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Chapter II

FINANCIAL FLOWS TO DEVELOPING COUNTRIES AND TRANSITION ECONOMIES

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Chapter II

FINANCIAL FLOWS TO DEVELOPING COUNTRIES AND TRANSITION ECONOMIES

A. Recent trends

Net private capital flows to developing countries rebounded in 2002, after falling below $20 billion in 2000 and 2001. However, despite the recovery, such flows stayed at less than a quarter of the peak reached in 1996, before the outbreak of the East Asian financial crisis. Foreign direct investment (FDI) remained the only positive component among the broad categories of private capital inflows, but it was well below the historical high registered in 2001 (table 2.1). The other components, net portfolio investment and bank lending, were again negative. Net official flows, including IMF lending, were stable at the level attained in 2001.

The picture is somewhat different for the group of the transition economies, where net private capital flows rose in 2002, reaching their highest level since 1995. All three components of private capital flows were positive, and higher than the levels of the previous year. Clearly, for many transition economies, the optimism generated by the progress towards their accession to the European Union (EU) has been an important factor in sustaining private capital inflows despite a general deterioration in global financial conditions.

Although net capital inflows to the developing countries increased, net resource flows, as measured by the current-account balance in table 2.1, were negative. Indeed, developing countries as a whole ran a current-account surplus for the fourth consecutive year. In 2002, the aggregate surplus amounted to more than $100 billion, exceeding the peak reached in 2000. Similarly, the transition economies maintained a current-account surplus for the third consecutive year. Thus in both categories of countries, net total capital inflows were used not for current-account financing, but for increasing foreign-exchange reserves. The increase amounted to an unprecedented $177 billion in the developing economies and to about $30 billion in the transition economies. Although international reserves of developing countries and the transition economies have been constantly rising in recent years, in the period since 1998 (1999

Table 2.1

NET CAPITAL FLOWS AND THE CURRENT ACCOUNT: DEVELOPING AND TRANSITION ECONOMIES, 1995–2002

(Billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002
Developing economies								
Private capital flows, net	157.0	208.1	96.6	38.9	66.2	18.2	17.9	51.8
Private direct investment, net	82.0	97.2	120.5	128.0	133.0	125.6	145.3	110.0
Private portfolio investment, net	34.2	81.5	41.6	-3.7	39.0	9.7	-41.7	-40.0
Other private capital flows, net	40.8	29.3	-65.5	-85.3	-105.8	-117.2	-85.8	-18.2
Official flows, net	34.3	-5.0	40.8	49.3	10.5	-0.7	25.6	22.9
Change in reserves	-80.1	-105.7	-58.7	-47.0	-80.1	-93.2	-100.5	-177.6
Current account balance	-88.6	-78.2	-45.9	-21.6	36.5	100.9	72.1	104.0
Latin America								
Private capital flows, net	39.1	65.3	58.7	63.3	50.2	50.5	34.7	2.1
Private direct investment, net	21.0	35.2	51.1	56.1	58.1	57.1	65.9	38.5
Private portfolio investment, net	7.0	44.1	28.3	23.7	19.6	21.2	2.8	-6.5
Other private capital flows, net	11.0	-14.0	-20.8	-16.5	-27.5	-27.8	-33.9	-29.8
Official flows, net	20.0	3.9	14.6	15.5	0.7	-4.3	23.7	18.4
Change in reserves	-22.9	-29.0	-13.2	8.4	8.7	-3.6	0.8	-1.3
Current account balance	-37.4	-39.9	-67.0	-90.5	-56.2	-47.7	-53.3	-16.8
Asia[a]								
Private capital flows, net	98.4	123.2	12.0	-44.9	6.3	-18.3	15.5	69.5
Private direct investment, net	52.6	53.7	56.4	59.3	60.3	53.0	46.5	55.3
Private portfolio investment, net	22.7	32.8	7.1	-17.9	14.4	4.3	-13.5	-18.1
Other private capital flows, net	23.1	36.6	-51.5	-86.3	-68.4	-75.5	-17.6	32.3
Official flows, net	4.3	-12.7	17.1	26.1	4.2	3.2	-6.0	-10.2
Change in reserves	-43.1	-46.6	-15.0	-67.9	-78.9	-49.0	-84.6	-166.9
Current account balance	-30.2	-37.4	22.1	110.9	95.4	79.1	77.7	102.4
China and India								
Private capital flows, net	37.4	48.5	28.3	-4.6	10.3	13.1	42.2	59.4
Official flows, net	3.9	2.3	1.5	5.6	7.0	-0.4	1.0	3.1
Change in reserves	-20.3	-34.4	-40.5	-9.1	-14.5	-16.5	-56.1	-93.7
Current account	-3.9	1.2	33.9	24.6	12.4	16.1	17.3	27.7
First tier NIEs[a]								
Private capital flows, net	11.3	16.1	-26.8	-17.8	20.9	3.3	-9.2	16.0
Official flows, net	-3.1	-11.4	2.8	4.9	-17.9	-9.0	-12.2	-15.4
Change in reserves	-11.7	-9.3	13.1	-47.2	-47.9	-31.5	-23.1	-55.0
Current account balance	11.9	1.8	13.7	63.0	48.7	34.9	43.2	51.2
Africa								
Private capital flows, net	11.3	10.0	9.0	10.4	13.7	4.8	6.0	5.5
Private direct investment, net	1.9	3.5	7.8	6.3	9.4	7.8	22.4	8.9
Private portfolio investment, net	2.5	2.8	7.0	3.7	8.2	-2.2	-9.1	-1.2
Other private capital flows, net	6.9	3.7	-5.9	0.4	-3.9	-0.8	-7.3	-2.3
Official flows, net	5.7	-2.2	3.2	4.2	2.0	3.0	1.6	2.2
Change in reserves	-2.5	-7.9	-11.1	2.8	-3.5	-13.2	-11.9	-1.4
Current account balance	-16.6	-6.2	-6.4	-18.6	-15.6	5.1	-0.4	-8.0
Sub-Saharan Africa								
Private capital flows, net	8.3	8.1	5.9	9.4	12.4	4.8	2.6	3.9
Official flows, net	6.0	-1.8	4.2	4.7	2.5	3.9	2.7	3.5
Change in reserves	-3.9	-5.2	-6.1	1.8	-3.8	-6.6	-1.8	3.4
Current account balance	-12.4	-7.0	-9.1	-16.9	-15.0	-2.7	-8.2	-13.0

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Table 2.1 (concluded)

