to the Latin American and Caribbean Regional Consultation on Financing for Development, which took place in Bogota, Colombia, in November 2000. The final version being presented here constitutes the Commission's contribution to the International Conference on the Financing of Development to be held in Monterrey, Mexico, in March 2002. Both in its organization of the Regional Consultation and in the preparation of this document, ECLAC received generous support from the Inter-American Development Bank.

José Antonio Ocampo
Executive Secretary, ECLAC
July 2001

Summary

During the 1990s, Latin America and the Caribbean succeeded in regaining access to external financing. This paved the way for major advances in macroeconomic management, the reduction of inflation and the resumption of economic growth. With few exceptions, however, the countries of the region failed to achieve the savings and investment rates required to fuel rapid growth in production. The 3.3% mean annual growth rate recorded for 1990-2000 not only falls short of the average for the three decades prior to the debt crisis —5.5%— but it also well below the 6% rate that ECLAC has estimated as the minimum rate necessary to achieve ambitious goals of economic and social development and, in particular, poverty reduction.

International capital flows have also been displaying two disturbing characteristics. The first has been the marked instability of such flows, with the sole exception of foreign direct investment. This, in conjunction with national policies that tend to accentuate external financing cycles rather than attenuating them, has often been reflected in a close correlation between capital flows and business cycles in the Latin American and Caribbean countries. The second is that many of these countries, especially the least developed ones, have been sidelined from the most dynamic sorts of private capital flows.

National efforts

These developments pose a major challenge. Meeting that challenge will call for a concerted effort on the part of the countries of the region, but the international environment will also have to be a favourable one if those efforts are to bear fruit. In order to grow at an annual rate of around 6%, the countries of the region will need to reach investment rates of from 4 to 6 points higher than the averages recorded for the 1990s. And in order to avoid driving up the countries' levels of external vulnerability, this increase in investment will have to be financed primarily by a concomitant expansion of domestic saving and must be coupled with the development of national financial markets, since this is the best way to ensure that savings will be channeled into productive investment.

This study underscores how important a role the reinvestment of private firms' earnings and public-sector saving can play in helping to boost national savings rates. It also points out that households and individuals can make a meaningful contribution to this effort, especially through special-purpose saving (e.g., for retirement, to buy a house or to cover educational expenses).

The dynamic development of financial systems and capital markets calls for reliable ground rules and strong regulatory schemes that will insure the systems' stability and provide proper protection for savers. The adoption of international regulatory and supervisory standards for their financial systems is a challenge that the countries have addressed, but a great deal remains to be done in this respect. The promotion of new agents and instruments to help create missing financial- and capital-market segments or to strengthen underdeveloped ones is another vital part of this task. These include functional secondary markets; investment, risk-capital and guarantee funds; and credit insurance or hedging instruments. One key element in developing these new mechanisms is a suitable regulatory system for financial governance which provides for standards regarding transparency and full, timely and accurate reporting that will protect the rights of savers.

In Latin America and the Caribbean, where long-term financing is still in short supply and where access to financial resources is segmented, the public-sector development banking system can play an important role in channeling resources to activities for which the private market offers sub-optimum amounts of resources or sub-optimum financing terms. Such activities include micro- and small-scale enterprises in both rural and urban areas, low-income housing, sustainable development, retooling and technological innovation. In order for this effort to be successful,

however, the fiscal costs of subsidies provided via development banks have to be as transparent as possible and the prompt payment of obligations must be guaranteed, with private institutions preferably being used as the first-tier agents for channeling these resources.

Export capacity will have to be strengthened if the region is to secure sufficient external resources and reduce its external vulnerability. The countries therefore need to work to create a pro-export environment by promoting competitive exchange rates and adopting active policies for boosting exports and engendering systemic competitiveness based on high-quality infrastructure, ambitious technological-development and labour-training policies, and the development of dynamic production chains. If this undertaking is to be successful, access to external markets for goods and services will also have to be secured on more favourable terms than at present.

Higher investment and savings rates, financial development and export growth should be combined with national efforts to reduce the excessive vulnerability of the region's economies to external financing cycles. This indicates that financial booms should be managed on the basis of explicitly prudential criteria, since economic crises are incubated during periods marked by excessive capital inflows, which gradually undermine the recipient countries' macroeconomic fundamentals.

This and previous ECLAC studies therefore suggest that what is needed in order to address this situation is a policy that melds general public-revenue stabilization funds; preventive monetary and credit policies during economic booms; the prudential regulation of the capital account based, wherever possible, on price instruments; strong prudential regulation and supervision of financial systems that are actively managed during economic booms in order to forestall a build-up of excessive levels of risk; and a "liability policy" designed to upgrade the maturity profiles of public and private external and domestic debt. In addition, even while bearing in mind that there is no such thing as an optimum exchange-rate regime for all countries under all circumstances, many quarters have drawn attention to the strengths of flexible managed exchange-rate systems, which seek to reconcile the conflicting demands for stability and flexibility.

The international and regional context

The external environment should provide three key elements. The first is access for developing countries to export markets. The second is a new international financial architecture which, thanks to improved global

governance, will make capital flows more stable. The third is the necessary machinery to provide the less developed countries with sufficient amounts of external resources on appropriate terms and conditions.

The necessary counterpart for the countries' export drive is access to external markets. Industrialized countries continue to maintain high levels of protection in respect of agricultural products and "sensitive" manufactures exported by developing countries. They also frequently make protectionist use of contingency measures and employ a range of technical standards that act as obstacles to developing countries' exports. Furthermore, small island countries that have seen a significant erosion of their trade preferences need adequate resources and technical support to modernize and diversify their export base.

The extreme instability of today's international financial system is associated with the marked asymmetry existing between the rapid development of world financial markets and the absence of suitable forms of macroeconomic and financial governance at the world level. If governance is to be improved, the major developed countries will have to coordinate their macroeconomic policies more closely with a view to ensuring greater macroeconomic stability at the global level, and all countries will have to accede to the use of macroeconomic and prudential surveillance mechanisms. International financial stability also requires a suitable institutional framework at the global level. This framework will need to include basic minimum standards for prudential regulation and supervision of the financial system and for the provision of the information that financial markets need in order to function properly. Appropriate crisis-management institutions will also be required.

There are two types of crisis-management institutions. First of all, a greater capacity to provide exceptional financing during crises has to be created, and suitable mechanisms need to be developed for providing liquidity to countries with sounds macroeconomic fundamentals when they are threatened by contagion. These two objectives can only be achieved if the International Monetary Fund has its own resources at its command, which it can secure through temporary issues of special drawing rights (SDRs). Of course, it should also be remembered that an increased use of SDRs within the international financial system is an end in itself which has long been advocated by developing countries. In order to forestall any problems of "moral hazard", however, these exceptional financing mechanisms should go hand in hand with the development of means of ensuring that private agents will be involved in resolving crises when they arise. While upholding the principle of voluntary negotiations between creditors and borrowers, international rules need to be drawn up

that will ensure the participation of all the interested parties in these types of negotiations and, through the development of suitable multilateral arbitration mechanisms, prevent them from being prolonged unduly.

It should be emphasized that schemes for ensuring creditors' involvement in resolving crises when they occur should be seen as a complementary measure rather than a substitute for exceptional financing, especially when the causes of the countries' problems are strictly temporary in nature (i.e., illiquidity) and are associated with problems of contagion. In fact, a sub-optimal combination of these two types of mechanisms which makes it necessary to rollover debts regardless of the circumstances as a condition for access to emergency financing may actually deepen a crisis rather than resolving it and, in the long run, will result in an insufficient amount of resources being channeled to developing countries.

In order to ensure access to sufficient resources, mechanisms need to be developed that will enable all countries to attract foreign direct investment (FDI) and private credit flows. FDI is fairly evenly distributed in the region, although its linkages with the national host economies should be a subject of priority concern in future. Private credit is much more concentrated, and guarantees or cofinancing arrangements should therefore be made with multilateral development banks to open up these markets for countries that are not yet receiving such flows. This type of support is now starting to be provided in new areas of private investment, especially infrastructure.

Multilateral banks have made a highly valuable contribution to financing for the region and will no doubt continue to be of key importance in the future. First of all, they play a vital role in marshalling resources for the less developed countries. Furthermore, the diversified profile of these institutions' loan portfolios for all the countries bears witness to the importance they place on high-priority social initiatives such as social development projects, sustainable development programmes and State reforms and on channeling resources to micro- and small-scale enterprises. The terms and conditions of the financing they provide is also more advantageous in terms of both maturities and cost than private financing, even for the region's relatively higher-income countries, which suggests that private markets tend to overestimate risk, especially (but not only) during crisis periods. Finally, they supply financing countercyclically, which helps to softer external shocks, and are the only source of long-term financing during crises. Their support has been crucial, even for the relatively higher-income countries, and has played a key role in restoring confidence in the countries concerned.

Official development assistance (ODA) continues to be an essential component of financing for the less developed countries. Bringing ODA up to the target level (0.7% of the industrialized countries' GDP) set under the aegis of the United Nations and making more transparent and efficient use of these funds should be priorities for future action. These resources should be supplemented with funds that can be used to ensure an adequate supply of global public goods or public goods having significant externalities, such as peace, sustainable development and the effort to combat the world drug problem. Steps should also be taken to expedite the implementation of the Heavily Indebted Poor Countries (HIPC) debt relief initiative, for which four of the region's countries may be eligible, and to ensure sufficient HIPC funding. This last point is essential in order to make sure that a disproportionate share of the cost of this initiative is not ultimately borne by other developing countries, either directly or through higher interest-rate spreads and reduced availability of resources for technical cooperation from multilateral development banks.

As work begins on building this global structure, three imperatives must be borne in mind. The first is the need for developing countries to be fully involved in the corresponding institutions. The second is the importance of maintaining countries' autonomy in implementing the policies they feel are most appropriate for their development. The third is the need —given the countries' varying levels of institutional development— for international rules and standards to take their differing absorption capacities into account.

Regional institutions play a decisive role in generating a positive interaction between national efforts and suitable international environment. These institutions include trade integration agreements, which are a key element in the diversification of the Latin American and Caribbean countries' export bases; the extensive network formed by the Inter-American Development Bank and subregional development banks, which are the main source of multilateral financing for the region; the Latin American Reserve Fund, an almost unique institution in the developing world which has done an outstanding job within the Andean Community in recent decades and is now taking steps to expand its membership; and the new macroeconomic coordination mechanisms that are currently being developed as part of various integration processes. The region should strive to consolidate all these processes and institutions, as well as to deepen regional cooperation in general. Solid regional institutions do not run counter to globalization. On the contrary, they help us build a stronger, more balanced global structure.

Resumen

A lo largo de los años noventa, América Latina y el Caribe obtuvieron un renovado acceso al financiamiento externo, lo que facilitó avances importantes en materia de gestión macroeconómica, reducción de la inflación y recuperación del crecimiento económico. Sin embargo, con contadas excepciones, los países de la región no alcanzaron niveles de ahorro e inversión que permitieran lograr altas tasas de expansión de la producción. El ritmo promedio de crecimiento entre 1990 y 2000, del 3.3% por año, no es sólo inferior al registro alcanzado en las tres décadas anteriores a la crisis de la deuda –5.5% anual–, sino también al 6% que la CEPAL ha señalado como necesario para alcanzar metas ambiciosas en materia de desarrollo económico y social, y en especial de reducción de la pobreza.

Los flujos internacionales de capital han mostrado, a su vez, dos características preocupantes. La primera ha sido su fuerte inestabilidad, de la que sólo se exceptúan los flujos de inversión extranjera directa. Ello, unido a políticas nacionales que muchas veces acentúan en vez de atenuar los ciclos del financiamiento externo, ha tendido a reflejarse en una alta correlación entre los flujos de capitales y el ciclo económico de nuestros países. La segunda es la marginación de un grupo importante de países, especialmente los de menor desarrollo relativo, de las corrientes más dinámicas de recursos de origen privado.

Los esfuerzos nacionales

Estos hechos crean grandes desafíos, que para ser superados exigen esfuerzos importantes por parte de los países de la región, pero también un contexto internacional favorable para que fructifiquen. Para crecer en torno al 6% por año, es necesario lograr tasas de inversión que superen entre cuatro y seis puntos los niveles promedio de los años noventa. Para evitar elevar excesivamente los niveles de vulnerabilidad externa, el financiamiento de la inversión adicional debe provenir esencialmente de una expansión concomitante del ahorro nacional y debe estar acompañado de un adecuado desarrollo financiero nacional, que garantice la mejor forma de transferir ese ahorro hacia la inversión productiva.

Este documento destaca el papel decisivo de la reinversión de las utilidades de las empresas privadas y del ahorro público en el esfuerzo por elevar los niveles de ahorro nacional. Señala igualmente que los hogares y las personas pueden contribuir a este objetivo, especialmente a través del ahorro con fines específicos, tal como aquel que se realiza para fines pensionales, de adquisición de vivienda o de educación.

El desarrollo dinámico del sistema financiero y el mercado de capitales exige, por su parte, reglas de juego estables y marcos regulatorios fuertes, que garanticen la estabilidad de los sistemas y la adecuada protección de los ahorradores. En particular, la adopción de estándares internacionales de regulación y supervisión financiera es un desafío que la región ha abordado, pero donde queda mucho por hacer. La promoción de nuevos agentes e instrumentos, que ayuden a crear segmentos inexistentes o complementar aquellos insuficientemente desarrollados en el mercado financiero y de capitales, es también parte esencial de esta tarea. Entre ellos se encuentran buenos mercados secundarios; fondos de inversión, de capital de riesgo y de garantía; seguros de créditos u otros instrumentos de cobertura de riesgos. Uno de los elementos esenciales para desarrollar estos nuevos mecanismos es una regulación apropiada sobre gobernabilidad financiera, que garantice los derechos de los ahorradores mediante normas sobre transparencia y entrega oportuna de información completa y confiable.

En América Latina y el Caribe, donde aún escasea el financiamiento de largo plazo y el acceso a los recursos financieros es segmentado, la banca pública de desarrollo puede desempeñar un papel importante, canalizando recursos hacia actividades a las cuales el mercado privado ofrece recursos en cantidades o condiciones subóptimas. Entre estas actividades cabe mencionar el financiamiento de la micro y pequeña

empresa rural y urbana, de la vivienda social, del desarrollo sostenible, y de los procesos de reconversión productiva e innovación tecnológica. Sin embargo, para que este esfuerzo fructifique, es necesario maximizar la transparencia de los costos fiscales de los subsidios que se asignen a través de la banca de desarrollo y garantizar el pago oportuno de las obligaciones, utilizando preferiblemente a instituciones privadas como agentes de primer piso para la canalización de los recursos correspondientes.

El fortalecimiento de la capacidad exportadora es indispensable para lograr un adecuado nivel de recursos externos y reducir la vulnerabilidad externa. Es necesario, por lo tanto, avanzar en la creación de un ambiente proexportador, basado en tipos de cambio competitivos, políticas de apoyo activo a las exportaciones y creación de condiciones de competitividad sistémica, mediante una infraestructura de calidad, políticas ambiciosas de desarrollo tecnológico y capacitación laboral y el desarrollo de cadenas productivas dinámicas. Para que este esfuerzo dé resultados satisfactorios, es necesario, como veremos, mejorar las condiciones de acceso a los mercados externos de bienes y servicios.

La elevación de los niveles de inversión y ahorro, el desarrollo financiero y la expansión exportadora deben combinarse a nivel nacional con esfuerzos orientados a reducir la excesiva vulnerabilidad de las economías de la región frente a los ciclos de financiamiento externo. Esto implica, en particular, que los auges de financiamiento deben ser administrados con claros criterios prudenciales, ya que las crisis económicas se gestan durante los períodos de entrada excesiva de capitales, que minan gradualmente los fundamentos macroeconómicos de los países receptores.

Éste y documentos anteriores de la CEPAL sugieren para ello una política que combine el uso de fondos de estabilización de ingresos públicos de carácter general; una política monetaria y crediticia preventiva durante los auges; una regulación prudencial de la cuenta de capitales, basada preferiblemente en instrumentos de precios; una fuerte regulación y supervisión prudencial de los sistemas financieros, manejada activamente durante los auges para evitar la acumulación de riesgos excesivos, y una "política de pasivos" orientada a mejorar los perfiles temporales de la deuda pública y privada, tanto interna como externa. Por otra parte, aunque se reconoce que no hay un régimen cambiario óptimo para todos los países en todas las circunstancias, se defienden las virtudes de los regímenes de flexibilidad administrada del tipo de cambio, que buscan conciliar las demandas opuestas sobre estabilidad y flexibilidad que enfrentan actualmente los regímenes cambiarios.

El contexto internacional y regional

El contexto externo debe proporcionar, por su parte, tres elementos esenciales. En primer lugar, acceso a los mercados para las exportaciones de los países en desarrollo. En segundo término, una nueva arquitectura financiera internacional, que, gracias a una mejor gobernabilidad global, proporcione mayor estabilidad a los flujos de capitales. En tercer lugar, mecanismos que permitan que los países de menor desarrollo relativo tengan también acceso a recursos externos en cantidades y condiciones adecuadas.

Los esfuerzos nacionales en materia de desarrollo exportador tienen como contrapartida necesaria el acceso a los mercados externos. En esta materia, subsisten en los países industrializados altos niveles de protección a productos agrícolas y manufacturas "sensibles" provenientes de los países en desarrollo, así como aplicaciones muchas veces proteccionistas de las normas de contingencia comercial y obstáculos técnicos a nuestras exportaciones. Por su parte, en el caso de los países insulares que han enfrentado una erosión significativa de sus preferencias comerciales, es necesario contar con recursos y apoyo técnico adecuados para modernizar y diversificar su base exportadora.

La enorme inestabilidad que acusa el sistema financiero internacional está asociada a la acentuada asimetría que existe entre el desarrollo dinámico de los mercados financieros mundiales, y la ausencia de una adecuada gobernabilidad macroeconómica y financiera a nivel mundial. Una mejor gobernabilidad exige una mayor coordinación de las políticas macroeconómicas entre los principales países desarrollados, con miras a garantizar una mayor estabilidad macroeconómica global; exige asimismo, por parte de todos los países, la aceptación de mecanismos de supervisión de las políticas macroeconómicas con claros criterios prudenciales. La estabilidad financiera internacional requiere también un marco institucional apropiado de carácter global, que incluya estándares mínimos de regulación y supervisión prudencial de los sistemas financieros y de suministro de la información que necesitan los mercados financieros para funcionar en forma adecuada. Requiere, por último, de instituciones apropiadas para manejar las crisis.

Estas últimas son de dos tipos. En primer término, es necesario aumentar la capacidad de proporcionar financiamiento excepcional durante los períodos de crisis y desarrollar mecanismos adecuados para suministrar liquidez a países con fuertes fundamentos macroeconómicos que enfrenten problemas de contagio. Uno y otro objetivo sólo se lograrán si el Fondo Monetario Internacional puede contar con recursos propios, provenientes de emisiones transitorias de derechos especiales de giro.

Más aún, el uso activo de tales derechos en el sistema financiero internacional es un objetivo en sí mismo, largamente defendido por los países en desarrollo, que conviene reiterar una vez más. Para evitar los llamados problemas de "riesgo moral", es necesario, sin embargo, que estos mecanismos de financiamiento excepcional vayan atados al desarrollo de instrumentos que permitan involucrar a los agentes privados en la solución de las crisis. Manteniendo el principio de la negociación voluntaria entre acreedores y deudores, es necesario diseñar reglas internacionales que garanticen la participación de todas las partes en este tipo de negociaciones y evitar que ellas se prolonguen excesivamente, desarrollando mecanismos apropiados de arbitraje multilateral.

En cualquier caso, es importante resaltar que los esquemas orientados a garantizar la participación de los acreedores en la solución de las crisis deben ser vistos como un complemento y no como un sustituto del financiamiento excepcional, especialmente cuando el origen de las dificultades que enfrentan los países es estrictamente temporal (de iliquidez) y está asociado a problemas de contagio. De hecho, una combinación subóptima entre los dos mecanismos, que exija en todas las condiciones refinanciar las deudas como condición de acceso al financiamiento de emergencia, puede acentuar las crisis, en lugar de resolverlas, y en el largo plazo canalizar un monto insuficiente de fondos a los países en desarrollo.

El acceso a recursos implica el desarrollo de mecanismos que permitan a todos los países beneficiarse de la inversión extranjera directa y de los flujos privados de crédito. La primera se encuentra en general bien distribuida en la región, aunque su articulación con las economías nacionales debe ser objeto de atención prioritaria en el futuro. Los segundos están mucho más concentrados y deben desarrollarse, por lo tanto, esquemas de garantías o cofinanciación de los bancos multilaterales de desarrollo, con miras a facilitar el acceso al mercado de los países que no se han beneficiado de dichos flujos. Este tipo de apoyos ya ha comenzado a existir en nuevas áreas de inversión privada, especialmente en infraestructura.

Los bancos multilaterales han realizado un aporte importante al financiamiento de la región, que seguirá siendo decisivo en el futuro. Cumplen, en primer lugar, un papel esencial en la movilización de recursos hacia los países de menor desarrollo relativo. Su cartera de préstamos a todos los países de la región es diversificada, y refleja la prioridad otorgada por estas entidades a proyectos de desarrollo social, desarrollo sostenible, apoyo a las reformas del Estado y a la canalización de recursos hacia la micro y pequeña empresa, entre otras actividades de

alta prioridad social. Sus condiciones, tanto en términos de costo como de plazo, son, además, más favorables a las del financiamiento privado, aún en el caso de países de mayores ingresos relativos de la región, lo que indica que los mercados privados tienden a sobreestimar el riesgo, sobre todo (pero no únicamente) durante los períodos de crisis. Proporcionan, por último, financiamiento en forma contracíclica, mitigando así los choques externos. En particular, constituyen la única fuente de financiamiento de largo plazo disponible durante las crisis. Este apoyo ha sido esencial, aun para los países de mayores ingresos relativos, y ha desempeñado un papel crucial en la renovación de la confianza en los países afectados.

La asistencia oficial para el desarrollo sigue teniendo, por su parte, un papel esencial en el financiamiento de los países menos desarrollados. El cumplimiento de la meta del 0.7% del producto interno bruto de los países industrializados, acordada en el seno de las Naciones Unidas, así como el uso más transparente y eficiente de estos recursos, deben ser las prioridades en el futuro. Estos recursos deben complementarse, además, con fondos destinados a garantizar una oferta adecuada de bienes públicos globales o con importantes externalidades, tales como la paz, el desarrollo sostenible y la lucha contra el problema mundial de la droga. Por su parte, la aplicación de la Iniciativa para los países pobres muy endeudados, de la cual son beneficiarios potenciales cuatro países de la región, debe agilizarse, garantizando, además, recursos adecuados para su financiamiento. Esto es necesario para evitar que dicho financiamiento recaiga excesivamente sobre otros países en desarrollo, tanto en forma directa como a través de mayores márgenes de intermediación y de menor disponibilidad de recursos para cooperación técnica por parte de los bancos multilaterales.

La construcción de este edificio global debe tener en cuenta tres elementos esenciales. El primero es una participación adecuada de los países en desarrollo en las instituciones correspondientes. El segundo es el mantenimiento de la autonomía de los países para adoptar las políticas que consideren apropiadas para su desarrollo. En tercer lugar, la normatividad internacional debe tener en cuenta la capacidad de absorción de los distintos países, dado su nivel de desarrollo institucional.

Es necesario destacar, finalmente, que en la interacción positiva entre los esfuerzos nacionales y un contexto internacional adecuado, las instituciones regionales desempeñan un papel decisivo. Estas instituciones abarcan los acuerdos de integración comercial, claves en la diversificación de la base exportadora de nuestros países; la nutrida red de bancos de desarrollo, conformada por el Banco Interamericano de Desarrollo y los bancos de desarrollo subregionales, que constituyen la

principal fuente de financiamiento multilateral en nuestra región; el Fondo Latinoamericano de Reservas, institución casi única en el mundo en desarrollo, que ha cumplido una tarea destacada en la Comunidad Andina en las últimas décadas y ha iniciado un proceso de ampliación de su composición y, finalmente, los nuevos mecanismos de coordinación de las políticas macroeconómicas que se han comenzado a desarrollar en el marco de diferentes procesos de integración. La región debe apostar a la consolidación de todos estos procesos e instituciones y a la profundización en general de la cooperación regional. Las instituciones regionales sólidas no son antagónicas a la globalización. Por el contrario, son una contribución al desarrollo de un edificio global mucho más sólido y equilibrado.

Chapter 1

Financing for development in the 1990s

In the final quarter of the twentieth century, macroeconomic conditions in the Latin American and Caribbean countries were closely linked to fluctuations in the region's capital inflows. During the second half of the 1970s and early 1980s, the region had received massive inflows of external credit. This process came to an abrupt halt in 1982, however, and then gave way to a severe, widespread shortage of external financing. From 1991 to 1994, a new wave of capital entered the region, only to be followed by another sharp contraction in late 1994 and early 1995, during which Mexico and Argentina were particularly hard hit. In the wake of this crisis, in 1996 and 1997, capital again became abundant. Then, with the onset of the Asian crisis in the second semester of 1997 and the Russian crisis in August 1998, capital markets of importance to the region continued to exhibit considerable volatility. In view of this instability, together with the stabilization of foreign direct investment (FDI) at fairly high yet nonetheless below-1999 levels, the steep downturn recently exhibited by the world and United States economies, and the low real price levels for a number of the region's export products, there is some doubt as to whether the region can recover its ability to attract flows of the magnitude needed to ensure robust growth in its principal economies.

All of these economic expansions and subsequent contractions have stemmed primarily from events on international markets. Access to external funds and improved macroeconomic management have spurred growth and resulted in significantly lower inflation, but investment levels have made no more than a partial recovery, and national savings rates

have been virtually unchanged. As a result, growth rates have remained substantially lower than they were before the debt crisis, while investment and economic growth have become highly susceptible to swings in external capital flows.

The countries' varying degrees of dependency on international financing are largely a function of each country's level of development. While many countries have benefited from FDI, the relatively more developed countries tend to be the focus of the more volatile debt and portfolio flows. On the other hand, although official development assistance (ODA) has played no more than a minor role in the region as a whole, it has been an important source of financing for the less developed countries, which have also been heavily dependent on family remittances from emigrants.

This chapter offers an overview of trends in external finance, key features of macroeconomic policy in the region over the past decade, major developments in the financial sector, and the impact of these factors on growth, saving and investment. These considerations then serve as the basis for an outline of the major challenges yet to be faced in connection with financing for development, which will be discussed in greater detail in the rest of the document.

1. Capital flows: resumed but volatile

(a) Main features of external financing in the region

An analysis of the different countries' balances of payments and international capital flows[1] reveals two major features of external finance in the region during the 1990s. The first is that, as international labour migration increased, family remittances became an important source of current income for some small countries (reaching levels close to the value of exports in some cases) which helped ease their external borrowing requirements. The second has to do with the appearance of new, mainly private sources of external financing to which the largest countries, in particular, have had access. The marked volatility of some of these flows has created new challenges in terms of the management of macroeconomic policy and national financial markets.

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[1] Information-source characteristics and differences are analysed in appendix 1.

(i) Financing needs

In the 1990s, the region as a whole exported enough goods and services to pay for 91% of its imports. Net borrowing requirements, represented by the current account balance, were equivalent to 13% of external purchases. These regional averages, however, mask major differences among the countries that reflect their varying levels of development (see table 1.1).[2] Over the past decade, the higher-income countries' earnings from their exports of goods and services generated enough foreign exchange, on average, to cover over 100% of their imports. By contrast, the ratio for the lower-income countries was only 76%.

Table 1.1 clearly shows that net current transfers (primarily remittances from relatives living abroad) have been playing a significant and expanding role in financing the imports of the less developed countries as a group. Total remittances from emigrants have reached particularly significant levels in countries having high rates of labour migration to more developed countries, especially the United States. According to conservative calculations, in 1999 migrants from Central America, the Dominican Republic and Mexico sent back close to US$ 10.5 billion in remittances. Mexico accounted for nearly US$ 6 billion of this sum, while between US$ 2.5 billion and US$ 3 billion corresponded to Central America (specifically El Salvador, Guatemala, Honduras and Nicaragua) and more than US$ 1.5 billion to the Dominican Republic. In the Caribbean, net receiving countries (excluding Haiti and the Dominican Republic) took in US$ 1 billion in remittances in 1998, or the equivalent of 7.4% of their GDP (ECLAC, 2000a; Torres, 2000; Samuel, 2000).

As may be seen in table 1.1, the relative significance of net current transfers (including remittances) varies inversely to the size of the economy concerned. Although Mexico is one of the world's largest recipients of remittances, this type of transfer represents a very small proportion of its GDP (1.5%). The significance of these transfers in El Salvador's social and economic affairs, on the other hand, is quite evident,

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[2] For purposes of analysis, the countries have been divided into three groups according to their per capita GDP. Group A countries reported a per capita GDP of under US$ 2,000 in 1998, estimated at prevailing market exchange rates: Bolivia, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Nicaragua and Paraguay. Countries in Group B reported a per capita GDP of between US$ 2,000 and US$ 4,000 in 1997: Colombia, Costa Rica, Jamaica, Panama and Peru. Group C countries reported a per capita GDP of over US$ 4,000 in 1997: Argentina, Barbados, Brazil, Chile, Mexico, Trinidad and Tobago, Uruguay and Venezuela. Group A and Group B account for 15% of the region's population each, while the countries in Group C contain 70% of the total. These groups' shares of the region's total GDP as of 1998 were 4.8%, 9.5% and 85.6%, respectively.

since they represented between 15% and 20% of GDP and between 50% and 100% of the value of its merchandise exports during the 1990s. The Dominican Republic, many of whose citizens have emigrated to the United States, Spain and other European countries, is in a similar position. In the economies that rely most heavily on remittances, large injections of these external resources influence macroeconomic variables, especially exchange and interest rates.

When measured by the current account deficit, external borrowing requirements (expressed as a percentage of GDP for each country) tended to be greater —even though they were on the decline— in lower-income countries (see figure 1.1.A and table 1.2). The borrowing requirements of countries with higher per capita incomes, on the other hand, are determined less by their trade deficits than by their debt service plus, in terms of their gross requirements, debt amortization.

The differences between certain groups of countries is also reflected in the figures on long-term financing actually received (see figure 1.1.B and table 1.3). Flows to the less developed countries levelled off at between 11% and 13% of GDP from 1993 on, which was below the figures for the early 1990s. In countries at an intermediate level of development and in the higher-income countries, however, these flows jumped from slightly less than 3% of GDP in 1990 to between 6% and 9% of GDP in 1996-1999.

(ii) Composition of long-term external financing

The composition of long-term financing has also differed substantially from one group of countries to the next. World Bank figures classify grants as a component of long-term financing, and their importance as a source of funding decreases as the country's level of development increases. In countries whose GDP is relatively smaller, this type of funding amounted to 6.8% of GDP, on average, during the 1990s. The relative level of such flows has been on the decline,[3] however, owing to the worldwide reduction seen in ODA, which totals a mere one third of the commitment of 0.7% of the industrialized countries' GDP agreed upon within the framework of the United Nations.

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[3] If inflows of grants are deflated by the United States WPI, the results show a real reduction of 16% between 1995 and 1998.

Table 1.1
STRUCTURE OF IMPORT FINANCING [a]
(Simple averages of percentages of goods and services imports)

Groups of countries [b]	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Group A										
Exports of goods and services	84.1	77.3	71.9	73.0	76.3	76.8	78.3	76.4	70.9	76.0
Net employee earnings	-0.4	0.0	0.1	-0.7	0.2	-0.4	-0.2	0.0	0.0	-0.4
Net capital earnings	-18.5	-17.8	-17.5	-15.2	-13.6	-12.1	-10.6	-8.5	-7.3	-9.9
Net current transfers	14.9	16.5	16.8	16.9	17.9	18.8	18.6	17.9	20.8	23.6
External borrowing requirements	19.8	24.0	28.7	26.0	19.2	16.8	13.8	14.2	15.6	9.7
Group B										
Exports of goods and services	96.1	98.5	97.4	84.5	86.9	83.7	84.6	86.2	84.4	98.3
Net employee earnings	1.0	0.5	0.5	0.4	0.5	0.4	0.4	0.4	0.4	0.1
Net capital earnings	-20.8	-17.3	-15.0	-11.6	-10.0	-10.0	-8.9	-8.9	-9.1	-16.9
Net current transfers	8.9	10.8	10.6	8.0	8.0	6.8	7.1	5.8	5.7	4.4
External borrowing requirements	14.7	7.5	6.4	18.7	14.7	19.0	16.9	13.8	15.6	9.4
Group C										
Exports of goods and services	141.9	112.9	107.0	101.1	106.5	107.3	110.1	97.0	88.5	101.4
Net employee earnings	0.3	0.4	0.3	0.2	0.1	0.2	0.2	0.1	0.1	0.1
Net capital earnings	-25.4	-19.2	-15.3	-14.7	-15.2	-13.5	-13.5	-11.9	-12.5	-14.6
Net current transfers	3.6	2.9	3.0	2.0	2.3	2.5	2.3	1.9	1.5	2.1
External borrowing requirements	-20.4	3.1	5.1	11.3	6.2	3.6	1.0	12.8	22.4	11.0
Latin America [c]										
Exports of goods and services	107.3	96.0	92.3	86.3	90.1	89.3	91.0	86.6	81.3	92.2
Net employee earnings	0.3	0.2	0.2	-0.1	0.3	0.1	0.1	0.2	0.1	-0.1
Net capital earnings	-21.8	-18.6	-16.3	-14.2	-13.3	-12.1	-11.2	-9.9	-9.8	-13.3
Net current transfers	9.3	10.2	10.3	9.2	9.6	9.5	9.4	8.7	9.6	10.3
External borrowing requirements	5.0	12.1	13.5	18.8	13.3	13.3	10.7	13.6	17.7	9.5

Source: Based on ECLAC figures.
[a] The structure of import financing was calculated based on the accounting identity of the balance-of-payments current account. Inverting this equation yields the following result: goods and services imports = goods and services exports + net earnings of employees + net capital earnings + net current transfers - balance on current account. The latter figure represents the external borrowing requirement that has to be covered with the net flow of capital resources and variations in reserves.
[b] Group A countries reported a per capita GDP of under US$ 2,000 in 1998 (estimated at prevailing market exchange rates): Bolivia, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Nicaragua and Paraguay. Group B countries reported a per capita GDP of between US$ 2,000 and US$ 4,000 in 1997: Colombia, Costa Rica, Jamaica, Panama and Peru. Group C countries reported a per capita GDP of over US$ 4,000 in 1997: Argentina, Barbados, Brazil, Chile, Mexico, Trinidad and Tobago, Uruguay and Venezuela.
[c] Simple average.

Table 1.2

STRUCTURE OF CURRENT ACCOUNT DEFICIT [a]

(Simple averages of percentages of GDP for each country)

Groups of countries [b]	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Group A										
Trade deficit	-5.4	-6.9	-11.5	-10.7	-9.4	-10.0	-7.9	-8.9	-11.0	-11.1
Net employee earnings	-0.0	0.1	0.1	-0.2	0.0	-0.1	0.1	0.1	0.1	-0.4
Net capital earnings	-5.5	-5.3	-8.2	-7.0	-6.9	-6.3	-4.0	-3.5	-3.0	-3.5
Net current transfers	3.7	4.1	5.9	6.5	6.1	7.6	5.9	5.9	7.3	8.3
External borrowing requirements	-7.4	-8.1	-13.7	-11.5	-10.1	-8.8	-5.9	-6.4	-6.7	-6.3
Group B										
Trade deficit	-3.3	-3.4	-3.7	-6.8	-4.3	-6.1	-6.8	-3.9	-4.7	-0.7
Net employee earnings	0.7	0.5	0.5	0.4	0.4	0.4	0.3	0.2	0.2	0.1
Net capital earnings	-6.4	-5.9	-5.1	-4.0	-3.7	-4.2	-3.6	-2.8	-3.1	-3.9
Net current transfers	3.5	3.7	4.2	3.7	3.8	3.6	3.7	2.3	2.2	0.8
External borrowing requirements	-5.8	-5.1	-4.1	-6.7	-3.9	-6.4	-5.9	-4.2	-5.4	-3.8
Group C										
Trade deficit	5.8	1.9	-0.7	-1.3	0.1	1.2	2.0	0.0	-2.1	0.3
Net employee earnings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net capital earnings	-3.3	-2.7	-2.5	-2.4	-2.6	-2.7	-2.5	-2.5	-2.3	-2.4
Net current transfers	0.4	0.4	0.4	0.3	0.4	0.5	0.5	0.4	0.4	0.5
External borrowing requirements	2.9	-0.4	-2.7	-3.3	-2.1	-0.9	0.0	-2.0	-3.9	-1.6
Latin America [c]										
Trade deficit	-1.2	-2.8	-5.2	-6.3	-4.6	-5.0	-4.2	-4.3	-5.9	-3.9
Net employee earnings	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Net capital earnings	-5.1	-4.7	-5.3	-4.5	-4.4	-4.4	-3.3	-2.9	-2.8	-3.3
Net current transfers	2.5	2.7	3.5	3.5	3.4	3.9	3.4	2.9	3.3	3.2
External borrowing requirements	-3.4	-4.5	-6.3	-7.2	-5.4	-5.4	-3.9	-4.2	-5.3	-3.9

Source: Based on ECLAC figures.

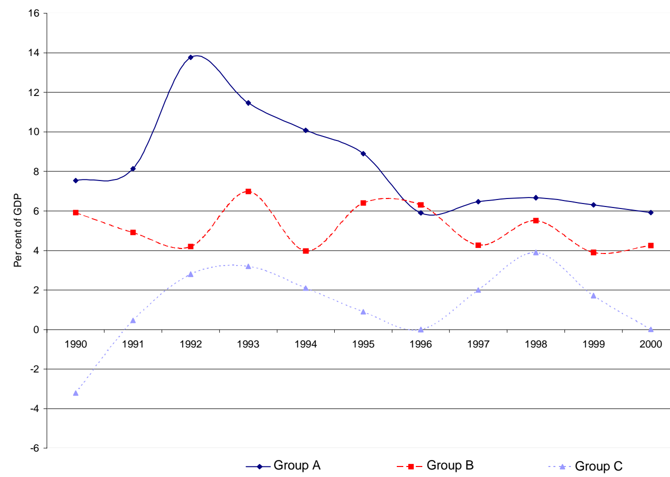
[a] The structure of financing requirements was calculated based on the accounting identity ratios of the balance-of-payment current account.

[b] See the classification given in table 1.1.

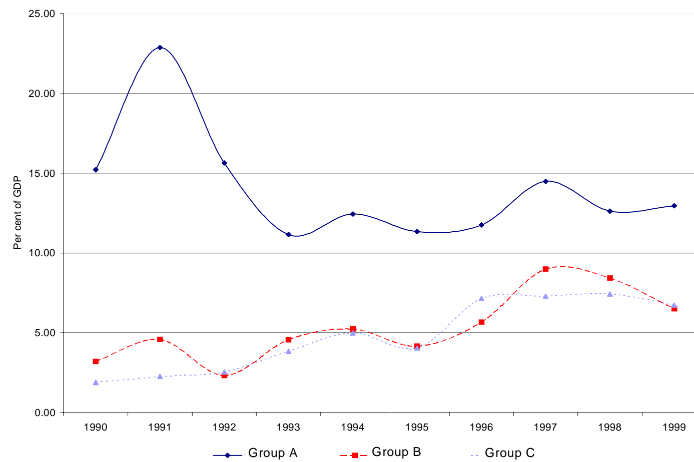
[c] Simple average.

Figure 1.1
LATIN AMERICA AND THE CARIBBEAN: CURRENT ACCOUNT AND LONG-TERM FLOWS
(Simple averages of percentages for each country)

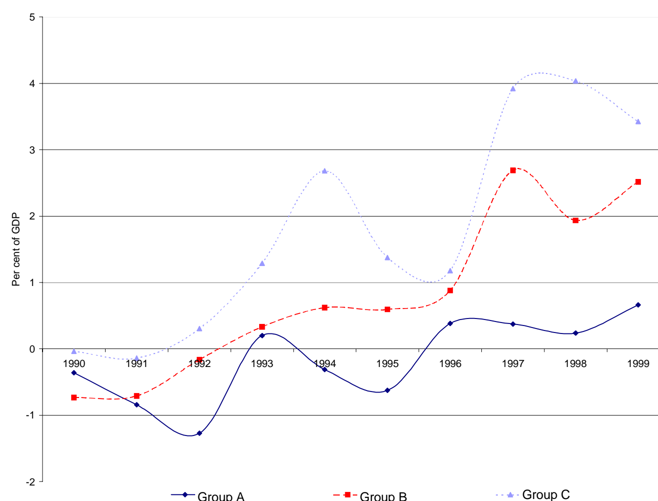
A. Current account deficit, by groups of countries



B. Net flow of long-term resources, by groups of countries



C. Net long-term private debt flows



Source: World Bank, *Global Development Finance*, Washington, D.C., May 2000; ECLAC, *Foreign Investment in Latin America and the Caribbean, 1999 Report* (LC/G.2061-P), Santiago, Chile, 2000. United Nations publication, Sales No. E.00.II.G.4.

Regarding other sources of long-term financing, table 1.3 illustrates the sharp reduction seen in the share of finance provided by net borrowings in the lower-income countries, in contrast to the situation in the higher-income countries, where its share expanded. A major shift was also observed in the composition of these funds, with one of the main changes being the increase seen in the share of borrowings from private creditors (bond issues, private bank credit and publicly guaranteed private debt), most notably in the higher-income countries (see figure 1.1.C). The poorest group of countries have much less access to these types of resources, and in fact have posted negative net flows for some years. As of 1998, six countries accounted for a full 93% of the region's total private debt (see table 1.4). By contrast, lower-income countries tended to rely more on multilateral sources of credit.

Over the course of the decade, FDI became the region's principal source of financing. At the international level, flows of FDI expanded from an annual average of US$ 243 billion between 1990 and 1996 to nearly US$ 830 billion by 1999. Nevertheless, even though developing countries received a growing share of these investment flows, by the late 1990s FDI flows were becoming increasingly concentrated in the industrialized countries owing, on the one hand, to the greater risk associated with investment in emerging markets and, on the other, to the

strength of the United States economy and the introduction of the single European currency (Botchwey, 2000; ECLAC, 2000b). Latin America and the Caribbean were the exception to the rule, however, with record levels of FDI being posted each year. Indeed, the region's inflows swelled from US$ 29.6 billion to over US$ 86 billion between 1995 and 1999 and accounted for 50% of total FDI for all developing countries (World Bank, 2000). FDI has been rising in all three groups of countries, especially those at the two extremes of the per capita income scale, but even so, since the beginning of the decade, its relative weight has been most significant in the middle-income countries. Nonetheless, four countries (Argentina, Brazil, Chile and Mexico) accounted for a full 72% of total FDI flows.

The third component of long-term external financing —equity investment— has contributed relatively little to the region's finances and is of some importance only in the higher-income countries. Its peak level of 2.2% of GDP was reached in 1996.[4]

(b) The volatility of capital flows

The degree of volatility exhibited by capital flows into Latin America and the Caribbean, as estimated by ECLAC, is shown in figure 1.2 (see appendix 1). Annual average inflows in 1991-1999 amounted to the equivalent of 3% of GDP. This level stands in contrast to the striking net outflows of around 2% of GDP recorded in 1983-1990, but is still well below the 5% mark reached in 1977-1981. Comparable figures were seen only during the boom years of 1991-1994 and 1996-1997, but waning flows in the crisis years of 1995 and 1998-1999 brought the average for the decade as a whole down to the figure noted above.

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[4] Some analysts consider equity investment to be a short-term flow because it is potentially more reversible than other components. Nonetheless, because it has no predetermined maturity, it is generally considered to be a long-term operation for balance-of-payments accounting purposes.

Table 1.3
CONTRIBUTION OF EXTERNAL LONG-TERM FINANCING, BY GROUPS OF COUNTRIES
(Percentages of GDP)

Group of countries[a] (simple averages)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total net long-term flows										
Group A	15.21	22.86	15.63	11.15	12.44	11.33	11.75	14.48	12.62	12.95
Group B	3.21	4.58	2.33	4.56	5.24	4.16	5.67	8.98	8.42	6.51
Group C	1.89	2.26	2.55	3.85	4.99	4.04	7.14	7.30	7.43	6.74
I. Net long-term debt flows										
Group A	8.23	3.59	2.67	2.68	2.52	1.72	2.58	4.63	2.00	3.19
Group B	-0.39	0.26	-1.42	-0.08	-0.34	-0.03	-0.29	2.29	1.94	2.48
Group C	0.54	0.27	0.63	0.61	1.26	1.17	1.78	1.03	3.01	0.91
II. Foreign direct investment										
Group A	0.78	0.91	6.69	3.28	3.74	3.47	3.28	4.46	5.87	6.32
Group B	2.01	1.94	2.39	2.18	4.05	2.98	4.50	6.14	5.98	3.69
Group C	1.08	1.66	1.47	1.98	3.09	2.56	3.15	5.28	4.30	5.71
III. Equity investment										
Group A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.05	0.00
Group B	0.00	0.00	0.28	0.79	0.85	0.71	1.09	0.27	0.07	0.12
Group C	0.17	0.26	0.40	1.04	0.57	0.25	2.15	0.93	0.06	0.09
IV. Grants										
Group A	6.20	18.36	6.26	5.19	6.18	6.14	5.89	5.40	4.71	3.44
Group B	1.59	2.38	1.07	1.66	0.68	0.50	0.37	0.29	0.44	0.22
Group C	0.10	0.07	0.05	0.21	0.07	0.06	0.05	0.05	0.06	0.02

Source: World Bank, *Global Development Finance, 2001*, Washington, D.C., 2001.

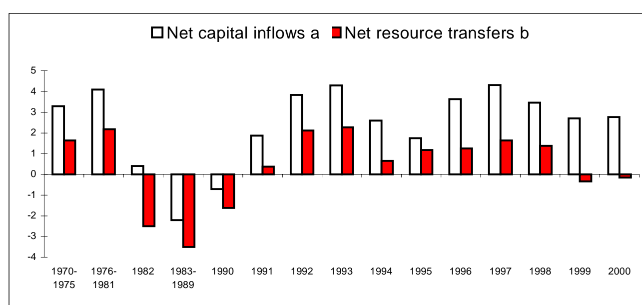
[a] See the classification given in table 1.1.

Table 1.4
STOCK OF DEBT WITH PRIVATE LENDERS, 1999

	Bonds		Commercial banks		Other		Total private lenders	
	Millions of dollars	Percentage	Millions of dollars	Percentage	Millions of dollars	Percentage	Millions of dollars	Percentage
Argentina	74,918	27.8	15,894	7.3	71	0.8	90,883	18.4
Brazil	69,602	25.9	102,885	47.4	1,632	19.1	174,118	35.2
Colombia	8,251	3.1	13,724	6.3	908	10.6	22,883	4.6
Chile	5,320	2.0	24,785	11.4	69	0.8	30,174	6.1
Mexico	69,767	25.9	43,624	20.1	3,250	38.0	116,641	23.6
Venezuela	21,278	7.9	5,472	2.5	1,325	15.5	28,074	5.7
Subtotal	**249,137**	**92.6**	**206,382**	**95.0**	**7,254**	**84.8**	**462,773**	**93.5**
Latin America and the Caribbean	**269,155**	**100**	**217,152**	**100**	**8,559**	**100**	**494,867**	**100**

Source: World Bank, *Global Development Finance, 2001*, Washington, D.C., 2001.

Figure 1.2
LATIN AMERICA AND THE CARIBBEAN: NET CAPITAL INFLOWS AND RESOURCE TRANSFERS
(As a percentage of GDP, at current prices)



Source: ECLAC, on the basis of official figures.

[a] Net autonomous capital inflows (includes errors and omissions).
[b] Net resource transfers are equal to net autonomous and non-autonomous capital inflows (loans, use of IMF credit and exceptional financing) less the balance on the income account (net profits and interest).

Differing degrees of volatility have been closely associated with the different types of resource flows concerned (see table 1.5). Bond issues, net commercial bank credit and equity investment have been the most volatile. FDI, by contrast, has been relatively stable and has even

exhibited a positive trend at critical junctures (such as Mexico in 1995 and Brazil in 1998, among others). Official flows, including resources from multilateral banks and compensatory funds (balance-of-payment financing), have displayed a definite countercyclical pattern, while, as noted earlier, ODA flows have been diminishing.

Thanks to its growth and stability, FDI has become the single largest component of external financing. On average, it accounted for three fourths of net capital flows from 1996 to 1999 and thus, for most of the countries in the region, served as a mainstay in financing the balance-of-payments current account deficit. In 2000, however, these flows fell off significantly (ECLAC, 2001). This decrease, together with what appeared to be a further reduction in 2001, indicates that, although FDI flows will remain high within the context of the region's historical patterns, the period during which such investment grew the most swiftly may have run its course. Around 60% of total FDI was used for capital formation, while the remaining 40% was used for the acquisition of existing assets. The nature of these flows will be examined in greater depth in chapter 3.

Table 1.5
LATIN AMERICA AND THE CARIBBEAN: SOURCES OF EXTERNAL FINANCING
(Net flows in millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000[a]
A. Debt											
Official[b]	6,823	3,435	1,220	2,674	-1,301	9,307	-8,212	-4,447	9,125	2,275	-2,701
Bonds	101	4,133	4,738	20,922	14,306	11,793	29,764	10,562	18,306	19,067	10,965
Commercial Banks[c]	2,731	1,275	4,302	201	6,212	15,068	16,200	29,646	-7,994	-16,130	4,339
B. Investment											
Direct	6,758	11,066	12,506	10,363	23,706	24,799	39,387	55,580	61,596	77,047	57,410
Equity	896	6,938	8,042	27,185	13,160	7,643	13,893	9,947	1,748	3,893	2,305
C. Compensatory funds[d]	24,539	13,727	8,207	6,309	5,223	30,752	-271	-4,215	8,869	6,629	1,155

Source: ECLAC, based on official figures from the World Bank, the International Monetary Fund (IMF) and the Bank for International Settlements (BIS).

[a] Preliminary estimates.
[b] Includes bilateral and multilateral funding, with the exception of IMF loans.
[c] Includes short-term flows since 1998.
[d] Includes loans, use of IMF credit and exceptional financing. In the early 1990s, exceptional financing consisted mostly of interest arrears; in recent years it has included resources from multilateral agencies, IMF, and the governments of developed countries.

The advent of the Brady Plan brought the consolidation of the secondary bond market. This market then became an increasingly important source of financing during the decade, with its operations being interrupted only by the fallout from the Mexican financial crisis in 1995 and the Asian crisis in 1997. While its operations were initially concentrated in the relatively larger countries (Argentina, Brazil and Mexico), it soon became a major source of funds for Chile, Colombia,

Uruguay and Venezuela and, later, for several smaller countries, including Costa Rica, El Salvador, Panama and Trinidad and Tobago.

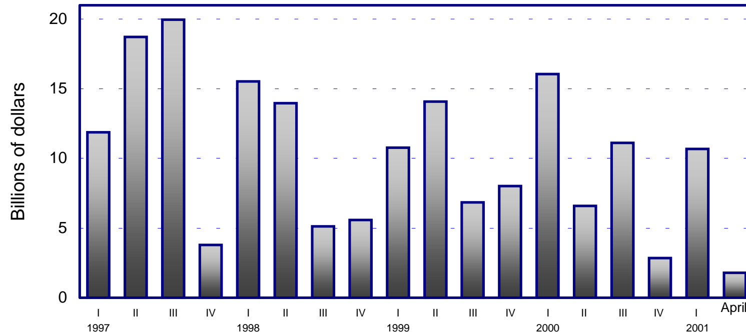
These flows have also proved to be erratic, however, with financing conditions being highly sensitive to fluctuations on international markets. During the first half of the 1990s, new issues by the region had an average term of between three and five years. In 1997, during the height of the boom in bond sales, the average term was significantly longer, but it shortened again in 1998-1999 (see figure 1.3). Finance costs had bottomed out in 1997 but then began to rise sharply in August 1998 following Russia's declaration of a moratorium and, although they have settled back somewhat since then, they have tended to remain above the figures posted prior to the Asian crisis. Contrary to conventional wisdom, according to which today's financial crises are severe but short-lived, years after the outbreak of the Asian crisis, conditions on the bond market have yet to recover fully.

Following a virtual stoppage of bank lending during the debt crisis (except for operations in connection with foreign trade), the net flow of commercial bank funds into the region remained very moderate until 1993. From that point on, net flows began to gain momentum, reaching a peak in 1997 that was followed by markedly negative flows in 1998 and 1999. The terms and conditions for this kind of financing, especially with regard to maturities, never rebounded to the levels seen before the debt crisis, however. Equity investment and the placement of American Depositary Receipts (ADRs) on the United States market have proven to be the most unstable sources of finance.

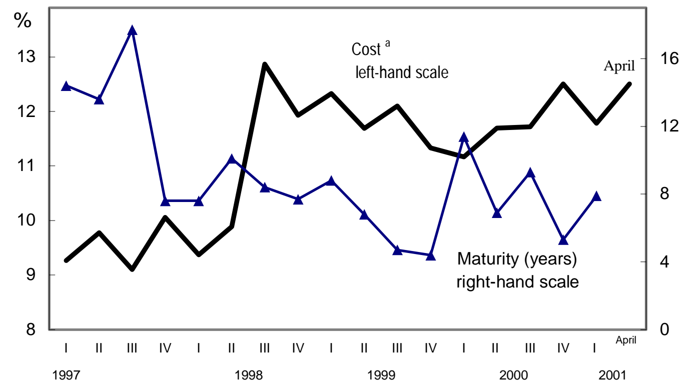
By contrast, official and compensatory financing has behaved countercyclically, as illustrated by the fact that during the steep downturns in private financing seen in 1995 and 1998, credit from these sources increased (see table 1.5). This response demonstrates how the International Monetary Fund, other multilateral agencies and the governments of some developed countries have helped bolster developing economies at critical junctures, with notable cases being Mexico in late 1994 and Brazil in 1998 and early 1999. In recent years, the net flow of bilateral resources into the region has turned negative as a result of Mexico's payment of the debt it incurred with the United States in 1995. Hence, multilateral sources have been the principal suppliers of official credit resources.

Figure 1.3
LATIN AMERICA AND THE CARIBBEAN: INTERNATIONAL BOND ISSUES
(In billions of dollars)

A. Amount



B. Cost and maturity



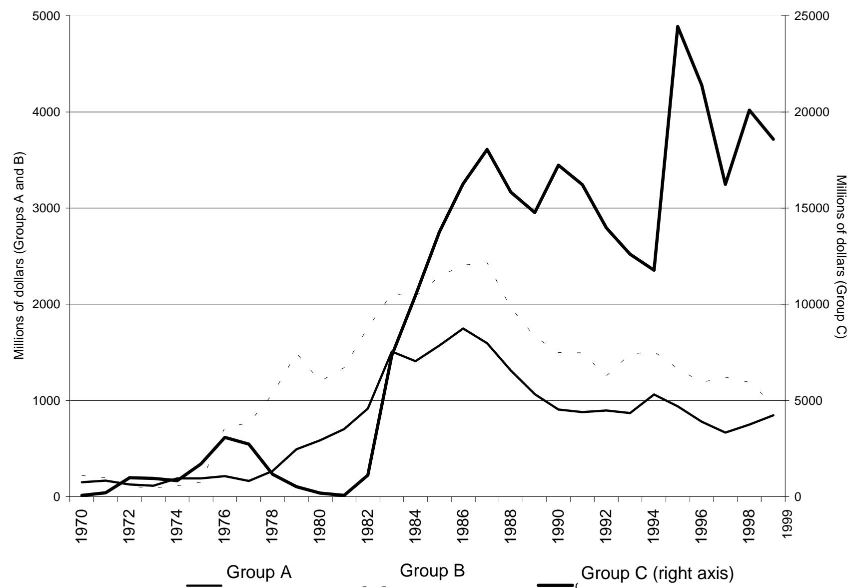
Source: ECLAC, on the basis of official figures from the World Bank and IMF.

[a] Sum of average spread on bond placements and long-term United States Treasury bond yields.

Since the most volatile capital flows tend to be concentrated in the higher-income developing countries, the need for exceptional financing in crisis periods is also greater in these countries (Ocampo, 1999a). Figure 1.4 clearly demonstrates this trend in IMF credits. In contrast to what occurred during the debt crisis, when all three groups of Latin American and Caribbean countries needed large injections of exceptional financing,

in the 1990s the need for special IMF support has been concentrated in the higher-income countries.

Figure 1.4
LATIN AMERICA AND THE CARIBBEAN: USE OF IMF CREDIT
(In constant 1995 dollars)



Source: World Bank, *Global Development Finance,* Washington, D.C., May 2000.

(c) Challenges posed by new modalities of integration into world markets

A close examination of the ways in which borrowers have gained re-entry into voluntary credit markets, especially the bond market, reveals a segmented form of integration into international finance that poses new challenges for some countries. Government issues represent dollar-denominated commitments whose only associated risk is that of default. The differential between the cost of credit in dollars to governments of emerging economies and the cost of the funds that the United States Government receives for bond issues provides a measurement of the value that these markets assign to the sovereign risk associated with the possibility of default. This differential is reflected in the premium that is paid for this type of financing. For most of the emerging economies, this

premium amounts to several percentage points (several hundred basis points) over the cost of credit for the United States Treasury. Since this premium is higher for Latin American countries and, among them, for those that the market regards as being riskier, the countries´ integration into these markets is clearly segmented. The risks of concern here are associated with debt/GDP (or debt/exports) ratios and/or with factors of political uncertainty. It is interesting to note, however, that in addition to reflecting factors specific to each country, this type of risk tends to shift in a similar way in the different countries in response to international shocks of various sorts. This points to the presence of contagion phenomena associated with the herd behaviour of some investors. These shocks may have their origin in economic decisions taken by industrialized countries, in the behaviour of what are regarded as high-risk stocks in industrialized-country markets (in recent years, technology stocks) or in disturbances in international commodity markets.

In the experience of the major emerging economies that have access to the bond market, in the wake of the Asian crisis risk premiums have borne little relationship to fiscal solvency and have instead been more strongly influenced by international agents´ perceptions regarding the availability of the international liquidity necessary to permit contract performance. Consequently, given prevailing levels of liquidity uncertainty, these economies have had difficulty in bringing the cost of capital down to developed-country levels, and this has hurt investment, boosted outward transfers and endangered the sustainability of macroeconomic strategies.

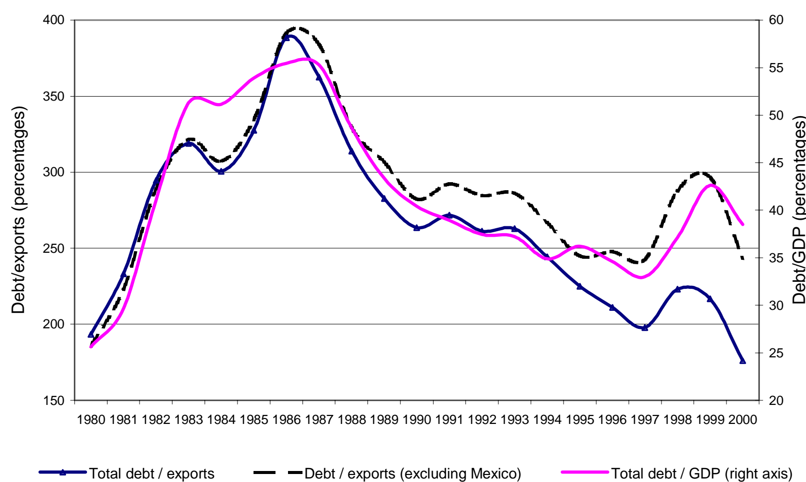
In fact, following a prolonged period of financial integration, public and private external debt has ended up playing a central role in determining the financial system's behaviour. When a country's debt service absorbs a large part of its gross capital inflows, its autonomy in deciding how and how much it should open up its financial system is limited. As a result of this situation, the option of using fixed exchange-rate regimes to reduce currency risk has been restricted for some countries. FDI and debt flows have caused the structure of the balance of payments to shift as the relative size of the trade deficit has declined while the relative level of payments of profits and interest has risen. Vulnerability has been heightened by increases in debt/GDP (or debt/exports) ratios and/or in current account deficit/GDP (or current account deficit/exports) ratios. The increase in vulnerability is also associated with the need for these countries' to match maturities and currencies efficiently when intermediating credit resources using these new modalities of external financing. When the market punishes borrowers for this heightened vulnerability by raising risk premiums and/or reducing or reversing financing flows, credit crunches tend to

ensue. Thus, in the presence of certain sorts of international financial shocks, countries' efforts to achieve integration into the world economy may lead them into a financing trap which, unless suitable international mechanisms for the provision of emergency funds are designed, can leave them mired in recessions for years on end.

An examination of the region's external debt position corroborates this analysis, since although the region's external debt is significantly smaller than it was during the critical years of the 1980s debt crisis, it nonetheless remains high. External debt coefficients declined considerably in the late 1980s and early 1990s and then continued to trend downward during the greater part of that decade, but the external debt/GDP ratio has never returned to the levels seen in the early 1980s and has been worsening in recent years (see figure 1.5). The trend in the external debt/exports ratio is more favourable, but, except in the case of Mexico, it remains higher than it was in the early 1980s. In fact, as shown in table 1.6, external debt coefficients are clearly lower than they were in 1980 in just five countries of the region, whereas, for all the rest of the countries, either the external debt/GDP coefficient or the external debt/exports coefficient is above 1980 levels, and in many cases, both of these indicators are higher. Hence, the fact that the region is now at less risk of a 1980s-style crisis has less to do with the countries´ lower levels of indebtedness than it does with the stabilization of inflation in the industrialized economies, since this makes an international interest rate hike such as the one seen during that period quite unlikely.

As a consequence of international capital markets´ tendency to overestimate the levels of risk associated with the Latin American countries and with emerging economies in general, especially during crisis periods, the effective interest rates paid by the countries of the region on private markets are high, and for many countries they clearly exceed the expected growth of exports and, in particular, of GDP. The countries of the region are therefore obliged to generate a trade surplus in order to service their debt, since otherwise they run the risk of seeing an increase in their external debt coefficients. This did not happen during the 1990s because of the abundant and steady inflow of FDI. If FDI levels off or declines, however, as appears to have been the trend in 2000 and 2001, and if profit remittances from existing investments continue to rise as expected, the pressure on the trade balance or on external debt coefficients will tend to build in the coming years.

Figure 1.5
EXTERNAL DEBT COEFFICIENTS



Source: ECLAC, on the basis of official figures.

Table 1.6
LATIN AMERICA AND THE CARIBBEAN: EXTERNAL DEBT COEFFICIENTS, 2000 AND 1980 [a]

		Debt/GDP			
		Lower		Higher	
Debt/exports	Higher	Panama	(51.4%)	Argentina	(52.4%)
		Trinidad and Tobago	(22.6%)	Bolivia	(52.0%)
				Brazil	(40.1%)
				Colombia	(43.4%)
				Ecuador	(110.1%)
				Guatemala	(20.2%)
				Guyana	(153.6%)
				Haiti	(31.5%)
				Honduras	(66.7%)
				Nicaragua	(265.0%)
				Peru	(50.5%)
				Uruguay	(26.9%)
	Lower	Costa Rica	(19.8%)	Chile	(50.5%)
		El Salvador	(21.0%)	Jamaica	(43.9%)
		Mexico	(28.2%)	Paraguay	(28.6%)
		Dominican Republic	(18.5%)		
		Venezuela	(27.6%)		

Source: ECLAC, on the basis of official figures from the relevant countries.

[a] The size of the debt, expressed as a percentage of GDP, in 2000 is shown in parentheses.

2. Macroeconomic policies and performance

(a) Macroeconomic management

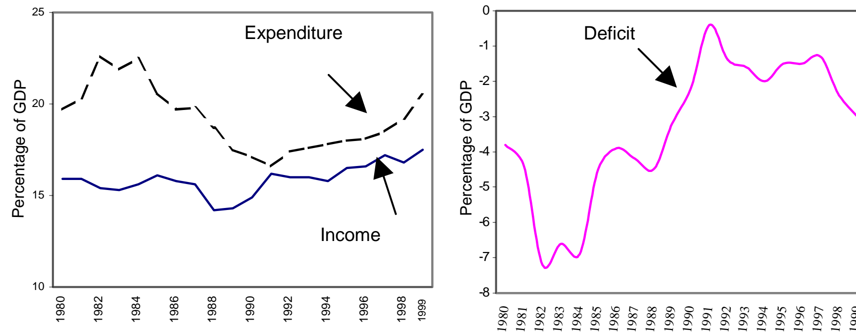
The region made great strides in the 1990s in the area of macroeconomic management, but it was also faced with new challenges, many of which followed certain basic patterns. One of its achievements was to hold on to the ground that it had won during the 1980s in terms of fiscal adjustment (see figure 1.6.A). During most of the decade, government deficits held steady at an average of around 1%-2% of GDP, although the recent crisis brought setbacks and revealed the presence of serious fiscal problems in several countries. These moderate fiscal deficits were consistent with increases in public spending, thanks to rising income levels. Expenditure has climbed by an average of just over three percentage points of GDP, and the increase has primarily taken the form of an upturn in public social spending, which rose from 10.1% of GDP in 1990 to 12.4% in 1997 (ECLAC, 2000c).

Disciplined management of fiscal accounts went hand in hand with strict monetary control, and this tended to push up interest rates significantly. Because inflation retreated in most of the countries, however, these tight controls did not preclude significant growth in the money supply or the expansion of domestic credit in real terms. After having dipped to negative or negligible levels in the early 1980s, interest rates began a resurgence in the mid-1980s and remained very high in the 1990s (see figure 1.6.B). This upswing in real interest rates lasted the entire decade from 1985 to 1995, driving up the return on savings (for term deposits) to a median that topped 5% annually. With bank brokerage commissions habitually above 10 percentage points, the median real annual lending rate rose above 15%.

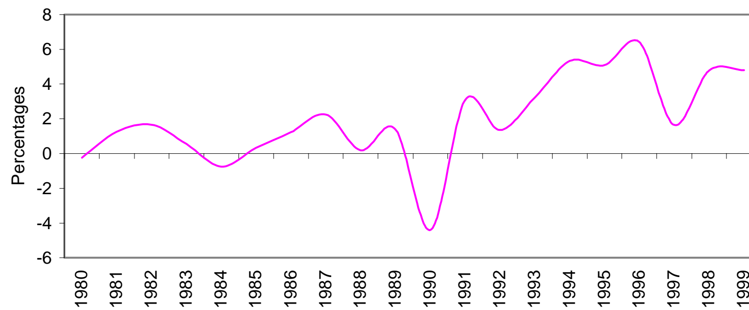
The early 1990s also witnessed the beginning of a real appreciation of local currencies that lasted until 1998 (see figure 1.6.C). As currencies appreciated and trade was liberalized, imports rose and large current account deficits were posted, with both of these increases being financed by the external capital that was flowing back into the region. In the end, as will be discussed at greater length below, the overvaluation of local currencies became the Achilles' heel of the countries´ stabilization strategies when capital flows began to wane. Because exchange-rate adjustments were too slow in coming, the countries became more dependent on external financial resources, replacing the risk of inflation with the risk of an external liquidity crunch. Tight control over fiscal accounts and monetary prudence were not enough to turn this situation around.

Figure 1.6
LATIN AMERICA AND THE CARIBBEAN: KEY MACROECONOMIC INDICATORS

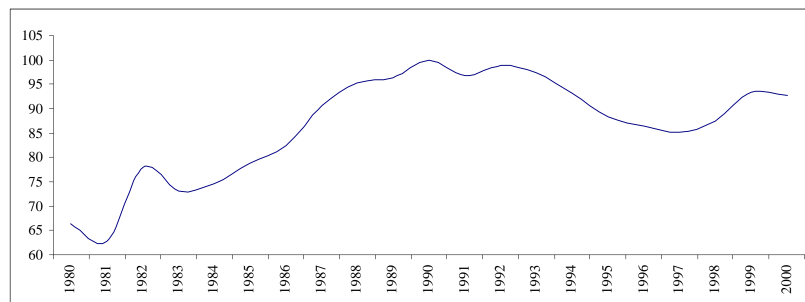
A. Central government income, expenditure and deficits



B. Net interest rate on deposits [a]



C. Real effective exchange rate for imports (index)[b]



Source: Based on ECLAC and IMF figures.

[a] Median for 19 countries.
[b] Median for 19 countries. An increase indicates a depreciation.

Currency disturbances late in the decade spurred the move towards greater exchange-rate flexibility that was seen in most of the countries of the region during the 1990s. A number of countries made explicit decisions to adopt flexible exchange-rate systems during that time. For the most part, they chose a currency float involving some degree of central bank intervention (a dirty float), which in some cases replaced the managed flexibility regimes (currency bands) that had previously been in use.[5] In fact, as indicated in table 1.7, currency floats became the norm throughout the region.

Table 1.7
LATIN AMERICA: EXCHANGE-RATE REGIMES, 2000

Fixed, semi-fixed or dollarized regimes	Crawling pegs or currency bands	Floats [a]
Ecuador [b]	Bolivia	Argentina
El Salvador	Costa Rica	Brazil
Panama	Nicaragua	Chile
Eastern Caribbean States	Dominican Republic	Colombia
Belize	Uruguay	Guatemala
	Venezuela	Guyana
		Haiti
		Jamaica
		Mexico
		Paraguay
		Peru
		Trinidad and Tobago
		Venezuela

Source: ECLAC, *A Decade of Light and Shadow* (LC/G.2113-P), Santiago, Chile, 2002.

[a] Most currency floats in the region provide for some degree of intervention by the central bank (a dirty float).
[b] Ecuador announced a dollarization plan at the start of 2000.

(b) Production

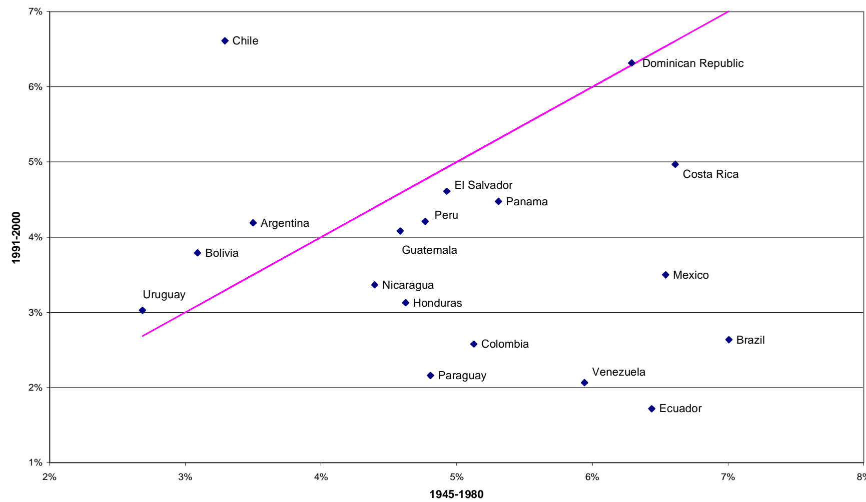
With the return of capital inflows, production activity rebounded. Accordingly, the average economic growth rate for the entire region increased from 1% per year during the "lost decade" to 3.2% in the 1990s. This rate of progress, while satisfactory, falls short of the region's pre-debt-crisis growth rates, which averaged 5.5% per annum from 1945 to

[5] Only a minority of countries, Mexico in particular, had adopted flexible exchange-rate systems before the Asian crisis.

1980. Most of the individual countries posted averages comparable to the regional figure, thus exhibiting a slower growth pattern than what had become common in the three and a half decades preceding the debt crisis. Only four countries displayed a contrasting trend, but all four had performed poorly in the period from 1945 to 1980. Within this group, the Chilean economy was conspicuous for its dynamism (see figure 1.7).

In line with these results, in the region as a whole and in the majority of the individual countries for which information is available, the growth rate of total factor productivity slowed between 1950-1980 and 1991-1999 due to marked decreases in labour productivity and meagre increases in the productivity of capital. The numerous factors contributing to this slowdown in total factor productivity growth included the obsolescence occasioned by the rapid pace of technological change, the destruction of production capacities which occurred in uncompetitive sectors that were exposed to outside competition, and the economy's inability to productively absorb the increase in the labour force caused by population growth and the entry of growing numbers of women into the labour market (ECLAC, 2000, pp. 55-58).

Figure 1.7
LATIN AMERICA: AVERAGE GDP GROWTH



Source: ECLAC, on the basis of official figures from the countries.

These growth rates and increases in productivity have been far too low to ensure satisfactory social progress and, in fact, have translated into a weak performance on the part of the region's labour markets (which have registered, to differing degrees in the various countries, rising rates of open unemployment and informal employment) and into poverty levels for the region as a whole as of 1999 that remained above those registered in 1980 (ECLAC, 2000d and 2000e).

Growth patterns have also been unstable and highly dependent on external financing. Figure 1.8.A shows that variations in capital flows were the main factor underlying changes in the region's economic growth rates throughout the 1990s. External credit booms coincided with flourishing production in 1991-1994 and again in 1996-1997, but both periods of growth were followed by adjustments in 1995 and 1998-1999.

This dependency reflects a procyclical pattern of macroeconomic management which has often accentuated the impact of sharp swings in international financing rather than buffering them. During the 1990s, booms in external financing and the resulting expansion in domestic credit have given rise to upturns in expenditure, especially in the private sector and this, coupled with appreciating exchange rates within a context of greater trade liberalization, led to a cyclical deterioration in the balance-of-payments current account (see figure 1.8.B). Ready access to external and domestic financing during such booms also tended to drive up the prices of domestic assets significantly (see figure 1.8.C).[6]

This combination of factors set the stage for a dramatic shift in expectations, and when international financing trends did an about-face, both the current account and asset prices therefore had to undergo a significant adjustment. Macroeconomic authorities were then faced with the need to deal with the imbalances that had been generated during earlier booms. In more than a few cases, these surges in external financing, which occurred against a backdrop of financial liberalization and weak prudential regulation and supervision, culminated in overt national financial crises. The extent of the necessary adjustments has depended on the severity of the imbalances that were generated in the different countries during those booms.

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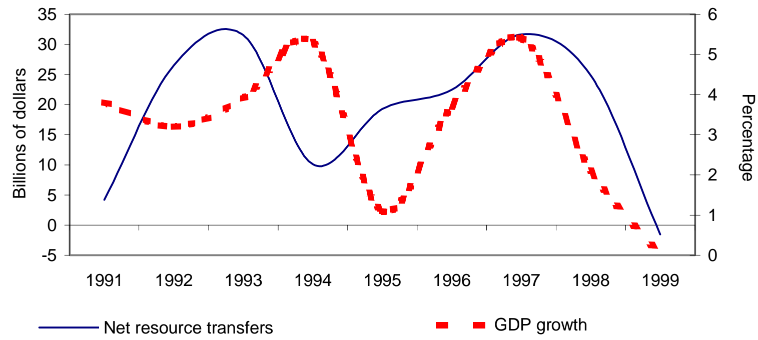
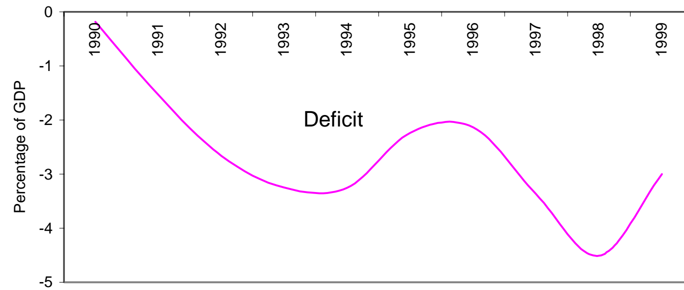
[6] Cyclical factors also influenced asset prices. Equity prices —which, along with real estate values, were severely depressed at the beginning of the decade— soared by 300%, measured in current dollars, between late 1990 and September 1994. After a sharp drop triggered by the Mexican crisis, which had contagion effects in all of Latin America's stock markets, average stock prices nearly doubled between March 1995 and June 1997 as portfolio investment flowed into the region.

Figure 1.8
LATIN AMERICA AND THE CARIBBEAN: KEY EXTERNAL INDICATORS

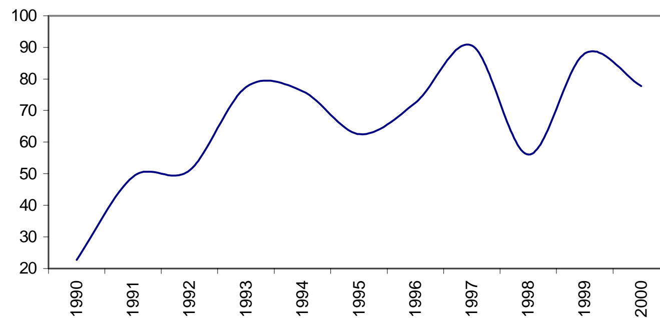
A. GDP growth and net resource transfers



B. Current account balance



C. Stock price index (in dollars, June 1997=100)



Source: ECLAC, on the basis of information from the International Finance Corporation (IFC) and the International Monetary Fund (IMF).