NET CAPITAL FLOWS AND THE CURRENT ACCOUNT: DEVELOPING AND TRANSITION ECONOMIES, 1995–2002

(Billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002
Middle East[b]								
Private capital flows, net	8.2	9.5	16.9	10.2	-3.9	-18.8	-38.3	-25.3
Private direct investment, net	6.4	4.7	5.2	6.2	5.3	7.7	10.5	7.3
Private portfolio investment, net	2.0	1.8	-0.9	-13.2	-3.2	-13.4	-22.0	-14.2
Other private capital flows, net	-0.3	3.0	12.6	17.1	-6.0	-13.1	-26.9	-18.4
Official flows, net	4.4	5.9	5.9	3.6	3.7	-2.5	6.3	12.5
Change in reserves	-11.6	-22.2	-19.4	9.7	-6.4	-27.3	-4.9	-8.0
Current account balance	-4.4	5.4	5.5	-23.3	13.0	64.3	48.0	26.4
Transition economies								
Private capital flows, net	51.4	20.2	-20.9	14.5	29.8	32.9	20.9	34.1
Private direct investment, net	13.0	12.3	15.5	20.8	23.8	23.4	25.2	29.2
Private portfolio investment, net	14.6	13.1	6.9	5.4	2.4	2.4	3.2	3.4
Other private capital flows, net	23.8	-5.1	-43.3	-11.8	3.6	7.1	-7.4	1.5
Official flows, net	-6.0	2.2	15.5	33.7	3.5	-3.1	13.2	2.9
Change in reserves	-37.4	-4.2	-3.3	-6.5	-6.7	-20.1	-18.0	-31.4
Current account balance	-4.9	-12.2	-25.9	-29.7	-2.5	24.8	12.0	10.3

Source: UNCTAD secretariat calculations, based on IMF, *World Economic Outlook*, April 2003.

Note: Figures under the item "other private capital flows" comprise other long- and short-term net investment flows, including private borrowing and residuals not covered under other items; due to limitations in data coverage such residuals may also include some net official flows. A minus sign in the lines for change in reserves indicates an increase.

a Excluding Hong Kong (China).

b Including Israel, Malta and Turkey.

for the transition economies) the main source of reserve accumulation has been current-account surpluses, whereas previously net capital inflows had provided financing for both current-account deficits and reserve accumulation.

The net transfer of resources from developing countries and transition economies was even greater when allowance is made for net payments on foreign investment income, including interest payments on outstanding debt and profit remittances. According to preliminary estimates by the United Nations Department of Economic and Social Affairs (UN/DESA), the net transfer of financial resources from developing countries, including net capital inflows, increases in reserve holdings and net payments on foreign investment income, reached an unprecedented $192 billion in 2002 (table 2.2). About $90 billion of this was transferred as net payments on foreign investment income, which exceeded total net capital inflows, including official capital inflows, by some $15 billion. Thus, on a cash-flow basis, developing countries' financial balance with the rest of the world was in the red, financed by surpluses generated on the trade account. This continued the trend that had started after the financial crisis in East Asia. In 2002, the net transfer of financial resources was negative for every developing region (except sub-Saharan Africa) as well as for the transition economies.

The downward trend in net private capital flows to developing countries that has persisted since the 1997 East Asian financial crisis has been influenced by a number of factors. First, there has been a general worsening of global financial conditions. In particular, volatility and risk have

Table 2.2

NET TRANSFER OF FINANCIAL RESOURCES TO DEVELOPING AND TRANSITION ECONOMIES, 1994–2002

(Billions of dollars)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*[a]
Developing economies	44.2	49.7	30.3	-2.7	-33.7	-120.9	-179.3	-155.1	-192.5
Africa	4.6	6.6	-4.4	-3.7	15.6	5.1	-18.8	-11.2	-9.0
Sub-Saharan Africa[b]	6.7	8.2	10.5	7.9	13.2	9.7	5.0	9.0	9.5
East and South Asia	5.1	25.6	22.4	-34.6	-130.1	-134.8	-110.4	-111.0	-141.5
West Asia	15.2	18.8	11.2	11.4	36.1	-0.3	-48.3	-34.9	-13.2
Latin America	19.3	-1.3	1.1	24.2	44.7	9.1	-1.8	2.0	-28.8
Transition economies	-2.2	10.0	20.0	30.2	33.7	4.5	-23.4	-9.7	-9.5

Source: UN/DESA, based on data from IMF, *World Economic Outlook*, April 2003; and IMF, *Balance of Payments Statistics Yearbook*, various issues.

a Preliminary estimate.

b Excluding Nigeria and South Africa.

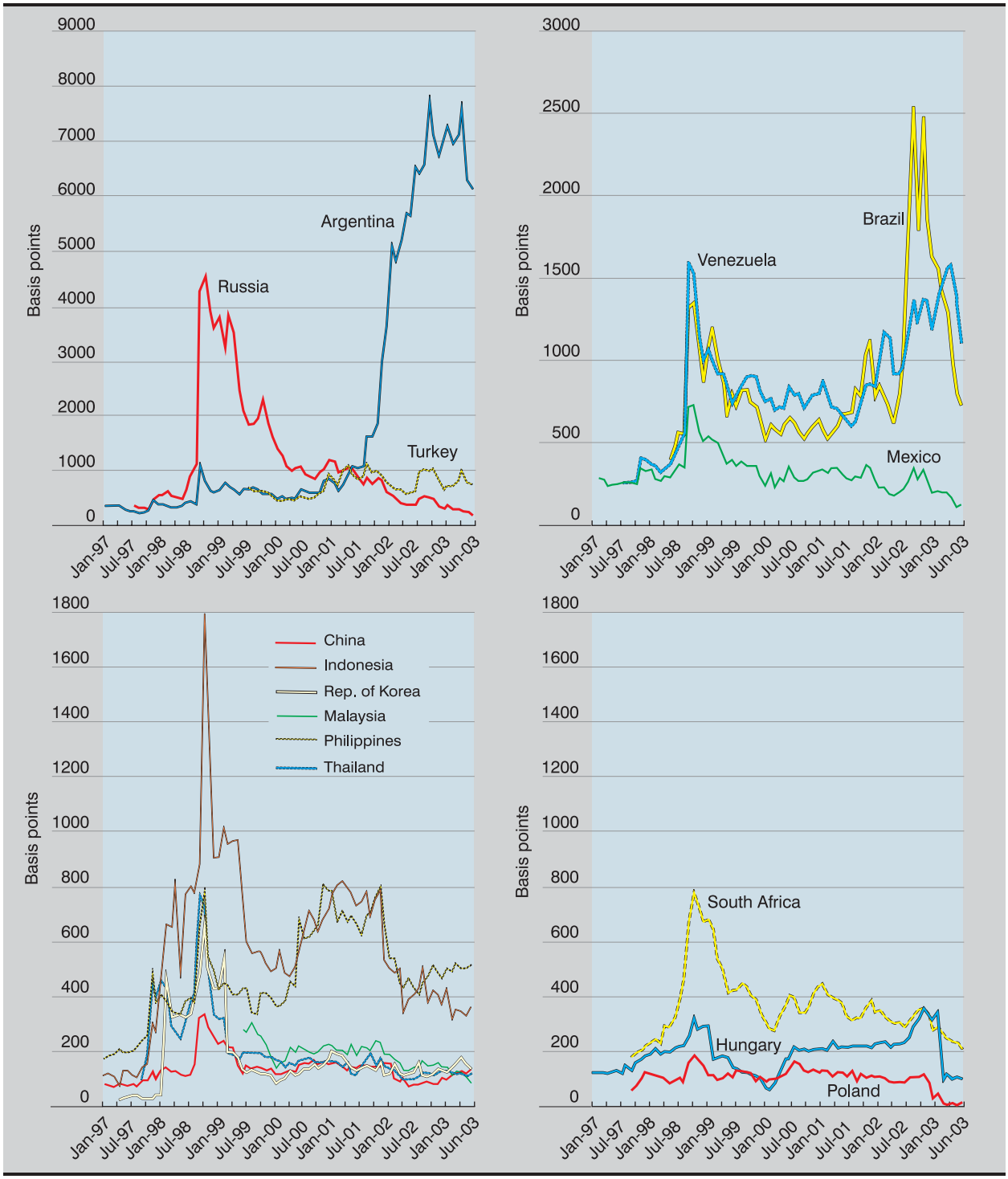
remained high due to a number of developments since the turn of the century, including the sharp decline of United States equity prices in 2000, the Turkish crisis and the Argentine debt default in 2001, and geopolitical uncertainties beginning with the terrorist attacks in the United States on 11 September 2001. All these have resulted in considerable increases in risk spreads on internationally issued emerging-market bonds which, on average, have remained at relatively high levels, despite some moderation since mid-2002 (fig. 2.1).