These pronounced cycles of economic activity have had major social impacts. A growing body of evidence suggests that the different phases of the business cycle have asymmetrical effects on social variables, including steep increases in unemployment or informal employment or steep drop-offs in real wages during crises, followed by slow or incomplete recoveries of those variables. The region has also witnessed sharp increases in poverty followed by very slow reversals of those trends and a deterioration in income distribution during crisis periods that are not reversed once the crisis ends (ECLAC, 2000d, chapter 8; Lustig, 1999). Incomplete reversal of the decline suffered by many indicators —real wages, poverty and income distribution— during the debt crisis despite the resumption of economic growth in the 1990s, constitutes the most conclusive evidence of this asymmetrical pattern.

(c) Levels and financing of investment

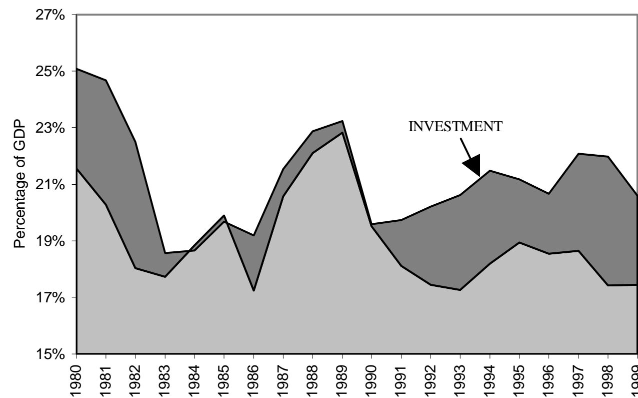
Investment levels dropped off steeply during the debt crisis. Later, as international capital began to flow back into the region from 1990 on, the rate of capital formation began to rebound. This recovery was only partial, however, since in most of the countries the increase in investment was made possible by an upswing in external financing that was not matched by any complementary expansion in national saving or greater access for investors (especially small and medium-sized investors) to long-term domestic or external financing. Investment levels in Latin America have therefore remained below the levels seen prior to the debt crisis (see figure 1.9.A). This decrease in investment coefficients has been sharper in the larger countries (whose exposure to private capital flows has been greater), as is illustrated by the fact that the investment coefficient for Latin America as a whole exhibits less of a recovery when calculated on the basis of a weighted average (by GDP levels) than when a simple average of the countries concerned is used (see figure 1.9.B).

This pattern indicates that the region's financial and capital-account liberalization drives, even when coupled with the lower levels of inflation and public debt seen during the 1990s, have had very limited success in speeding up capital accumulation. Moguillansky and Bielchowsky (2000) show that the expansion of domestic credit was, in many cases, countered by large interest-rate spreads, while big firms able to borrow abroad initially benefited from currency appreciations that were not always a reflection of increases in productivity. FDI has followed cycles closely linked to public privatization programmes, which have been winding down as these sectors' modernization processes near completion. Thus, investment decisions have become highly sensitive to the volatility of external financing, both because of its direct effects on domestic interest

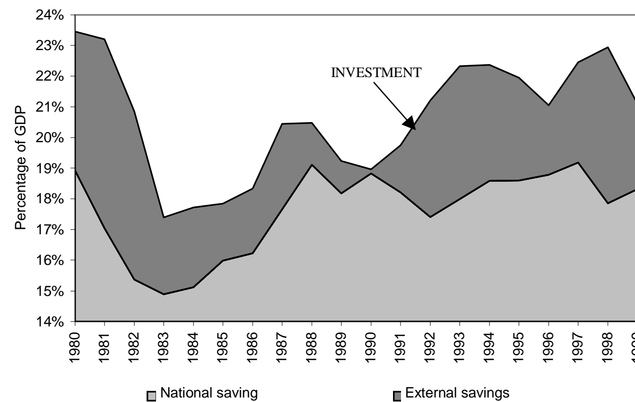
rates and exchange-rate risk and because of the behaviour of FDI. Meanwhile, the segmented nature of access to external finance and the high cost of domestic credit relative to international levels has confined long-term financing to a small number of agents and sectors. The different policy options that have been used to deal with these challenges have given rise to differing results in terms of the effort to achieve steady increases in both national saving and investment.

Figure 1.9
LATIN AMERICA AND THE CARIBBEAN: INVESTMENT FINANCING

A. Weighted average



B. Simple average



Source: ECLAC, on the basis of the countries' official national accounts figures.

National savings behaviour has been a decisive factor in countries where investment rates have undergone sustained increases. Table 1.8 provides an overview of events in five Latin American countries which, in either the first or second half of the 1990s, achieved economic growth rates averaging over 5% annually for more than six years in a row (Argentina, Chile, Dominican Republic, El Salvador and Peru). The five countries´ ability to sustain such high economic growth rates has varied.

The table differentiates between two phases of economic activity following the start of a reactivation triggered by renewed access to external financing. The first three-year phase of the reactivation as such is underpinned by growth based on a greater use of installed production capacity following the removal of external constraints. During the second three-year growth stage, the economy is nearing the production frontier, and its rate of growth is therefore more closely linked to the level of investment effort.

The main reason why macroeconomic variables have performed so differently in these countries is that their ability to achieve concurrent increases in investment and national saving have differed. Argentina and Peru, where GDP growth slowed considerably after the changeover from the reactivation stage to the following growth stage, also posted smaller increases in national saving and investment. By contrast, Chile, the Dominican Republic and El Salvador, where growth did not slow down after the reactivation phase, also had much stronger performances in terms of their investment coefficients and, most importantly, significant upswings in national saving.

There is extensive evidence that points to a substantial substitution effect in the 1990s between national and external saving, which means that large shares of the increased capital inflows were used to expand consumption. According to available estimates, between 45% and 50% of international capital flows translated into decreases in national saving (Uthoff and Titelman, 1998). Consequently, the improvements seen in investment coefficients were not coupled with increases in national saving. The result was a greater dependence on external saving as a means of financing investment. Hence, each time adjustment programmes had to be implemented to restore external balance, they had a strong negative impact on investment. The end results was that economic reactivation did not give rise to a sustainable growth process except in cases where it entailed an increase in investment and national saving that reduced the economy’s external vulnerability.

Table 1.8
FAST-GROWTH COUNTRIES IN THE 1990s: GROWTH, SAVING AND INVESTMENT [a]

	GDP growth (percentages)		Change between reactivation phase and growth phase (percentage points of GDP)			
	Reactivation phase	Growth phase	External saving	National saving	Nominal investment	Real investment
Group 1						
Chile	6.2	6.8	-2.9	+5.9	+3.0	+3.3
El Salvador	5.0	6.2	-1.9	+4.0	+3.5	+3.3
Dominican Republic	5.2	6.9	-0.7	+3.7	+2.9	+7.2
Group 2						
Argentina	8.7	2.8	0.0	+1.9	+2.0	+2.1
Peru	9.3	3.7	-0.6	+0.7	+0.1	+2.0

Source: ECLAC, on the basis of official national accounts figures.

[a] Based on simple averages for the periods concerned. The following years were chosen for each country to mark the turning point between the recessionary and reactivation phases: Argentina, 1990; Chile, 1985; Dominican Republic, 1993; El Salvador, 1989; and Peru, 1993. The three years immediately following the years indicated are defined as the reactivation phase; the subsequent three years are defined as the growth phase.

In more general terms, events in the region show that a recovery of investment that is financed by external savings rates in excess of 3% of GDP (the average for the 1990s) is not sustainable because of the extreme vulnerability of such a pattern of accumulation to shifts in the international economic environment. In such a setting, any slackening of capital flows will bring investment and economic growth to a halt. Accordingly, if high, stable economic growth rates are to be achieved, investment and national saving have to be raised at the same time in order to reduce the dependence of the country's investment activity on volatile external flows (ECLAC, 1996 and 2000d, chapter 9; Ffrench-Davis and Reisen, 1998).

Investment and savings figures for the Caribbean are very different from the statistics for the rest of the region, as the Caribbean countries have had much higher rates of both investment (30.4% of GDP in 1990-1996) and national saving (22.8% of GDP in the same period) (ECLAC, 2000e, chapter IV). These figures reflect two important facts that differentiate the Caribbean from the rest of the region. The first is the wide gap, in relative terms, between national saving and investment, which gives rise to a high degree of dependence on external funds (financial resources, ODA and transfers from migrants). The second is a low level of capital efficiency, as attested to by the fact that high rates of

investment have not been reflected in high rates of economic growth. This indicates that capital productivity continues to be particularly low in the subregion (see box 1.1). The causes of this situation have not been fully analysed, but one of the reasons may be that these economies are too small to take advantage of economies of scale.

Box 1.1
SAVING AND INVESTMENT IN THE CARIBBEAN

All the Caribbean countries suffer from chronic current account deficits, which means that a high percentage of investment has to be financed with external resources. Remittances from Caribbean emigrants residing in the United States, Canada, Europe and other Caribbean countries are recorded as external saving and constitute a large proportion of this type of financing. Accordingly, remittances strongly influence the countries' balance-of-payments position, as well as their overall development. Jamaica and the members of the Organization of Eastern Caribbean States (OECS) —with the exception of Antigua and Barbuda— are the main recipients of these significant flows. In fact, remittances amount to 9% of the OECS countries' GDP and as of the mid-1990s were equivalent to 100% of merchandise exports in Montserrat and Anguilla, 20% in Jamaica and 9% in Guyana (ECLAC/CDCC, 1999).

Measured on this basis, the current account deficit shrank significantly in the larger countries, declining from an average of 4.9% in the 1980s to 0.4% in the following decade. Trinidad and Tobago actually recorded a current account surplus amounting to an estimated 10.7% of GDP in the 1990s, but at the expense of investment. The current account deficit has generally been larger in the OECS countries, where it totalled an average of 26.6% and 18% of GDP in the 1980s and 1990s, respectively.

In the 1980s, while in the OECS countries investment reached 33.2% of GDP and economic growth rates averaged 5.1%, the relatively larger countries posted an investment/GDP ratio of 22.9% and their economies contracted (-0.4%). This apparently high level of investment efficiency in the OECS countries changed in the 1990s, however, when GDP growth slackened to an average of 2.1% despite the fact that the investment/GDP ratio rose to nearly 36.4%. Part of this slowdown in GDP growth is attributable to the significant contraction that occurred in Montserrat (-6.6%) as a result of the damage done to the country's economic infrastructure by volcanic eruptions. Meanwhile, a strong recovery in the larger countries' economies brought their growth rates to 2.1%, while the investment rate increased to 29.3%.

(continued)

Box 1.1 (conclusion)

Although these figures demonstrate the importance of investment for the economic growth of these countries, it is also interesting to note that, although the investment ratio of the OECS countries has reached levels comparable to those of South-East Asia, the same cannot be said of their growth rates. Along the same lines, even though the larger Caribbean countries' investment rates are higher than Latin America's, their economic growth rate is lower. These patterns indicate that their marginal capital/GDP ratios are very high.

Approximately 22% of gross capital formation corresponds to public investment. Public saving plays a fundamental role in ensuring the stability of growth. The economies of Antigua and Barbuda (from 1993 to 1995), Belize (from 1990 to 1992), Guyana (from 1991 to 1993), Saint Kitts and Nevis (from 1993 to 1995) and Saint Lucia (from 1990 to 1992) all underwent reactivations that boosted their annual growth rates to over 4%. Only some of these countries were able to maintain these rates after the reactivation, however. In those that did so (Antigua, Guyana and Saint Kitts), initially negative public saving rates improved significantly during the recovery process and thus helped to create an appropriate macroeconomic climate for continued growth. Just the opposite occurred in Belize and Saint Lucia, however. These economies started out with high public saving rates, but these rates declined as their recovery process proceeded and eventually converged at less than 3%.

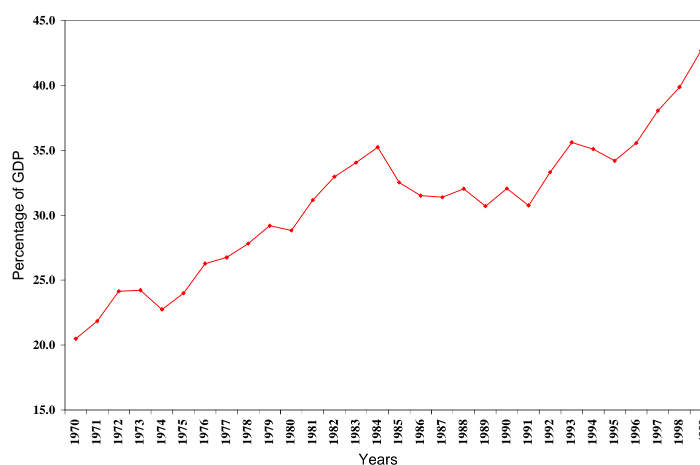
3. Recent developments in the financial sector

Financial and capital-account liberalization processes have led to major shifts in the region's financial structures, but they have also clearly demonstrated that the development of stable, deep domestic financial markets is a task which the region still has before it. Recent bank failures in many countries of the region have also shown, however, that such markets can develop only within an appropriate framework of prudential regulation and supervision capable of ensuring that financial intermediaries maintain viable levels of solvency and liquidity. In order to deepen the region's financial markets, explicit measures are needed to promote long-term saving and channel it into investment, and access to financing has to be provided to sectors that have traditionally been excluded from financial markets (Held, 1994; Mishkin, 1996; Wyplosz, 1998). These twin challenges —increasing long-term financing and opening up access to excluded sectors— underscore the major flaws of the financial reforms implemented to date (ECLAC, 2000d, chapters 9 and 10; Ffrench-Davis, 1999).

(a) Principal features of recent financial trends

In pursuit of the overall objective of improving the financial system's efficiency, the financial liberalization programmes undertaken by many countries of the region during the last three decades were designed to replace financially repressive regimes, in which the economic authorities regulated interest rates and the supply of loanable funds, with a free market system. One of the results of this process has been greater financial deepening (see figure 1.10). Calculated as a ratio between M_3 and GDP, this variable has increased from an average of 25% in the 1970s to 32% in the 1980s and 36% in the 1990s. On a regional basis, this coefficient has trended upward throughout the period in question with the sole exception of the second half of the 1980s and early 1990s, when the process was hampered by debt-crisis-related adjustments.

Figure 1.10
M_3/GDP RATIOS IN LATIN AMERICA [a]



Source: ECLAC, on the basis of information from the International Monetary Fund, *International Financial Statistics* (several editions). The countries included in the calculation of simple averages are: Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Peru, Dominican Republic, Uruguay and Venezuela.

[a] M_3/GDP: 1970-1999. Simple average.

Nevertheless, banking operations are still limited relative to GDP (see figure 1.11.A) and are concentrated in short-term financing. This reinforces the business community's tendency to borrow short-term funds to finance long-term investments, which heightens the production sector's vulnerability and, indirectly, that of the financial sector as well. At the

same time, the banking sector's spreads are much larger than those of the developed countries, which results either in higher financial costs for the domestic business sector or in excessive self-financing. Both options limit the national business sector's international competitiveness and the country's economic expansion. Additionally, the active use of external financing has increased the production sector's vulnerability to exchange-rate variations.

The structure of the region's banking sector has also changed considerably. The market share of State commercial banks has declined while that of foreign banks has expanded. There are fewer institutions than before, and the average size of banks has tended to increase. Capitalization levels have improved relative to the 1980s, as have non-performing portfolio indices. Despite all of these changes, however, banking crises occurred in at least 13 countries of the region in the 1990s (see section 3.b).

Development banks had played an important role in economic development financing in other periods, but they were hit by severe crises during the 1980s and 1990s that reduced their lending capacity (Alide, 2000). This has exacerbated the situation with respect to long-term financing and has thus placed additional constraints on economic growth. Steps are beginning to be taken in some countries to design financial instruments that will stimulate long-term financing through the use of venture capital, investment and guarantee funds, credit insurance and the development of derivatives markets. In some countries, pension system reforms involving varying schemes for changing over from pay-as-you-go regimes to individual capitalization systems have been the most important change, but their capacity to finance real investment through the provision of a larger supply of long-term resources has been limited, as will be discussed later on.

Although the 1990s saw significant achievements in the area of price stabilization, the development of long-term markets was also hampered by the fact that their operating environment was marked by inflation rates above international levels. Long-term financial instruments should include measures that protect their value from inflation. The most common such mechanisms have been indexation and the denomination of financial paper in foreign currencies.

In addition, the region's securities markets are still very small (see figure 1.11.B), and its primary markets have been shrinking rather than expanding (Dowers, Gomes-Acebo y Masci, 2000). In a majority of the countries, especially in the less developed ones, family-based ownership regimes predominate and in some cases are even becoming more prevalent than before. The development of equity markets has also been

hindered by the lack of regulations designed to reduce the level of risk associated with a lack of transparency and of mechanisms for defending the rights of minority shareholders in open corporations.

(b) Inadequate prudential regulation and supervision

Following an almost universal pattern,[7] 13 countries in the region were troubled by severe bank solvency problems during the 1990s (see table 1.9). This pattern was also in evidence in the 1980s, when the banking systems in eight countries of the region experienced severe problems. Two factors have been responsible for this situation. First, nearly all the countries´ financial liberalization programmes were undertaken in an institutional setting that was predisposed to insolvency. Contributing factors included serious shortcomings in the countries´ prudential regulatory and supervisory systems, which in turn stemmed from faulty risk-control measures, insufficient capital adequacy and provisioning rules, supervisory programmes that were either too weak or that focused on accounting and financial details, and explicit or implicit State guarantees on deposits and other obligations (Held, 1994). Second, macroeconomic environments marked by major shifts in relative prices and in economic activity, such as those that have characterized many countries of the region, tend to generate high levels of systemic risk.

Since there are either explicit or implicit State guarantees on bank deposits in all the countries of the region, the public sector has had to absorb most of the losses and subsequent costs of bailing out banks and borrowers. Governments have used a range of strategies, such as offering emergency central bank loans to affected institutions, buying up non-performing high-risk bank loan portfolios, rescheduling credit for distressed borrowers, and offering preferential exchange rates to debtors. These programmes have resulted in losses for public institutions, either because they involve some subsidization of interest rates or exchange rates, or because the financial institutions in question ultimately fail to meet their obligations. The high fiscal or quasi-fiscal costs involved in resolving financial crises, which in some cases have amounted to between 10% and 20% of GDP, attest to the high social rate of return afforded by policies designed to prevent financial crises from happening.

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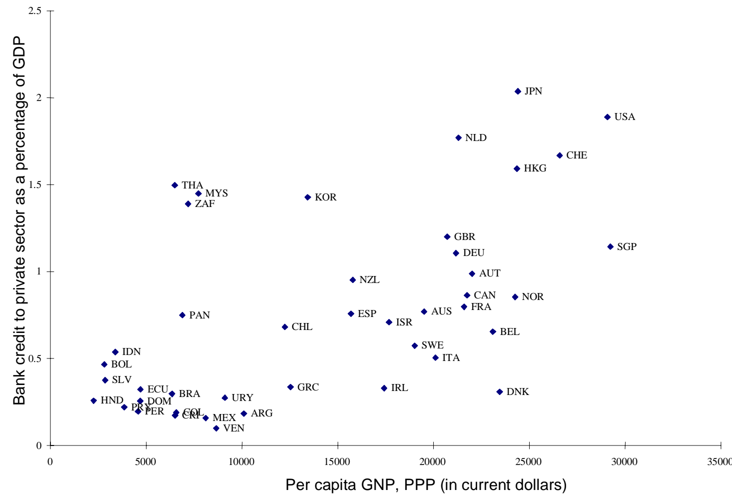
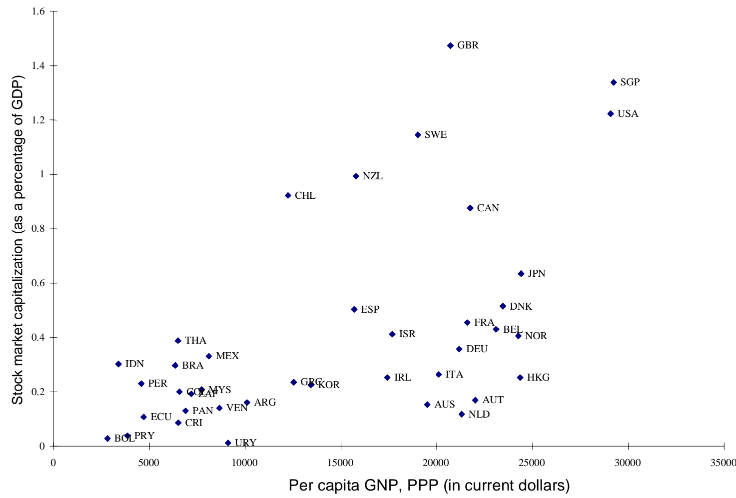
[7] The International Monetary Fund (1998) has reported that 133 of its 181 member countries had experienced major banking problems between 1980 and 1996, including 41 banking crises in 36 countries. This means that financial problems have taken on a global scale not seen since the Great Depression of the 1930s.

Figure 1.11
A. INTERNATIONAL COMPARISON OF THE SHARE OF BANK CREDIT TO THE PRIVATE SECTOR AS A PERCENTAGE OF GDP



B. INTERNATIONAL COMPARISON OF THE SHARE OF SECURITIES CAPITALIZATION AS A PERCENTAGE OF GDP



Source: ECLAC, on the basis of Thorsten Beck, Asli Demirguc-Kunt and Levine Ross, “A new database on financial development and structure”, Washington, D.C., World Bank, January 1999, unpublished.

Table 1.9

LATIN AMERICA AND THE CARIBBEAN: BANKING PROBLEMS IN THE 1990s

Country	Starting year	Extent of problems	Losses or cost of bailout (as a percentage of GDP)
Argentina	1995	Banking crisis: 45 out of a total of 205 institutions closed or merged	
Bolivia	1994	Significant banking problems: Closure of two banks holding 11% of total assets in 1994. Four out of 15 banks holding 30% of total assets, experienced severe problems with their portfolios in 1995. Problems of insolvency experienced by some institutions in 1999	
Brazil	1994	Significant banking problems: 76 out of a total of 271 banks were the object of government intervention, were placed under a special regime, merged or were liquidated. Non-performing portfolios amounted to 10% of credit outstanding at the end of 1998	8%-11%
Colombia	1998	Significant banking problems: Non-performing portfolios amounted to 13% of loans at the end of 1999	4%-5%
Costa Rica	1994	Significant banking problems: Closure of a major State bank in late 1994. State-owned commercial banks' non-performing portfolio (after deduction of loan provisions) exceeded their capital in 1995	
Dominican Republic	1992	Significant banking problems: Non-performing portfolio is estimated at more than 5% of the total. Liquidation of three small banks and government intervention in the third largest private bank (7% of total assets) in 1996	
Ecuador	1995	Banking crisis in 1999 following the appearance of significant problems in 1995-1996. Government intervention in 11 of 40 banks between December 1998 and June 1999. Deposits frozen in March 1999. External auditing of banks in April-July 1999	10%-15%
Guyana	1993	Significant banking problems: Liquidation and merger of a major public bank. Substantial write-downs on portfolio of successor bank in 1993-1994	7%
Haiti	1994	Significant banking problems: The political situation led to a run on deposits in 1994. Perception of financial instability since that time	
Jamaica	1994	Significant banking problems: Closure of an investment banking group in 1994. Steps had to be taken to shore up a medium-sized bank in 1995	
Mexico	1994	Banking crisis: Non-performing portfolios amounted to 12% of total in December 1995. Government intervention in six banks holding 17% of total assets in 1995. Large-scale sale of portfolios to the FOBAPROA banking fund. Banks experienced problems with portfolios in 1999	15%-21%
Paraguay	1995	Banking crisis: Government intervention in banks holding around 10% of total deposits in 1995. Intervention in six local banks and restitution of deposits in 1996-1998	8%
Venezuela	1994	Banking crisis: Intervention in 18 out of 47 banks in 1994-1995. Signs of financial instability in banking institutions in 1999	17%-18%

Source: C. Goodhart and others, *Financial Regulation*, London and New York, Routledge, appendix to chapter 1, 1998; Gerard Caprio and Daniela Klingbiel, “Bank Insolvency: Bad Luck, Bad Policy or Bad Banking?”, *Proceedings of the World Bank Annual Conference on Development Economics*, Michael Bruno and Boris Pleskovic (eds.), Washington, D.C., World Bank, 1996; Pedro Sáinz and Alfredo Calcagno, *La economía brasileña ante el Plan Real y sus crisis*, Temas de coyuntura series, No. 4 (LC/L.1232-P), Santiago, Chile, 1999. United Nations publication, Sales No. S.99.II.G.13.

This indicates that although liberalization may allow financial institutions to mobilize much larger amounts of funds, it will also expose them to various new types of risks unless rules are in place that will ensure those institutions´ solvency and efficiency. It is therefore essential to improve the operational efficiency of financial institutions and capital markets and to adopt prudential regulatory systems to safeguard such institutions´ solvency. Another critical factor is the existence of a suitable supervisory capability to ensure that the objectives of organizational and prudential regulations are met. Depending on how credit and capital markets have evolved, supervision of the sector may involve one or more specialized public-sector authorities, whose performance will depend upon the relevant institutions´ degree of autonomy, political support and technical capacity.

(c) Penetration of international banks

The globalization of financial markets has brought about a fast-paced restructuring of the local and international banking industries. The expanding scope of regional and global competition has obliged financial institutions to boost their efficiency and has, in effect, altered the optimum scale of operations. Operating on a national scale, perhaps with a few branches in other countries, used to be the optimum approach, but today, if a bank wants to operate efficiently, it is increasingly obliged to maintain a presence in several countries, including the major financial centres, and to offer a full range of financial products. This has given rise to a wave of mergers and strategic alliances between banks and other financial agents around the world and to many foreign banks' penetration into developing-country markets.

The Latin American and Caribbean region was no stranger to this trend during the 1990s. The process was particularly intense between 1996 and 1998, when foreign banks increased their share of total deposits from 16% to 30% (Salomon Smith Barney, 1998). Today, foreign institutions hold at least some degree of control over nearly 60% of the loans and 50% of the equity of the region's seven largest economies' banking systems (Salomon Smith Barney, 1999). The greater involvement of international banks has been prompted by the liberalization strategies implemented in these economies, the move to privatize State-owned financial institutions, and the existence of potentially high profits and brokerage margins as well as new business opportunities (Calderón and Casilda, 2000). Spanish banks have been the most aggressive entrants. They now own one third of the total assets of the region's 20 largest foreign banks and have thus overtaken even United States banks, which have traditionally been the leaders in this industry within the region. There are large privately-held

local financial groups that have managed to withstand this tendency towards concentration, however, and large, State-owned financial entities are also operating which, in some countries, continue to be the dominant providers of financial services.

These strategic changes have proven beneficial for the countries' financial development, but they have also brought new hazards. On the positive side, there have been gains in competitiveness, access to financial products usually available only in more modern systems, and the possibility for local firms to meet calls for large amounts of financing by going through international banks operating in their own countries. It is also true, however, that as financial conglomerates have increased their scale of operation and diversified their business components, prudential supervision has become much more difficult. The expansion of local financial groups into other countries, as well as their presence in international financial centres, is also a factor in this respect.

As was clearly demonstrated by the failure of a number of large international banks and national banks with foreign branches during the 1990s, the wide range of opportunities available to institutions wishing to elude internal and external controls, conceal losses and camouflage illicit operations pose a truly daunting challenge for the agencies responsible for prudential supervision. The existence of large financial conglomerates has made it necessary to have much more information than before in order to evaluate a bank's solvency. Insufficient progress has been made in this area, and for the time being, the exchange of information among supervisory authorities continues to operate as an informal network rather than within an institutional structure. In the absence of more specific information, prima facie cases regarding the nature of loans made by a given entity and its relationship with other components of the financial conglomerate in question appear to be the most viable option, in the short run, for safeguarding the solvency of an institution operating in one country in the event of the failure of a foreign-owned parent bank, another component of the same conglomerate or a subsidiary. Unfortunately, this type of presumptive statute is not provided for in the financial legislation of most countries of the region, and this void poses a serious problem in terms of the preventive function of prudential regulation and supervision.

(d) Pension funds[8]

Another important institutional development in the region has been the creation of pension funds. Several of the countries in the region (Argentina, Bolivia, Chile, Colombia, El Salvador, Peru and Uruguay) have converted their public pay-as-you-go pension systems into individual capitalization schemes, using methods that vary from one case to another. One of the explicit financial objectives of these reforms[9] has been to increase the stock of long-term savings for investment.

These processes have not all been equally successful in boosting saving and channelling it into investment. Such an outcome is subject to at least two factors: how governments cover the fiscal costs of the transition, and the types of restrictions that prudential regulations place on the management of pension funds. The transition costs are the payment obligations for the still-functioning State-run pension system, plus the obligations created by the new system: current pension payments, the transfer of past contributions into the new system and guaranteed minimum pensions. These obligations need to be covered by funds other than contributor payments, since those monies have to be rerouted to private pension funds (ECLAC, 1998a). If the national treasury fails to generate enough net savings to cover these costs, then the increase in net private saving may be offset by a larger public deficit. If this occurs, then the State begins to compete with investors for financial resources, including pension funds, and the reforms will therefore be less effective in promoting the financial market's development.

Even when, as in Chile, these costs are financed through fiscal adjustments, the prudential regulations applying to pension fund management have placed priority on the corresponding investments' safety and liquidity. This has predisposed fund portfolios towards government debt paper and short- or medium-term private securities; as a result, the amount of funds being provided to finance long-term investment has been smaller than expected (see table 1.10).

In view of this situation, further institutional changes are needed in order to provide pension programmes with the financial instruments they need to become an effective source of real long-term investment funds. Some of the types of instruments that have been used successfully to

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8 The role of pension funds in channelling financial saving towards real investment is also examined in chapter 4.

9 This discussion does not, of course, provide an exhaustive analysis of the objectives of pension reforms. ECLAC (2000d, chapter 6) offers a more comprehensive study of the effects which these reforms have had on social security systems.

channel pension-fund resources into real investment are indexed mortgages, corporate bonds and third-party rated equities.

Table 1.10
PENSION FUND MANAGERS AND INVESTMENT INSTRUMENTS IN LATIN AMERICA AND THE CARIBBEAN
(Late 1999)

Country	Number of fund managers	Structure of investment (percentages)		
		Government securities	Term deposits	Other
Argentina	14	52	20	28
Bolivia	2	66	32	2
Colombia	8	39	21	40
Chile	8	36	17	47
El Salvador	5	33	32	35
Mexico	13	98	0	2
Peru	5	8	21	71
Uruguay	6	61	34	5

Source: ECLAC, on the basis of data from PrimAmerica Consultores.

(e) Credit for excluded sectors

Another factor that poses a challenge for national financial systems is the heterogeneity of the sector composed of small- and medium-sized enterprises (SMEs) and microenterprises, which make up the majority of the region's firms and employ 85% of its working population. Some of the strategies that have been used to assist and modernize small production units have involved providing greater access to information and technology, suitable marketing channels and financing (ECLAC, 2000d, chap. 10). Traditional mechanisms for supporting small businesses, most notably subsidized credit from public-sector development institutions, have undergone changes in the course of recent financial reforms. Rather than providing credit subsidies, today's support strategies are geared towards helping small production units to obtain bank loans. To this end, a number of mechanisms have been created to help small businesses compile the accounting and financial information that banks need in order to evaluate the level of risk associated with such companies.

In line with this new approach, more recent financial development strategies have sought to strengthen development banks as second-tier institutions capable of attracting funds in credit and capital markets on a wholesale basis and offering lines of credit or rediscounts to first-tier banks and institutions that work directly with business firms. A number

of instruments have proven useful, including venture capital funds, credit insurance or guarantee funds, leasing arrangements and, in the specific case of microenterprises, solidarity circles.

Despite numerous advances in implementing increasingly complex and more fully integrated measures, credit access programmes continue to have no more than a limited impact, especially in the case of microenterprises and the rural sector. The measures adopted to date have focused on furnishing complementary (i.e., non-redundant) resources, on improving the targeting of small production units and achieving resource additionality, and on ensuring neutrality in the granting of credits. The greatest difficulties in implementing credit access programmes have been information and risk asymmetries, high operating costs, and the limited availability of data on micro-credits. Consequently, the financial sector still lacks an appropriate mix of public and private institutions to improve access to financing for small businesses.

Another purpose of the reforms introduced in recent decades has been to provide low- and medium-income groups with greater access to housing. Since the 1980s, most of the countries in the region have reoriented their housing assistance policies towards a three-pillar approach based on State subsidies, prior savings and mortgage credit. Under this new kind of system, commercial banks or specialized institutions have opened up mortgage credit lines, explicit rules have been established concerning mortgage collateral, and insurance schemes have been developed that include mortgage life insurance policies and arrangements for handling mortgage operations in the event of bankruptcy.

The implementation of this type of strategy has run up against obstacles of two kinds. First, on the operational level, poorer households have had difficulties in meeting the prior savings requirement. This is an increasingly serious problem in the case of houses having a higher value due to rising land prices. Second, financial difficulties have been encountered by these programmes due to a shortage of long-term financing and the lack of credit instruments capable of simultaneously providing security, liquidity and attractive profits for investors.

4. Three pillars of financial institution-building

Conditions in the countries of the region over the past decade have been marked by sharp contrasts. On the one hand, there have been impressive achievements in the areas of price stability, fiscal consolidation and macroeconomic management in general. On the other hand,

economic crises have followed one after the other, owing in large measure to irregular, unequal access to external financing, an inability to boost both investment and national saving simultaneously, and the insufficient development of the region's financial systems. Consequently, although the region's economic growth rate has improved since the "lost decade," it is still unsatisfactory.

The region faces three key challenges in the sphere of development financing: (i) to bring about an improvement in the capacity of developing countries and the international financial system to prevent and manage financial crises more effectively and thus reduce the region's vulnerability to external shocks; (ii) to begin operating more effectively in the world economy by pursuing a dynamic process of export development and seeking to ensure access to FDI and international financing based on strategies geared to each country's role in world markets; and (iii) to raise public and private savings rates and to further the development of the countries' financial systems in order to ensure suitable financial intermediation, stimulate long-term financing and facilitate credit access for traditionally excluded sectors.

The problems affecting the international financial system therefore need to be thoroughly analysed so that appropriate courses of action can be proposed for promoting world economic stability, averting currency and financial crises, responding quickly and effectively when such crises do arise (especially during times when international liquidity is tight) and helping to eliminate debt overhangs, including those of the higher-income countries of the region. It is particularly important to prevent the market's tendency to overestimate risk during such periods from exacerbating the crisis, thereby creating self-fulfilling prophecies. The role that regional as well as world institutions should play in all these respects must be examined. Steps should also be taken to explore the development of countercyclical macroeconomic policies from a national economic perspective, with careful thought being given to the prudential management of such policies during boom periods. In addition, attention should be devoted to the role of the exchange-rate regime, the regulation of capital flows, and the prudential regulation and supervision of financial systems.

It is equally important to identify the different types of ways in which the countries of the region have positioned themselves in international financial markets and how these linkages tie in with the international financial and trade agendas. In both cases, the experience of relatively less developed countries merits special attention. Export development policies and developing countries' access to international goods and services markets are also areas that warrant further

examination. Policies on FDI and other long-term capital flows need to be analysed within their proper context, as do the role of multilateral, regional and subregional development banks in expanding the countries' access to international financing; how to restore the flow of ODA and how to make better use of those resources; and what types of mechanisms should be created to expedite the flow of remittances sent by migrants. Further consideration also needs to be given to the implications of the Heavily Indebted Poor Countries (HIPC) Initiative for our region.

Increased national saving and national financial development are essential preconditions for stability and economic growth. The countries therefore need to explore various institutional development and policy options for boosting the saving rate while placing top priority on the maintenance of a balanced, sustainable macroeconomic environment and on long-term incentives for technological innovation and enhanced competitiveness. Particular emphasis should be placed on measures for enhancing the savings efforts of the public sector and of private firms alike and on appropriate institutional mechanisms for encouraging household and personal saving. In order to ensure suitable financial intermediation, the countries need to move forward with the development of effective systems of prudential regulation and supervision, improve the standards and statutes that regulate the activity of corporations (corporate governance), develop liquid markets and instruments for long-term financing, and encourage the creation of new financial instruments and activities such as venture capital funds, investment funds and securitization. Finally, the striking inequities characteristic of this region, which are reflected in the problems experienced by the countries in accessing the financial system, call for the development of mechanisms for facilitating the provision of credit to micro-, small and medium-sized enterprises and to low-income sectors.

Chapter 2

Promoting stability of capital flows for development financing

The dramatic increase seen in international financial flows in recent years has been coupled with a trend towards the diversification of those flows. As shown in the previous chapter, in the 1990s the region received ever-larger amounts of foreign direct investment (FDI), while the international bond market, medium- and short-term bank loans, and equity portfolio investment also expanded. With the exception of FDI, all these flows were highly volatile. Official, bilateral, and multilateral sources helped to cushion the impact of financing cycles to some extent by providing funds when private capital markets dried up. Official development assistance (ODA), which is an important source of funding for the relatively less developed countries in the region, has been steadily diminishing, however.

There is well documented evidence that changes in the composition of these flows and their variation over time have in large part been generated by developments in source countries, particularly the United States (see Calvo, Leiderman and Reinhart, 1993; Culpeper, 1995; Griffith-Jones, 1998). Institutional changes paved the way for financial internationalization. Early in the decade, the recession in the United States, a sluggish demand for funds and very low interest rates prompted United States investors to start looking for other markets. The high level of international liquidity also contributed to a boom in international financing in the years leading up to the Asian crisis, and Latin America was a receptive market. At peak periods during the boom, a number of

Latin American countries received capital inflows far in excess of what they could absorb.

It will be argued here that international financial crises are spawned during periods of excessive capital inflows which gradually undermine the recipient countries' macroeconomic fundamentals. These crises are, then, an inevitable consequence of the booms in capital inflows that precede them.

In addition, the liquidity crises that tend to sweep over emerging economies during times of massive capital outflows generally leave deep marks on their economies, including declines in economic activity and investment, higher unemployment and a sharp increase in poverty. As was discussed in the preceding chapter, there has been a strong correlation between the business cycles experienced by Latin America in the 1990s and net capital inflows.

According to the conventional wisdom that has arisen in recent years, because financial crises have been of short duration and the countries involved tend to return to capital markets relatively quickly, there is no need for any far-reaching reforms in the international financial system. The information presented in the previous chapter shows up the weaknesses of this argument, however. While it is true that some countries which are hit by financial crises may manage to return to capital markets, their market access conditions tend to worsen, the interest-rate spreads on their paper tend to widen, and new contracts often have shorter terms and include put options that allow creditors to demand early settlement of financial obligations. In fact, years after the Asian crisis, financial markets have not yet fully returned to their pre-crisis state.

Moreover, the economic and social costs of crises are often long-lasting or even permanent. Crises of this sort bring about an abrupt shift in an economy's growth curve, among other reasons because of the sudden interruption of the accumulation process and the loss of both tangible and intangible (business experience, firms' reputations and commercial contacts) capital. Recovery is hindered for years afterwards by domestic financial crises, and the ensuing bailout operations drain fiscal and quasi-fiscal accounts for years on end. In addition, as noted in the preceding chapter, the effects on social indicators are asymmetrical, since employment, poverty and income distribution all worsen rapidly during crises but recover slowly, if at all.