Moreover, two developments have reduced the opportunities for international arbitrage: a greater convergence of inflation and interest rates between emerging-market economies and industrial countries, and the shift of many emerging-market economies to a regime of floating exchange rates. According to estimates by the UNCTAD secretariat, the difference between average short-term nominal interest rates of the G-7 countries and a group of 14 emerging-market economies has been decreasing almost constantly since the mid-1990s: the difference was as high as 30 percentage points in 1995, dropping to some 8 points at the end of the century and to less than 5 percentage points in 2001 (fig. 2.2).[1] When these margins were quite high, they provided important short-term profit opportunities through international arbitrage, particularly in countries which pursued stabilization programmes based on fixed exchange rates or crawling pegs. This was the case in Latin America and some transition economies, as well as in many East Asian economies that traditionally pursued a policy of stable nominal exchange rates under price stability. Such regimes often provided implicit exchange rate guarantees, thereby reducing the currency risk. In recent years, many of these countries, particularly in East Asia, have shifted to floating rates while reducing interest rates sharply from the peaks reached during the financial crisis. In others such as Malaysia, where exchange rates remain nominally fixed to the dollar, domestic interest rates have been too low to yield profits from arbitrage. However, in Latin America, notably in Argentina and Brazil, the downward trend in inflation and interest rates has been somewhat reversed with the breakdown of fixed or pegged currency regimes and the consequent rise in interest rates. Although this has also meant a significant increase in both currency and credit risks, as noted in chapter I, the ex-

Figure 2.1

YIELD SPREADS OF SELECTED INTERNATIONALLY ISSUED EMERGING-MARKETS BONDS,[a] JANUARY 1997 TO JUNE 2003

(Basis points[b])



Source: Thomson Financial Datastream.

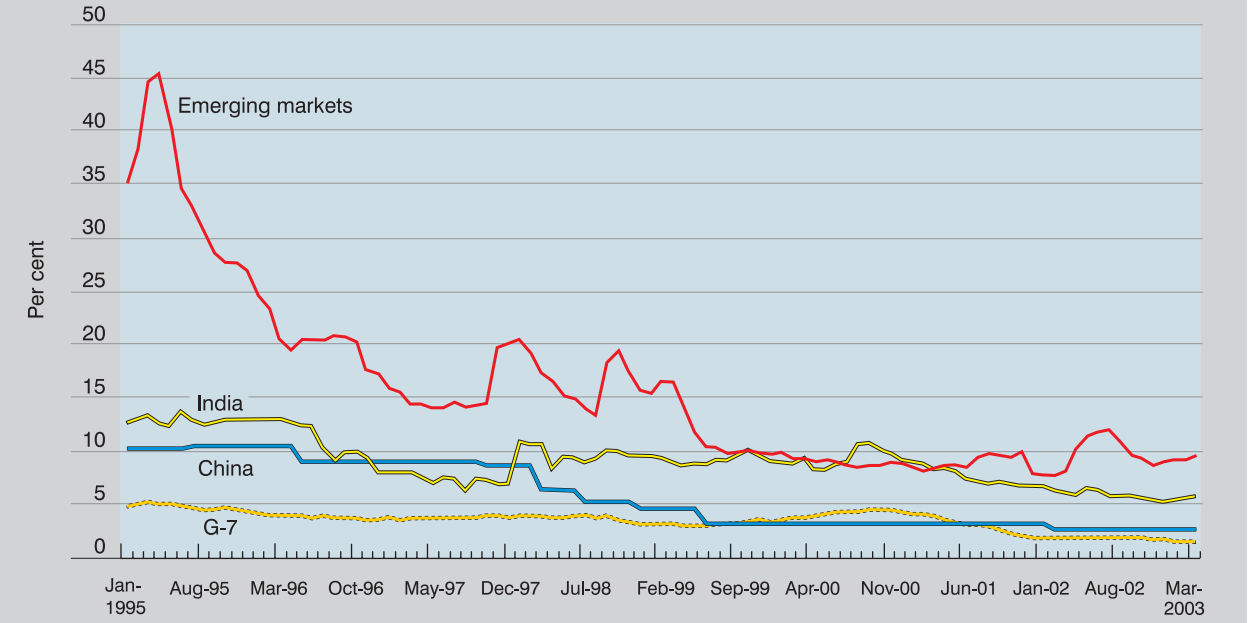
a Differential between the yield on a representative bond issued by the borrowing country and those of the same maturity issued by the government of the country in whose currency the borrower's bonds are denominated.

b One basis point equals 0.01 per cent.

Figure 2.2

REPRESENTATIVE SHORT-TERM INTEREST RATES IN THE G-7, EMERGING MARKETS, CHINA AND INDIA,[a] JANUARY 1995–MARCH 2003

(Per cent)



Source: IMF, *International Financial Statistics*; World Bank, *World Development Indicators, 2003*; and Thomson Financial Datastream.

a Weighted averages for G-7 and emerging markets (Argentina, Brazil, Chile, Czech Republic, Hungary, Malaysia, Mexico, Peru, Poland, the Republic of Korea, Russian Federation, Singapore, Taiwan Province of China, and Thailand).

tremely high yields in some of these countries (e.g. Brazil) have been attracting a certain amount of short-term capital to the region.

Finally, financial crises in many developing countries have prompted governments to strengthen scrutiny of their financial systems with a view to reducing their vulnerability to a reversal of capital flows. Many countries in East Asia and elsewhere have tightened their regulation and supervision of the banking system to prevent excessive risk-taking. This has included a stricter application of certain prudential measures, such as capital requirements, and more effective restrictions on open foreign-exchange positions. Tightened financial oversight, together with reduced profitability and increased currency risks of arbitrage-related flows, has certainly played a role in checking short-term speculative flows into emerging-market economies in recent years.

However, there has also been considerable diversity among developing countries regarding the causes and effects of private capital flows, as well as their volume and composition. Latin America has seen a significant change of fortune in terms of its risk profile and the volume of private capital inflows. It received virtually no net inflows of private capital in 2002 after being the largest recipient the previous year. International bond issues by Latin American countries were halved in 2002 compared to 2001, and their spreads, which had risen sharply, first with the Argentine default and then with political uncertainties in Brazil, declined considerably in the more recent period, reaching very low levels for

a few countries, including Mexico. However, they remained extremely high for Argentina, Brazil and Venezuela (fig. 2.1). The downward trend in net portfolio inflows that started after 1997 continued unabated, with a net repatriation of such investment for the first time in 2002. Net inflows of FDI fell to almost half the level reached in 2001, after having remained relatively stable at over $50 billion during the previous five years.

Although net capital inflows to the developing countries increased, net resource flows were negative.

In Latin America, with the exception of a few countries, recent trends in international capital flows and resource transfers are reminiscent of the conditions prevailing during the debt crisis of the 1980s. In 2002, the region as a whole combined a contraction in output with a trade surplus that was generated entirely through import compression brought about by a fall in domestic absorption; exports of goods and services remained unchanged from the level of the previous year, following a decline between 2000 and 2001 (IMF, 2003, table 31). However, the current account was still in deficit, as net payments on foreign investment income exceeded the trade surplus. Since net private inflows and changes in reserves were negligible, a large proportion of official inflows, in addition to the trade surplus, was used to finance net transfers to private investors abroad in the order of $30 billion in 2002 (table 2.2).[2] In other words, as in the 1980s, resource transfers from the region were the result of reduced private capital inflows and were accompanied by tightened balance-of-payments constraints, reduced growth, and increased external indebtedness to official creditors.

The net transfer of financial resources from developing countries reached an unprecedented $192 billion in 2002.

The picture is quite different in Asia, which received a significant amount of private capital in 2002. Indeed, at about $70 billion, this was more than four times the level of the previous year. Net private capital inflows to India and China, amounting to an estimated $59 billion, accounted for more than four-fifths of the total inflows to the region. This included a surge in FDI to China that was attracted, as anticipated in *TDR 2002*, by the country's accession to the World Trade Organization (WTO). The first-tier NIEs (excluding Hong Kong, China) received $16 billion while net private inflows to the rest of Asia were negative.

Unlike Latin America, the Asian economies generated large current-account surpluses through a rapid expansion of exports. The total current-account surplus in Asia exceeded $100 billion, with China and India together accounting for some $28 billion and the first-tier NIEs (excluding Hong Kong, China) for $51 billion. Since net official inflows to the region were negative on account of payments to the IMF, net private capital inflows were, in effect, used, together with the current-account surpluses, to pay off official creditors and to add to international reserves, at an unprecedented amount of $167 billion; China and India accounted for around $94 billion and the first-tier NIEs for $55 billion. In China and India reserve accumulation was mainly from net capital inflows, while in the first-tier NIEs it was largely from current-account surpluses. In other words, unlike the situation in Latin America, the net transfer of financial resources from East and South Asia reported in table 2.2. was associated with a net acquisition of assets abroad rather than increased indebtedness.

In Asia, notably among the NIEs, recent changes in the volume and composition of private capital inflows reflect as much the behaviour and choices of the recipient economies as the risk-return assessment of international investors. This is because their strong balance-of-payments position has precluded the need for foreign capital for balance-of-payments purposes. In this context it should be noted that the figures on net private capital inflows in table 2.1 are reported on a balance-of-payments basis, including external capital transactions by both residents and non-residents. Given that the capital-account regimes in the region contain relatively few restrictions on FDI inflows and portfolio in-

vestment by non-residents in domestic financial markets, such components of private capital inflows are largely autonomous and reflect the risk-return assessment of investors. However, a number of countries in the region have also become exporters of FDI, and such outflows are netted out with non-resident inflows in table 2.1. Borrower behaviour is equally, if not more, important for net debt-creating flows, including international bond issues and bank lending. In recent years, many of the East Asian economies which have enjoyed high sovereign ratings and low spreads have done without international bond markets in view of their comfortable payments positions. Instead, they have chosen to pay off to international banks the debt that they had inherited from rapid borrowing in the period leading up to the 1997 crisis. Similarly, many corporate borrowers have opted for local currency loans and domestic bonds, rather than borrowing in foreign currency, even though they have had access to international markets.

The situation in the transition economies taken together was similar to that in the East Asian economies. Increased inflows of private capital in the form of FDI and current-account surpluses, in the context of relatively rapid growth, helped to add significantly to their international reserves and improve their net foreign asset positions. However, there were considerable variations within this group. While smaller countries ran relatively high current-account deficits financed by net private capital inflows, the Russian Federation enjoyed an improvement in its current account thanks to rising oil revenues. This led to an upgrading of its credit rating and to a reduction of its spreads, thus improving significantly the country's access to international bond markets.

Sub-Saharan Africa, including South Africa, saw a relatively large increase in its current-account deficit in 2002. While both net private and official capital inflows were positive, they fell short of the current-account deficit. As a result, the region suffered a sizeable decline in its international reserves. Countries in the Middle East, as well as Turkey, experienced net private capital outflows on account of withdrawals of portfolio investment and declines in international banks' exposure to the region; these were not compensated by the moderate inflow of FDI. The region as a whole generated a current-account surplus, but the underlying factors varied across countries. The oil-exporting countries in the Middle East saw considerable improvements in their trade and current-account balances as a result of higher oil prices and export revenues, while in Turkey, such improvements occurred in much the same way as in debt-stricken Latin American countries. The breakdown of the Turkish exchange-rate-based stabilization programme in February 2001, and the consequent financial crisis, plunged the economy into a deep recession, leading to massive cuts in imports. There was a sharp rise in spreads on Turkish bonds and reduced access to international markets, increasing the country's reliance on IMF financing (Akyüz and Boratav, 2003).

In Latin America, recent trends in international capital flows and resource transfers are reminiscent of the conditions prevailing during the debt crisis of the 1980s.

Therefore, while the past couple of years have seen a significant deterioration in global financial conditions as a whole, its effects on developing and transition economies have varied considerably depending on their real economic performance, particularly with respect to trade, and their degree of indebtedness. The international financial markets have continued to differentiate between emerging markets with respect to risks and returns. This is clearly seen in the large differences in the risk spreads of different emerging-market economies as well as in their degree of access to international capital markets. Many economies in East Asia that have succeeded in combining expansion of economic activity with strong payments positions have not needed foreign capital to sustain economic growth, and it is precisely these countries that have attracted relatively large amounts of private capital because of their favourable risk-return profiles. However, while receiving sizeable inflows of private capital, many of these countries have improved their net external asset positions thanks to their large current-account surpluses. By contrast, most Latin American countries with weak trade and growth

performance and high external-debt burdens have failed to receive sufficient amounts of private capital to meet their needs for imports and payments of foreign investment income. As a result, they have been forced to cut economic growth and imports, rely on official flows, or use their foreign-exchange reserves in order to balance their external accounts.