There are two main policy approaches to financial crisis management. The first aims at minimizing the chances of a crisis by taking preventive measures. The second approach recognizes that no

matter what kind of preventive policies are implemented by individual countries or by the international community, crises will always occur, so it is important to have international and regional tools for dealing with them. Another important aspect of crisis management is the prevention of contagion, which can unfairly affect other countries even if they have solid macroeconomic fundamentals.

This distinction is somewhat artificial, of course, since a suitable institutional structure for crisis management is the best way to avert a crisis in the first place. This is because the creation of such institutions will influence financial agents' expectations and behaviour in ways that will tend to make crises become less frequent. In fact, to a great extent, crises can be said to be the result of a type of behaviour which is motivated by the absence of international institutions capable of regulating the globalization of financial activity.

The first section of this chapter examines how situations of risk or vulnerability arise and reviews the principal macroeconomic effects of capital inflows, with emphasis on the lessons learned from recent experiences. The second section analyses the international aspects of crisis prevention. The third discusses the types of measures that recipient economies can adopt. The fourth section looks at the two main dimensions of crisis management, i.e., emergency financing and multilateral rules governing the suspension and renegotiation of foreign debt obligations. The final section discusses the need to round out the international financial architecture with a regional link.

1. Capital flows and the new generation of financial crises

It is important to distinguish among different types of capital flows, since they have different time horizons, respond to different incentives, have different agents behind them, and have very different effects on the host economies. FDI, for example, has a long-term horizon and has the potential to contribute not only capital, but also technology and export marketing channels to its host countries.[1] Some medium- and long-term loans from international banks and suppliers also have a multi-year time horizon and are non-speculative in nature, which means that these flows are more closely linked to productive investment.

Portfolio investments and shorter-term bank loans are at the other extreme. Many of the agents who supply funds to these markets are

[1] As noted in the preceding chapter, however, in recent years a large portion of FDI has been used for the acquisition of existing assets (approximately 40%).

attracted to emerging economies by the chance of realizing capital gains and currency profits by taking advantage of short-term differentials in interest rates and the possible appreciation of host-country currencies. The actions taken by some agents prompt others to follow suit, generating a bandwagon effect. Capital inflows put pressure on exchange rates, stock prices, and interest rates, thus yielding windfall profits that stimulate additional inflows. The accumulation of liabilities can therefore be regarded as a "rational" form of individual behaviour that stems, in large part, from the way in which the actions of numerous agents build upon one another.

Investors operating on the basis of short-term horizons will therefore continue to supply funds until expectations of an imminent change in the trend begin to build up. As the amount of capital invested in a country (or region) increases and debtors become increasingly dependent on additional infusions of capital (the current account deficit plus rollovers of maturing and liquid debts), investors become more sensitive to any hint of bad news. In fact, following significant increases in share prices and in the value of the local currency, together with rising levels of foreign indebtedness, the likelihood of a change in expectations grows exponentially. When this change does occur, everyone wants to be the first one to pull out in order to avoid losses. The ensuing stampede will, therefore, be a "rational" form of behaviour from the standpoint of individual agents.

It is not yet fully understood why a given country becomes a "fashionable" destination for capital flows. Sometimes it is because a country has made structural reforms that please international markets or has attained what is regarded as a sustainable form of macroeconomic stability. In other cases, its terms of trade are improving and the trend is expected to last for some time. In some instances, even though agents are aware that a country is experiencing unsustainable imbalances (e.g., Russia before the 1998 crisis), capital inflows continue because markets remain liquid and agents therefore think they will be able to pull out in time.

In financially open economies, such as most of the Latin American ones, the behaviour of local agents often accentuates the imbalances generated by external financial agents. During periods of plentiful capital inflows, higher interest rates on local markets and expectations that local currencies will appreciate make it very attractive to borrow abroad, but just the opposite is true when downward pressure is brought to bear on these currencies. During boom periods, local agents also shift the composition of their portfolios towards assets denominated in the local currency; then, during crises, they liquidate local-currency assets and take

refuge in investments denominated in reserve currencies. Furthermore, as pointed out in the preceding chapter, many countries' macroeconomic policies not only fail to mitigate the effects of external financing cycles but actually tend to exacerbate them. This approach gives rise to procyclical patterns of public and private spending and to the revaluation of the exchange rate during bouts of euphoria on capital markets. Adjustments in the opposite direction thus become inevitable once these exceptional conditions cease to exist.

The speculative component of these flows therefore translates into excessive inflows during booms and an interruption of new flows coupled with substantial outflows during times of crisis. These outflows are usually substantial in the case of short-term loans and equity portfolio investments. Situations in which short-term debt begins to exceed available international reserves may trigger capital flight. Everyone wants to avoid being trapped in a country whose reserves are insufficient to meet its short-term obligations. Creditors do not roll over their loans, and investors liquidate their assets, sometimes taking substantial capital losses. The dynamic of short-term capital flows thus tends to have a serious destabilizing effect (Rodrik and Velasco, 1999). Bond holdings, on the other hand (which are medium- or long-term investments), may be trapped in recipient countries during crises, but they then lose liquidity, and governments and local companies will therefore have difficulty placing new issues or will have to accept much less favourable financing terms (shorter maturities, larger spreads to be paid, and exit options for investors).

A hallmark of these boom-and-bust cycles in volatile capital flows is that they tend to be disproportionate in relation to the size of the host economy. It is not unusual for a country that is "fashionable" on international capital markets to receive inflows amounting to 10% of GDP or more. Net capital flows to emerging economies also tend to be very large compared to the size of their financial markets. In contrast to developed economies, where net capital flows are rarely equivalent to more than 5% of the money supply (measured by M2), in emerging economies this proportion may amount to between 10% and 25% during booms (see table 2.1).

Inflows of this magnitude are very difficult to absorb without destabilizing the recipient economies. Typically, the real exchange rate appreciates, the current account deficit swells, the money supply expands, stock market and real estate prices rise disproportionately, and external saving is substituted for domestic saving. When these things occur, the

Table 2.1
NET CAPITAL FLOWS[a] AS A PERCENTAGE OF M_2 IN SELECTED EMERGING AND DEVELOPED ECONOMIES

Country	1990-1998	1990-1994	1995-1998
Argentina	22.0	25.5	18.2
Brazil	7.2	3.3	10.4
Canada	3.1	4.2	1.7
Chile	18.6	18.9	19.2
Colombia	18.5	11.8	26.0
Ecuador	19.6	16.4	19.3
Indonesia	3.1	2.1	4.2
Japan	9.1	8.9	8.4
Malaysia	1.7	1.8	1.7
Mexico	11.2	13.2	6.3
Republic of Korea	18.9	23.8	12.9
Switzerland	5.7	4.7	7.0
United States	5.7	5.3	6.0
Venezuela	14.5	18.5	11.4

Source: International Monetary Fund (IMF), *International Financial Statistics*, Washington, D.C., February 2000.

[a] Net inflows or outflows (outflows in Switzerland and Japan, inflows in the other countries).

host country finds itself in a vulnerable position in which any “bad news” (economic or political) —be it national, regional, or even from distant developing countries— or any turnaround in conditions in industrialized countries can trigger capital flight and a speculative attack on the local currency.

From the standpoint of host countries’ policies, an essential feature of these sharp fluctuations in international capital flows is that they have a highly exogenous component. Because of the exogeneity of international capital flows, there is an important lesson here for host countries: the maintenance of macroeconomic balances is not enough in itself to keep capital flows stable. In fact, sometimes macroeconomic stability itself, if it is perceived as a permanent condition, may attract capital in quantities that end up destabilizing the recipient economies.

Another manifestation of the exogenous nature of capital flows is contagion. When a crisis breaks out in one country, international creditors and investors will try to pull out before a similar crisis occurs in other countries that have received large inflows of foreign capital and that may exhibit some of the symptoms shown by the country in crisis. Furthermore, some highly leveraged international investors who sustain losses in one country will be forced to liquidate investments in other countries to restore their own liquidity in the face of margin calls or withdrawals. This may cause a financial crisis to spread even to countries with sound macroeconomic fundamentals. One piece of evidence

regarding the extent to which this type of behaviour pattern causes events in one economy to be transmitted to the rest is the close correlation existing among external credit conditions for countries having very different macroeconomic fundamentals (Bustillo and Velloso, 2000). As shown in table 2.2, the correlation coefficients for bond spreads in the countries of the region are fairly high. Although to some extent these coefficients are consistent with the real and financial interrelationships existing among these economies, they are mainly a reflection of the behaviour of investors that fail to distinguish between countries having different macroeconomic policies and fundamentals.

Table 2.2
CORRELATION COEFFICIENTS FOR BOND SPREADS IN SELECTED COUNTRIES
(December 1997-September 2000)

	Argentina	Brazil	Ecuador	Mexico	Panama	Peru	Venezuela	EMBI+[a]	Latin American EMBI
Argentina	1.00								
Brazil	0.86	1.00							
Ecuador	0.27	0.21	1.00						
Mexico	0.78	0.91	-0.02	1.00					
Panama	0.90	0.85	0.42	0.73	1.00				
Peru	0.76	0.64	0.15	0.69	0.59	1.00			
Venezuela	0.90	0.85	0.19	0.83	0.83	0.72	1.00		
EMBI+	0.86	0.96	0.31	0.89	0.86	0.63	0.85	1.00	
Latin American EMBI	0.94	0.98	0.26	0.91	0.90	0.73	0.92	0.96	1.00

Source: ECLAC, on the basis of data provided by the Emerging Markets Bond Index Plus (EMBI+).

[a] J.P. Morgan Emerging Markets Bond Index Plus.

Contagion has a significant regional component. After the Mexican crisis of December 1994, Argentina also registered copious outflows of capital. Following the crisis that broke out in Thailand in July 1997, capital stampeded out of Indonesia, Malaysia, the Philippines, the Special Administrative Region of Hong Kong, Singapore, the Chinese province of Taiwan and the Republic of Korea. In 1998-2000, practically every country in South America experienced severe international financial difficulties, even though many of them had quite sound macroeconomic fundamentals prior to the onset of their difficulties.

Some of the economies that felt the impact of the latest international financial crisis were well prepared to deal with capital flight; other countries were exhibiting some signs of fragility when the crisis hit (high levels of short-term debt relative to international reserves, large current account deficits and an appreciation of the exchange rate that was

unsustainable over the long run). It should be emphasized, however, that crises can affect economies in very different states of health. Even the Republic of Korea, one of the hardest-hit countries, had quite solid macroeconomic fundamentals, since it had a fairly well-balanced fiscal budget and low inflation and had maintained a notably high growth rate for quite some time. Neither its current account deficit nor the appreciation of its currency in the years immediately preceding the crisis were excessive. Its principal weaknesses were a ratio of short-term debt to reserves of more than 1.0, and companies with high gearing ratios, which made them very vulnerable to rising interest rates, shrinking demand and currency depreciation (Agosin, 2000a). One of the lessons to be learned from the recent financial crisis is, then, that they can affect both saints and sinners alike.

The hallmarks of this new generation of financial crises are thus the magnitude and intensity of external financing cycles, their strong exogenous elements and the high risk of contagion. These characteristics are largely attributable to decisions taken by short-sighted agents specializing in microfinance, whose actions build on one other (Pfaff, 2000). The outcome, unsurprisingly, is unsustainable macroeconomic imbalances, "wrong" or outlier macroprices and an unfavourable environment for productive investment (particularly in tradables). It is therefore imperative to work towards the creation of an international environment that is less likely to generate financial cycles of this sort, together with institutions capable of dealing with volatility when it occurs. It is equally important for macroeconomic policy makers in developing countries to avoid placing the economy in a vulnerable position during periods of euphoria on international capital markets, since only then will it be possible to attain a sustainable macroeconomic equilibrium and create an environment conducive to investment and growth.

2. Crisis prevention: international aspects

The shortcomings of the existing international institutional structure in providing an appropriate framework of governance for international capital transactions are becoming increasingly evident. At present, the international community does not have the tools it needs to provide an increasingly globalized world economic system with the global public goods it requires, one of which is international financial stability.[2] From the standpoint of the issues of concern to us here, the

[2] There is a great deal of literature on the issues addressed in the following discussion. Regarding the concept of "global public goods" as applied to the international financial

three basic elements involved in ensuring an adequate supply of this particular global public good are: (a) coherence among the major economies' macroeconomic policies and development of a normative framework and surveillance systems to monitor all countries' macroeconomic policies; (b) development of an appropriate international financial institutional structure to prevent the build-up of an excessive level of financial risk; and (c) a speedy response capacity for coping with crises that threaten international financial stability. As will be seen further on in this chapter, these elements also have regional dimensions.

(a) Global macroeconomic management

Since the collapse of the Bretton Woods system of fixed (but adjustable) parities, the nominal and real variability of advanced countries' currencies has increased tremendously (Krugman, 1989). The resulting privatization of exchange-rate risk fueled the development of worldwide financial markets (Eatwell, 1997; Eatwell and Taylor, 2000). Although the financial development process has led to the creation of special instruments for managing the associated risks, it has also given rise to additional elements of financial and macroeconomic instability to which developing countries are particularly vulnerable.

This instability is related to the marked asymmetry existing between the dynamic development of world financial markets and the lack of adequate macroeconomic and financial governance at the global level. The globalization process has made it necessary to coordinate the major developed countries' macroeconomic policies more closely in order to achieve the policy coherence necessary for global macroeconomic stability. Developing countries' interests must be suitably represented in these coordination schemes in order to ensure that the major economies' macroeconomic policies are designed to internalize their impact on developing countries, reduce the volatility of their exchange rates and smooth out external financing cycles, all of which have proven to be very costly for developing countries.

This coordination must be coupled with the surveillance of all countries' macroeconomic policies and the development of basic standards for the management of fiscal, monetary, and financial policies. Surveillance functions, which at the global level are the responsibility of the International Monetary Fund and are carried out by means of the

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system, see Helleiner (2000), Kaul, Grunberg and Stern (1999), and Wyplosz (1999). Regarding international financial reform, see, among others, IMF (1998, 1999 and 2000), United Nations (1999), UNCTAD (1998), Akyüz and Cornford (1999), Eatwell and Taylor (2000), Eichengreen (1999), Fischer (1999), Griffith-Jones and Ocampo (1999), Ocampo (1999a and 1999b), and White (2000).

consultation process conducted under article IV of its Articles of Agreement, should be clearly preventive in nature. In order to make this possible, surveillance must be backed up by mechanisms for monitoring events on financial markets and by vulnerability indicators or an early warning system. The nature of the preventive macroeconomic policies that developing economies should adopt will be discussed in the following section.

The policy approaches outlined in that discussion could be used to improve the standards for macroeconomic management being developed by IMF. These standards currently include codes of best practice for transparency in fiscal matters and in monetary and financial policy, and they may be expanded to include codes of best practice for public debt and foreign debt management. In any event, these codes should observe two basic principles. First, developing countries' policy-making autonomy should be upheld, and this includes their right to choose their own exchange regime and the type of capital account regulations they feel are best suited to national conditions (United Nations, 1999; Ocampo, 1999b). Second, these countries have a limited capacity to absorb complex regulations, and the standards to be adopted should therefore take into account their institutional constraints, especially in the case of the less developed countries, along with their macroeconomic policy traditions.

As will be discussed in greater detail later on, the design of subregional and regional macroeconomic policy surveillance and coordination schemes should also be an objective for developing countries. This issue is becoming increasingly important in Latin America and the Caribbean as a result of the integration processes now under way and the contagion that has characterized financial markets.

(b) An appropriate institutional framework for financial stability

International financial stability also requires an appropriate global institutional framework. This framework has two important components: minimum standards for the prudential regulation and supervision of financial systems, and the provision of the information that financial markets need to function properly. The adoption of standards in all of these areas fulfils the dual purpose of guaranteeing greater stability for national financial systems and allowing them to establish a more stable position in international markets. As already noted in connection with macroeconomic policy, the corresponding standards should take into account the different countries' absorption capacities and their regulatory traditions.

Prudential regulation and supervision play a key role in preventing financial agents from undertaking excessive risks and in ensuring that they have sufficient assets to cover the risks they do assume. The prime objective pursued by these means is to prevent the emergence of systemic problems. The stringency of these standards should therefore be consistent with the risks assumed by economic agents as a group, rather than gauging their exposure simply on an individual basis.

In industrialized countries, the focus should be on the regulation and supervision of the more highly leveraged institutions and transactions. Despite an awareness of these problems, progress in this area has been halting, and the steps that have been taken have mainly focused on indirect regulation (of credit intermediaries) rather than taking a direct approach. Industrialized countries should also give due weight to an adequate risk assessment of the transactions they carry out with net borrower countries. This is especially important in the case of short-term funds and instances in which the sums involved in these operations are disproportionate to the size of those countries' economies and financial sectors. These kinds of risk assessments would discourage high-risk financing at its source, and these issues are, in fact, being discussed in the G-7 Financial Stability Forum, but developing countries are not well represented in that debate. The standards that should apply to such countries are outlined later on in this chapter and are discussed in greater depth in chapter 4. Furthermore, effective measures should be adopted in all countries to prevent and punish money laundering and other financial crimes in accordance with the recommendations on this subject issued by the United Nations.[3]

The role played by information in ensuring the proper operation of financial systems has been widely recognized in the recent economic literature. Although some information problems may be insurmountable (information asymmetries between creditors and borrowers regarding projects and the latter's financial situation), transparent information undoubtedly helps markets to function better.

Some observers have asserted that one of the main causes of recent crises has been a lack of information about countries that have been receiving large capital inflows. This argument is not completely on target, however. In point of fact, in most cases basic information on macroeconomic conditions in the principal emerging economies was available long before the countries were hit by these financial crises. Moreover, as stated in the previous section, even with adequate information, it may be rational for individual agents with short-term time

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[3] See Blum and others (1998) and United Nations (1998).

horizons to take positions which, from a collective standpoint, generate a high level of systemic risk (Ffrench-Davis, 1999, chapter VIII.C). It should also be remembered that the same information can be interpreted very differently at different points in time depending on economic agents' expectations. This is true even of the best-informed economic agents (investment banks, rating agencies, intergovernmental bodies and governments themselves). In other words, the essential problem is the volatility of economic agents' opinions and expectations, not necessarily the factual information on which they base their decisions (Ocampo, 1999a; Eatwell and Taylor, 2000).

Be this as it may, measures designed to improve the quality, quantity and transparency of the information available to economic agents certainly can help enhance market efficiency and the stability of capital flows (Ahluwalia, 2000). Several important initiatives have been undertaken in this area in recent years. One of them is the development by IMF of standards for the provision of timely, high-quality economic and financial market information. To date, around 50 countries are participating in this initiative. Achieving greater uniformity in the data provided on business firms' financial and accounting positions also facilitates an accurate interpretation of the information. The International Standards on Accounting and Reporting now under discussion within UNCTAD offer a good opportunity to achieve greater uniformity in countries' accounting practices. The development of a deep and transparent equities market can also help cushion the impact of sharp swings in international capital flows. A larger supply of high-quality accounting information on different companies can contribute to this objective as well. To this end, the International Accounting Standards Committee (IASC) has developed a basic set of accounting standards for adoption by the International Organization of Securities Commissions (IOSCO).

Rating agencies are one of the main types of private institutions responsible for providing information to investors, but their performance during the recent financial crisis was unsatisfactory. This was because, as it turned out, they were not immune to the volatility of opinions and expectations of the economic agents involved in emerging markets during the sharp financial boom-and-bust cycles of the 1990s. This fact, together with the inclusion of "subjective" elements in their rating of sovereign risk, has generated a procyclical pattern of risk assessment. As a result, in instances where the market regards the information they provide as being credible, they have tended to exacerbate financial cycles rather than attenuating them (which is what a good information system should do). In some instances, however, the information furnished by rating agencies

has not been heeded by the market, which, for that matter, has access to the same information regarding sovereign risk that rating agencies do.

In effect, the major agencies' ratings of Latin American countries during the 1990s were in line with the trend of the business cycle, as ratings were lowered during the Mexican currency crisis, improved in 1995-1997 and then moved downward again in 1998-1999. What is more, as is shown in table 2.3, rating agencies do not appear to have supplied the market with any additional information. Between July 1998 and December 2000, spreads were already moving in the direction that would later be indicated by rating agencies' announcements in 70% of all cases. And more than 70% of the time, spreads moved in just the opposite direction as that suggested by these agencies following these announcements.

Table 2.3
EFFECTS OF CHANGES IN STANDARD & POOR'S AND MOODY'S RATINGS ON MARKET BEHAVIOUR
(July 1998-September 2000)

(a) Market moves in direction indicated by rating changes prior to their announcement			
	Yes	*No*	*Inconclusive*
3 months before	12	5	-
1 month before	6	11	-
(b) Market moves in direction indicated by rating changes following their announcement			
	Yes	No	Inconclusive
3 months before	5	12	-
1 month before	6	10	1

Source: ECLAC, on the basis of data from Merrill Lynch, *Emerging Markets Debt Quarterly*, October 2000.

This indicates that the governments of developed countries, perhaps with the help of multilateral financial institutions, should take steps to encourage private institutions to rate sovereign risk on the basis of strict, objective parameters that are publicly known. These principles should also serve as a foundation for the development of systems for the regulation and supervision of these agencies' activities and of mechanisms for exchanging information between them and regulatory bodies. A more radical alternative would be to replace the sovereign risk ratings now provided by these agencies with a rating system applied by supervisory bodies in the countries of issue in accordance with objective parameters agreed upon internationally.

(c) An effective crisis response capacity

The financial crises of the past prompted the development of national instruments such as the lender-of-last-resort function of central banks, mechanisms for intervening in distressed financial institutions, deposit insurance and rules for refinancing or liquidating non-financial entities that run into difficulties. Although these mechanisms were designed as crisis management tools, they also have a preventive function because they help discourage the destabilizing types of expectations that generate systemic crises.

At least for the time being, however, it does not appear to be feasible to implement the majority of these mechanisms at the international level. The only one that has been applied at this level so far is a limited version of the lender of last resort, which takes the form of the IMF emergency credits granted to countries in trouble. However, its development has lagged far behind the growth of the international financial market. Giving the Fund a greater response capacity for coping with crises caused by sharp fluctuations in international capital markets would help to prevent destabilizing expectations from heightening crises in the affected countries. During recent crises, IMF intervention has also been important in preventing serious problems of contagion.

This kind of intervention can, however, lead to problems of moral hazard (i.e., the assumption of excessive risk by creditors or borrowers based on the expectation that they will be bailed out if they run into trouble). This is why it must be coupled with appropriate systems for the prudential regulation and supervision of financial activities and with procedures for ensuring that creditors will bear a fair share of the costs of resolving financial crises. The first of these elements has already been discussed; the latter will be analysed in the fourth section of this chapter.

3. Preventive policies in recipient countries

It is the responsibility of recipient countries to prevent the economic booms associated with heavy capital inflows from triggering crises. These measures should be oriented, first and foremost, towards the prudential management of those booms. This system of management should be paired with a foreign-exchange regime that strikes a balance between real exchange-rate stability and a degree of flexibility that will allow the economy to adapt to external financial shocks. It should also be backed up by “self-insurance” mechanisms that provide protection against external disturbances. The relative importance of the various

instruments and measures will vary according to the structural characteristics and macroeconomic tradition of each country.[4]

(a) Prudential management of booms

Consistent and flexible macroeconomic management during booms is the primary component of any crisis prevention policy. This management effort should be oriented towards preventing public and private agents from building up unsustainably large debts and towards avoiding imbalances in key prices, especially the exchange rate and the prices of national assets (financial assets and real estate). In the area of fiscal policy, as will be discussed in more detail in chapter 4 of this report, the authorities should strive to establish a structural balance —or even a surplus— in public finances in order to help strengthen the economy's savings capacity and give themselves more manoeuvring room for the implementation of countercyclical policies. This requires the generation of budget surpluses during booms, preferably through public revenue stabilization funds (for tax revenues and, where relevant, for government proceeds from commodity exports), in order to give policy makers the leeway they need to ease fiscal constraints during the subsequent downturn and, in particular, to soften the impact of the crisis on the most vulnerable sectors of society. It should be noted that in addition to funds set up to stabilize earnings from commodity exports, which already exist in several countries (coffee and oil funds in Colombia, copper and oil funds in Chile, and an oil fund in Venezuela), general tax revenue stabilization funds have recently been established under new fiscal responsibility legislation.[5] The international community should support the design of these types of stabilization instruments.[6]

Monetary and exchange policies should be geared towards preventing cyclical booms from leading to spikes in external and domestic borrowing by the private sector and unsustainable surges in the real exchange rate. These measures will be more effective if they are accompanied by the prudential regulation of capital inflows, the prudential regulation and supervision of the financial system, and an explicit liability policy aimed at improving the maturity profile of public and private debt from both domestic and external sources. In addition,

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[4] These issues are discussed in greater detail in ECLAC (2000d, chapter 8).

[5] For a discussion of the advisability of these general tax stabilization mechanisms, see ECLAC (1998b).

[6] For example, multilateral banks could set up credit systems designed to underpin social safety nets. Under such a system, during periods of fiscal prosperity, national matching funds could be deposited in interest-bearing accounts in the banks, where they would be held until the next time a crisis hits and the credit is disbursed.

the experiences of Asian and Latin American economies during recent crises have shown that it is counterproductive to place too much emphasis on interest rates as a means of stabilization while curbing adjustments in the exchange rate because this will accelerate the deterioration of the financial situation and will put additional pressure on government coffers (owing to the cost of bailing out the financial sector and the increase in the cost of servicing the domestic public debt, especially if it is large).[7]

The prudential regulation of capital inflows serves the same function as a liability policy in the case of external indebtedness, and to the extent that they are effective in reducing capital inflows, they also give macroeconomic authorities more breathing room for the adoption of tight monetary policies during booms and the prevention of an unsustainable appreciation in the exchange rate. Permanent prudential regulation instruments —especially variable reserve requirements or taxes on capital inflows which can be tightened or loosened as needed— are preferable to alternating between allowing the free inflow of capital and imposing quantitative controls on outflows during times of crisis. In fact, the latter system can be entirely futile if policy makers improvise by applying it without prior planning during crises. In such cases, rather than producing the expected results, it may lead to the massive evasion or avoidance of controls.

Chile and Colombia have both been successful in managing capital flows by applying non-interest-bearing reserve requirements to financial flows.[8] A number of studies have concluded that this instrument has had positive effects on the maturity profile of foreign debt, as it increases the cost of short-term borrowing without affecting the flow of longer-term capital.[9] These studies indicate that reserve requirements have also been effective in reducing total inflows of capital or, in what amounts to the same thing, in providing greater scope for a sustainable increase in domestic interest rates and/or modifying devaluation expectations. The question as to whether or not these effects actually do occur has, however, been more controversial.[10] To the extent that there is an imperfect substitution between short- and long-term capital (especially on the

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[7] For an analysis of these variables in the case of Latin America, see ECLAC (1999a).

[8] Until May 2000, Chile also required that foreign portfolio and direct investments remain in the country for one year. Colombia directly regulates such investments.

[9] Agosin and Ffrench-Davis (2000); Agosin (1998); Larraín, Labán y Chumacero (1997); Le Fort and Lehmann (2000); Barrera and Cárdenas (1997); Ocampo and Tovar (1999); and Villar and Rincón (2000).

[10] See also, in this regard, Valdés-Prieto and Soto (1998) and de Gregorio, Edwards and Valdés (2000).

supply side), the effects of this instrument on the maturity profile of liabilities should also reduce total capital inflows.

It has been argued that improving the prudential regulation and supervision of financial systems could serve as a substitute for the prudential regulation of capital flows (Mishkin, 1999). There is no doubt that proper financial regulation and supervision are crucial in achieving domestic macroeconomic stability. They may also help buttress the economy's lines of defense against instabilities associated with capital flows. An essential element in small, financially open economies is controlling currency mismatches between assets and liabilities in the financial system, but when non-financial firms, especially the larger ones, have direct access to external credit, prudential regulations will be ineffective in preventing such currency mismatches for the economy as a whole. The mismatches that are accumulated during boom periods will undermine the solidity of the financial system because non-financial agents with both external and local-currency liabilities will eventually run into difficulties. The fundamental advantage of reserve requirements or taxes on capital inflows is precisely that they apply a non-discriminatory price instrument to both financial and non-financial agents alike. This measure also attacks the problem at its roots, i.e., the excessive increase in external borrowing and the differential that tends to exist between the cost of external and domestic borrowing during booms owing to expectations of an appreciation of the currency.

The only effective substitute for the direct prudential regulation of capital flows is a combination of prudential regulation of financial intermediaries and tax mechanisms designed to discourage external borrowing by non-financial agents; one example would be the taxation of business enterprises' net foreign-currency debtor positions, as suggested by Fischer (1998). This type of measure would not affect borrowing by natural persons or equity investments, however. Another consideration is that designing a system of flexible taxation of external borrowing by non-financial companies is considerably more complex than regulating capital flows at the border.

A flexible exchange rate is a disincentive for short-term borrowing and for some types of portfolio flows, and in this sense it acts somewhat like a liability policy as well, but it does not help attenuate medium-term financing cycles. On the contrary, expectations of fluctuations in the real exchange rate may actually accentuate these cycles (Ffrench-Davis and Ocampo, 2000).

Prudential regulation and supervision can, in any case, be a useful tool for preventing domestic credit from expanding too rapidly during boom periods. In order for these instruments to serve this purpose,

however, they have to be applied countercyclically (ECLAC, 2000d, chapter 8) in order to counter the procyclical effects of the traditional approaches used in this sphere (including the Basle Core Principles). This is because, during booms, the capital increases made possible by intermediaries' burgeoning profits enhance their credit capacity, whereas there is a considerable lag before the debt overhangs of non-financial agents become apparent and are then reflected in provisioning levels. On the other hand, during times of crisis, smaller profits, the increase in non-performing loans and higher provisions weaken financial institutions' credit capacity, which can reduce liquidity and hence the ability of businesses to meet their loan obligations. These phenomena are accentuated by asset price cycles, since during booms, real estate and equities used by borrowers as loan collateral are valued at inflated prices and can thus be used to over-borrow; the opposite occurs during recessions.

These factors should be taken into consideration in the design of instruments for the prudential regulation and supervision of financial intermediaries. During cyclical booms, capital requirements and/or rating standards should be more rigorous, as should supervision, especially for financial institutions whose portfolios are expanding rapidly. Another option is to place limitations on the value of equities and real estate that can be used as collateral. During downturns, on the other hand, it is important to prevent regulatory restrictions from aggravating credit constraints and illiquidity problems, which could undermine the quality of portfolios in the financial system.

It should be emphasized that credits are not the only flows that can be excessive or destabilizing. Portfolio investments tend to be extremely volatile, and they can rise to very high levels in countries that are beginning to open up their financial systems. For all of these reasons, it is important for countries to be free to adopt the policies best suited to their circumstances. Accordingly, obstacles should not be placed in a country's way if it wishes to undertake the prudential regulation of capital flows. On the contrary, international institutions should help provide information on the experiences that a number of countries have already had in this regard so that other countries can expand their range of options and learn from what others have done.

(b) The foreign-exchange regime

The foreign-exchange regime is subject to a range of contradictory demands that are quite difficult to reconcile. First, the long-term performance and diversification of a country's exports are strongly influenced by the real exchange rate. In terms of trade activity, it is

therefore advisable to have appropriate, stable incentives for international specialization. Second, strong external shocks —which are transmitted primarily through the capital account, but also through the trade account— generate a demand for flexible economic instruments that can help an economy to absorb those shocks. Third, given the existence of major currency mismatches between developing countries' assets and liabilities, variations in the exchange rate have considerable wealth effects.

In recent times, the idea has taken hold that the only stable foreign-exchange systems are those located at the two extremes of the spectrum: either a completely flexible exchange rate or a strong anchor for the exchange rate (convertibility or dollarization). This view is based on the argument that intermediate systems, such as those based on a managed form of flexibility or "soft anchors", are highly vulnerable to speculation. This argument emphasizes the possibility that capital movements may be generated endogenously in response to inconsistencies between foreign-exchange policy and other economic policies. Nevertheless, the major challenge for the various systems is how to manage largely exogenous fluctuations in the capital account. In this regard, the systems at either extreme do not resolve the problems posed in the preceding paragraph but instead simply disregard some of the demands made on a foreign-exchange regime.

Even with national macroeconomic policies that are designed to keep inflation low, a floating exchange regime imparts a high degree of volatility to both the nominal and real exchange rates in a world in which capital is intrinsically volatile. An overabundance of capital can cause symptoms of Dutch disease to appear during booms that may have long-lasting effects. In more general terms, exchange-rate instability creates inconsistent incentives in sectors that produce tradables. This can discourage investment in these sectors, thus dampening economic growth. Furthermore, in the presence of major currency mismatches, fluctuations in the exchange rate will have procyclical wealth effects (profits generated by the appreciation of the currency during booms and losses due to the depreciation of the currency during crises) that accentuate the business cycle. In small, open economies with very shallow currency markets, extremely strong pressures that can have severe effects on economic activity and price levels can be generated by changes in the expectations of just a few dominant agents.

The major advantage of having a nominal anchor is that, so long as it is accompanied by prudent fiscal policies, the real exchange rate remains stable. In many instances, however, the stability of this macroeconomic price is achieved only when the currency has already become overvalued during the transition. On the other hand, the volatility

of capital flows tends to destabilize domestic activity in countries using this type of regime. This is even more the case when a nominal anchor is used in conjunction with a currency board.[11] This problem represents a formidable challenge for countries that have opted for a nominal anchor. During periods of heavy capital inflows, the authorities allow the monetization of increases in reserves, and economic activity will be buoyant. During times of pessimism, capital flows out of the country, the money supply shrinks, GDP falls and unemployment rises. The absence of mechanisms to facilitate the adjustment of relative prices to external shocks (falling export prices, the devaluation of an important trading partner's currency or the appreciation of the currency to which the country's exchange rate is tied) can entail high adjustment costs. If the authorities relinquish the use of monetary policy, however, the central bank cannot serve as a lender of last resort, and this may lead to serious problems if the national financial system is overtaken by a crisis.

The main strength of intermediate (i.e., "managed flexibility") regimes, which include dirty floats, exchange-rate bands and crawling pegs, is that they seek to combine flexibility with stability. As has already been pointed out, this can generate speculative pressures if the authorities' decisions do not enjoy enough credibility. This points up a major difference between "soft" anchors and systems of managed flexibility, however, since the former lack the usual types of mechanisms for maintaining flexibility and are therefore particularly vulnerable to speculation. An essential characteristic of managed flexibility systems is that, in order to combine flexibility with stability, they need to provide for some type of regulation of capital flows so that they can respond to the many different demands mentioned earlier. Another of their strengths is thus their ability to use other instruments besides the exchange rate to cope with pressure generated by the capital account.

In more general terms, the most important lesson to be drawn from the way exchange rates have functioned over the past few decades is that no single foreign-exchange regime is the best one for all countries at all times. Every country must choose the degree of nominal exchange-rate flexibility it needs, in keeping with its objectives and its real possibilities for managing other economic policy variables.[12]

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[11] With this type of system, policy makers explicitly renounce the use of monetary policy, whether by allowing the monetization of increases in international reserves or by allowing liquidity to contract when reserves shrink. When a nominal anchor is used but there is no currency board, the central bank still has the ability to sterilize the monetary effects of changes in international reserves.

[12] For a more detailed analysis of the issues discussed in this section, see Frankel (1999), Hausmann (2000), Velasco (2000), and Williamson (2000).

(c) "Self-insurance" mechanisms

One way of preventing crises is to maintain sufficient (current or contingent) reserves to deal with them. The existence of this form of "self-insurance" serves to discourage speculative attacks on local currencies and thus helps ward off crises.

Building up international reserves can be costly, however, since, as recent crises have shown, net capital outflows can amount to several percentage points of GDP. If a crisis is severe enough, even national agents may shift most of their demand for liquid assets to assets denominated in foreign currencies. Stated more generally, the essential problem is that international reserves have a high opportunity cost because their social productivity is low. Nonetheless, there is no doubt that international reserves should be higher in countries that are active on international capital markets than in countries with more closed capital accounts.

Some countries (Argentina, Mexico and Indonesia) have attempted to take out "self-insurance" by negotiating contingent lines of credit with private international banks, for which they pay a commission (equivalent to a call option). This is an interesting alternative that may prove to be less costly than maintaining high levels of reserves. The market for these lines of credit is still at an early stage in its development, however, and, here again, the supply of such funds may be insufficient in times of severe crisis, particularly if contagion becomes a concern.

Consequently, self-insurance, while necessary and appropriate, is costly and is therefore a second-best solution when compared to collective insurance programmes backed up, in this case, by multilateral instruments capable of providing the necessary international liquidity.

4. Crisis management

No matter how appropriate preventive policies adopted at the international and national levels may be, crises will continue to occur, and suitable multilateral crisis-management mechanisms are therefore needed. In fact, the existence of an adequate crisis response capacity is the best way to reduce the chances that a crisis will occur in the first place. It is equally important to back up these mechanisms with adequate adjustment measures at the national level.

In theory, there are two ways to deal with international financial crises. The first is to create an emergency financing facility which will partially replicate lender-of-last-resort functions at the international level.

The second option is to allow the countries affected by the crisis to temporarily apply a debt standstill and suspend outflows of portfolio capital. An alternative to taking these steps on a unilateral basis would be to establish orderly multilateral rules for this type of action. As will be discussed in greater depth later on, however, the two options are not mutually exclusive. On the contrary, the second course of action may be necessary to ensure a proper distribution of the costs of the adjustment between debtors and creditors and to avoid the moral hazard problems associated with emergency financing.

(a) Emergency financing

Recent crises have made it clear that governments' ability to take action at critical junctures has lagged far behind the development of financial markets. Indeed, there has been a dramatic reduction in central banks' international reserves relative to international capital flows. In 1977, the ratio of banks' international reserves to annual transactions on foreign-exchange markets was 1 to 15, but by 1998 it had fallen to just 1 to 234.[13] This means that, at the same time as the volume of international capital transactions has been mushrooming, the ability of even the largest countries to combat speculative trends on international capital markets has been steadily deteriorating.

Nor does the IMF have the authority or the resources to undertake this task. In its present institutional form, it is not in a position to become a lender of last resort (see Eichengreen, 1999; Ocampo, 1999a; Rodrik, 1999a). So long as it does not have the ability to create money unconditionally,[14] it will not have the means to serve as the central banks' central banker. Nor does it have the authority to ensure that it will be able to recover the funds it lends. Although the principal mechanism for mobilizing resources under exceptional conditions —loan agreements with the main industrialized countries— was expanded during the latest crisis, its resources are still limited and have therefore had to be supplemented at the most critical junctures with bilateral resources provided on an ad hoc basis. The uncertainty created by all these financing mechanisms reduces their ability to send signals that will bolster confidence, particularly in the face of crises that are of a much greater magnitude and that spread much more quickly than in the past.