B. Prospects for capital flows to developing countries: a historical perspective

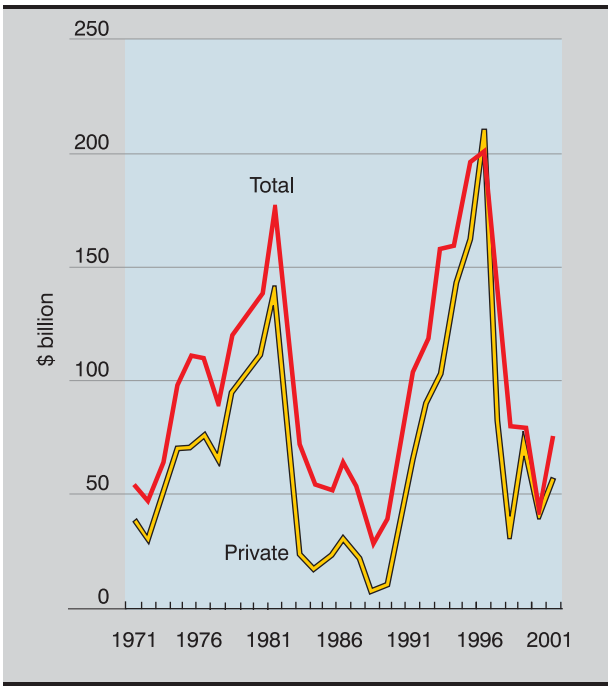
Short-term prospects for capital flows to developing countries reflect a number of positive and negative developments, apparent since the second half of 2002. For many developing countries, which had previously faced stringent external financial conditions, spreads started to decline, in some cases sharply, beginning in the second half of 2002. Recent economic and political developments in Argentina, Brazil and Turkey have helped restore investor confidence from the low levels observed throughout 2001–2002, reflected not only in reduced bond spreads, but also in declines in their domestic interest rates and a rebound in their currencies. Credit ratings have also been upgraded for many other emerging markets, including Mexico, the Republic of Korea and the Russian Federation, with the former two countries now enjoying investment grade status.

However, these improvements in the risk-return profiles of emerging markets need to be weighed against a number of adverse developments that became apparent in early 2003. First, as discussed in the previous chapter, recovery in the industrial countries has been delayed, with attendant consequences for export earnings and payments of the developing countries, including East Asian economies that are highly dependent on developed-country markets. Second, the gyrations in currency markets – notably the sharp rise of the euro against the dollar and yen – add to uncertainties and tend to encourage flight to liquidity, as do political uncertainties in the Middle East. Finally, the spread of the Severe Acute Respiratory Syndrome (SARS) has been causing disruptions to international movements of goods and natural persons, particularly in East Asia.

Perhaps a more fundamental question is to what extent recent declines in capital flows to developing countries constitute a cyclical downturn, which is expected to be followed by a strong rebound, similar to the situation after the previous cycle that started in the early 1970s. Indeed, from a longer-term perspective, capital flows to developing countries appear to be at the end of a second 10-year cycle of expansion and contraction: the first beginning in the early 1970s and ending with the debt crisis, and the second beginning in the early 1990s and ending with the recent slowdown (fig. 2.3). It appears that, although the two periods differ in the nature and composition of capital flows, they are similar in terms of cumulative net inflows to emerging markets: from 1974 to 1981 cumulative net inflows in constant (2000) dollars amounted to $1.155 billion com-

Figure 2.3

REAL NET CAPITAL INFLOWS TO DEVELOPING COUNTRIES, 1971–2001



Source: IMF, *World Economic Outlook*, 2003 database; World Bank, *Global Development Finance, 2003*.
Note: Real flows are nominal flows adjusted for changes in the United States GDP deflator.

pared to $1.243 billion between 1992 and 2001. The general similarity also holds on a regional basis for Latin America (fig. 2.4), where cumulative net inflows amounted to $523 billion in the first cycle and $683 billion in the second.

However, a detailed examination of the conditions that produced these two surges in capital flows to emerging markets suggests that they are not part of a recurrent cyclical pattern. Rather, they appear to be more the result of ad hoc policies introduced in response to specific global circumstances, accompanied by the deregulation of financial markets and liberalization of international financial flows. Moreover, these post-war cycles are not the first episodes of rapid expansion and contraction of capital flows to developing countries. Indeed, they have occurred with varying frequency and under different circumstances ever since the new States in Latin America emerged from colonial rule in the first quarter of the 19th century. While surges in capital flows started for different reasons in different episodes, more often than not these cycles ended in financial distress, as had already been noted in the inter-war years:

> The fiscal history of Latin America ... is replete with instances of governmental defaults. Borrowing and default follow each other with almost perfect regularity. When payment is resumed, the past is easily forgotten and a new borrowing orgy ensues. This process started at the beginning of the past century and has continued down to the present day. (Winkler, 1933: 41)

As discussed in some detail in chapter VI, independence for the Spanish colonies in Latin America around 1820 was followed by a rapid increase in capital inflows, which resulted in widespread defaults about 10 years later and in the disappearance of international lending to the region until around 1850 (see chap. VI, box 6.1). During the remainder of the 19th century, capital flows to the region were sustained, but they were punctuated by frequent defaults by individual country borrowers. The excesses surrounding the United States stock market boom of the "roaring twenties" also spilled over to Latin America. Loans made to the region between 1924 and 1929 reached $1.2 billion, as United States bankers started to compete for attractive underwriting fees on new loans, at times misinforming lenders of the creditworthiness of the borrowers (Winkler, 1933: 48). However, the fall-off in exports produced by the Great Depression, coupled with a cutback in international lending, created difficulties in servicing the debt. At the end of 1933, delinquent Latin American bonds amounted to about $3 billion, or about 60 per cent of the non-Russian delinquent bonds on the New York market.[3] By 1935, there were defaults on 85 per cent of Latin American dollar bonds and over 50 per cent of European-currency bonds (United Nations, 1955).[4] Private lending totally dried out well into the 1950s (fig. 2.4).

The inter-war experience led to a change in thinking on the role of international capital movements in the global financial architecture. In the words of the United States Secretary of the Treas-

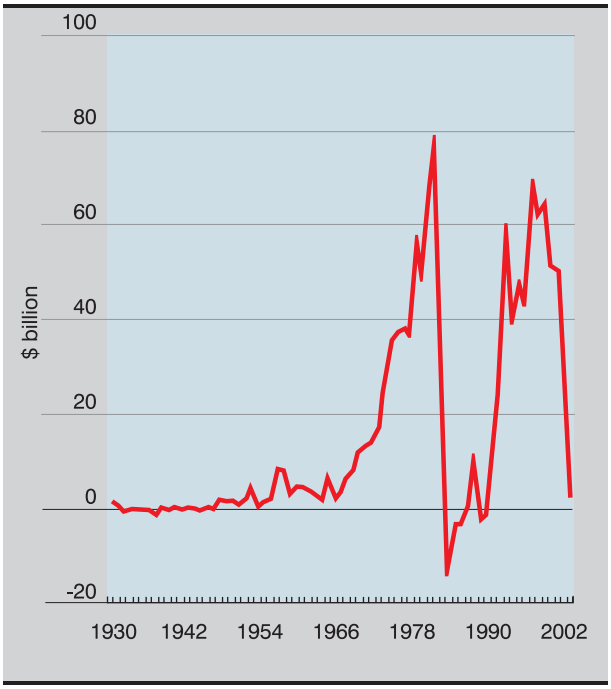
ury, the architects of the post-war financial system intended "to drive … the usurious money lenders from the temple of international finance" in order to make the system respond to the needs and interests of "sovereign governments, and not of private financial interests".[5] Until the beginning of the 1970s, virtually all lending to developing countries, and particularly to Latin America, was by official bilateral and multilateral creditors, while private flows consisted mainly of FDI by United States companies (fig. 2.5).

The picture had already started to change in the 1960s in conjunction with the rapid expansion of the Eurodollar market, driven by mounting United States external deficits and deregulation and liberalization of United States financial markets. In the late 1960s, several Latin American countries had relaxed their controls on foreign currency borrowing by their domestic banks and eased entry conditions to their markets for international banks from industrialized countries. The surpluses of oil exporters vis-à-vis industrial countries in the early 1970s gave new momentum to international capital movements, expanding further the Eurodollar market and leading to the return of private international lending to Latin America (fig. 2.4 and 2.5). Much of this was in the form of syndicated bank lending, mainly to private companies and public enterprises involved in industrialization programmes. In comparison, FDI flows were small and portfolio flows almost non-existent.[6]

The Latin American economies seemed particularly attractive to international lenders because they had been able to sustain high rates of growth throughout the 1950s and 1960s, and they were keen to maintain growth by making policy adjustments to offset the negative impact of the rise in petroleum prices on their external balances.[7] The process was generally encouraged by the Bretton Woods institutions and some of the major creditor countries, notably the United States, as a way of avoiding a collapse of global demand. However, the size of inflows was determined not so much by the region's external financing requirements as by the volume of rapidly expanding international liquidity associated with rising petroleum surpluses and a growing United States current-account deficit.[8] Thus the inflows were historically large, and in many cases exceeded the absorptive capacity of the recipient economies. The Asian economies were less involved in this initial expansion of international lending (fig. 2.6), although some, such as the Republic of Korea, were able to sustain growth by borrowing abroad as well as adopting measures to boost exports.

Figure 2.4

LATIN AMERICA: REAL NET PRIVATE CAPITAL INFLOWS, 1930–2002

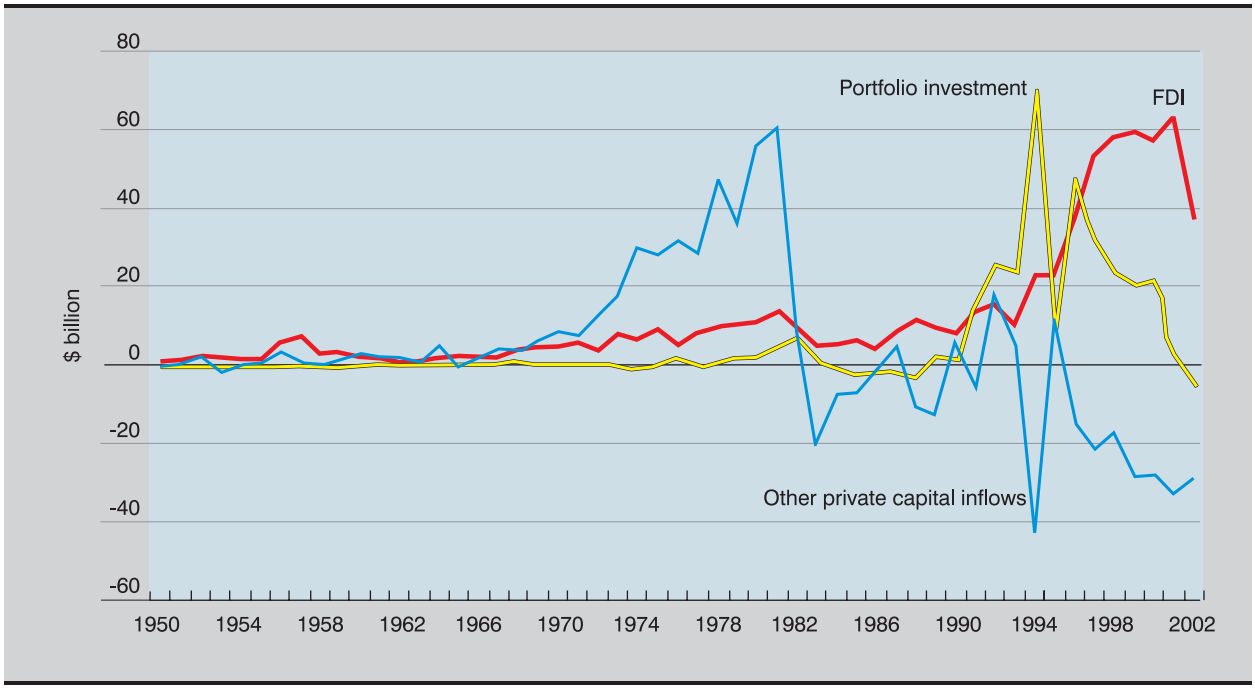


Source: IMF, *World Economic Outlook*, 2003 database.
Note: Real flows are nominal flows adjusted for changes in the United States GDP deflator.

This initial period of large private capital inflows marked the beginning of a major shift from multilateral to private lending for developing countries facing payments difficulties. Although most Latin American borrowers had initiated successful adjustments, private finance allowed them greater policy space than did multilateral lending with conditionalities. In any case, the latter had been limited by the resources and policies of the international financial institutions. Hence, international liquidity creation came to depend increasingly on the lending decisions of globally active commercial banks, based on their judge-

Figure 2.5

LATIN AMERICA: REAL NET PRIVATE CAPITAL INFLOWS, BY TYPE, 1950–2002



Source: ECLAC, Statistical Division; IMF, *World Economic Outlook*, 2003 database; and World Bank, *Global Development Finance, 2003.*

Note: Real flows are nominal flows adjusted for changes in the United States GDP deflator. The item "other private capital inflows" comprises other long- and short-term net investment flows, including private borrowing and residuals not covered under other items; due to limitations in data coverage such residuals may also include some net official flows.

ments concerning the risk-return profiles of borrowers, rather than on the amount of liquidity required to support adjustment policies in individual countries or to ensure the stability of international payments.

This shift from official to private financing opened the way for boom-bust cycles in international lending: while surges in capital flows often allowed adjustment to be postponed, rapid reversals, unrelated to the underlying fundamentals of the recipients, required severe adjustments. The sudden change in United States monetary policy at the end of the 1970s to bring inflation under control was just such an external trigger that eventually caused a sharp discontinuity in liquidity flows, giving rise to the debt crisis and to negative net resource transfers from Latin America (fig. 2.7).[9] Although this was not the first time since the 1930s that a negative transfer or resources occurred, its size in the 1980s was unprecedented.