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[13] Calculations based on Felix (2000, table 6).

[14] The creation of special drawing rights (SDR) is one way of issuing means of payment, but it requires an explicit agreement by the Fund's Board in each case, with an 85% majority vote. The last time SDRs were issued was in January 1981.

In the wake of the Mexican crisis, IMF set up the Emergency Financing Mechanism, which allows it to take action more swiftly during severe crises. It also created two additional facilities: the Supplemental Reserve Facility (SRF), for exceptionally large-scale financing needs; and Contingent Credit Lines (CCLs), designed to help countries to resist financial contagion. The SRF is subject to traditional stand-by arrangements, and has already been used. In order to be eligible for CCLs, countries must have received a positive evaluation during the annual consultations carried out under article IV of the IMF Articles of Agreement and must have adopted some of the standards mentioned in the second section of this chapter. One of the conditions for disbursement of the corresponding funds is that they must also enter into a stand-by arrangement. Given the uncertainty that still exists about some of the conditions for using this line of credit, the possibility that countries may send negative signals to the market if they avail themselves of this option, and the modest amount of funds available, it is not surprising that no country has yet applied for it.

The conditions imposed under IMF programmes have been the subject of heated controversy in recent years. It has been argued, first of all, that the Fund's traditional macroeconomic conditionality (particularly with regard to the adoption of tight fiscal and monetary policies designed to deal with financial crises originating in the current account of the balance of payments) may be inappropriate when the crisis stems from the capital account, and even less so when it is a result of contagion. Under these circumstances, traditional policies may deepen the crisis in the affected countries. In point of fact, the requirement set by the Fund for the reduction of the Asian countries' fiscal deficits following their request for IMF assistance had to be eased later on when it became apparent that the fiscal targets were exacerbating the recession. It has also been argued that the higher interest rates which the Fund demanded in order to stem capital outflows aggravated the business sector's liquidity crisis and thus pushed many firms into bankruptcy without necessarily stopping capital flight during the early stages (or, hence, the over-adjustment of the exchange rate) (Furman and Stiglitz, 1998; Radelet and Sachs, 1998).

The increase in the scope of IMF conditionality, which in recent decades has expanded from traditional macroeconomic areas to include issues relating to economic and social structures, has also been very controversial. In fact, a recent report by the United Nations asserted that such issues "by their very nature, should be decided by legitimate national authorities, based on broad social consensus" (United Nations, 1999, section 5). The expansion of conditionality to include social policy, governance and issues relating to private participation in crisis resolution has also been criticized by the Group of 24, the main forum of developing

countries on international monetary and financial issues (Group of 24, 1999b). The idea of confining conditionality to the traditional areas of macroeconomic policy and finance has been supported by a broad group of analysts holding very different ideological positions and views of the Fund's proper role.[15] An external evaluation has expressed a similar view of IMF macroeconomic surveillance activities (Crow, Arriazu and Thygesen, 1999).

In light of these considerations, it is clear that the Fund's capacity to provide external liquidity during crises should be expanded. In order to prevent the spread of financial crises through contagion, special attention should be focused on facilities designed to protect countries with solid economic fundamentals from speculative attacks. The mere existence of a properly funded facility of this nature would alter the international regime and economic agents' behaviour. Thus, in order to do its job, the Fund must have a larger volume of resources at its disposal on a more flexible basis. The eligibility requirements for its various lines of credit should also be redefined.

Despite the technical and political difficulties involved, the potential benefits of having multilateral financing facilities for countries faced with potentially destabilizing capital flight are great enough to warrant a continuing effort on the part of the international community to find ways of improving or developing them (see, in this regard, the proposals of Williamson, 1996; Ezekiel, 1998; and Ahluwalia, 1999, among others). These facilities should have sufficient resources to enable them to go to the aid of affected countries and to be readily accessible. Following the practice established for recent lines of credit, these loans should be for short terms and their interest rates should be higher than traditional IMF credits in order to encourage borrowers to pay back the loans as soon as possible. They should be renewable, however, since the available data indicate that these markets do not bounce back very quickly.

When there is conclusive evidence of the existence of macroeconomic imbalances that have been brought about by national policies, access to multilateral resources should be subject to conditionality. In light of the recent controversy, however, the expansion of conditionality to areas beyond the traditional spheres of macroeconomic and financial policy is of debatable value and should therefore be subject to explicit multilateral negotiations.

Recent programmes have embraced the principle that macroeconomic programmes adopted within the IMF framework should

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[15] Council on Foreign Relations (1999), Meltzer and others (2000), Collier and Gunning (1999), Feldstein (1998), Helleiner (2000b), Ocampo (1999b) and Rodrik (1999b).

take into account their effects on the most vulnerable sectors of the population. Given the asymmetric behaviour of social variables throughout the cycle (see chapter 1), this principle should be upheld. Moreover, its scope should not be confined to the design of appropriate social safety nets, but should also encompass the design of macroeconomic adjustment packages themselves based on further analyses of the social impact that various adjustment measures are likely to have. A consensus has not yet been reached regarding this issue, nor is enough known about it. In this, as in all areas in which conditionality is applied, the principle that adjustment policies should have the genuine support of the relevant national authorities (that is, the principle of "ownership") should also be respected. This principle is, moreover, essential in ensuring appropriate institution-building and the sustainability of the adjustment measures themselves.

Facilities designed to block contagion should have a low level of conditionality, not only because it is inappropriate in cases where imbalances are attributable to speculative attacks motivated by factors unrelated to national policies, but also because it can interfere with efforts to respond swiftly to critical situations when they arise. To make sure its funds are not being used to defend unsustainable policies, IMF should apply a few basic, uncontroversial eligibility requirements relating to macroeconomic stability and the current account balance. Nonetheless, there are some technical difficulties involved in the *ex ante* definition of eligibility requirements that remain to be overcome. Some experts have argued that this would turn IMF into a certifying agency, and that a ruling on its part that a country is not eligible for lines of credit could actually trigger a crisis. Instead of undertaking any *ex ante* determination of eligibility requirements, one alternative would be to set up a system based on simple guidelines that could be used to review applications quickly whenever the market is experiencing turbulence.

If IMF is to respond in a flexible manner to financing needs during times of crisis, its resources will have to be expanded considerably. Among the available options, the best one is the temporary allocation of special drawing rights (SDR) to all member countries when a crisis hits. These temporary allocations could later be destroyed in order to avoid creating liquidity on a permanent basis. Another option would be to allocate SDRs only to the member countries that are in crisis; those countries would later reimburse IMF after the crisis subsides, at which time the SDRs would be destroyed. The third possibility is for IMF to issue itself SDRs for use during crises. The last two options would require

the amendment of the IMF Articles of Agreement.[16] Of course, greater use of SDRs in the international financial system is an end in and of itself which has long been advocated by developing countries and which should not be contingent upon the adoption of specific lines of credit.

(b) Multilateral rules for external debt standstills and workouts

The alternative to emergency financing is the suspension of debt payments. In its most extreme form, this would involve renegotiations between the debtor country and its creditors with a view to rescheduling and possibly reducing the debt. For obvious reasons, this is a path that few countries would want to take, since it entails breaking off normal relations with creditors. The subsequent restoration of credibility could be a long and costly process, and only countries in critical situations will therefore resort to this kind of solution.

A broad consensus has arisen out of recent debates that the private sector should be involved in solving problems of indebtedness and capital flight associated with financial crises. Without private-sector involvement, debtors have to shoulder a disproportionate share of the cost of the crisis, the moral hazard problems of creditors are exacerbated, and the amount of resources needed to deal with crises becomes excessive. It should be emphasized that such schemes should be seen as a supplement rather than as a substitute for emergency financing, especially when the relevant countries' difficulties (illiquidity) are strictly temporary in nature and are largely the result of contagion. In fact, a suboptimal combination of the two mechanisms, which would in any case require debt refinancing as a prerequisite for access to emergency finance, could deepen the crisis rather than helping to solve it and, in the long run, channel an insufficient amount of resources to developing countries.

Although debt standstills are extreme solutions, they can help solve problems of both illiquidity and insolvency in recipient countries. In the first case, the deferral of debt payments by countries with obvious liquidity problems but with solid macroeconomic fundamentals could help prevent temporary difficulties from turning into more long-lasting problems for debtors and creditors alike. In the second case, the renegotiation of payment obligations is unavoidable, and any delay would be harmful to both debtors and creditors and could lead to an inequitable distribution of the costs of the crisis among creditors (between those who withdraw their capital and those who keep it in the affected

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[16] For different variations on the first of these proposals, see United Nations (1999), Council on Foreign Relations (1999), Meltzer and others (2000), and Camdessus (2000). Regarding the latter two, see Ezekiel (1998) and Ahluwalia (1999).

country or countries). In both cases, a debt standstill will make it possible to distribute the costs more fairly between creditors and debtors.

It has taken a great deal of time to develop national institutions capable of dealing with these problems, and there are no such mechanisms in existence at the international level. Any institution established on this front should obviously maintain voluntary negotiations among the parties as an essential element, but multilateral rules also need to be devised in order to contend with the two basic problems of coordination that negotiations of this type entail: the possibility that some creditors (and, perhaps, debtors) will be reluctant to be involved in the solution (the "free rider" problem); and the slow pace or repetitive nature of the negotiation process, which is very costly for both debtors and creditors ("zero-sum game").

To solve the first of these problems, collective action clauses must be included in debt contracts (be they for sovereign bonds, bonds issued by private institutions, or private bank loans) that authorize the countries where the debtors are located to defer payment (on which interest will accrue) for a limited period of time in cases of capital flight for reasons beyond their control, or to unilaterally declare a standstill for a longer period of time if their payment capacity is clearly insufficient. These clauses should be universal and should thus apply equally to debt contracts entered into by industrialized countries so that the market will not penalize countries that introduce such clauses by charging higher interest rates or restricting their access to funds.[17] Temporary standstills could also be expanded to include outflows of portfolio capital.

Although it is difficult to think of an alternative to a debtor country declaring itself to be in financial distress, the Fund could recommend that countries make use of this mechanism and could perhaps go on to authorize standstills (especially the longer-lasting moratoriums), thereby legitimizing them. The latter option can also help to avert problems of moral hazard on the part of debtors, i.e., the declaration of a standstill without just cause, although, as noted at the beginning of this section, this may not be a significant problem. Some analysts believe that the Fund is already empowered under article VI to take actions of this sort. In addition, the Fund should continue its practice of lending into arrears to countries that are making an effort to move in the right direction because this encourages creditors to cooperate in resolving the crisis.

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[17] There are already widely known precedents for the mandatory inclusion of this type of clause in debt contracts, especially for bonds issued on the British market (Griffith-Jones, 1998).

The existence of standstill clauses could help keep capital inflows from reaching excessive levels during booms, as creditors and investors would then be internalizing the risks of illiquidity or insolvency in recipient countries more fully. This approach has its own costs, of course, which would most likely take the form of higher interest rates.

A possible means of solving the second problem would be to set up multilateral arbitration mechanisms to settle disputes regarding debt renegotiation or refinancing processes. It may also be appropriate to promote flexible arrangements that take foreseeable contingencies into account so that renegotiations can be avoided and incentives can be provided for creditors to continue providing resources to countries facing difficulties during critical periods.

Whatever systems are devised should be applicable to all countries, regardless of their level of development. This means that the special multilateral schemes developed for the poorest countries, which will be discussed in the next chapter, are complementary rather than being replacements for the more general programmes mentioned in this chapter. As the corresponding plans are developed, accumulated experience should be taken into consideration as well. In this regard, it should be noted that the renegotiation of Ecuador's debt is undoubtedly a substantial improvement over the debt renegotiations that took place during the debt crisis, which were belatedly but effectively remedied by the Brady Plan.

5. The regional link

Mechanisms of a strictly multilateral nature, as referred to in sections 2 and 4 of this chapter, should also have a regional dimension. Although recent crises have highlighted the fact that certain types of "global public goods" and services of international financial institutions have been supplied on a suboptimal scale, it would be a mistake to conclude that any additional supply of such goods and services should come exclusively from worldwide organizations (Ocampo, 1999a and 1999b). On the contrary, the requisite structure should have a regional link. Countries in a given region face common international financial problems, and since regional contagion is a feature of the new generation of financial crises, regional institutions capable of preventing and managing crises in one country could have major externalities for the other countries in the same region. A model of this sort makes it clear that today's globalization process is also a process of open regionalism, in which subregional and regional organizations must therefore play an increasingly important role.

Such institutions can contribute, first of all, to crisis prevention. Improved macroeconomic coordination among Latin American and Caribbean economies could help avert crises and prevent them from spreading when they do arise. This coordination may include a wide variety of aspects, such as the adoption of common fiscal and monetary policy standards, common practices in the prudential regulation and supervision of financial intermediaries, possible agreements on exchange-rate management, and in the long run, perhaps even shared currencies. The countries in the region have begun to make headway in the first of these directions within the context of subregional integration processes.

Regional mechanisms can also help to resolve crises. In fact, the region has had one of the most interesting experiences in this area in the form of the Latin American Reserve Fund (FLAR). This fund has a 20-year record of service to the Andean Community during which it has been an important source of financing for the five member countries (Bolivia, Colombia, Ecuador, Peru and Venezuela). For the smaller countries (Bolivia and Ecuador), FLAR has been as important a creditor as IMF. With the recent accession of Costa Rica, FLAR has begun to reach out to Latin American countries outside the Andean Community as a step towards strengthening its institutional sphere of activity further (FLAR, 2000).

At the international level, the most ambitious proposal on this front is the creation of an Asian monetary fund, which was discussed at Japan's behest at the IMF meeting held in the Special Administrative Region of Hong Kong in November 1997 (Hamada, 2000). This idea recently took on a more concrete form when 13 Asian countries —members of the Association of South-East Asian Nations (ASEAN) plus China, the Republic of Korea and Japan— reached an agreement in May 2000 to establish currency swap arrangements among their central banks (Park and Wang, 2000).

Since financial contagion has a significant regional component, the existence of regional funds would have important advantages over an architecture consisting solely of a global fund (Agosin, 2000b; Mistry, 1999; Ocampo, 1999b; ECLAC, 1999b). The first advantage lies in the possibility of modifying financial agents' expectations and behaviour towards the region as a whole as a means of preventing contagion. With expanded international reserves provided by other members of the fund, and perhaps also lines of credit (including contingent lines) obtained by the fund on international markets on better terms and in larger quantities than the countries could obtain if they dealt as individuals, the participating nations would have a much stronger line of defence against crises. The fund could also play an important role in furthering the coordination of macroeconomic policies and prudential regulations.

Is a Latin American fund feasible? A recent study estimates that a fund made up of 15% of the reserves of 11 countries in the region (including all the largest ones except Mexico) could provide enough financing to deal with capital flight amounting to the total short-term debt of the countries, taken individually (Agosin, 2000b). Moreover, a fund of this size could cope with capital flight from each country, taken one at a time, equivalent to its entire money supply (measured by M2), with the exceptions of Argentina and Brazil. In the case of Argentina, a fund this size would be enough to finance capital flight equivalent to all of M1 (bills and coins in circulation plus demand deposits) and more than half of M2 (M1 plus time and savings deposits). This suggests that a common fund made up of even a modest percentage of the region's reserves could protect the countries from sequential financial crises. These calculations do not, moreover, consider the possibility that the fund could arrange for contingent credit lines on international capital markets or that contributions might be made by developed countries or IMF.

It should also be noted that, although there is some degree of covariation in capital movements among the different countries, it is not so high as to make it necessary for such a regional fund to cope with simultaneous capital flight from all the countries, which would indeed make it unviable. In fact, the Latin American Reserve Fund's experience shows that, even in a subregion such as the Andean Community, exceptional financing requirements are sufficiently spread out over time to allow a reserve fund to play an important role. In addition, the underlying premise is that by stopping an incipient crisis in one country, a regional fund can help to see to it that the crisis does not spread to other countries.

Regional funds could be recognized by IMF as an integral part of the international financial system. Viewed from this standpoint, they could serve as intermediaries between the Fund and individual countries in some respects. In times of crisis, the regional funds could be given near-automatic access to IMF resources. If a new contingency facility of the Fund were financed with SDR allocations, the regional funds could be authorized to use their members' local currencies to acquire SDRs for onlending to countries in crisis.

It should be noted that the proposed network of institutions already exists in the case of development banks, as the World Bank, the Inter-American Development Bank and four subregional banks —the Andean Development Corporation, the Central American Bank for Economic Integration, the Caribbean Development Bank and the Financial Fund for the Development of the River Plate Basin (FONPLATA)— are currently operating in concert on this front.

Chapter 3

Trade linkages and access to the international capital market

The foreign exchange needed by the region to make external payments has mainly come from export earnings and, in the case of the less developed economies, to an increasing extent from the remittances sent home by migrant workers. As discussed in the preceding chapter, ready access to international financial markets enables national authorities to design better macroeconomic policies for coping with swings in domestic economic activity and fluctuations generated by changes on world markets. It also represents an important source of investment finance to supplement domestic savings efforts.

Based on the analysis of external financing flows to Latin America and the Caribbean presented in chapter 1 and the characteristics of the region's export base, guidelines are set out for the development of its export sector, as a first line of action for strengthening external financing. The discussion will then turn to the question of access to long-term external funds —both official and private, and within the latter, both financial resources and FDI— and ways of enhancing their contribution to regional economic development. The analysis of official resource flows will address issues related to financing for sustainable development and the Heavily Indebted Poor Countries (HIPC) Initiative.

1. Strengthening export capacity as a means of boosting growth and reducing external vulnerability

Strengthening export capacity is the first line of action for securing adequate levels of external funding (ECLAC, 1998b and 2000d). A greater export capacity will contribute to financing for development both by helping to finance imports (thereby easing the constraints that import requirements may place on economic growth) and by reducing external vulnerability.

Despite a resolute effort to diversify the region's products and markets in recent decades, its exports are still heavily concentrated in commodities. While it is true that the share of total exports represented by commodities and natural-resource-intensive manufactures (industrial commodities) has been cut to less than half, the countries of the region —with the exception of Mexico and some Caribbean economies, where services are the main source of income— remain heavily dependent on commodities (see table 3.1).

This degree of concentration makes the region's economies highly vulnerable to fluctuations in the international prices of their export products, as illustrated in table 3.2. As may be seen from the table, average fluctuations around the trend were greater in the 1980s than in the 1990s, and export unit values have systematically varied more than those of imports. It also shows that the degree of variability is greater among the region's less developed countries; this translates into greater instability in their export earnings, which then has knock-on effects on investment and growth.

The creation of a pro-export environment is a key component of any effort to expand and diversify the region's export base, for without such an environment other export-promotion measures are unlikely to succeed. Policies for managing the risk associated with the variability of external markets are another important element. And in order for initiatives in these areas to bear fruit, adequate access to those markets is essential. The following discussion of these topics will be supplemented by a brief examination of possible means of making better use of remittances from emigrants.

Table 3.1
SHARE OF COMMODITIES AND NATURAL-RESOURCE-INTENSIVE MANUFACTURES
(As a percentage of total exports)

Country	1965	1999
Argentina	60.8	56.5
Barbados	8.9	22.5
Belize	21.9	36.2
Bolivia	97.9	44.1
Brazil	78.7	43.0
Chile	96.1	73.0
Colombia	92.8	77.0
Costa Rica	78.2	29.7
Ecuador	89.5	81.7
El Salvador	80.3	47.0
Guatemala	77.3	60.9
Honduras	87.3	60.0
Jamaica	63.8	…
Mexico	76.4	17.3
Nicaragua	83.3	66.0
Panama	92.9	74.9
Paraguay	51.5	62.9
Peru	65.4	62.9
Trinidad and Tobago	90.0	82.6
Uruguay	12.3	24.9
Venezuela	99.4	95.2

Source: ECLAC, *Latin America and the Caribbean in the World Economy, 1999-2000* (LC/G.2085-P), Santiago, Chile, March 2000. United Nations publication, Sales No. E.00.II.G.17.

Table 3.2
VARIABILITY OF EXPORT AND IMPORT UNIT VALUES AND TERMS OF TRADE
(Percentages)[a]

	Unit value of exports			Unit value of imports			Terms of trade		
	1980-1989	1990-2000	1980-2000	1980-1989	1990-2000	1980-2000	1980-1989	1990-2000	1980-2000
Group A	7.3	3.4	5.5	3.7	2.2	3.0	9.0	3.9	6.5
Group B	4.0	3.3	3.5	2.3	2.1	2.2	5.1	3.2	4.0
Group C	4.7	3.1	3.9	2.6	1.7	2.0	6.2	2.9	4.5

Source: ECLAC, *Latin America and the Caribbean in the World Economy, 1998* (LC/G.2038-P), Santiago, Chile, March 1999. United Nations publication, Sales No. E.99.II.G.3; *Preliminary Overview of the Economies of Latin America and the Caribbean, 2000* (LC/G.2123-P), Santiago, Chile, December 2000. United Nations publication, Sales No. E.00.II.G.138.

[a] Estimated as the mean absolute deviation (expressed as a percentage) from trend values; calculated as a three-year moving average.

(a) Creation of a pro-export environment

Three crucial elements in the creation of a pro-export environment are the maintenance of competitive and stable real exchange rates, the elimination of anti-export biases and the development of systemic efficiency.

The cornerstone of any export development strategy is a stable, competitive exchange rate, since it is highly unlikely that other measures can succeed in offsetting the negative effects of unstable or unduly low real exchange rates on the profitability of exports. There are two different dimensions to be taken into account here. At the national level, the macroeconomic policy mix should aim to keep real exchange rates at levels compatible with growth and with medium- and long-term external equilibrium. At the same time, care has to be taken to avoid major lags not compensated for by productivity increases and currency appreciations resulting from transitory inflows of foreign funds. At another level, the increasing integration of regional markets is posing new challenges since, as recent evidence shows, volatility in bilateral exchange rates has negative effects on both intra- and extra-regional trade.[1] It is therefore worth considering the potential contribution to the region's export development of regional macroeconomic coordination mechanisms, as well as other proposals for improving its external stability, as analysed in chapter 2 of this report (Agosin, 2000b and Mora, 2000).

One of the main anti-export biases is generated by high import tariffs, which raise the prices of tradable inputs (either imported or produced locally) used in the production of exportable goods. This bias is compounded by inadequate drawback or tariff suspension mechanisms. Although the trend in the region has been towards lower and more uniform import duties, in some cases tariffs remain a disincentive to export activity, and in such cases appropriate systems need to be set up to reduce or mitigate this effect. Tariff suspension mechanisms are more effective in achieving this end for regular exporters than drawback systems are, and such mechanisms have played a vital role in promoting the growth of export activity in South-East Asia and Mexico. Customs-free zones are, of course, another very important mechanism for a number of small countries in the Caribbean Basin.

Another essential element of a pro-export climate is the existence of conditions conducive to systemic efficiency. Stable export growth clearly depends on continuing improvements in productivity, and policies to

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[1] Recent studies suggest that a 10% variation in the real bilateral exchange rate above or below its mean value (calculating the mean at each point in time) is associated with an 8.6% reduction in exports (Mora, 2000).

promote the diffusion and adaptation of technology play a part in this. Other important aspects of external competitiveness include the efficiency of export infrastructure (transport systems, ports, storage systems, etc.), the development of complementarities between export firms and the production chains of which they are a part, and the removal of barriers through, in particular, the simplification of export procedures.

(b) Active pro-export policies

Measures aimed at identifying sources of external demand and promoting the countries' exportables in external markets have been of fundamental importance in backstopping export activity. This task has traditionally been performed by government promotion agencies, but recently the private sector has also begun providing export services. Public-sector agencies or private associations can also play an important role in promoting various sorts of product- or market-specific associations to help exporters to take advantage of economies of scale and the externalities generated by a collective presence in external markets. These activities are particularly important for small and medium-sized firms seeking market access.

Another key component is the development of adequate financing mechanisms and pre- and post-shipment insurance schemes. Progress in this area has been quite slow in most of the region despite the importance of such elements, particularly for small and medium-sized firms that lack access to foreign credit. The few exceptions include Banco de Comercio Exterior (BANCOLDEX) in Colombia, Banco Nacional de Comercio Exterior (BANCOMEXT) in Mexico and the greater priority being assigned to this area of endeavour by the Government of Brazil. It should be mentioned that the practice of extending credit to export firms is compatible with the Uruguay Round agreements, provided that it is not offered at subsidized interest rates.

One type of activity that has not received sufficient support is the creation of investment banks or other private-sector institutions to channel venture capital to new firms or greenfield activities that will help to diversify the export base. The work of the Fundación Chile and some activities being carried out by national development banks continue to be isolated examples of initiatives in this area. Efforts in this field also need to be coordinated with activities aimed at promoting technology-based enterprises.

Although the new rules of the World Trade Organization (WTO) limit most export subsidies, it is still possible to design programmes with

subsidy content.[2] In setting up such programmes, it is important to ensure that any subsidies which are included are moderate, temporary, subject to regular evaluations and designed primarily to help diversify the export base or destination markets.

(c) Policies for managing the risk associated with external-market variability

The demands involved in the management of risk arising from the variability of external trade point up the ongoing importance of efforts to diversify export products and destination markets. They also underscore the need to develop "self-insurance" mechanisms to cushion the domestic effects of changes in external prices, together with international mechanisms based on risk-management tools to counteract the effects of fluctuations in the prices brought by the region's export products on external markets.

Some countries have made use of export-price stabilization funds in order to protect themselves against external variability.[3] These national efforts help to attenuate the domestic impact of external volatility, and their effects on the stability of producer and/or public-sector incomes have generally been assessed positively. Stabilization funds have sometimes been criticized for failing to fully isolate the country from price fluctuations, but this objective is not only misguided —as it is unwise to insulate national producers from international price trends— but would also make such funds financially unsustainable.

There have been a number of attempts to use insurance-like mechanisms such as producer and consumer agreements, buffer stocks, variable tariff schemes and marketing boards to mitigate export price fluctuations. At the multilateral level, during the fourth United Nations Conference on Trade and Development (UNCTAD) in 1976, an Integrated Programme for Commodities was approved. In addition, the participating governments recognized the need to negotiate a Common Fund for Commodities in order to develop viable financial instruments to fund individual price stabilization agreements. Negotiations for the approval and ratification of this fund were complicated by disagreements among

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[2] WTO allows the use of horizontal subsidies (not specific to export activities alone). It also authorizes subsidies on technology development projects covering up to 75% of the corresponding costs, and there is still some room for certain types of direct subsidies under the *de minimis* clause.

[3] Although these schemes are mainly applied to export products, in Chile they have also been used to moderate the domestic effects of fluctuations in international oil prices. Price-band schemes for agricultural products are also being used in several countries to smooth out the domestic effects of fluctuations in the prices for such products. An analysis of this latter type of mechanism is beyond the scope of this document, however.

the major industrialized countries, however, and although the agreement was formally signed in the late 1980s, by that time product agreements had already ceased to exist, had fallen into disuse or had been modified in ways that significantly curtailed their price stabilization functions.

More recently, there has been renewed interest in the use of market-based instruments for risk management, and it has been suggested that multilateral lending agencies should act as bridges between the suppliers of such instruments and institutions in developing countries that do not have access to them. Whether these instruments can be applied to the region's exports on a suitable scale, and especially at an affordable cost, remains to be seen, however. These alternatives could prove particularly burdensome for countries with highly concentrated exports and/or those that are highly exposed to regionwide systemic fluctuations.

It should be stressed that although both self-protection mechanisms and international insurance schemes can help mitigate risks, they do not reduce exposure to risk and can be costly. The diversification of exports and destination markets therefore continues to serve as the region's principal proactive risk-reduction strategy.

(d) Access to external markets

A key element of any export diversification and development strategy is improved access to destination markets. Notwithstanding the achievements of the Uruguay Round, there are cases where very high tariff levels still apply (see table 3.3) to products of importance for the region, as well as highly variable tariff rates resulting from the tariffication of quantitative restrictions. These problems are particularly serious in the case of agricultural products, where the high production subsidies provided by industrialized countries (which underwent no more than moderate cuts in the Uruguay Round) continue to distort international markets. In addition, tariff escalation based on a product´s degree of processing continue to hinder developing countries´ efforts to export manufactures. As regards quantitative restrictions, the use of textile quotas continues to be permitted under an agreement for their gradual dismantlement, and some of the region's exports are subject to practices equivalent to voluntary export restraints, even though such restraints are explicitly prohibited in the Uruguay Round agreements.

Table 3.3
PRESENCE OF HIGH TARIFFS ON AGRICULTURAL PRODUCTS IN MAJOR DESTINATION MARKETS AFTER THE URUGUAY ROUND

Market	Percentage of tariff lines with rates > 12%	Number of tariff lines with rates > 100%	Products with high tariff rates
European Union	45	33	> 200%: meats, grape juice
Japan	40	146	> 300%: butter, wheat, groundnuts, rice
United States	19	26	> 100%: groundnuts, tobacco, tobacco products
Canada	11	68	> 200%: powdered milk, butter, cheese

Source**:** Prepared on the basis of United Nations Conference on Trade and Development/World Trade Organization (UNCTAD/WTO), *The Post-Uruguay Round Tariff Environment for Developing Country Exports: Tariff Peaks and Tariff Escalation* (TD/B/COM.1/14/Rev.1), Geneva, 28 January 2000.

Despite stricter oversight since the creation of WTO, the use of contingent trade measures (antidumping and countervailing duties and safeguard clauses), which are sometimes applied for protectionist purposes, is still widespread. Nearly half the disputes heard by the WTO Dispute Settlement Body relate to measures of this kind, some of which have recently been imposed on a number of the region's successful export products. These measures have been applied to no more than a small portion of the products traded by the region, but they nevertheless discourage new export projects because they create a great deal of uncertainty as to the prospect for regular market access under reliable rules. What is more, additional antidumping duties are generally much higher than average tariff rates.

Other measures that amount to discriminatory barriers to the region´s exports include technical, sanitary and phytosanitary standards. Although these types of measures have also come under stricter multilateral control, their application by developed countries often entails requirements that are hard for developing countries to comply with. The international community therefore has to develop means of distinguishing between regulations that are justified on these grounds and ones that are tantamount to camouflaged non-tariff barriers.

These considerations underscore the importance of pursuing multilateral efforts to eliminate trade practices that hurt developing countries, especially in the cases of agricultural products, labour-intensive manufactures and other manufactures deemed to be "sensitive" by industrialized countries. In addition, many small countries, especially in

the Caribbean, have suffered from an erosion of the trade preferences that they have traditionally enjoyed in industrialized markets. It is essential to make sure that these countries have access not only to such markets, but also to the resources and technical support they need to modernize and diversify their export base.

An especially promising line of action for the diversification of the export base entails taking advantage of the substantial increase in intraregional trade that has been spurred, among other things, by bilateral and multilateral integration agreements and treaties. The evidence shows that intraregional trade contains a higher proportion of manufactures than extraregional trade does, thus helping to reduce export concentration. This is also a key component of a strategy for gaining entry into the more dynamic, high-technology segments of world trade. During the recent crisis, however, this trade segment displayed a marked degree of cyclical vulnerability, particularly in South America, owing both to downturns in these economies and to fluctuations in bilateral exchange rates. Here again, this underscores the need for more sophisticated mechanisms for coordinating macroeconomic policy at the subregional and regional levels.

(e) Emigrant remittances

As discussed in chapter 1, emigrant remittances have become a major source of external funds, especially for the less developed countries. Three main policy approaches have been identified that would permit this source of financing to be used more effectively. These policy packages focus on forwarding costs, the potential productive use of these resources, and migrants´ organizational and entrepreneurial capabilities.

(i) Cost of sending remittances

The lack of competitive formal mechanisms for sending remittances has allowed specialized agencies to offer below-market exchange rates and charge large commissions for this service. As a result, the cost of sending remittances is very high, and the receiving households' savings and buying power is diminished accordingly. Proposals have been made, with some variations from country to country, to regulate this market by promoting competition, either by encouraging formal financial agencies to enter this line of business and give it greater transparency by posting their fees and charges (commissions and exchange rates), or by helping emigrants to organize themselves so that they can increase their bargaining power. Non-governmental organizations could assist with the creation of alliances or, conditions permitting, advantage could be taken of the internationalization of banking systems and the development of

suitable instruments, such as dollar accounts or credit cards on which payments can be made in the United States.

(ii) Productive use of remittances

Unlike the situation with respect to exports and FDI, and despite the importance of this source of funds, there is a conspicuous lack of public policies on remittances. There is, in fact, no regional policy that considers population expulsion areas as zones in which migrants and their families can act as agents of development by allocating part of their savings capacity to projects that will stimulate activity in those areas. There is convincing evidence that such a policy could be successful, since in cases where this savings capacity has been channeled properly, the response has been positive. There is thus a promising production and financial development potential which would allow for the adaptation and consolidation of schemes that could use a mix of public resources and remittances to finance development projects, the design of pilot projects using government seed capital, and the development of suitable tax incentives and attractive financial instruments that would provide emigrants with a means of investing in their home countries. Possible ventures include investments in real estate or in businesses and the development of idiosyncratic products that would find a market among emigrants in their host countries. Finally, as a means of promoting other sources of financing, remittances could be used as collateral for loans from social and development banks.

(iii) Organizational capacity

Since the number of migrants is so large, their effective organization could afford many advantages. As one possibility, they could develop an information network and distribution channels for products from their home countries. In addition, once they are organized, their shared background will motivate them to undertake community infrastructure projects; these sorts of initiatives will require appropriate institutional designs to enhance their development capabilities, especially in the areas of education and training.

2. Official external financing

The 1990s saw a number of worrisome developments concerning the future availability of official financing for the region. In the first place, when compared with other components of external debt flows, net bilateral financing has decreased and multilateral flows have grown only slowly, as shown in figure 3.1. Second, official development assistance

(ODA), which is particularly important for the region's less developed countries, has also tended to decline (see table 3.4). Third, although the Heavily Indebted Poor Countries (HIPC) Initiative has generated high expectations on the part of some of the region's poorest countries, this initiative has been hindered by operational difficulties which have affected not only HIPC-eligible countries, but other countries of the region as well, along with the regional and subregional agencies that have resources committed in those countries. On a brighter note, one of the more positive developments on the ODA front has been the introduction of specific initiatives for financing the sustainable development agenda, although their scope remains limited.

Figure 3.1
LATIN AMERICA: LONG-TERM DEBT FLOWS, BY SOURCE

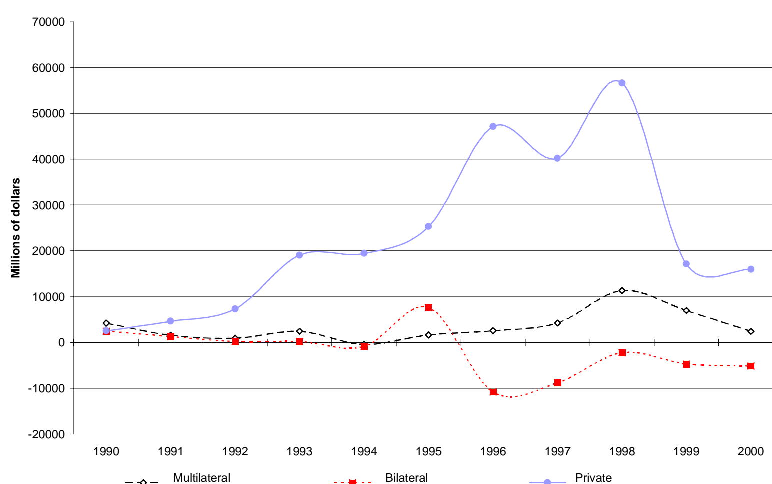

Table 3.4
NET OFFICIAL DEVELOPMENT ASSISTANCE RECEIVED
BY LATIN AMERICA AND THE CARIBBEAN
(Millions of dollars)

	1994	1995	1996	1997	1998	ODA/GDP 1997 %
Group A	3,026	3,570	3,546	2,853	2,793	3.2
Group B	694	833	729	748	787	0.4
Group C	1,097	1,095	999	674	615	0.1
Latin America and the Caribbean	4,817	5,498	5,274	4,275	4,195	0.3

Source: World Bank, *Global Development Finance*, Washington, D.C., May 2000.

(a) Uncertainties relating to ODA and bilateral resources

Despite the recent appearance of some more encouraging signs, the future of ODA is widely seen as very uncertain, since official aid budgets generally reflect domestic conditions in the donor countries more than the needs of recipient countries. The first element of uncertainty, which has been a factor since the early 1990s, stems from changes in official assistance levels caused by budget cuts in donor countries. Second, public opinion in these countries has become increasingly skeptical of the effectiveness of development assistance. In addition, the ending of the cold war changed certain strategic and commercial interests that had previously served to promote official assistance, at the same time that private capital inflows to developing countries have undermined its perceived urgency.

According to World Bank data, Latin America and the Caribbean received 7.3% of total ODA in 1999. It is interesting to note that over the last decade (1990-1999) the recipient sectors for such funds have changed significantly. Manufactures, agriculture, traditional energy and communications have become less attractive sectors for public funding, while basic social services and environmental protection have been attracting more attention.

ODA levels need to be restored so that the target of 0.7% of the industrialized countries' GDP, as agreed upon within the framework of the United Nations, can be met. Such resources should be channelled primarily to the less developed countries and small island States, where vulnerability to natural disasters, erosion of trade preferences and economic fluctuations have dramatically worsened in recent decades. In all these countries, programmes should be evaluated chiefly in terms of their social impact. ODA should also be used to support the provision of global public goods or goods having strong international externalities, including peace, the global environmental agenda (climate change and conservation of biodiversity) and the war on drugs worldwide. For their part, recipient countries need to improve the efficiency and transparency with which they use these resources since, apart from anything else, this is a necessary condition for domestic harmony and integration into a globalized world.

It should be noted that non-concessional bilateral resources are also an important source of financing for the region, and especially for the less developed countries. The points discussed above are equally valid for this type of funding. As seen in the preceding chapter, bilateral funding has also been used for emergency financing programmes. Although it may continue to play a useful role in cases of scarce multilateral financing, it is a suboptimal source for this purpose, and its function as a stabilization

mechanism needs to be brought under the broader agenda for the reform of the international financial architecture.

(b) The role of multilateral, regional and subregional development banks

Development banks —whether they operate at a multilateral level (World Bank), on a regional scale (Inter-American Development Bank, IDB) or in a subregional context (Andean Development Corporation, ADC; Central American Bank for Economic Integration, CABEI; Caribbean Development Bank, CDB; and the Financial Fund for the Development of the River Plate Basin, FONPLATA)— play a major role in supplementing domestic investment financing and private external funding. The key role played by regional and subregional lending agencies during the 1990s is clearly illustrated by their share of the credit channelled to the region. Table 3.5 shows that these resources are particularly important for the least developed countries, where the World Bank's International Development Association (IDA) also plays a major part. Multilateral financing from all these sources accounted for 84.7% of long-term external credit received by these countries in 1995-1998. Regional and subregional bank credit is also very important for countries with per capita incomes of between US$ 2,000 and US$ 4,000 (group B in table 3.2), where these sources accounted for 15% of long-term credit during that period and slightly over half in the first part of the decade. The corresponding amounts are smaller for the higher-income countries.