It is not clear for how long negative transfers of this magnitude could have continued before the depression in economic activity needed to generate them would have led to social unrest and political instability. As default would have been politically unacceptable to creditors and full repayment politically unacceptable to debtors, a third option was required. This took the form of the 1989 Brady Plan, which provided an elaborate scheme that allowed debtor countries to refinance their debt to commercial banks by issuing "Brady Bonds" in international markets. The shift in the international approach to the debt problem encouraged a change in domestic policy in the major borrowing countries to make them more

"investor friendly". This involved bringing rapid inflation – which had plagued the region in the 1980s – to a swift halt, opening up domestic markets to foreign competition, privatizing public enterprises and liberalizing the financial system. The initial effect of the Brady Plan on the composition of flows was the replacement of syndicated bank loans by portfolio flows (fig. 2.5). However, with increased sales of public assets to foreigners and the greater participation of developing countries in international production networks, by the second half of the 1990s FDI had replaced portfolio and bank flows as the main source of external capital.

Asia started receiving greater inflows during the late 1980s (fig. 2.6 and 2.8), as the rapidly expanding first- and second-tier NIEs offered attractive alternatives to the stagnating Latin American economies. Nonetheless, portfolio inflows in Asia were still less than half those in Latin America ($124 billion and $270 billion respectively between 1991–1998), as the Brady initiative did not have the same impact on investment in East Asia as in Latin America.

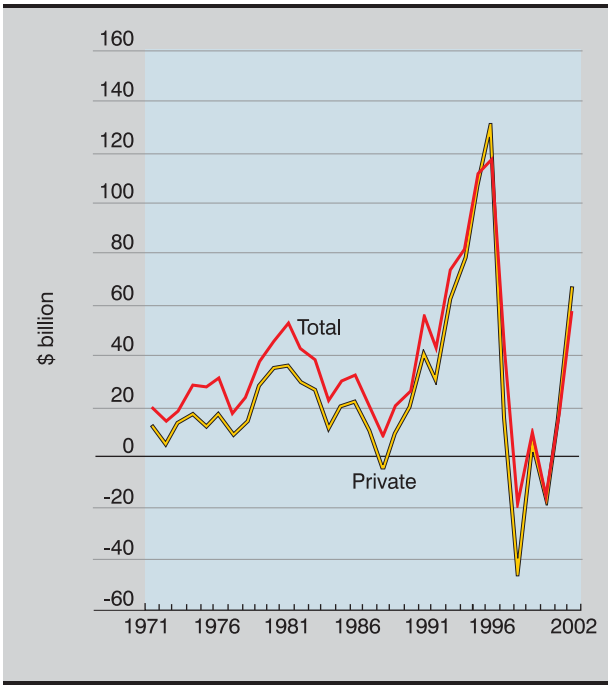
As a result of the success of the Brady Plan and the stabilization policies that brought rapid reductions in inflation, private inflows quickly returned to the levels of their earlier peaks. Just as in the earlier period, an unexpected increase in United States interest rates along with political uncertainty produced another financial crisis, this time in Mexico in 1994, that spread to Argentina and reduced inflows by more than half. This provided an additional impetus to investment in East Asia, although equity markets there had already peaked and there was evidence of slower growth and weaker macroeconomic fundamentals. In addition, as a result of large interest-rate differentials between developing East Asia on the one hand, and Japan and the United States on the other, international banks, that had cut lending to emerging markets since the 1980s, started to intermediate between low borrowing rates in the United States and Japan and higher interest rates in the rapidly growing East Asian emerging-market economies. This led to a rapid accumulation of short-term liabilities in these economies (fig. 2.8).

Despite their better macroeconomic fundamentals, the rapid surge in lending produced similar results in the economies of East Asia as it had in Latin America some 15 years earlier. The second upswing in capital flows was brought to an end in 1997–1998 by a reversal of bank flows and portfolio investment, and led to the emergence of negative net transfers similar to those experienced in Latin America in the 1980s. More recently, as noted above, the region has had record current-account surpluses, used to pay off outstanding bank loans and build large foreign-exchange reserves. There has also been a change in the composition of flows, with a larger share of direct investment, including mergers and acquisitions.

Thus the two cycles of rapid expansion of international capital flows met very specific policy needs: the first, to recycle petrodollars in order to avoid a collapse of global demand; and the second, to relieve United States banks of non-

Figure 2.6

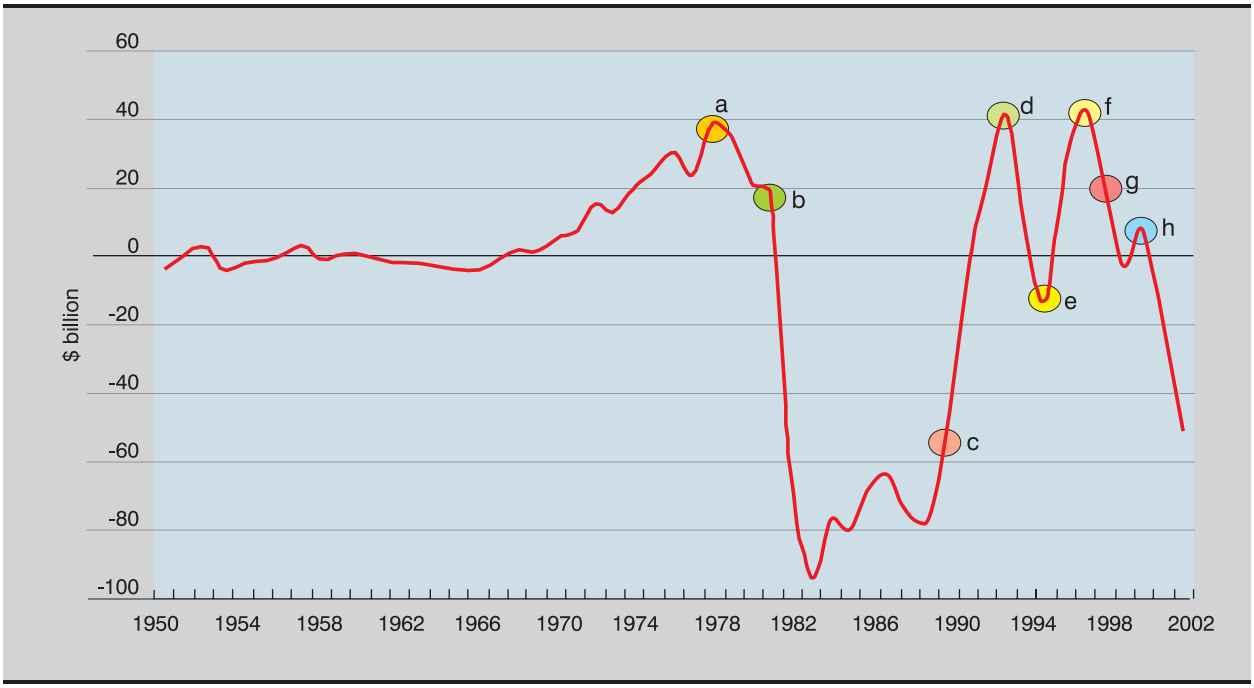
DEVELOPING ASIA: REAL NET CAPITAL INFLOWS, 1971–2002



Source: IMF, *World Economic Outlook*, 2003 database.
Note: Real flows are nominal flows adjusted for changes in the United States GDP deflator.