Even for the latter, one of the great virtues of multilateral banks has been their capacity to provide countercyclical financing to cushion the effects of external shocks and prevent crises from deepening. This has been clearly evident in the growth of such funding during the external financing droughts that occurred in the wake of the Asian crisis (see figure 3.1) or during the debt crisis. This source has supplemented rather than substituting for the balance-of-payments financing provided by the International Monetary Fund (IMF) and some bilateral sources, especially since these banks are the only source of long-term financing that is available at times of crisis, unlike exceptional financing. This type of funding also makes it possible to smooth out necessary fiscal adjustments by averting the need, in particular, to cut critical social programmes and making it possible to introduce social safety nets for the most vulnerable sectors. No less importantly, the support provided by multilateral banks has acted as an important catalyst in shoring up or restoring confidence in countries at times of crisis and hence reinstating private flows. This characteristic has turned them into a highly valued asset in the eyes of stakeholder governments from developing countries, as reflected in the commitments assumed during their capitalization processes.

Table 3.5
NET LONG-TERM DEBT FLOWS, BY SOURCE
(Millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	1990-1994	1995-1999
Group A												
Net long-term debt flows	1,118	498	297	958	639	988	1,289	1,968	930	1,740	100.0	100.0
Public sources	1,060	675	753	781	836	1,017	917	1,377	812	1,212	117.0	77.1
Multilateral	355	341	565	517	740	1,118	894	1,475	900	1,271	71.7	81.8
World Bank	43	25	9	9	122	340	183	194	246	566	5.9	22.1
IDB and other development banks	312	316	557	507	618	778	712	1,282	654	705	65.8	59.7
Bilateral	705	334	188	265	96	-101	23	-98	-89	-59	45.2	-4.7
Private sources	58	-177	-456	176	-197	-29	372	591	118	528	-17.0	22.9
Group B												
Net long-term debt flows	-184	-335	-573	1,237	2,120	1,967	3,151	5,412	2,102	5,517	100.0	100.0
Public sources	145	107	-445	130	-539	-337	-596	299	197	1,315	-26.5	4.8
Multilateral	15	-349	-122	345	-493	171	141	654	832	1,673	-26.6	19.1
World Bank	-329	-367	-701	19	-586	-164	-204	121	162	507	-86.7	2.3
IDB and other development banks	344	18	579	326	93	334	345	533	670	1,166	60.0	16.8
Bilateral	130	455	-323	-215	-46	-507	-737	-354	-636	-359	0.1	-14.3
Private sources	-329	-441	-128	1,107	2,659	2,304	3,746	5,113	1,905	4,203	126.5	95.2
Group C												
Net long-term debt flows	8,294	7,318	8,746	19,514	15,365	31,580	34,397	28,257	62,671	12,090	100.0	100.0
Public sources	5,489	2,089	843	1,747	-1,598	8,604	-8,591	-6,221	8,091	-286	14.5	0.9
Multilateral	3,844	1,586	492	1,581	-671	374	1,509	2,120	9,589	4,010	11.5	10.4
World Bank	3,225	747	-178	452	-778	-266	384	430	2,000	1,077	5.9	2.1
IDB and other development banks	619	838	670	1,130	107	640	1,125	1,690	7,589	2,933	5.7	8.3
Bilateral	1,645	504	352	165	-927	8,230	-10,101	-8,341	-1,498	-4,296	2.9	-9.5
Private sources	2,805	5,229	7,902	17,768	16,963	22,976	42,988	34,478	54,580	12,375	85.5	99.1
Latin America and the Caribbean												
Net long-term debt flows	9,228	7,482	8,470	21,709	18,125	34,535	38,837	35,637	65,703	19,347	100.0	100.0
Public sources	6,694	2,871	1,152	2,658	-1,300	9,284	-8,270	-4,545	9,100	2,241	18.6	4.0
Multilateral	4,214	1,578	935	2,443	-424	1,662	2,545	4,249	11,321	6,954	13.5	13.8
World Bank	2,939	406	-871	480	-1,242	-89	363	744	2,409	2,150	2.6	2.9
IDB and other development banks	1,274	1,173	1,806	1,963	818	1,752	2,182	3,505	8,913	4,804	10.8	10.9
Bilateral	2,480	1,293	217	215	-877	7,622	-10,815	-8,794	-2,222	-4,713	5.1	-9.8
Private sources	2,534	4,611	7,318	19,051	19,425	25,251	47,106	40,182	56,603	17,106	81.4	96.0

Source: World Bank, *Global Development Finance 2001*, Washington, D.C., 2001.

Multilateral and bilateral ODA is also provided on clearly advantageous terms and conditions (see table 3.6), as loans from these sources have longer maturities and lower interest rates than private credit. Lending terms are especially favourable in the case of new commitments to the less developed countries. This, in combination with the greater relative significance of these resources for the poorer countries, reflects the special attention they have received from these institutions, although favourable terms are also extended to the region's higher-income countries.

Table 3.6
LATIN AMERICA AND THE CARIBBEAN: AVERAGE TERMS AND CONDITIONS OF NEW COMMITMENTS
(Simple averages)

		Interest rates (percentages)		Maturities (years)	
		Official sector [a]	Private sector [b]	Official sector [a]	Private sector [b]
Group A	1990	4.0	9.5	28.1	6.4
	1994	4.2	7.3	26.2	9.1
	1998	4.7	5.5	28.0	8.5
	1999	4.0	6.0	29.7	7.7
Group B	1990	6.8	8.3	14.5	5.4
	1994	6.5	7.5	18.0	6.8
	1998	6.3	8.1	13.8	7.0
	1999	5.1	8.8	17.5	11.0
Group C	1990	7.4	9.0	17.2	10.9
	1994	6.4	8.5	17.7	6.7
	1998	7.7	8.1	13.3 [d]	7.9
	1999	6.7 [c]	8.5	19.6 [e]	11.0

Source: World Bank, *Global Development Finance 2001*, Washington, D.C., 2001.

[a] Bilateral loans and resources from multilateral agencies.
[b] Bond debt and international bank loans.
[c] Country average (except Venezuela).
[d] Country average (except Chile).
[e] Country average (except Mexico).

Thanks to their preferential relationship with developing countries and their readiness to adapt to modern risk- and portfolio-rating systems, IDB and ADC have better ratings than the countries of the region themselves and can thus secure external financing at a lower cost than the countries could individually. This is especially important in the case of ADC, as all of its stakeholders are developing countries in the region. These institutions are therefore able to provide financial intermediation services that are highly beneficial for their member countries, which

would otherwise have to shoulder very high costs or would simply not have access to sufficient financing. This fact, together with the generally high quality of multilateral development bank portfolios, suggests that private agents tend to overestimate risk, especially during crises. Overestimation of risk is a market failure that in itself justifies the operations of multilateral development banks.

The loan portfolios of regional and subregional banks have diversified profiles that vary from one to another. These institutions give priority to social development projects and have played a pioneering role in financing sustainable development programmes and channelling resources to production sectors that have traditionally been bypassed by such flows, particularly small and medium-sized enterprises. At the institutional level, they have been active in providing support for State modernization programmes. They also contribute to the development of physical infrastructure, certain production sectors and, in some cases, foreign trade operations, particularly those linked to integration processes. Technical assistance, provided directly or in connection with project financing, has been an additional characteristic of these institutions, alongside their role as a meeting place for member countries to exchange information and analyse successful (and, equally importantly, unsuccessful) development experiences.

Development banks can act as catalysts for private resource flows in three different ways: furnishing guarantees for the timely payment of public debt or the timely fulfilment of commitments (in the form of guarantees or subsidies) assumed by the State in support of private projects; providing direct financing or cofinancing for innovative private projects (with the funds being supplied either directly by the bank or by a related financial corporation); and providing venture capital (through the relevant financial corporation) to innovative enterprises. These mechanisms are being developed in a variety of ways by the banks and their corporations, and they have been particularly effective in stimulating private-sector investments in infrastructure. Development banks have also pioneered means of guaranteeing the servicing of public bond debt when issues are floated at times of great uncertainty on the capital market. In all of these cases, private investors value not only the solidity of multilateral institutions, but also their special relationship with the governments concerned, which makes their support even more valuable. These operations should continue to be expanded on the basis of a strictly defined criterion of additionality, i.e., through the development of support mechanisms that are unavailable in the private sector at any given point in time. One new line of action could be to underwrite bonds issued by countries that have not previously used this financing modality.

Regional and subregional institutions can also contribute to the development of financial markets by issuing debt securities that will help create markets with longer maturities and investing in small-business lending and microfinance institutions. This would help create and deepen market segments that tend to be underdeveloped. Support for the operations of national development banks is another essential element in order to achieve results in these areas.

To summarize, multilateral banks play a vital role in channelling resources to the region under more favourable terms than private-sector financing; they supplement private investment when private capital is not available on acceptable terms and conditions; they help improve financing terms by restoring confidence; they can act as catalysts for new private investment and for financial market development in the countries of the region; they provide a forum for the countries; they contribute to the regional integration process; and they are a mechanism for channelling technical assistance and information useful in preparing, financing and executing development programmes. For all these reasons —although they certainly need to prioritize their actions, and their activities should aim at greater efficiency and transparency— multilateral banks continue to play a crucial role, even for middle-income countries.

Table 3.7
COMPOSITION OF SELECTED REGIONAL AND MULTILATERAL BANKS' LOAN PORTFOLIOS
(Percentages)

	World Bank 1998-2000	IDB 1997-1999	ADC portfolio as of 31/12/99	CABEI cumulative 1961-1999	CDB cumulative 1970-1999
Social services, social and environmental protection and investment	24.8	27.3		7.1	11.0
Education, science and technology	9.4	6.1			
Urban development, housing and physical infrastructure	1.3	6.2		31.1	
Agriculture, forestry and fishing	6.0	1.5	2.0	2.7	5.8
Industry, mining, quarrying, oil and gas	1.2	9.1	11.0	4.4	9.8
Electricity, energy and water	2.3	8.8	21.0	14.5	8.8
Transport and communications	8.7	9.6	24.0	10.1	25.3
Tourism and microenterprise	0.0	1.3		2.5	3.1
Multi-sector and other	5.3	2.6	14.0	27.6	13.3
Finance and distribution	12.5	0.3	28.0		22.8
Economic policy, public sector reform and public admin.	28.5	27.3			
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: ECLAC, based on annual reports of the World Bank, IDB, ADC, CABEI and the Caribbean Development Bank.

(c) The Heavily Indebted Poor Countries (HIPC) Initiative

Since the mid-1980s the absolute and relative share of total lending to the poorest countries in the region that is provided by private creditors has systematically declined (see table 3.8). Bilateral financing has also decreased. Thus, unlike resource flows elsewhere, in the poorest countries the proportion of total debt owed to multilateral creditors has increased. In some of these countries, foreign borrowing levels are very high and represent a major development constraint. In view of this situation, an initiative to reduce the external debt of heavily indebted poor countries was introduced in 1996. Four countries from the region —Bolivia, Guyana, Honduras and Nicaragua— fulfil the eligibility requirements for this programme.

Table 3.8
COMPONENTS OF EXTERNAL DEBT OF LATIN AMERICAN COUNTRIES CLASSIFIED AS POOR [a]

	1980	1985	1990	1995	1998	1999
(Millions of dollars)						
Long-term debt	11,953	23,948	32,782	37,494	36,071	36,885
Public and publicly guaranteed debt	10,107	22,887	32,222	36,545	34,256	34,715
Multilateral creditors	2,516	5,195	9,009	12,846	15,010	15,860
Bilateral creditors	3,128	7,518	13,920	14,620	10,482	10,100
Private creditors	4,463	10,174	9,293	9,079	8,764	8,755
Unguaranteed debt	1,846	1,061	560	949	1,815	2,170
(Percentage composition)						
Long-term debt	100.0	100.0	100.0	100.0	100.0	100.0
Public and publicly guaranteed debt	84.6	95.6	98.3	97.5	95.0	94.1
Multilateral creditors	21.0	21.7	27.5	34.3	41.6	43.0
Bilateral creditors	26.2	31.4	42.5	39.0	29.1	27.4
Private creditors	37.3	42.5	28.3	24.2	24.3	23.7
Unguaranteed debt	15.4	4.4	1.7	2.5	5.0	5.9

Source: World Bank, *Global Development Finance 2001*, Washington, D.C., 2001.

[a] Bolivia, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras and Nicaragua.

The original objective of the HIPC initiative was to do away with overborrowing and reduce the level of eligible external debt[4] to

[4] In order to be eligible for reduction under the HIPC Initiative, debts have to have been incurred before the cut-off date, which is defined as the point in time when countries first agreed to renegotiate their debt with the Paris Club. Under this criterion, the cut-off dates for determining the percentage of bilateral debt eligible for reduction are as

sustainable levels. Generally speaking, given appropriate economic policies, a sustainable level of external debt is understood to be a level at which external liabilities can be met without resorting to further renegotiation, write-offs or an accumulation of arrears and without sacrificing economic growth. More recently, these objectives have been modified to give greater emphasis to freeing up resources so that, rather than being used to service external liabilities, they can be channelled into poverty reduction programmes.

Some critics of the HIPC Initiative contend that eligible countries have to travel down a long and complex road in order to benefit from it. This argument is outlined in box 3.1. The decision as to whether a country will be admitted into the programme is not taken until three years after it has adopted a reform programme, and during this period the main recourse available to the country is debt reschedulings. Moreover, the date on which debt relief will finally be provided (the "floating completion point") tends to be a distant, indeterminate point on the horizon which is subject to fulfilment of a reform programme, the achievement of macroeconomic stability targets and the creation of conditions for sustainable growth. Although steps have already been taken to streamline the initiative, its terms and conditionality continue to be restrictive.

A second criticism is that, given the established cut-off dates, only a small proportion of bilateral debt will be eligible for reduction once all these conditions have been met. As may be seen in table 3.9, the percentage of official debt eligible for reduction in the countries of the region that can avail themselves of this initiative ranges between 21% and 31% for Bolivia, Honduras and Guyana, although it is greater in the case of Nicaragua. Hence, given the larger role played by multilateral financing in the first three countries, debt relief there is likely to depend chiefly on the efforts made by multilateral agencies. These agencies are therefore likely to be faced with a significant challenge in securing enough resources to finance this programme, and this is particularly true in the case of regional and subregional institutions (Tromben, 2000). The sustainability of the debt coefficients defined in the initiative has also been the object of a great deal of controversy, especially in the case of the African countries (Botchwey, 2000).

follows: Bolivia (31/12/1985), Guyana (31/12/1988), Honduras (01/06/1990) and Nicaragua (01/11/1988).

Box 3.1
THE ENHANCED HEAVILY INDEBTED POOR COUNTRIES INITIATIVE

This initiative is divided into two phases of adjustment and economic reform: a **decision point** at the end of the first phase; and a "**floating" completion point**, which comes at the end of the second phase and is the point in time when debt reduction is applied.

First phase

The country must establish a three-year track record of sound performance and, in conjunction with civil society, prepare a poverty reduction strategy paper (PRSP). The Paris Club offers the possibility of rescheduling debt service falling due during the three-year consolidation period under the Naples terms (67% reduction in maturities). Other bilateral and commercial creditors offer terms that are, at the least, comparable.

Decision point

There are two possibilities at the end of this first phase:

- If the traditional conditions of debt reduction have been sufficient to achieve external debt sustainability **==>** exit from the initiative.
- If it is impossible to achieve debt sustainability without assistance from multilateral institutions and governments involved in the HIPC initiative **==>** eligibility.

In this case, all creditors (multilateral, bilateral and commercial) undertake to provide debt reduction at the floating completion point. The amount of the assistance depends on the reduction needed to bring the debt to sustainable levels at the decision point.

Second phase

The World Bank and IMF, working with the government in question and with broad participation by civil society and the donor community, identify structural reforms and social development actions (including macroeconomic measures) that represent a significant step towards sustainable development and poverty reduction. The World Bank and IMF offer provisional assistance within this framework. Other multilateral and bilateral creditors and donors offer temporary debt relief measures as they deem appropriate.

Floating completion point

Implementation of the reforms previously agreed upon is supervised on a transparent basis. Once those reforms have been carried out, the completion point is considered to have been reached. The Paris Club will then offer to reduce the eligible debt on more concessional terms (up to, or, where necessary, even more than 90% of net present value) in order to provide the country with a way out of its unsustainable debt position. Other bilateral and commercial creditors are to offer at least comparable treatment in terms of the volume of debt. Where necessary, multilateral institutions will take additional steps to reduce the debt to a sustainable level, seeking broad and fair burden-sharing by all creditors involved.

Source: World Bank and International Monetary Fund (IMF), "Modifications to the initiative for debt reduction in heavily indebted poor countries (HIPC)" (DC/99-25), Washington, D.C., Joint Ministerial Committee of the Boards of Governors of the World Bank and the International Monetary Fund on the Transfer of Real Resources to Developing Countries, September 1999.

Table 3.9
NET PRESENT VALUE OF OFFICIAL DEBT PRIOR TO THE HIPC INITIATIVE (1998)

	Bolivia		Guyana		Honduras		Nicaragua	
	Millions of dollars	Percentages	Millions of dollars	Percentages	Millions of dollars	Percentages	Millions of dollars	Percentages
Official debt	**3,724**	**100.0**	**1,078**	**100.0**	**3,219**	**100.0**	**5,239**	**100.0**
A. Bilateral	1,444	38.8	401	37.2	1,366	42.4	3,877	74.0
- Before cut-off date	791	21.2	335	31.1	854	26.5	3,372	64.4
- After cut-off date	635	17.1	66	6.1	513	15.9	505	9.6
B. Multilateral	2,280	61.2	677	62.8	1,853	57.6	1,362	26.0
IMF	210	5.6	127	11.8	101	3.1	41	0.8
World Bank	534	14.3	130	12.1	509	15.8	233	4.4
IDB	1,225	32.9	222	20.6	765	23.8	567	10.8
Other	311	8.4	199	18.5	478	14.8	521	9.9
Memorandum								
- Cut-off date	Dec. 1985		Dec. 1988		June 1990		Nov. 1988	

Source: World Bank, *Global Development Finance*, Washington, D.C., May 2000.

The availability of resources to finance the initiative has been a third obstacle to its implementation. Some multilateral financing institutions, particularly those with large proportions of their portfolios in eligible countries, face serious difficulties in financing the commitments they have to assume under the HIPC Initiative. This is an especially critical problem for CABEI, which incurred heavy costs in refinancing Nicaraguan debt just a few years ago. In the case of IDB, developing-country stakeholders have had to bear the cost represented by the diversion of technical cooperation resources to finance the initiative; and in the World Bank, the demand for funds for this initiative, along with others faced by this institution, has driven up borrowing costs. Some countries of the region have incurred (Mexico, in particular) or will have to incur (the Central American countries) additional commitments in connection with write-offs of bilateral debt with beneficiary countries. No overall assessment has been made of the distribution of the costs of the programme —including those associated with the decrease in the amount of funds available for technical assistance and wider interest-rate spreads— in order to prevent the burden from falling disproportionately on other developing countries.

By April 2001, four countries of the region (Bolivia, Guyana, Honduras and Nicaragua) had reached the decision point, and US$ 8.49 billion in debt service relief is to be provided to them. This corresponds to a US$ 3.012 billion reduction in present value (see tables 3.10 and 3.11). As compared to the payments made in 1998-1999 (i.e., before the Enhanced HIPC Initiative was created), this level of debt relief would translate into an effective savings in debt service equivalent to an estimated 2% of GDP

for Bolivia, Honduras and Nicaragua in 2001-2003 and a significantly greater amount for Guyana.[5]

Table 3.10
DEBT RELIEF COMMITMENTS MADE TO POOR COUNTRIES OF THE REGION UNDER THE HIPC INITIATIVE AS OF MARCH 2001
(Net present value in millions of dollars)

	Multilateral creditor sales						
	Total	World Bank	IMF	IDB	Other [a]	Subtotal	Bilateral and other creditors
Bolivia	**1,302**	194	84	467	128	873	429
Guyana	**585**	68	74	116	105	363	222
Honduras	**556**	98	30	134	77	339	217
Nicaragua	**3,267**	189	82	387	465	1,123	2,144
Total	**5,710**	**549**	**270**	**1,104**	**775**	**2,698**	**3,012**

Source: World Bank, *Financial Impact of the HIPC Initiative. First 22 Country Cases*, Washington, D.C., 10 April 2001.

[a] Includes US$ 508 million from CABEI and US$ 53 million from ADC.

Table 3.11
ESTIMATED DEBT RELIEF UNDER THE HIPC INITIATIVE

	Bolivia	Guyana	Honduras	Nicaragua
Committed nominal reduction in debt service, in millions of dollars	2,060	1,030	900	4,500
Debt service savings, on a due basis, as a percentage of GDP [a]	2.0	9.2	2.0	8.0
Debt service savings, on a paid basis, as a percentage of GDP [a]	1.8	11.8	1.6	1.6
Debt service savings, on a paid basis, in millions of dollars [a]	177.2	90.5	104.6	45.3

Source: World Bank, *Financial Impact of the HIPC Initiative. First 22 Country Cases*, Washington, D.C., 10 April 2001.

[a] Average annual savings; comparison of payments for 1998-1999 and 2001-2003.

[5] In 1999 Guyana received a reduction in debt service under the original HIPC Initiative.

These debt relief commitments represent a major contribution on the part of regional multilateral banks (IDB, CABEI and ADC) that could, in some cases, reduce their capital. This possibility has prompted proposals that all the countries of the region should help strengthen these institutions by pooling their resources to provide the necessary funds. Table 3.12 shows the cost of the HIPC Initiative by countries and by groups of creditors. In addition to the contribution being made by regional multilateral institutions, these figures demonstrate that a significant portion of Nicaraguan debt reduction costs are being absorbed by other Central American countries, particularly Costa Rica, Guatemala and even Honduras, which is itself a beneficiary of the initiative.

Table 3.12
ESTIMATED HIPC DEBT RELIEF COSTS, BY COUNTRY AND CREDITOR
(Net present value in millions of dollars as of end-1999)

	Bolivia	Guyana	Honduras	Nicaragua	Total
Total	**1,282**	**566**	**524**	**3,154**	**5,526**
Multilateral creditors	**862**	**353**	**321**	**1,060**	**2,596**
World Bank	189	66	92	179	526
IMF	83	70	29	77	259
IDB	469	114	126	365	1,074
Other [a]	121	103	74	439	737
Official bilateral creditors	**420**	**213**	**203**	**2,094**	**2,930**
A. Paris Club members	**391**	**158**	**159**	**823**	**1,531**
Australia				1	1
Austria	9			1	10
Belgium	22				22
Brazil				29	29
Canada	1	1	1		3
Denmark		1	1		2
Finland				5	5
France	18	1	5	33	57
Germany	95	7	7	213	322
Israel				1	1
Italy	20		14	41	75
Japan	143	1	88	96	328
Netherlands	8	3	2	17	30
Russia		1		235	236
Spain	43		28	124	195
Sweden	1				1
Switzerland			1	1	2
Trinidad and Tobago		88			88
United Kingdom	9	39		1	49
United States	22	16	12	25	75

Table 3.12 (conclusion)

B. Other official bilateral creditors	**22**	**27**	**41**	**1,232**	**1,322**
Algeria				18	18
Argentina		1			1
Brazil	10	2			12
Bulgary				60	60
China	7	5		3	15
Colombia			3		3
Democratic People's Republic of Korea				2	2
Costa Rica			4	369	373
Czech Republic				4	4
Former Republic of Yugoslavia				4	4
Guatemala			5	351	356
Honduras				96	96
Hungary				5	5
India		1		1	2
Irán				25	25
Kuwait		6	6		12
Libya		5		56	61
Mexico			9	41	50
Polland				6	6
Peru				7	7
Taiwan, Province of China	5		10	118	133
United Arab Emirates		1			1
Venezuela		6	4	47	57
Slovenian Republic				19	19
C. Commercial creditors	**7**	**28**	**3**	**39**	**77**

Source: IMF/World Bank, *Heavily Indebted Poor Countries (HIPC), Progress Report* (DC2001-0012), Washington D.C., 2001.

[a] Includes CABEI and ADC.

Given this situation, it is clear that further adjustments need to be made in the HIPC Initiative in order to ensure that it will operate smoothly, achieve its aims and be properly funded. One of the highest priorities in the use of the HIPC Trust Fund should be defraying the costs borne by the corresponding subregional banks.

(d) Financing the sustainable development agenda

One of the most positive developments on the official financing front during the last decade has been the implementation of specific initiatives for financing the global sustainable development agenda. These initiatives have primarily been launched by multilateral banks themselves. Both the World Bank and IDB have allocated significant

sums for environmental management. In 1999, the World Bank's environmental portfolio in Latin America and the Caribbean amounted to about US$ 3 billion, or one fifth of the total resources allocated to this sector worldwide. The main targets of these projects in the region were pollution and urban environmental management (50%), natural resource and rural environmental management (34%), and institution-building (9%). Approximately 9% (US$ 894 million) of total IDB lending in 1999 went to environmental or natural resource conservation projects. In this case, the main targets were urban management (especially anti-pollution and drinking water projects), natural resource conservation, and the prevention and mitigation of natural disasters. Initiatives in this field are also being pursued by subregional banks.

A number of innovative multilateral financing mechanisms have been devised to finance the implementation of the global environmental agenda by developing countries. Two of these, the Global Environment Facility (GEF) and the Multilateral Fund of the Montreal Protocol, are fully operational, although their resources are limited in comparison to the scope of existing international commitments. GEF was set up in 1991 to enable developing countries to meet the incremental costs of tackling global-scale environmental problems (loss of biodiversity, climate change, depletion of the ozone layer and environmental problems relating to international waters and desertification). The financial contribution made by GEF up to 1998 amounted to over US$ 2 billion, and about one fifth of this was used to finance projects in Latin America and the Caribbean. The executing agencies for this facility are the World Bank, the United Nations Development Programme (UNDP) and the United Nations Environment Programme (UNEP), with most of the funding coming from developed countries. The Multilateral Fund of the Montreal Protocol provides financial assistance to developing countries in order to help them find alternatives to ozone-depleting substances used in a number of industrial processes. Since 1990 the Fund has disbursed over US$ 1 billion.

Negotiations on the Kyoto Protocol are introducing new approaches to investment and financing for sustainable development. Since 1997 the international community has been negotiating the "clean development mechanism" (CDM) defined in article 12 of the Protocol, which is designed to complement the United Nations Framework Convention on Climate Change. This mechanism gives developed countries the chance to meet their greenhouse gas reduction commitments (mainly carbon dioxide) at less expense than the investment that would be required to do so nationally and, at the same time, gives developing countries an opportunity to reduce carbon emissions at a lower cost. Under this provision, certified reductions in greenhouse gas emissions in developing countries resulting from energy efficiency projects or the

conservation and management of forests (which operate as carbon sinks) could be "sold" to developed countries to enable them to meet their emission reduction commitments at a lower cost.[6] These negotiations have not yet been concluded, however, and many issues surrounding the CDM remain to be resolved, including transaction costs, market prices and adaptation strategies. Pilot schemes are being tried out in Costa Rica, which has been a pioneer in this field, and elsewhere in the region with a view to paving the way for the full application of the Kyoto Protocol.

One of the most innovative aspects of this mechanism is that it could be the start of a genuine system for pricing global environmental services and turning them into tradables. It also shows that developing countries have promising opportunities for diversifying their comparative advantages as they pursue the international environmental agenda. The appraisal of global environmental services opens up an opportunity for resource and technology transfers to countries with major comparative advantages in terms of forests, biodiversity and the potential for achieving greater energy efficiency through a reduction in the use of fossil fuels.

3. Access to private international finance

Countries' varying degrees of access to private resources in the international financial system are a function of many different factors whose individual weights are difficult to establish but which, taken together, help determine how attractive the region is in the eyes of foreign investors and how much confidence it inspires in them. The following discussion will focus on two alternative means of gaining access to private flows: the creation of an attractive financial environment, and the promotion of FDI.

(a) Development of an attractive financial environment for private investors

The region's ability to attract long-term external financing on a competitive and stable basis will largely be determined by the countries' success in strengthening their national financial systems (banking and

[6] The total annual emission reduction required of developed countries is calculated at approximately 1.3 billion tons of carbon. Recent estimates put the price of reducing one ton of carbon —in the absence of international emissions trading— at between US$ 584 per ton in Japan and US$ 116 in transition economies. With the participation of developing countries through the CDM, however, the price would come down to US$ 24 per ton (Ellerman, Jacoby and Decaux, 1999).

capital markets) so that they can offer risk-return profiles which financiers will regard as being more attractive and safer than those of other regions.

The emphasis on profitability and country risk as factors influencing the inflow of private external resources has spurred the implementation of policies aimed at strengthening external solvency and stability and creating mechanisms for absorbing exchange-rate risk. Recently, greater attention is being devoted to devising means of rating private debt issuers more accurately, formulating regulations and legal provisions to protect minority investors from abusive practices on the part of controlling stakeholders, and promoting transparent reporting by corporate managers.

One of the main reasons why there is such an urgent need to bring the region's financial regulations up to international standards is the increasing presence of foreign private institutional investors (pension funds, investment funds and insurance companies). In addition to these investors' natural desire to gain a better understanding of the risks existing in new markets, regulatory authorities in the more developed countries have been making a greater effort to safeguard investors' solvency by making sure that they properly assess the implicit risks associated with all the assets contained in their portfolios. This has drawn attention to institutional shortcomings in the countries of the region that are limiting their access to this market. Overcoming these failings will be a key element in the region's bid to position itself in international financial markets.

The difficulty of reconciling the accounting and regulatory practices of countries in the region with those of private investors' home countries is a problem which, at the very least, calls for a special effort on the part of providers of external funds to improve their reporting practices. Furthermore, this explicitly closes off access to some of the least expensive sources of external funds for potential borrowers in the region. Although some countries have made progress in this area, the region continues to exhibit major lags, especially in terms of regulations governing the capital market and those designed to promote transparency and sound corporate governance.

The modernization of regulatory practices and the introduction of effective prudential supervision —both of which should be oriented towards progressively raising standards until they match those prevailing in more developed financial centres— are one of the main tasks that the region must complete in order to position itself appropriately in international financial markets. The consensus surrounding the Basle Committee's recommendations regarding banking regulation and supervision has paved the way for legislative advances in this area. A

number of major shortcomings remain, however, as will be discussed in greater detail in the following chapter.

(b) FDI: characteristics and guidelines for enhancing its contribution to development

Between the 1950s and the 1970s, foreign investment was primarily channelled into manufacturing activities geared to supplying the region's heavily protected national markets. More recently, international market trends and the new patterns of competition resulting from financial and trade liberalization have drawn the interest of new entrants and forced transnational corporations operating in the region to rethink their strategies.[7] This has altered investors' orientations and the part played by FDI in external financing.

Table 3.13 summarizes the investment strategies, broken down by production sector, used by transnational corporations operating in the region. As will be seen, the reorientation of FDI was triggered by transnational corporations' own pursuit of greater efficiency in their integrated international production systems. Illustrative examples are provided by investment and exports in Mexico and the Caribbean Basin. In most cases these are United States firms that are exploiting specific advantages —low wages, geographic proximity and preferential access to that market— to become more competitive in their own country so that they can contend with competition from Asian firms (ECLAC, 2000b, chapter II and 1998c, chapter IV).[8] Other foreign investors have sought access to national and subregional markets for manufactured goods. This strategy has led them to invest heavily in the automotive, food, chemical and machinery industries with a view to supplying large local and subregional markets (ECLAC, 1998c, chapters II and IV). In addition, the deregulation process in Latin American economies —and especially the privatization of public-sector assets— has opened up investment opportunities in sectors that previously had been off-limits to private-sector activity generally and to foreign firms in particular. This has resulted in an influx of firms that previously did not maintain a major presence in Latin America, particularly in services and extractive industries.

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[7] Some of the transnationals operating in Latin America withdrew (in some cases continuing to supply local markets with exports from their countries of origin or from subsidiaries); others have tried to defend or increase their market share by rationalizing their operations (chiefly on the basis of strategies for defending themselves against imports) or by restructuring and making new investments (ECLAC, 2000b).

[8] There are a number of provisions that give United States firms special access to their own market, notably Rule HTS 9802, which allows firms based in the United States to export components originating in that country for assembly abroad and then re-import them while paying tariffs only on the value added abroad (ECLAC, 2000b, chapter IV).

Table 3.13
LATIN AMERICA AND THE CARIBBEAN: STRATEGIES OF TRANSNATIONAL CORPORATIONS IN THE 1990s

Corporate strategy Sector	Efficiency	Raw materials	National or regional market access
Primary		**Oil/gas**: Argentina, Bolivia, Brazil, Colombia, Venezuela **Minerals**: Argentina, Chile, Peru	
Manufactures	**Automotive**: Mexico **Electronics**: Caribbean Basin, Mexico **Clothing**: Caribbean Basin, Mexico		**Automotive**: Mercosur **Agribusiness**: Argentina, Brazil, Mexico **Chemicals**: Brazil **Cement**: Colombia, Dominican Republic, Venezuela
Services			**Finance**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela **Telecommunications**: Argentina, Brazil, Chile, Peru **Electric power**: Argentina, Brazil, Central America, Colombia **Gas distribution**: Argentina, Brazil, Chile, Colombia **Tourism**: Central America, Caribbean Basin, Mexico

Source: ECLAC, on the basis of data from the Unit on Investment and Corporate Strategies of the Division of Production, Productivity and Management.

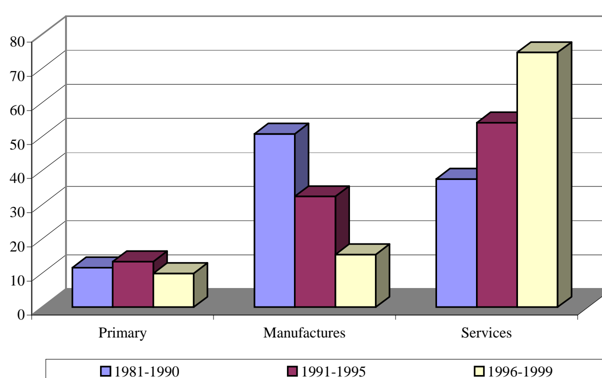
Decisive factors in the entry of foreign investors in the services sector have included the size of the local market, the regulations in place and technological changes. Their impact can be seen through the contributions they have made to systemic competitiveness in the economy as a whole, the access of the population to new products and services, and the dissemination of international best practices. This is of the utmost importance in Latin America and the Caribbean, as investment in these sectors grew significantly in the 1990s —especially in telecommunications, electricity, financial services and retail trade— and has come to represent an increasing proportion of total FDI, as shown in figure 3.2.[9] The arrival of transnational corporations in the region's extractive industries brought a new model for the organization of

[9] European firms have been particularly active here, especially Spanish companies that have focused on member countries of the Southern Common Market (Mercosur) and Chile. As a result, Spain has become the second largest investor in the region and the largest of European origin (Calderón and Casilda, 2000; ECLAC, 2000b, chapter III).

production, the application of new technologies and regulatory changes in countries possessing natural resources. In general, the benefits brought by these investments have been increased exports of natural resources and construction of the necessary infrastructure.

While FDI has certainly supplemented domestic saving in providing investment financing, some aspects of foreign firms' impact on recipient economies warrant more careful scrutiny, as they offer important national policy lessons. In some cases, economic authorities have looked to FDI for a more stable source of financing to cover external deficits and a means of modernizing the production apparatus and thus improving productivity and international competitiveness, but these objectives that have not been fully achieved.

Figure 3.2
LATIN AMERICA: SECTORAL DISTRIBUTION OF FDI, 1981-1999
(Percentages)



Source: ECLAC, on the basis of official data processed by the Unit on Investment and Corporate Strategies of the Division of Production, Productivity and Management.

A large proportion of these capital inflows have been generated by the transfer of existing assets, rather than the creation of new production units. Their contribution to gross fixed capital formation has therefore been limited, since the purchase of existing assets has been the modality most frequently used by foreign investors in the region. In the early 1990s (and in some countries, especially Brazil, in the last few years as well), these purchases were occasioned by the privatization of State-owned enterprises; more recently the focus has shifted to the acquisition of private firms. The purchase of existing assets accounted for around 40% of the total between 1997 and 1999, and the figure had been even higher in

earlier years.[10] In addition, a large proportion of greenfield investment in the region has focused on the modernization and expansion of recently acquired service enterprises (ECLAC, 2000b and 1998c).

Nonetheless, privatization programmes did provide additional revenues that helped finance structural reforms and ease external constraints. Even though, at least initially, it has not increased production capacity, this type of investment has made it possible to improve the quality of services (mainly telecommunications, transport, and power generation and distribution), and this has had a positive effect on the systemic competitiveness of recipient countries.

Since these high levels of FDI largely stemmed from changes in ownership among the leading enterprises in the largest economies of the region, they were bound to be a temporary rather than permanent feature of these economies. Inward FDI has probably peaked, and it is quite possible that FDI inflows will decline in relative terms over the next few years. The downturn in FDI in 2000 and 2001 is, in effect, a reversal of the upward trend seen until then and, for the reasons noted above, may be a long-lasting one. In any case, as noted in chapter 1, multinational corporations' growing involvement in the region's development ensures that FDI levels will remain significantly higher than they were before the 1990s.

The contribution made by FDI to development has been modest from the standpoint of national integration, however. On the one hand, export development focusing on natural resources or on natural-resource-based industrial commodities continues to reproduce enclave economies, mainly in oil and mining. On the other hand, in the case of the export model based on the assembly of manufactured goods (found chiefly in Mexico and the Caribbean Basin), the rules of access to the United States market virtually prohibit the use of physical inputs produced locally, thereby limiting the formation of positive production linkages.[11] Nevertheless, despite the scant local content of many of these activities, the incorporation of cutting-edge technology, together with the creation of a few incipient technological clusters and an impressive increase in exports, make these experiences positive ones in terms of their contribution to the international competitiveness of host economies.

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[10] The boom in mergers and acquisitions reflected the many operations carried out in the largest Southern Cone countries, including privatizations in Brazil in 1997 and 1998 (Telecomunicações Brasileiras (TELEBRAS) and electric power distribution companies) and the sale of local private-sector enterprises in Argentina and Chile in 1999 (Yacimientos Petrolíferos Fiscales (YPF) and ENERSIS S.A.).

[11] Mexico's entry into NAFTA has given it greater advantages over the Caribbean Basin countries (Mortimore, 1999).

The large investments made by many foreign companies in restructuring their long-standing operations in the Mercosur countries and the arrival of new entrants in response to the changed competitive landscape have significantly increased these industries' export potential. Even though most of these firms cater to domestic markets, the need to compete with imports has forced them to become more competitive in international terms.

Despite the positive systemic effects that FDI has had on external competitiveness, steps need to be taken to prevent an excessive bias towards non-tradables, since this could generate future balance-of-payments pressures. The adoption of proactive policies aimed at promoting a greater convergence between national objectives and those of foreign investors has a key role to play here.

In order to overcome the external vulnerability of the region's economies, priority should be placed on using FDI to help create a competitive production structure. In countries with a relatively abundant natural resource endowment and a supply of the required types of labour, FDI could contribute to the development of the kinds of industrialization processes and manufactured-goods export models seen in more developed countries. While it is true that investments made to gain access to raw materials and those aimed at boosting efficiency both tend to strengthen the recipient country's export performance, manufactures are the most dynamic category of exports, have the highest technological content and offer the greatest potential for positive externalities for the rest of the country's economy. In cases where tourism-related resources and skills predominate, association with foreign investors provides access to international quality standards and management practices.

Although trade liberalization and deregulation are necessary to attract FDI and stimulate exports, the Latin American experience shows that they are not enough in themselves to promote technological dynamism, foster the formation of positive linkages with the rest of the economy or help ensure environmental protection. It is therefore important to design active policies for the development of production and to adopt a proactive stance towards FDI in promoting a closer match between national development goals and the objectives of transnational corporations.

The growing convergence of foreign investment regulations in most Latin American and Caribbean countries has tended to erode the spurious advantages that can arise from the existence of different legal frameworks. Instead, the countries of the region are using other means of differentiation in an effort to stand up to strong international competition for investment. These include measures designed to enhance and promote

their countries' "image" and to create a generally pro-investment environment by furthering the development and increasing the sophistication of factors of production (human capital, finance, etc.), infrastructure, and the institutional framework for technological research and development. The articulation of FDI and long-term development policy thus emerges as the chief strategy for sustaining investment flows and strengthening their contribution to the development of the countries of the region.[12] If a clearly defined policy of this type is absent, FDI is likely to be less beneficial and less effective in contributing to the host country's development.

[12] Leading examples are provided by Ireland, Scotland and Singapore, and, increasingly, Costa Rica, where national institutions have been proactive in channelling investments towards the higher value-added and higher-technology categories of manufacturing and towards priority activities, goals or regions.

Chapter 4

Mobilizing domestic resources to provide financing for development

As ECLAC has noted in previous documents (ECLAC, 2000b and 1996), if the countries of the region are to reduce their income gap with the developed countries and bring poverty levels down at a desirable rate, per capita income will need to grow by 4%-5% a year. Depending on the particular demographic characteristics of each country, this would mean that GDP growth would have to be between 5.5% and 6.5% and investment rates would have to around 26%-28%, i.e., between four and six percentage points of GDP higher than the averages for the 1990s. To avoid the volatility-related risk that a higher level of external financing might entail (see chapters 1 and 2), a corresponding increase in domestic saving would be essential. In addition, from a microeconomic and financial standpoint, a proper allocation of household, corporate and government saving is important to ensure adequate investment financing, since otherwise savings efforts may be frustrated. Consequently, policies are also needed that will result in the development of solid financial systems capable both of supplying funds on suitable terms and conditions for profitable investments by business enterprises of all sorts and of ensuring security, liquidity and profitability for savers.

This chapter is organized around these two facets of national financing. The first two sections deal with the complexities involved in designing savings policies and explore a number of policy options for raising corporate, household and government saving. The third section looks at the policy principles required to strengthen the role of the

banking system, the capital market and development banks in financing productive investment.

1. The complexity of saving

Recent international crises have provided valuable lessons about how to deal with the new challenges involved in financing development in a context of globalization. They have also served to confirm the enduring validity of a number of tenets, among them that economies with high levels of external saving are vulnerable to international cycles and that the maintenance of prudent and sustainable limits on current account deficits ought to be an ongoing objective for national economic authorities. The corollary of this is that the bulk of investment financing should come from domestic saving.

Despite the relationship between national saving and future economic prosperity, it is difficult to implement policies that will succeed in raising savings rates. The main political difficulty is that, in most cases, higher saving entails a reduction in present welfare. Reducing budget deficits, achieving financial balance in pension systems and promoting —or even compelling— prompt payment of debts, to name just a few examples, can carry a high political cost in the short run while producing major economic benefits in the medium term. Voluntary saving is another highly complex phenomenon, as decisions to save depend on a vast number of variables, many of which cannot be controlled by the economic authorities. Effective strategies for its promotion are therefore very difficult to design.

Saving behaviour is one of the factors to which economists and economic authorities pay the greatest attention. Nonetheless, there is still a great deal of debate as to what its determinants are and what policy recommendations should be made in order to foster a greater willingness to save. Although the following discussion will by no means provide an exhaustive analysis of this question, it will identify some of the difficulties involved and set out a number of elements that could serve as a basis for the design of effective policies to promote saving.

First of all, saving decisions are, by definition, intertemporal and are influenced not only by present opportunities, incentives, policies and institutions, but also by perceptions about the future. A climate of greater predictability —within a sound, stable macroeconomic environment— is a necessary (but not sufficient) prerequisite for any strategy to increase

saving.[1] Likewise, in an economy whose financial system is weak, or where property rights are ambiguous or economic agents are at the mercy of discretionary decisions by third parties, be these public or private, voluntary saving and its use to finance productive investment will be discouraged. When it comes to creating a climate of confidence in order to encourage saving, it is particularly important to have an institutional structure that motivates borrowers, lenders, intermediaries and regulators to establish transparent financial contracts and to comply with them. This same structure must also provide for appropriate prudential regulation to protect the owners of financial assets from systemic risk. Clear and transparent ground rules are an integral part of a pro-saving environment, while corruption, tax evasion, money laundering and poorly functioning judicial systems, among other institutional failings, undermine the predictive capacity that is essential to saving and investment decisions, to say nothing of the obvious unacceptability of these institutional flaws on ethical grounds.

A second type of complexity arises from the absence of a clear relationship, either theoretically or empirically, between the return on savings —normally represented by the after-tax interest rate— and personal and household savings rates. As profitability rises, it is difficult to predict whether people will save more because saving is better rewarded (substitution effect), or whether they will save less in order to attain a given future level of expenditure (income effect). This theoretical complexity has not been resolved by the empirical evidence, which is ambiguous and evinces a statistical relationship that in most cases differs from zero by no more than a negligible margin. Despite the theoretical and empirical ambiguity of the link between saving and profitability, however, many countries have developed incentives —particularly tax incentives— to raise the return on saving in the hope that saving will increase accordingly.

This ambiguity is largely due to the fact that existing incentives focus more on asset ownership than on saving as such. Personal and household saving, like that of any other agent, is the difference between current income and current spending, and its corollary is an increase in wealth through the acquisition of assets or a reduction of liabilities. Incentives for ownership of particular assets are therefore, by definition, incomplete. Theoretically, incentives should focus on the flow of saving,

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[1] The subject of macroeconomic balances is analysed only briefly in this section. This should not, however, be construed as implying that the adoption of sound and consistent macroeconomic policies is of only incidental importance to saving. It is impossible to overemphasize the importance of sound macroeconomic management as a necessary condition for stimulating saving and investment.

defined as current income minus current expenditure. This consideration gives rise to a persuasive criticism of fiscal systems that tax income rather than expenditure. The argument here is that personal income taxes discriminate against saving because they tax the income that is saved and then, later on, tax the profits on those savings. Thus, there is an element of double taxation on savings that could theoretically be eliminated by replacing income taxes with (progressive) taxes on consumption. Under such a system, consumer loans would be taxed but the service on those borrowings would be exempt. Systems of this kind are, however, so difficult to design and administer that they are essentially infeasible, as they would require natural persons to maintain comprehensive financial accounts so that they could determine their own tax base.

In the absence of taxes that fully reward personal and household saving, tax systems generally have total or partial exemptions for income derived from the ownership of certain assets, such as the interest earned on deposits in the financial system.[2] This stimulus is, however, subject to the following leakages, which diminish its potential: (i) it benefits not only saving, but existing assets as well, and there is no guarantee that the proceeds from the latter will not be used to finance additional consumption; (ii) some saving would have taken place even without the incentive; (iii) there is an incentive to alter the composition of portfolios so as to raise the proportion of tax-exempt assets, without producing any increase in net saving; and (iv) if the incentive is a subsidy rather than an exemption, the profitability of the subsidized assets may exceed the cost of borrowing funds, thereby encouraging taxpayers to "borrow to save". In this case there is no additional saving. These arguments highlight the income effect generated by incentives aimed at boosting the profitability of personal and household saving. In addition, incentives for asset ownership have a fiscal cost in the form of lower tax receipts, which reduces public-sector saving.[3] In order for national saving to rise, personal saving has to rise by more than public-sector saving falls. In other words, households need to increase their saving by an amount greater than the benefit received (they need to reduce their consumption).

A third difficulty is that there is no guarantee that the savings of certain agents will be used by them or other national agents to finance new productive investment or to provide additional working capital. For

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[2] These incentives are also generally justified on the grounds that they foster a habit of saving or give pro-saving policy signals. In these cases, there is an implicit assumption of irrationality on the part of economic agents which does not always have a basis in fact.

[3] This argument assumes that current spending by the public sector remains unchanged. If expenditure is reduced in order to keep public saving constant, then national saving will rise for this reason, not because of the incentive.

example, all things being equal, higher savings invested in external assets will increase national saving, but they are also likely to result in lower net external saving, without there necessarily being any increase in domestic productive investment. Similarly, by definition, any new borrowing makes use of the savings of other agents. This use of others' savings may go to finance borrowing for consumption, temporary losses, interest debt reschedulings and write-downs, purchases of existing fixed assets or financial assets, or fiscal deficits. Productive investment competes for financing with these and other uses for savings. Consequently, financial saving does not always coincide with national saving.

Most private uses of savings for purposes other than investment financing are legitimate, however, and there is no reason to discriminate against them. For example, prudent access to consumer credit leads to greater well-being, although the fact remains that excessive borrowing will invariably be counterproductive. What is more, the purchase of durable consumer goods does in fact have an investment component (albeit a non-productive one), and the financing provided for such purposes has a savings component, since goods of this kind, once purchased, yield a benefit in terms of consumption and an improved quality of life over a long period. The accounting conventions used in national accounts, for example, treat housing investment as part of gross fixed capital formation, even though housing for one's own use is a durable consumer good rather than a capital good.[4] There are also types of expenditure that clearly have a component of productive investment in human capital even though national accounts treat them as consumption, such as expenditure on education. From the point of view of policy design, there is no reason to discriminate against alternative uses of savings, except, of course, as far as is necessary to ensure that borrowing is prudent, sustainable and transparently managed.

The key point, though, is that productive investment has to compete for financing with alternative uses of savings. In accounting terms, only savings that finance investment constitute national savings. In the final analysis, then, it is national saving, plus external saving, that finances investment, as defined in accordance with national accounts conventions.[5] Thus, a favourable climate for productive investment is also a necessary —although not sufficient— condition for higher national

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[4] Under the same accounting convention, GDP figures in national accounts include a contribution from the housing stock equivalent to the income that it is hypothetically capable of generating.

[5] For national accounts purposes, investment is defined as the sum of gross fixed capital formation plus changes in inventories, and investment financing is defined as the sum of national saving plus external saving (deficit on the balance-of-payments current account).

saving. Most of the ingredients of a pro-savings environment —predictability, a sound financial system, appropriate macroeconomic policies, etc.— are also conducive to productive investment. When it comes to designing incentive policies, on the other hand, there is less ambiguity regarding methods for enhancing productive investment than there is in the case of policy measures for boosting saving.

2. Policies for boosting public and private saving

Despite the complexities outlined in the preceding section, there is considerable scope for using specific types of policies, over and above those already noted, to stimulate national saving. The general thrust of all such policies is to encourage, urge and even oblige economic agents to save. For the most part, in the following discussion corporate, household and public-sector saving decisions are dealt with separately. From the point of view of their future growth potential, the public sector and business enterprises are the agents that have the capacity to make the greatest contribution. This is because individuals and households take saving decisions primarily as a function of intertemporal consumption decisions. Those decisions, in their turn, are based on increases in income which are basically determined by macroeconomic conditions (growth) and income distribution. Firms, by contrast, have an ongoing interest in the accumulation process, and governments whose fiscal authorities work on the basis of a medium-term policy horizon have an ongoing interest in maintaining stability and in ensuring that they do not crowd out the private sector. These issues will be explored in greater depth in the following analysis.

Of course, there is no guarantee that the successful use of one of the above mechanisms to boost saving will necessarily contribute to the financing of productive investment. As mentioned earlier, saving by some agents may be used to finance other types of spending. Any increase in national saving needs to be accompanied by a simultaneous and matching effort to stimulate productive investment, to channel savings into this type of investment and into long-term financial instruments, and to develop appropriate financial intermediation mechanisms.

(a) Reinvestment of corporate profits

One of the main lessons to be learned from the “Asian miracle” is that corporate saving must be channelled into productive investment if a country is to succeed in furthering its development (Akyüz and Gore, 1996). Another lesson to be learned from this experience, however, is that

specific policies need to be used to encourage firms to reinvest their profits.

Gross corporate saving consists of firms' reinvested profits and depreciation funds. Companies can also choose to finance their operations with other agents' savings by borrowing, which they may do in many different ways, or by issuing equity. The conventional theory on optimum corporate behaviour is not yet capable of accounting for business investment and financing decisions simultaneously. On the one hand, investment theory assumes that the structure of financing —when broken down into reinvested profits, borrowing and capital contributions— is exogenous. Under this assumption any increase in investment will raise profit reinvestment and borrowing by generally predictable percentages. On the other hand, according to the theory of corporate financing, which looks at the financial structure as such, regardless of the amount of the investment, reinvested profits take the place of other sources of financing. According to this theory, the tax structure is crucial in determining the financial behaviour of business enterprises.[6] If taxes on reinvested profits are low, then reinvestment will become the main source of financing, and there will thus be a major stimulus for saving. This tallies with investment theory, which states that reductions in taxes on reinvested profits are a more effective incentive for productive investment than equivalent reductions in taxes on distributed profits. Reinvestment will reduce the flow of dividends to shareholders, at least in the short run, but there is a counterbalancing effect because a larger volume of reinvested profits will raise the market value of the company. Hence, shareholders will realize capital gains that will compensate them for the reduction in dividend receipts. At the extreme, under a system of taxation that operates on a withdrawal basis, profits would be tax exempt until they were withdrawn. To sustain tax revenues from capital income —which is the correct way to measure the impact of alternative tax structures— reductions in taxes on reinvested profits would have to be offset by increased taxes on distributed profits. Otherwise, there is a risk that tax revenues will decrease, thereby reducing the public sector's contribution to national saving.

Taxation on a withdrawal basis entails serious practical problems, however. First, it would need to be applied across the board. If such a scheme were applied only to certain activities while others were subject to the traditional sort of tax on corporate profits or to a presumptive income system, a substantial volume of revenue might be lost. This is because

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[6] The Modigliani-Miller theorem asserts that with perfect prediction, and in the absence of risk and bankruptcy, the tax structure will be the sole consideration for a company in determining its financing structure.

when different tax schemes overlap, tax planners will concentrate profits in firms to which a withdrawal-basis tax scheme applies and withdrawals in firms to which other tax systems apply, using transfer prices to shift profits and liquidity around. Second, the withdrawal-basis system requires closer oversight, more complicated accounting procedures and an entire range of complementary tax regulations to prevent the use of simulations that will allow firms to take advantage of legal loopholes.

The decision to move towards a withdrawal-basis tax seems less advisable in countries that have a high degree of tax erosion (due to exemptions, special tax regimes, poor administration, etc.). In such cases, legally mandated tax incentives exist more in theory than in practice, since non-payment of taxes erodes both revenues and, to an even greater extent, the desired effect of incentives. In such cases, there are all the costs associated with the use of more complex tax schemes but the benefits are more uncertain. In such situations, it seems more advisable to concentrate efforts on reducing tax erosion by using simpler systems, and it will always be easier to tax income at the source. In countries with more effective tax systems, on the other hand, there is less of a gap between the intent of the law and its practical outcome, and the costs and benefits of alternative systems can be weighed more accurately.

Some of the simpler ways of improving tax systems inadvertently increase the propensity of firms to borrow rather than to reinvest profits. The recommendations concerning these methods aim at increasing corporate saving as a source of investment finance and reducing the propensity to borrow. The clearest example of this is the practice, which is quite common in many countries, of making nominal interest payments deductible as a business expense. In the absence of monetary correction for the effects of inflation, however, real after-tax interest contains an implicit tax incentive which generates an artificial bias towards a greater use of borrowing as a source of corporate financing. The greater the inflationary component in the nominal interest rate, the greater the hidden incentive to borrow. The obvious solution is to introduce adjustments to correct for the accounting effects of inflation.

Another element worth considering is the way accelerated depreciation is treated in countries that have consolidated their profits tax with the top marginal personal income tax rate. As is well known, skilfully designed accelerated depreciation schemes are a powerful tool for stimulating productive investment. Their main effect is the benefit derived from delaying the payment of profits taxes because of the difference between financial profits (with normal depreciation) and accounting profits (with accelerated depreciation). Countries that have consolidated their profits taxes with personal taxes make profit

withdrawals tax exempt based on the argument that such withdrawals have already been taxed within the company. The combined effect of accelerated depreciation and tax consolidation is that the benefit is extended to personal taxes, as untaxed profits can be withdrawn while maintaining the exemption for personal taxes. One possible solution to this problem is for financial profits deriving from accelerated depreciation to be recorded as taxable accounting profits upon withdrawal. This approach preserves the incentive for using retained profits as a source of finance, since taxes on those profits are deferred until their withdrawal, and, at the same time, prevents leakage into personal income of a tax benefit whose primary intent is to increase investment financing.

The list of cases is a long and specialized one. What is clear, however, is the importance of evaluating and reviewing tax and accounting rules to detect hidden biases that may inadvertently discourage the reinvestment of corporate profits.

(b) Household saving

Intertemporal consumption decisions are associated with intertemporal saving decisions, where expectations of future income play a determining role. People may decide to save now and consume later, or to borrow and consume now and to save later (when they pay off their consumer debts). This characteristic of personal saving provides a useful opening for institutional efforts to promote saving habits. Incentives and regulations designed to encourage, or force, individuals and households to save for specific purposes are less subject to leakage and thus have a greater potential for raising saving rates.

The most obvious case is that of social security saving, which is used to finance old-age pensions, survivors' benefits and disability pensions. Pension systems have rules making the payment of contributions mandatory (forced saving), and the rights conferred under pension systems have the force of law. Underfunded pension systems have two negative effects on saving. On the one hand, their deficits compete for financing with other uses, which means that they drain off resources that would otherwise be available for financing investment (national saving). On the other hand, saving in pension schemes is a partial substitute for voluntary saving by contributors, since if there were no formal pension system many individuals would save voluntarily. The extent to which substitution takes place will depend more on the expected benefits (which are linked primarily to pension system expenditure) than on the level of contributions (linked mainly to pension system revenues). Furthermore, the expected benefits are also influenced by people's life expectancies. As this increases over time, without there being a matching

increase in contributions, pension systems invariably exhibit a tendency towards underfunding. So long as contributors do not feel that this underfunding will threaten their pension rights, however, they will have no incentive to increase their voluntary saving. The obvious conclusion is that pension systems need to be constantly assessed so that any deficits, whether current or actuarial, can be corrected without damaging the redistributive elements that any pension system should ideally contain.

The conversion of pension systems into privately managed individual capitalization systems, such as those introduced in a number of countries in the region, represents a special case. Theoretically, from the point of view of their contribution to saving, there are no major differences between individual capitalization, or funded, systems and pay-as-you-go systems, with more important factors being the level of contributions, the system's coverage, retirement age, management costs, State pension insurance and, in the case of pay-as-you-go systems, replacement rates. Another important factor is how sensitive the system's benefits are to pressure from organized groups, whose cumulative effects are greater in older systems. The chief point is that, regardless of the pension system's institutional structure, the smaller its deficit or the larger its surplus is in terms of both flows and present value, the greater its contribution to saving will be.

Although alternative systems ought to be evaluated primarily on the basis of their effectiveness as pension schemes, it must be recognized that individual capitalization systems have the additional advantage of helping to improve the operation of local capital markets, both because efforts have to be made to develop and expand these markets if such systems are to operate and because the existence of this kind of link between the capital market and the pension system necessitates greater transparency and governance. If national saving is to be increased, however, the development of local capital markets requires a concomitant effort to find ways to ensure that institutional investors, and particularly pension systems, will use their long-term resources to finance productive investment. This, in turn, means that instruments and rules for assessing risk and profitability conditions need to be devised. This subject will be discussed in greater detail further on.

Another highly significant aspect of pension reform is the fiscal management of the system during the transition period. By their very nature, these reforms have a long transition period, since for several decades the State will be obliged to cover the revenue loses of the old pay-as-you-go system while the new capitalization system builds up sufficient income, over a span of many years, without being obliged to pay out equivalent benefits. The pension savings built up by capitalization

systems may, in fact, be more than offset by the dissavings or deficits generated by the pay-as-you-go systems, since they are losing their revenues while continuing to pay out benefits. Financing these deficits by issuing government bonds that are paid for with the surplus from the new system does not generate net saving in the short term and can steer the system as a whole in a dangerous direction. Consequently, if these reforms are to be sustainable over time, fiscal efforts have to be made to offset the larger public-sector social security deficit arising as a consequence of the reform. Of course, the greater this effort, the stronger the effect on overall saving.[7]

This line of reasoning is predicated on the existence of forced saving, which may be higher or lower than the voluntary saving that would have taken place if there had been no pension system. In the first case, there will be a net contribution to saving, since people are being forced to save more, unless they are able to borrow against their pension savings. Although it will never be possible to eliminate all leakage from the system, it is advisable to introduce legal provisions to prevent people from either drawing on these savings for non-pension purposes or using them as collateral for personal loans. In the second case, pension saving is substituted for voluntary saving and does not represent a net contribution to overall saving. In either cases, it is advisable to permit additional voluntary contributions or to set up complementary systems for voluntary pension saving. Apart from the institution-building that a complementary system will require, it seems best to exempt voluntary contributions to such a system from personal taxes and then to tax whatever benefits are subsequently paid out. To avoid leakage, the rule that pension savings may be drawn upon only for pension-related purposes should also apply to tax-exempt voluntary pension savings, and their use as loan collateral should be restricted.

In addition to pension saving, another way of boosting personal and household saving is to put the emphasis on savings set aside for specific and clearly identifiable purposes. For example, targeted subsidies can be provided for saving to purchase a home or to pay for a child's education (particularly higher education, which has a higher direct cost and a greater opportunity cost for students of working age). These subsidies can be allocated using a scoring system which rewards prior saving and reflects household income and living conditions; they should

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[7] The question of how pension system reforms affect national saving and how this is related to the fiscal deficit generated by the changeover from a pay-as-you-go to an individual capitalization system has been analysed by ECLAC on the basis of Chile's experiences in this area. See ECLAC (1999, chapter VII), Arrau (1996), Holzman (1997), Uthoff (1998) and Mesa-Lago (2000).

come into effect only when the targeted event occurs (the purchase of a home or admission into an institution of higher education, in the examples given). Although such incentives are also subject to leakage, their income-effect components are clearly weaker than those associated with general incentives to asset ownership.[8]

Another case worth mentioning is that of personal saving as a hedge against unforeseen events. Such contingencies can best be dealt with through a good insurance and reinsurance system. Indeed, insurance policies represent an important form of saving. Life insurance is the most obvious example, and there are a variety of ways of encouraging people to purchase such policies, although all of them necessitate a reliable regulatory framework that meets international standards. Some of these savings mechanisms may be compulsory, as in the case of individual capitalization pension systems, where the pension is generated by the purchase of a life annuity that is paid out by the pension fund upon retirement. Other examples are disability insurance provided under the pension system and fully or partially self-financed unemployment insurance. Housing mortgages or other types of long-term personal loans generally require borrowers to take out mortgage life insurance and other forms of insurance to ensure servicing (fire insurance, unemployment insurance, etc.). Mandatory insurance against road accidents is another case in point. All of these are compulsory forms of insurance which, apart from their direct effect in providing protection against covered losses, help to raise personal and household saving.

Policy measures can also be used to encourage people to take out voluntary insurance coverage (e.g., life insurance, insurance against catastrophic illnesses and occupational injuries, etc.). In all these cases, the insurance is providing coverage for involuntary losses of some sort, so there is less likelihood of leakage. Tax incentives for individuals and/or groups to take out such insurance are more likely to raise national saving than, for example, direct incentives for the ownership of particular assets.

In short, the main point being made here is that, in the absence of reliable schemes for stimulating personal and household saving, one alternative is to use rules and incentives to boost special-purpose saving.

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[8] The market-based financing of low-cost housing through the use of demand subsidies has been analysed by ECLAC on the basis of an examination of initiatives in Chile, Colombia and Costa Rica. See Held (2000) and Szalachman (2000).

(c) Financing public investment

ECLAC (1998a) has discussed the need for the consolidation of the fiscal adjustment made by the region in the last two decades. The Commission's proposed fiscal covenant contains a set of policy recommendations for raising the level of public revenue, increasing the productivity and transparency of public spending, and enhancing its contribution to equity and to the construction of democratic institutions. The following discussion will focus on the close link between consolidation of the fiscal adjustment and the contribution that proper management of public finances can make to generating and increasing national saving.

Many countries in the region have had traumatic experiences due to a lack of fiscal discipline which eventually led to painful economic adjustments. In some instances these events coincided with periods when credit was readily accessible, particularly during the second half of the 1970s. The anguish caused by this economic instability had the effect of raising the political and economic value of stability. During the two decades that followed, substantial progress was made by most of the countries of the region in bringing order to their fiscal accounts and to the institutional structures needed to do so, thereby demonstrating that important lessons had been learned from recent events. The boom in voluntary financial inflows over the last three decades, coupled with an increasing degree of market sophistication and the emergence of numerous alternative ways of accessing the resources available on financial markets, has inevitably fostered the belief that progress towards solving the region's most pressing problems can be accelerated by means of public spending. The obvious corollary to this, however, is vulnerability to cycles and unforeseen shocks. In other words, when advantage is taken of the fiscal degrees of freedom available during upturns, the inevitable consequence is a lack of fiscal degrees of freedom for coping with downturns. If policy makers refrain from using that greater leeway during expansionary phases, on the other hand, the downswings will be less traumatic and they will have more policy options for handling them. No major economic agent is going to help the State to refrain from short-term borrowing to meet urgent present needs. Nor can the State expect any support if it chooses not to spend transitory revenues. Meeting the challenges involved in implementing a fiscal policy based on a medium-term horizon demands a level of political determination, strength and decisiveness that only public authorities themselves can be asked to provide. It is evident that a proper analysis of fiscal-policy costs and benefits inevitably has an intertemporal

component, and it is equally obvious that there is a very close link between this issue and national and public-sector saving.

A strategy for boosting national saving will have a much greater chance of success if macroeconomic policy makers' main fiscal objective is to persevere in their adjustment efforts until a structural balance —or, better still, a structural surplus— has been achieved in the country's fiscal accounts. To put it another way, such a strategy will be more likely to succeed if, after stripping out the effects of the business cycle and sporadic government revenues, the authorities aim to achieve a public savings rate (current revenue in excess of current outlays, including interest payments) sufficient to finance all public investment (real and financial) and still leave something to spare.[9] It was pointed out earlier that productive investment competes for financing with a range of alternative uses of financial savings. And in point of fact, a public sector that is running a deficit is a major competitor for these limited resources, since, by drawing in outside savings, the deficit partially crowds out financing for private productive investment, puts pressure on the balance-of-payments current account deficit (external saving) and, except insofar as it is used to finance new public investment, reduces national saving.[10]

It is important to stress that the target being proposed here is a structurally balanced budget or a structural budget surplus. This should by no means be construed as suggesting that the countercyclical role which fiscal policy necessarily has to play should be relinquished. On the contrary, if public finances are put on a structurally more solid footing, they can then be used more actively in contending with recessions or unforeseen shocks, as well as helping to avert the need to cut public spending and permitting the implementation of special programmes for dealing with the crisis.

To achieve a structural fiscal balance, it is necessary to arrive at an estimate of public revenues, corrected for a variety of factors. One correction is for the business cycle's effect on public accounts, particularly revenue. An overheated economy temporarily generates additional tax revenues that would not otherwise be available, just as an economy in

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[9] As was noted earlier, accounting conventions treat items involving human capital formation or improvements in living standards (such as spending on education, training, health, etc.) as current expenditure. This bias has particularly important implications for public social expenditure. In that area, consideration could be given to drawing a distinction between income policies having a clearly a current expense) and social investment policies.

[10] A budget deficit must be funded by a matching level of third-party savings. This includes not only net borrowing over a given period of time, but also asset sales. The sale of equity in public enterprises, for example, also draws on the savings of other agents.

recession denies the State tax revenues that would otherwise be available. A fiscal policy that sets deficit/surplus goals without considering the effects of the business cycle will tend to raise spending during upturns and reduce it during downturns, thereby generating counterproductive procyclical pressures. A correct measurement of the structural balance on fiscal accounts requires an accurate estimate of potential GDP and of the levels of public revenue and expenditure consistent with this estimate.

Another kind of correction can be made by preparing separate estimates that will differentiate between the long-term trend in the terms of trade and short-term fluctuations. Public accounts are sensitive to the terms of trade in most of the region, and transitory export-price spikes or shocks can also produce an illusion of strength or weakness in public accounts. Given this situation, the establishment of stabilization funds for the main goods that are exported and imported (with the accounts for such funds being kept separate from fiscal accounts) is an extremely useful mechanism for safeguarding fiscal stability. Indeed, a good way to stabilize fiscal policy in the first place is to set up general stabilization funds that will help smooth out not only fluctuations in earnings caused by changes in the terms of trade, but also the effects of temporary increases in income during the expansionary stage of the cycle and those resulting from the sale of assets. Proceeds from the sale of State assets or the award of concessions are, in particular, one-off revenues that can create the illusion of solidity in fiscal accounts in the short run. What these and other corrections have in common is that they separate out the transitory or short-lived components of public accounts from their structural components. This differentiation is necessary if fiscal policy is to have a medium- and long-term horizon.[11]

Yet another important consideration in this respect is the treatment of the public sector's contingent liabilities. State guarantees, be they explicit or implicit, should be properly determined in advance (Arenas de Mesa, 1999). Cases requiring special attention include unemployment insurance, explicit or implicit pension system insurance, insurance for infrastructure projects contracted out to the private sector, and fiscal and

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[11] It is of interest for the region to examine the recent experience of the countries in the euro zone in this respect. The need to coordinate the member States' fiscal policies has required not only the establishment of fiscal compliance targets, but also the creation of more sophisticated public accounting methods to differentiate the structural and transitory components of public accounts. It should be noted that, within certain limits, a degree of flexibility is allowed in the implementation of fiscal policy with regard both to differences between actual deficits and structural ones and to short-term deviations from the agreed level of structural deficit for countercyclical purposes (never for procyclical ones). In the final analysis, the main consideration for policy coordination purposes is the medium-term position of fiscal accounts.

quasi-fiscal resources associated with financial crises. When such crises arise, it is understood that the State is responsible for guaranteeing the continuity of the payment chain. In particular, the State is expected to guarantee, either wholly or in part, the ownership rights of savers during systemic crises. As will be seen later on, adequate prudential regulation of the financial system is essential if this is to be achieved. In addition, during times of crisis the State must premise its actions on the principle that when financial losses occur, fiscal and quasi-fiscal resources must never come into play until the corresponding banks' capital and reserves have first been entirely exhausted, without exceptions. The sequence in which the costs of a crisis are distributed will continue to be an issue of prime importance in the region. Self-interest is always a good incentive for proper management of the banking system by its stakeholders.

The previous paragraph introduces a more generic and highly important subject for the region which ECLAC has addressed on many occasions: the transparency of public accounts (ECLAC, 1998a, chapters I and II). Contingent liabilities, implicit insurance against financial crises and a range of other items do not show up in public accounts. Tax benefits are one such item. By contrast with the practice followed in some developed countries, in the region the cost of these benefits is simply ignored, which makes proper cost-benefit analysis virtually impossible. Another is excessive regulations, which generally are used because public resources are too scarce for direct action to be taken by means of incentives. Yet another is arrears in fiscal payments, which are not recorded as part of the public debt or of the budget deficit. Clearly, efforts to consolidate the fiscal adjustment will have to entail more stringent rules to ensure transparency in public expenditure.

Consolidating the fiscal adjustment until a prudent structural balance or surplus has been achieved is a feasible goal only if there is a willingness to pay the short-term costs of the transition. This calls for an ongoing commitment to improving the productivity of public expenditure and the performance of public institutions, to reducing tax erosion in the region and to increasing the transparency of public accounts. Above all, however, it calls for budgetary priority-setting with regard to the composition of public revenues and expenditure. In the final analysis, the use of outside savings (deficit) to finance recurrent government expenditures implies that the objective of contributing to national saving and to the financing of private investment is of only secondary importance to the State.

Reference was made earlier to the fallacy implicit in using short-term resources from privatizations to finance government spending. Privatization processes are complex and have to be designed and

evaluated from a variety of standpoints. It is particularly important to ensure an adequate supply of public goods and merit goods and to protect society from abuses by privately run natural monopolies, which means that a suitable regulatory system must be in place before privatization. The quality of the administration and management of public enterprises and infrastructure are also an important consideration. If, however, increasing national saving is a policy priority, there will also be other decision-making criteria that should be considered by the authorities. In particular, the privatization process has an important contribution to make to fiscal adjustment on a different level.

The fact is that investment by public-sector agencies and firms is usually a source of pressure on the overall public deficit. Deferring such investment can also carry a high cost in the medium and long terms. Quite often, it is not only socially profitable (as public-sector investment is expected to be) but is highly profitable in market terms as well, and this, it could be argued, means there is scope for public-sector borrowing without harming the State's net wealth position. There can be no doubt that a fiscal deficit of this nature is less harmful economically. Nonetheless, the argument that the deficit competes for savings with other uses, including the financing of private investment, is still relevant. The merits of other arguments notwithstanding, a major contribution to saving can be made by the privatization of public infrastructure projects and enterprises that need to increase their productive investment substantially.

Where these public investments are profitable in market terms and the State cannot finance them out of its own resources —in other words, without running a deficit— privatization can free up public resources for other expenditures. The cross-effects that come into play here are of interest from the standpoint of national saving. When public-interest investments are financed with private savings, the State does not have to divert its own resources into these investments. It will then have resources it can use to finance institution-building or social policies without incurring a deficit. A successful tender should yield public revenues that internalize the market value of the assets sold for the benefit of the State. If these resources, which are by nature transitory, are used to prepay public debt or to capitalize the development banking system, for example, then they will be recycled into the financial system and will thereby contribute to the financing of productive investment and to national saving. As pointed out earlier, however, these are not the only considerations that should carry weight in privatization programmes.

Hence, given the competition for financing and the cyclical nature of external resource flows, efforts to achieve a prudent fiscal policy

should be redoubled. At a time of increasing international financial liberalization, it is becoming more and more difficult for central bank authorities to adopt an active stance in managing their exchange-rate and monetary policies. Consequently, fiscal policy is being called upon to play an increasingly important role in macroeconomic management.

3. Policies to develop financial intermediation for purposes of productive investment

In order to boost the region's growth rates and reduce its vulnerability to external fluctuations, efforts to increase national saving should be coupled with measures for channelling these funds into investment. Most of the region's financial systems suffer from serious shortcomings that diminish the effectiveness of such measures, however. As noted in chapter 1, bank financing is less developed in Latin America and the Caribbean than it is in other regions, the system's intermediation spreads are wider, and its long-term segment is quite shallow. Furthermore, capital markets are small, and some of them have become even smaller during the 1990s.

Events in the region indicate that the public policy approach required in order to surmount these obstacles will have to go beyond the bounds of policies focusing entirely on the liberalization of financial markets. In the wake of costly bank crises in countries of the region and elsewhere, and in view of the fact that key segments of the financial market (especially long-term credit, SMEs and the capital market) have shown very little spontaneous growth, a consensus has emerged regarding the vital role that the State will be called upon to play as a regulatory and supervisory agent and as a catalyst for institution-building in the various components of the financial system.

(a) Financial regulation and supervision

The crises that have been associated with financial liberalization processes have led to greater caution in the design and implementation of regulatory and supervisory systems and to a more accurate perception of the costs of systemic crises. At least 14 countries made fundamental changes in their regulatory and supervisory systems during the 1990s, and there is a widely held commitment to compliance with the Basle recommendations. On the other hand, there is a strong tendency to deregulate interest rates, lower entry barriers and reduce regulatory *dirigisme* in lending. To balance this out, greater powers have been given to supervisors, and financial oversight has been strengthened. Generally

speaking, the supervisory problems that remain have more to do with problems of implementation than with legislation. To improve this situation, supervisory bodies will have to be supplied with more public and human resources and given greater autonomy from political authorities. In terms of the allocation of public funds, it is worth pointing out that good financial supervision, insofar as it prevents systemic crises, is a highly profitable investment.

Within the sphere of regulation, there are five areas that need to be strengthened.[12] First, there is a sizeable vacuum in the regulations covering financial conglomerates. This problem has a number of aspects which will be analysed further on. Second, a high degree of concentration in the banking system is very costly. Banks that are too large may be prone to problems of moral hazard, in the sense that they are "too big to fail" and their managers may become lax if it is believed that these institutions enjoy some degree of implicit State insurance. Third, the presence of more foreign financial institutions increases the international correlation of systemic risks, since if a parent company fails, its subsidiaries and international agencies will be weakened and vice versa. Consequently, it is wise to discourage market entry by institutions whose parent companies' home countries do not have a reliable supervisory system or have not consolidated their regulation of conglomerates. Fourth, the management of first-tier State banks should be reworked, and steps should be taken to ensure that market standards are used when rating their portfolios. It seems advisable to adopt regulatory and supervisory standards equivalent to those used in the private commercial banking system. This would entail strengthening the legal powers of bank supervisors and shielding the supervisory system from political pressure. Fifth, regulation and supervision of the credit, currency and maturity risks of commercial banks need to be strengthened. Since these risks stem from both micro- and macroeconomic conditions, there is a need, as was pointed out in chapter 2, to deploy prudential regulatory and supervisory instruments in a way that will avoid generating the procyclical macroeconomic effects that arise in this field when traditional approaches are used.

When considering these five areas, there are a number of points that need to be made. The main task is the regulation of financial conglomerates. Generally speaking, the regulation of financial conglomerates is defined as a set of rules covering the operations of a business group that is active in a variety of financial industries, such as banking, securities, insurance and pensions, and that may have branched

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[12] These lines of reasoning are based on Held (1994), ECLAC (1998b, chapter XII), and Livacic and Sáez (2000).

out into manufacturing and commerce as well. This dimension of regulation has already been incorporated into some legal codes, as in El Salvador and Mexico, and to some extent in those of Ecuador and Venezuela. Almost without exception, however, these rules have yet to be implemented.

This more comprehensive view of the regulation of conglomerates is not the only one that should serve as a basis for action in the region, however. There are also more obvious and clearly delimited shortcomings in the regulation of these conglomerates, such as the absence of integral, consolidated regulation and supervision of what could be called "banking sub-conglomerates", whose activities are confined to financial intermediation (attraction and placement of financial resources). In practice, there are a variety of unsupervised bank-related agencies and mechanisms operating under legal provisions designed specifically to elude supervision.

The most widespread mechanism of this type is unregulated offshore centres. Using such centres, a bank or its shareholders can create a separate financial entity in a different country that has few regulatory requirements, and then use that entity to account for some of the banking activities carried out in the country of origin. Bank secrecy provisions place such entities beyond the reach of the local supervisory body. In some countries this practice has taken on very substantial dimensions when measured as a percentage of duly recognized local banking activity. Thus, for example, during the banking crises in Venezuela (1994) and Ecuador (1998), it was discovered that a substantial proportion of banking activity was being accounted for by offshore subsidiaries.[13] A similar situation occurred in Paraguay's banking crisis of 1995. Another formula used to evade regulation and supervision is the creation of unregulated or very lightly regulated entities that are artificially "separated" from the bank by means of various subterfuges. Trust funds are the type of entity most commonly used for this purpose in a number of countries. A lack of regulation has led to crises in El Salvador, Guatemala and Paraguay, among others.

With regard to the participation of foreign financial institutions in national markets, recent evidence shows that discriminatory practices in the issuance of bank charters or licences are costly. What is recommended here is that objective (non-discretionary) rules be introduced for new banking operations wishing to enter the market. Such rules should be based on the principles of solvency, fitness (ethical conduct, over and

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13 To resolve these crises, the authorities of these countries extended State insurance coverage to these operations.

above strict definitions of legality) and financial experience, which have nothing to do with whether the parent company is local or foreign. The only additional requirement that should be used in respect of the entry of foreign businesses is the existence of reliable bank regulation and supervision in the parent company's home country and, ideally, the negotiation of international cooperation agreements between the two countries' supervisory authorities.

Banking supervisors should also have the necessary powers to regulate the banking system's degree of concentration. When banks are "too big to fail", systemic risk increases and the potential effectiveness of monetary and exchange-rate policies in dealing with difficult economic circumstances is weakened, quite apart from the risk of monopoly practices. Since the nationality of banks makes no difference to the risk of concentration, the relevant provisions should not discriminate between domestic and foreign banks.

Regulatory systems in the region also suffer from failings in the regulation of market (currency and interest-rate), country and liquidity risks. The most influential type of risk in the immediate term is currency risk, since a large percentage of financial assets are denominated in dollars (Argentina, Peru, Venezuela and Ecuador before dollarization), but the situation will depend on the direction taken by exchange-rate regimes in the region. Again, as banking markets increase in sophistication and the volume of longer-term operations expands, greater progress will have to be made in regulating the risks (interest-rate and maturity risks) inherent in these areas.

The Latin American and Caribbean region has a particular need for adequate safeguards against liquidity risk, since if this type of risk is not dealt with satisfactorily it can quickly turn into solvency risk. Some countries have introduced innovative measures to address this issue (e.g., Chile's regulation of maturity risk and Argentina's imposition of liquidity requirements when a deposit is nearing maturity).

In all of the world's financial systems, however, the biggest financial risk is still credit risk. In the region, where products are less sophisticated than in the developed countries, the relative weight of credit risk is greater still. A growing number of countries have introduced regulations under which credit risk is to be evaluated using methods that project the borrowers' ability to pay, but, in practice, default (i.e., the discovery of payment difficulties *a posteriori*) is still the most widely used procedure. In such cases supervision loses a large part of its effectiveness as a preventive tool and instead becomes an exercise in the measurement of financial problems after the event.

A similar problem that has been a factor in almost all Latin American banking crises has to do with the practice of extending loans to bank stakeholders. Since the 1980s, every country in the region has introduced regulations and legal provisions to deal with related-party lending. With few exceptions, however, their actual implementation has been quite limited, as there are serious difficulties in obtaining the information needed to detect such operations, and supervisors have lacked the necessary resources to keep up with the subterfuges employed for this purpose. What is more, existing legislation does not include the presumptive evidence laws that would provide supervisors with the powers they would need to apply the regulations effectively.

While it is true that a great deal of unfinished business remains on the banking regulation and supervision agenda, the prospects for progress seem to have improved. The recent international crisis and the ongoing debate about a new international financial architecture have once again highlighted the need for adequate banking regulation and supervision (see chapter 2). It is interesting to note that the perception that a correlation exists among the systemic risks of different countries has prompted the international financial community to work to promote suitable systems of prudential regulation in line with internationally accepted recommendations.[14] What is more, private banking institutions have welcomed and promoted these regulatory and supervisory schemes because they understand that they, too, benefit from stability in the financial system. The best known of the Basle recommendations is the one relating to capital adequacy. According to this recommendation, a financial institution's total risk-weighted financial assets have a prudential limit which is determined by its capital and reserves. It is thus recognized that overlending entails an element of risk that threatens the stability of the financial system. Banking supervision also needs to be more active in overseeing and protecting against credit, currency and maturity risk and in demanding the timely establishment of provisions for those risks.

The common aim of all these measures is to provide proper safeguards against systemic risk and help ensure that the payment chain works smoothly. To this end, ensuring proper compliance with financial contracts brings a range of benefits for saving and investment financing. Just as a credit operation involves the direct or indirect use of others' savings by the borrower, subsequent repayments on this debt —up to and including the point in time when it is extinguished— will, in most cases, require an effort by the borrower to save. If the debt is not repaid, the

[14] The application of international standards to banking regulations and supervision is also facilitating the internationalization of the banking system.

borrower has not only ceased to contribute to national saving, but has also carried out an implicit expropriation of third-party savings. If the financial system is to function properly, an appropriate balance needs to be struck in terms of lenders' rights, and abusive practices, whether on the part of borrowers or lenders, need to be prevented.

First-tier State banking is a case that warrants special mention. In general, governments are more likely to recover only a portion of their direct financial investments, since collection is politically costly. It is therefore important for first-tier State banks to comply with the same regulatory, supervisory and ratings standards as private commercial banks or, if this is not possible, for a second-tier State banking mechanism to be used instead.

(b) Capital market development

Despite the region's achievement of greater price stability, tighter fiscal discipline and better financial regulation, its capital markets have not taken on a greater role in lending funds to support local economic activity. During the 1990s, only four countries (Argentina, Brazil, Chile and Mexico) posted steady growth in trading volumes on their capital markets, and even in these cases, the growth rates were well below those of the United States and Europe.[15] Even more alarmingly, most of the countries' capital markets have been shrinking, and the number of firms listed on their exchanges continues to decline (Dowers, Gómez-Acebo, and Masci, 2000). Thus, one of the tasks that will have to be accomplished in order to strengthen investment financing is the development of a deep, broad and efficient capital market.

As capital markets deepen, new forms of financial intermediation are appearing that are not, in a strict sense, what is normally thought of as bank intermediation. The issuance of shares and debt instruments, the securitization of assets, leasing and factoring operations, the use of financial derivatives in hedging operations, and the growing participation of institutional investors (pension funds, insurance companies, and mutual, investment and venture capital funds) are just some of the many new mechanisms that have come into use. Much of this new activity, whose hallmark has been the creation of new agents and markets, has necessitated the emergence of a secondary market for "second-hand" transactions involving tradable assets, and this represents a new and potentially large source of liquidity for all kinds of agents. If these new

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[15] In 2000, Latin American stock markets' capitalization averaged 25% of GDP, whereas the figure was 200% in the United States and 60% in Europe. Similar figures are recorded for firms listed on the exchange (see figure 1.11).

developments, and especially the creation of new agents and markets, take place in an orderly and stable fashion, the positive effects for national saving and development financing will become evident.

The development of new forms of financial intermediation may or may not be linked to banking activity. For example, leasing and securitization operations are essentially alternative types of credit, and banks are becoming increasingly involved in supplying these products. Other activities, particularly those linked to institutional saving, such as pension fund management, stock brokering and insurance, do not necessarily have to be connected with banking as such. Universal banks, which are more common on the European continent, enable virtually all financial activities to be brought within the sphere of banking operations, with the aim here being to obtain the benefits of synergies in financial activity. The niche operations typically found in the United States, by contrast, seek specialization and aim to find more dynamic and flexible ways of responding to financial innovation. There is no way to determine the superiority of one system over the other, and indeed there are more and more points of convergence between the two. In either case, it is important to have proper supervision of the tangible and intangible assets shared between banks and their allied financial activities. As mentioned earlier, in order for these safeguards to work, there has to be a consolidated form of supervision of financial conglomerates, or at least of the subset of activities engaged in by banking consortia.

If the dynamic innovation process being seen in the capital market is to be managed successfully, the focus should be on improving transparency, disclosure and governance in the handling of third-party resources. The common objective of all such efforts is the provision of adequate safeguards for ownership rights and confidence among minority stakeholders. For example, the main activity of institutional investors (insurance companies, pension funds and mutual funds, etc.) is the management of third-party funds. For this activity to prosper, an act of faith is required on the part of the agents who hand over portions of their assets to be administered by others. Any perceived possibility that this trust might be abused by fund managers will discourage investors from participating and, incidentally, reduce the potential for channelling savings through these mechanisms. A suitable regulatory framework should perform a preventive function, rather than simply imposing sanctions once losses have been sustained. Consequently, regulations must provide for severe and effective penalties for the use of inside information and failures to resolve conflicts of interest properly. In addition, regulators should maintain strict accounting requirements. Other requirements should include regular, independent and reliable audits; the establishment of oversight committees; independent risk

assessments; separate accounting for fund managers' own assets and third-party assets; and sufficient capital reserves to ensure that fund managers are solvent enough to safeguard the interests of fund contributors in the event of unforeseen contingencies or management error.

The transparency which is so essential for the sound development of capital markets is just as important in the case of corporate assets. The development of an equity ownership structure may be hindered if the regulatory system is unable to defend the ownership rights of minority shareholders vis-à-vis the controlling shareholder. The regulations applied in this area should not, however, restrict the management capabilities of controlling shareholders, except insofar as is necessary to ensure that minority stakeholders have equal rights over the profits of the company. Corporate governance laws, which are constantly being updated in developed economies, should be designed with a view to enabling minority shareholders to carry out appropriate oversight and auditing of transactions with parties linked to the controlling shareholder. The sharp differences in market value between blocks of shares that provide a controlling interest and minority shareholdings are, by and large, a reflection of market failures and of a lack of corporate governance. This is particularly true at times when controlling interests are changing hands and strategic partners are being sought. What is recommended in this case is that corporate governance and takeover laws be reviewed and updated, as the region displays obvious and widespread shortcomings in this regard. The effect of sound regulations in this area is to reduce perceived risk and thus lower the cost of financing investment through the issuance of equities. A close and proper correlation between the economic benefits flowing to controlling and minority shareholders can also lead to increased participation by institutional investors in the ownership of firms in which they do not seek a management role, thus establishing a more direct link between productive activities and the supply of financial resources.

The primacy of the ownership rights of investors over those of institutional fund managers and the equality of ownership rights (although not of management rights) between minority stakeholders and controlling shareholders are two aspects that must be given priority in a regulatory framework designed to promote the development of deeper national capital markets in the region. The same requirements apply to the creation of appropriate mechanisms for consolidated project financing, which are increasingly being used to finance productive investment megaprojects.

Two further requirements that are important for the proper development of capital markets are the provision of protection against inflation in financial contracts and incentives for risk absorption based on the use of financial derivatives. In the first case, the obvious solution is to encourage indexation of long-term financial instruments and contracts. The main objection to indexation is that it perpetuates the effects of temporary inflationary shocks, but the benefits of a longer horizon for contracts and decision-making, particularly in the financial sphere, greatly outweigh the costs associated with indexation. The experience of the 1990s shows that, even in highly indexed economies, consistent macroeconomic policy is capable of reducing inflation to satisfactory levels. Inflation uncertainty, by contrast, can raise the cost of long-term credit to the point where it becomes prohibitive.

Furthermore, the orderly development of a financial derivatives market makes it possible to deal with other risks inherent in financial operations, to the benefit of both investors and borrowers. Clearly, however, it is important (particularly for the purpose of determining capital requirements) for the accounts of derivatives brokers and risk arbitrageurs to reflect the assets and liabilities implicit in their operations clearly and transparently. Large-scale transactions by undercapitalized intermediaries give rise to undesirable risk correlations that encourage herd behaviour among financial investors. This is an area in which recent international experience and know-how offer useful innovations in the form of more appropriate regulatory and supervisory mechanisms that can give capital markets greater stability. In the final analysis, long-term stability and sound, transparent management of price, maturity, interest-rate and currency risks, among others, are necessary ingredients for the successful development of capital markets in the region.

(c) Development banking

Views on the role of development banking have changed substantially in the last 50 years (see box 4.1). In recent decades, these banks have been the object of a great deal of criticism on the following counts: (i) interventionist and unproductive management of scarce financial resources which lacks any clear or transparent rationale based on economic and social considerations; (ii) a tendency to finance development institutions by drawing primarily on fiscal and multilateral sources that carry a high opportunity cost (higher still in the case of budget deficits); (iii) poor risk management, which in the long run leads to crises that impose high financial costs on the State; (iv) management of long-term resources based on short-term political and social criteria; and (v) inadequate collection policies that have often resulted in unacceptably low loan recovery rates.

Box 4.1
CHANGING VIEWS OF THE ROLE
OF DEVELOPMENT BANKS

For many years after the Second World War, the role of development banks in supporting growth and development was undisputed. The reconstruction of Europe and Japan, which, from a political standpoint, was deemed too important to be postponed, required long-term financing for capital formation. Most economists agreed that private long-term lending institutions and markets were inefficient in the industrialized countries hardest hit by the war and virtually non-existent in less developed countries. Proposals for the creation and expansion of development banks were based both on the Keynesian paradigm and on other more orthodox approaches. For example, it was argued that financial underdevelopment led to a scarcity of saving instruments, with the result that potential savings either remained idle, in the form of hoarded funds, or were simply spent on consumption. Lack of financial development therefore translated into low levels of loanable funds and less investment.

In the 1970s, this picture changed significantly. In the political sphere, Europe and Japan had recovered completely, and the problems of less developed countries were seen as being important only in the context of the cold war. At the theoretical level, as a result of the development of financial theory based on the hypothesis of market efficiency, the State's role in financing investment was increasingly called into question. According to this view, low savings rates and low levels of financing for investment were associated with "financial repression"; that is, with policies that included limits on interest rates, selective credit and other types of government intervention in financial markets.

This theory held that low (and even negative) real interest rates discouraged saving. The consequences were: (i) a scarcity of private financing for investment, which forced governments to use selective credit policies, with development banks serving as the primary instrument for their implementation; (ii) the influencing of public credit by political factors, which made the allocation of the scarce credit available inefficient and resulted in low long-term growth; and (iii) the inability of governments to finance their deficits, which led to inflationary financing.

In the 1980s, this view predominated among multilateral agencies, which showed an increasing tendency to include financial liberalization as one of the conditions required of countries during the debt crisis. In the 1990s, most of the countries of the region adopted this strategy, which, in addition to the deregulation and liberalization of their financial systems, and in some cases of their capital accounts, also called for specific measures to scale back the role of public financial institutions, including development banks (ALIDE, 1999).

(continued)

Box 4.1 (conclusion)

Nevertheless, these reforms have not only failed to achieve significant progress in building up savings rates, but have also increased the region's dependency on external financing. What is more, openness to international financial markets has not yet resulted in the further development of national capital markets. In addition, a number of sectors, such as small and medium-sized enterprises, construction of public housing and technology-related firms, still lack access to the scant supply of private financing. In view of this situation, some authors and institutions have reconsidered previously-held positions and have turned their attention to the role which public development institutions could play in breaking the vicious circle of low investment, low growth and low savings rates. For example, in a well-known report, the World Bank (1993) acknowledged that development banks and other public lending agencies had played a key role in the achievement of high investment-led growth rates in some Asian countries. More recently, a report prepared by the United Nations (1999) supported this view and highlighted the role of development banks in promoting growth.

Nevertheless, the benefits of good development banking are also substantial. First, for private financial institutions, the transaction costs of evaluating and financing smaller companies are high, and this results in a tendency towards the concentration of lending. Second, while the resources of development banks might be channelled into higher-risk businesses and agents, the risk diversification afforded by their large number of borrowers tends to reduce portfolio risk. Third, development banking is often the first step in the financial history of small and new clients, who can then "graduate" to the private market. Fourth, because of the instability of international financial flows, larger firms with better risk ratings tend to borrow on the international market when capital is in ample supply and then return to the national market when credit becomes tighter. This tendency to move in and out of national financial markets has made the supply of financing for companies that lack access to international markets highly unstable. Development banking provides them with a steadier source of financing, thereby partially insulating them from cyclical fluctuations. Lastly, owing to the higher level of risk and a lack of long-term deposits, national financial markets may offer a suboptimal volume of long-term credit, which exposes investors that cannot draw on longer-term external credits to maturity risk and exposes those that can to currency risk.

The criticisms made of development banks and the arguments made in their favour are equally valid, and all of them are supported by historical evidence. Is it possible to design development banks in such a way as to maximize their advantages and remove the drawbacks that have given rise to valid criticisms of their past performance? In the view of ECLAC, such a combination is feasible, appropriate and necessary,

since most of the criticisms made of development banks could be obviated by a good institutional design. The essential point is that a financial system that manages risks in accordance with market criteria and that is subject to appropriately stringent regulation and supervision has a bias against the more "expensive" and higher-risk agents. The introduction of instruments such as leasing operations, securitization and the creation of venture capital funds can partially offset this bias, but it is clearly not enough. There are no natural incentives in the market for the provision of banking services to informal activities, small farm owners or, more generally, small and medium-sized enterprises, and this has major social and economic costs. Incentives for the development of long-term credit segments and segments oriented towards financing innovative activities may also be inadequate. An appropriate development strategy needs to focus not only on equity in the distribution of the benefits of growth, but also on equity in opportunities for making a productive contribution to the development process. Access to financing is an inherent part of this second component of equitable development. In addition, access to long-term credit is necessary in order to achieve high levels of investment. At the same time, however, the system has to protect itself against excessive risk, which has a high economic cost, and against abuses by borrowers whose behaviour is distorted by the perception that they enjoy some degree of "political insurance" if they fail to meet their financial obligations.

To reconcile these objectives, a first line of policy should focus on the need for constant oversight of development banks' portfolio risk. The market has an important role to play in this connection. This could be done, for example, if a development bank were set up as an independent off-budget institution (as a State enterprise, for example), were not covered by government third-party deposit insurance, and were subject to regular rating of its portfolio risk by outside agencies. These three components have the common feature that they make portfolio risk transparent without biasing its assessment by incorporating the sovereign risk of State financing. In addition, they would make it necessary for proper accounting standards to be followed when competing for private funds.

A second line of action should focus on the improvement of collection policies. In order for this to happen, as pointed out earlier, first-tier development banks should be organized like commercial banks and should be subject to exactly the same regulation and supervision as private banks are. This would improve the transparency of their commercial operations, force them to apply stricter collection policies and permit the financial effects of short-term political pressures to be rapidly detected.

Perhaps the best collection policy for a development bank would entail its organization as a second-tier bank. The targeting difficulties experienced by such banks would, however, make it necessary to improve their channelling mechanisms and the design of the subsidies used to pursue their social objectives. Appropriate targeting may require a combination of interest-rate subsidies, partial subsidies on credit insurance premiums or the operation of partial guarantee funds, subsidies for credit ratings by first-tier intermediaries and training in project management and design for potential borrowers. Of course, these subsidies and transfers would have to be based on a proper social and economic assessment. It is of equal importance, however, that they be well designed, that they operate transparently, that the associated fiscal cost be explicit and, ideally, that their financing come directly from duly budgeted public funds. An interesting example of this approach is provided by the Kreditanstalt für Wiederaufbau, the German reconstruction credit bank, which is independently managed but can provide subsidies of this type up to the funding limit set each year in the federal budget. The main advantages of funding subsidies out of the fiscal budget, apart from greater transparency, is that development banks can then generate operating profits that will build up their long-term resources and can turn to the market to obtain additional funds. If there were no State guarantees for privately obtained funds, development banks would be obliged to manage their portfolio risk better and improve their collection policies.

Lastly, development banks should concentrate their short-term activities on financing investment and working capital for firms that would not normally have access to private financing. In the medium term, they should be run in a way designed to avoid building up a permanent, stable customer base. In fact, one of their management objectives should be to initiate the financial history of customers who can then turn to private finance once they have “graduated”. As part of this effort, the financing of debt reschedulings and the capitalization of interest should be exceptions to the rule that are approved on a case by case basis, insofar as possible without public guarantees or subsidies. The development of leveraged long-term credit mechanisms in the development banking system should form part of wider efforts to develop long-term segments in national capital markets.

The combination of credit schemes and State subsidies in areas of high social profitability, which has been analysed here in relation to the activities of development banks, may be applicable to other sectors as well. In fact, one of the areas in which this model has been used the most in the region is low-cost housing (see chapter 1). There are good reasons for the State to be involved in this area, since the private financial system,

working on its own, has no incentive to offer the kinds of sums, maturities or interest rates that would accurately reflect the social return on the provision of low-cost housing. The State, by contrast, can and should assess this social return and, on the basis of that appraisal, allocate fiscal resources accordingly. Its participation in this field may be based on various combinations of direct subsidization of low-cost housing, interest rates and/or previous saving with indirect subsidies provided through partial credit insurance, in cases where second-tier financing is being provided, or mortgage life, fire or unemployment insurance. The scale of these subsidies may differ depending on the economic circumstances of the households concerned. The main thing is to have reasonably certain knowledge of how much public funding is being used for these subsidies so that supplementary credit can be offered on acceptable conditions for intermediation through the market.

This model can also be applied to sustainable development financing and support for retooling initiatives in crisis-hit regions or sectors. Financial support for high-technology activities can also be provided using this model or, alternatively, can take the form of venture capital put up by development banks or financial corporations involved in the relevant projects, preferably as minority stakeholders. Means of providing support for innovative export-oriented activities have already been examined in the preceding chapter. Finding ways of encouraging private venture capital institutions to become increasingly involved in providing supplementary funding must, of course, be a priority in all these areas.

In all these fields of activity, State subsidies should be based on the principles of transparency and competition for scarce resources, and hidden, untargeted and unassessed subsidies must be kept to a minimum. The clear, legally institutionalized distinction between public subsidies and financial intermediation is a basic principle for the proper management of public funds. By contrast, the subsidies implicit in a poor collection policy or in non-transparent financial risks are simply a reflection of design flaws that lead to a socially costly leakage of public funds. State guarantees for loan reschedulings or interest capitalization are specific examples of poor insurance or collection policies. Rigorous compliance with financial contracts is the basis of any efficient financial system and, in the long run, more funding can be provided at a lower cost when the interests of lenders are protected. It needs to be pointed out just as forcefully, however, that because of the concentrative bias associated with this principle of good financial practice, the State has to be involved. To avoid repeating the errors made by development banking in the past, the key recommendation here is that the fiscal costs of linked subsidies and portfolio risk be made as transparent as possible in cases where the

State decides, for legitimate social reasons, to take a guiding role in financial activity.

(d) Institution-building as a financial development policy

Financial systems are prone to market failures and, in other cases, tend to lack certain markets, segments or components. Institutional design and development policies therefore have a key role to play in channelling saving into productive investment. Experiences in countries of the region and in more advanced nations have demonstrated that the spontaneous development of private financial systems is not necessarily well structured or complete. In fact, there are gaps in important market segments that can be closed up only by deliberate government action, and such action is therefore necessary in order to strengthen investment financing.

One example of this is the boost given to the development of the housing credit segment by the introduction, on the government's initiative, of mortgage-backed securitized financial assets. Ginnie Mae and Fannie Mae[16] were originally a single housing mortgage institution that was created in the United States in 1934 as part of that country's economic recovery plan. In 1970, Ginnie Mae introduced the world's first securitized asset to provide housing finance, thereby creating an entirely new market. Around the same time, the government withdrew from Fannie Mae, giving a strong boost to private participation in a market that had previously been developed on the public sector's initiative. As another example, Chile's quite well developed mortgage credit system is the result of its creation of an explicitly indexed unit of account that protects financial savings from inflation and makes it feasible to offer longer maturities.[17] Thanks to the country's 1981 pension system reform programme and the banking system's return to solvency following the banking reforms instituted in the wake of the 1982-1986 financial crisis, the development of institutional saving agents has resulted in the creation of a large market for long-term financing based on securitized mortgage instruments. In both cases, public policy was a key factor in the creation of the institutional structure needed to deal with crucial aspects of financing for activities requiring long horizons.

The first step is to achieve sufficient macroeconomic stability to permit the terms of financial saving to be lengthened and to create instruments that will serve this purpose. The second, especially in less developed systems, is to

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[16] The official names of these institutions are the Government National Mortgage Association and the Federal National Mortgage Association, but they are generally known by the nicknames used here.

[17] Argentina, Colombia and Uruguay have also frequently used indexed financial assets to provide housing finance, but they have also employed other mechanisms.

create institutional saving agents capable of attracting long-term savings (pension funds, insurance companies, investment funds, etc.). It should be borne in mind that such agents generally behave like financial investors —i.e., they do not become directly involved in the operations of the real investment project— because experience has shown that this is not an area in which they have comparative advantages. This situation poses three new challenges: to control the level of risk, to absorb risk and to cover risk. In some cases, each of these functions is performed separately by a specialized institution.

Risk assessment and control is usually performed by a first-tier institution which applies standardized procedures for rating direct investors and is able to reduce its portfolio risk through diversification. This portfolio is backed by borrowers' capacity to pay and, in the case of housing, is secured by mortgages. This first-tier institution consolidates the different individual loans and offers them on the market as a single meet their payments) remains with the first-tier institution, since it possesses comparative advantages in the assessment of this risk, whereas the financial risk (the chance that future interest rates will differ from current rates and that the value of the portfolio assets will fluctuate) is transferred to the financial investor. In both cases, regulatory provisions exist which include risk-absorbing capital and provisioning requirements to safeguard the intermediary-investor's solvency. Mechanisms for risk coverage are another essential institutional design component that will facilitate the development of a long-term credit market. Examples include guarantee funds and credit insurance, which are geared mainly towards covering commercial risk. Financial risk can also be covered in a deep secondary market through the use of specialized hedging instruments.

In other cases, the creation of an appropriate regulatory framework may not suffice to provide access to credit for small businesses or for investment in innovative projects. A lack of guarantees or collateral usually limits SMEs' access to credit, while in the case of innovative activities, an excessive reluctance to assume risk tends to hinder real investment. Public-sector support may take various forms, but its objective is invariably to limit exposure. The establishment of public/private guarantee funds and the subsidization of credit insurance premiums are tools that may be used to cover and absorb smaller firms' credit risk. Institutions such as venture capital associations formed by both public and private investors can be useful sources of investment financing. As discussed earlier, public action by such institutions as development agencies or banks may be necessary in cases where private agents have difficulty in gauging and covering the risks involved. The key institutional design components, however, are modalities of intervention and regulation that will pave the way for the development of all segments of a financial market by playing a complementary role and serving as a catalyst in cases where a financial system's own evolution does not lead to the development of long-term segments.

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Annex

Information sources for measuring capital flows to the region

The two main sources of information on international capital flows received by the region that have been used in this document are the data compiled by ECLAC based on the fifth edition of the International Monetary Fund's *Balance of Payments Manual* and World Bank data on aggregate net flows. The sources for the tables and figures contained in the document are indicated in table A.1.

The main differences between the above two information sources are the following:

(a) **Short-term capital:** included in the ECLAC series but not in the World Bank's statistics.

(b) **Compensatory financing (other than IMF credits):** included in the World Bank series but not in the ECLAC data.

(c) **Official transfers:** included in the World Bank series but not in the ECLAC data.

(d) **Errors and omissions**: included in the ECLAC series, where they are assumed to represent capital flight; not included in the World Bank data.

(e) **Number of countries:** the ECLAC statistics refer to 19 countries and those of the World Bank to 29.

(f) **Foreign direct investment:** net inflows (outflows) are included in the ECLAC data; the World Bank series include inflows only.

Table A.1
A. INFORMATION SOURCES FOR SELECTED TABLES

	Table	ECLAC based on IMF Balance of Payments Manual	World Bank
1.1	Structure of import financing	•	
1.2	Structure of current account deficit	•	
1.3	Contribution of external long-term financing, by groups of countries		•
1.4	Stock of debt with private lenders, 1999		•
1.5	Latin America and the Caribbean: sources of external financing		•
3.4	Net official development assistance received by Latin America and the Caribbean		•
3.5	Net long-term debt flows, by source		•
3.6	Latin America and the Caribbean: average terms and conditions of new commitments		•
3.8	Components of external debt of Latin American countries classified as poor		•
3.9	Net present value of official debt prior to the HIPC initiative (1998)		•

B. INFORMATION SOURCES FOR SELECTED FIGURES

Figure	ECLAC based on IMF Balance of Payments Manual	World Bank
1.1 Latin America and the Caribbean: current account and long-term flows		•
1.2 Latin America and the Caribbean: net capital inflows and resource transfers	•	
1.3 Latin America and the Caribbean: international bond issues	•	•
1.4 Latin America and the Caribbean: used of IMF credit		•
1.6 Latin America and the Caribbean: key macroeconomic indicators	•	
1.8 Latin America and the Caribbean: key external indicators	•	
3.1 Latin America: long-term debt flows, by source		•

Based on the information contained in table A.2 (World Bank statistics on net inflows to the region, together with ECLAC data on autonomous capital inflows and other components of the balance of payments), figure A.1 gives net flows for 1990-1999 as calculated using data from both sources. Except in 1992, calculations based on World Bank

data show a higher level of flows and steadier growth than do calculations performed using the methodology employed by ECLAC. If the unadjusted series are compared, the difference between the two ranges from a minimum of US$ 4.6 billion in 1993 to a maximum of US$ 74.5 billion in 1998. Once they have been adjusted for purposes of comparability, the differential narrows to a minimum of US$ 4.6 billion in 1994 and a maximum of US$ 34.2 billion in 1999.

The information contained in table A.2 makes the data more comparable thanks to the following adjustments in the ECLAC series: (i) the exclusion of short-term capital for the last three years; (ii) the inclusion of compensatory financing (other than IMF credits); (iii) the exclusion of errors and omissions; and (iv) the exclusion of capital outflows in the form of outward foreign direct investment. In the case of figures A.2 and A.3, the difference between the two information sources for the first half of the decade is attributable to the fact that the ECLAC data do not include compensatory financing; in the second half, the differentials are primarily due to the fact that the ECLAC series include other net short-term flows. Discrepancies caused by the different number of countries covered by the two and the times at which the data are updated persist, of course.

The World Bank statistics refer only to transactions involving long-term liabilities, i.e., total disbursements less amortization, and do not include outward direct investment (the acquisition of assets abroad by developing-country residents). This accounts for the sizeable difference between the net long-term flows given in the World Bank series and the figures for net external financing that have been calculated on the basis of the balance of payments using the ECLAC methodology. Other causes of discrepancies include short-term flows, delays in updating the information, differences in reporting procedures, the use of cash-basis or accrual-basis accounting, accounting difficulties associated with derived figures and a shortage of data on off-shore financial centres.[1]

[1] The World Bank also notes other limitations. Firstly, its statistics on private flows to the countries are annual figures and therefore do not reflect sudden changes in market financing. Secondly, the quality of the estimates for the most recent years varies considerably from category to category. The available information on net and gross official flows is quite reliable, as are the data on disbursements in bond markets and those of commercial banks. Debt amortization payments are computed on the basis of the terms and conditions of the relevant contracts, even though actual payments may differ. It is particularly difficult to estimate flows of equity investment since, although information on stock purchases in international markets is available, direct purchases on developing countries' equity markets are estimated on the basis of trading reports whose reliability and coverage may vary.

Table A.2
NET CAPITAL FLOWS, BY INFORMATION SOURCE

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 [b]
World Bank											
(Long term)											
Aggregate: net flow of resources	**21,787**	**30,998**	**35,164**	**65,651**	**61,744**	**75,347**	**99,400**	**113,779**	**141,985**	**116,375**	**102,379**
ECLAC-IMF											
(Short and long term)											
(1) Autonomous capital (I+II)	**-7,497**	**22,393**	**48,588**	**61,051**	**41,773**	**29,051**	**66,457**	**84,600**	**65,597**	**41,843**	**68,100**
Balance on financial account (I)	-7,621	21,377	48,646	64,867	47,647	34,989	71,369	89,779	74,516	46,858	67,021
(2) Errors and omissions	124	1,016	-59	-3,816	-5,874	-5,938	-4,911	-5,178	-8,919	-5,015	1,079
(3) Outward foreign investment	-1,067	-1,359	-1,913	-2,757	-3,729	-4,226	-3,169	-7,898	-8,976	-8,444	-8,610
(4) Short-term capital [a]								-21,154	-31,597	-20,253	-7,497
(5) Compensatory financing (does not include IMF credits)	**23,026**	**13,853**	**9,114**	**5,887**	**5,742**	**17,122**	**531**	**7**	**5,969**	**6,632**	**-2,722**
Adjusted series (1)-(2)-(3)-(4)+(5)	**16,471**	**36,588**	**59,673**	**73,511**	**57,118**	**56,337**	**75,068**	**118,837**	**121,059**	**82,186**	**80,406**

[a] Official statistics for seven countries.
[b] Preliminary estimates.

Note: ECLAC uses information compiled on the basis of the fifth edition of the IMF *Balance of Payments Manual*, which has the following characteristics:

- It includes short- and long-term autonomous capital.
- Foreign direct investment includes inflows; outward foreign investment is deducted.
- It does not include exceptional financing or IMF credits, which form part of the global balance.
- It does not include official or private transfers; these transactions are entered as current and capital transfers on the current account.
- It includes errors and omissions, most of which are some form of capital flight.
- Portfolio investment swaps are deducted from equity investment.

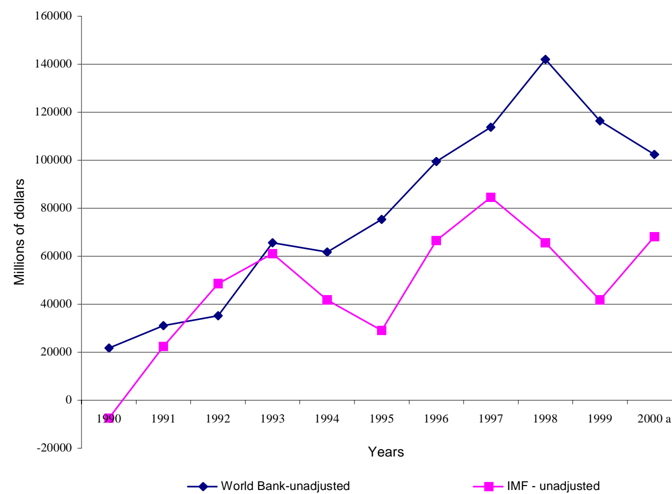
The ECLAC regional aggregate includes 19 countries; the ECLAC figures are more up to date.

The definition of net resource flows used by the World Bank includes the following elements:

- Long-term capital is included; short-term capital is not.
- Foreign direct investment includes inflows only; outward foreign investment is not deducted.
- Exceptional financing is included.
- Grants and donations are included.
- Errors and omissions are not included.
- Portfolio investment swaps are not deducted from equity investment.
- The regional aggregate includes 29 countries.

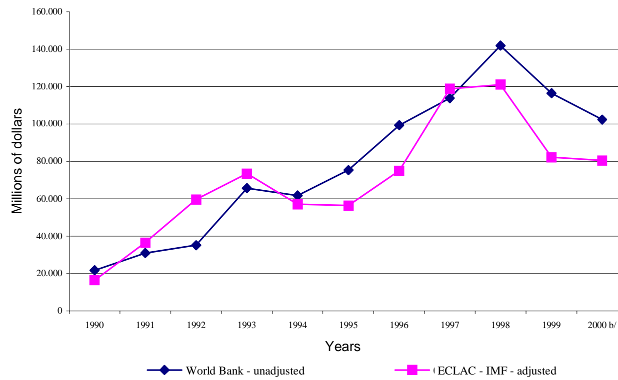
On this basis and as is indicated in table A.1, ECLAC figures compiled in accordance with the fifth edition of the IMF *Balance of Payments Manual* have been used to assess the volatility of short-term flows as part of an analysis of this factor and how it relates to economic policy management. World Bank series have been used to examine the structure and behaviour of net long-term flows over time and to classify most of the countries into three groups based on their per capita GDP.

Figure A.1
NET CAPITAL FLOWS, BY INFORMATION SOURCE
(Unadjusted series)



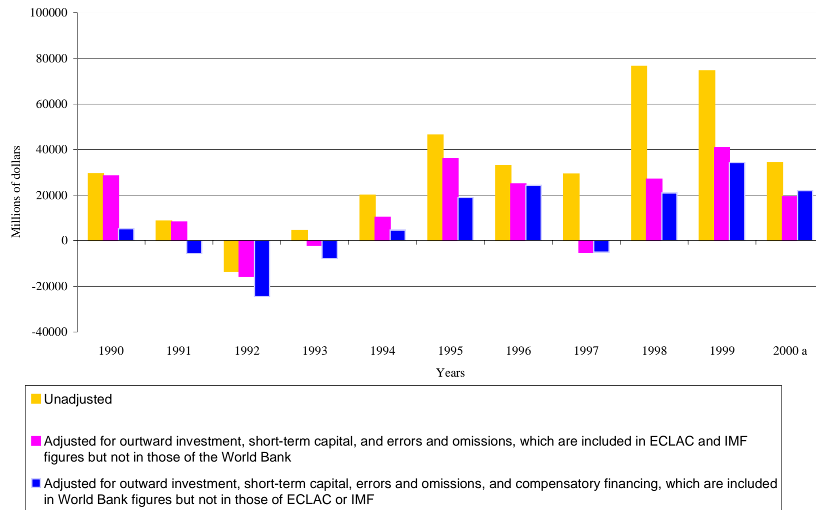
[a] Preliminary figures.

Figure A.2
CORRECTION OF SERIES, BY SOURCE[a]



[a] Figures compiled by ECLAC on the basis of IMF data adjusted for outward investment, short-term capital, errors and omissions and compensatory financing.
[b] Preliminary figures.

Figure A.3
DIFFERENCES IN NET RESOURCE FLOWS, BY SOURCE AND ADJUSTMENT



[a] Preliminary figures.