Figure 2.7

LATIN AMERICA: REAL NET TRANSFER OF RESOURCES, 1950–2002



Source: ECLAC, Statistical Division.

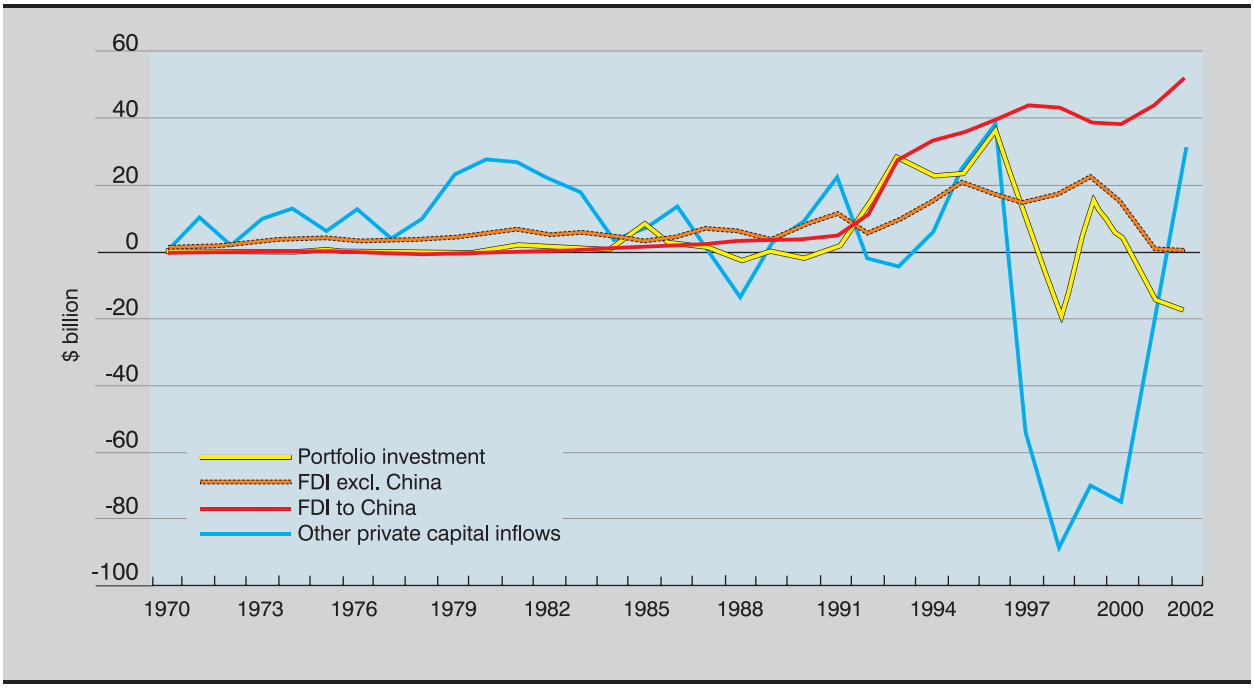
Note: Excluding net transfers with the IMF. Real transfers are nominal transfers adjusted for changes in the United States GDP deflator.
a: Sharp rise in dollar interest rates.
b: Mexican debt crisis 1982.
c: Introduction of the Brady Plan; reduction of dollar interest rates.
d: Mexican financial crisis 1994.
e: "Real Plan" in Brazil.
f: East Asian financial crisis 1997.
g: Russian and Brazilian financial crisis 1998–1999.
h: Beginning of the Argentinean crisis.

performing loans, which had resulted from the previous cycle in a way that would avert economic stagnation or political disruption in Latin America. Both surges were driven by special policy measures and financing vehicles. The first boom was made possible by financial deregulation in the industrialized countries and the rapid growth of Eurodollar markets. The second boom was greatly helped by the success of the Brady Plan and progressive liberalization and privatization in developing countries, which gave rise to a reflexive, self-reinforcing, but unsustainable process.[10]

That these cycles were not the result of autonomous market forces responding to long-term fundamentals in the recipient countries, and that they both ended with financial crises, widespread debt servicing difficulties and defaults, suggests that the magnitude and direction of the flows that were observed in the 1970s and 1990s were due more to special factors and policies that motivated behaviour on both the supply and the demand side. As such they are not likely to return as part of any natural cycle of free international capital markets. On the other hand, the history of international capital flows in periods of minimum government intervention and control suggests that financial markets do have a tendency to produce boom-bust cycles in individual economies, with periodic defaults as the natural outcome. Thus, over the

Figure 2.8

DEVELOPING ASIA: REAL NET PRIVATE CAPITAL INFLOWS, BY TYPE, 1970–2002



Source: IMF, *World Economic Outlook*, 2003 database; and World Bank, *Global Development Finance, 2003*.
Note: Real flows are nominal flows adjusted for changes in the United States GDP deflator. The item "other private capital inflows" comprises other long- and short-term net investment flows, including private borrowing and residuals not covered under other items; due to limitations in data coverage such residuals may also include some net official flows.

medium term, capital flows to developing countries may recover, but they are unlikely to reach the peaks experienced at the beginning of the 1980s and the mid-1990s, and they may not necessarily take the same form or go to the same destinations. ■

The magnitude and direction of the capital flows in the 1970s and 1990s were due more to special factors and policies and are not likely to return as part of any "natural" cycle.

Notes

1 The term emerging-market economies refers to Argentina, Brazil, Chile, Mexico, Peru, the Republic of Korea, Malaysia, Singapore, Taiwan Province of China, Thailand, the Czech Republic, Hungary, Poland and the Russian Federation. The figures above are weighted averages. The difference is even smaller for unweighted average rates.

2 There were also payments of interest on official debt, but these were small compared to payments on foreign investment income.

3 Winkler, 1933: 204–205. Russia accounted for $17 billion in defaulted bonds.

4 Maddison (1985) gives delinquency rates for 1935 for individual countries, which were 100 per cent for Chile, Colombia and Mexico, 93.2 per cent for Brazil, 62.9 per cent for Cuba, 87.1 per cent for the rest of Latin America and 23.6 per cent for Argentina.

5 Cited in Gardner, 1969: 76.

6 For a detailed account of the growth of private capital flows to developing countries from the 1950s onwards until the debt crisis, see *TDR 1984*, chap. IV.

7 See Cohen and Basagni (1981) for details of the adjustment policies implemented in various Latin American countries in response to the rise in petroleum prices.

8 By taking the oil surpluses in the form of Eurodollar deposits it was possible for the international banking system to create liquidity far in excess of the surplus created by the oil price increases.

9 For a detailed analysis of the events leading to the 1980s debt crisis, see *TDR 1985*, Part Two.

10 Soros (1987) identified this process as supporting the overvaluation of the dollar in the first half of the 1980s, and the experience of countries such as Argentina and Brazil seems very similar in terms of the process he described. Just as the overvaluation of the dollar in the 1980s was justified on the basis of increased returns resulting from supply-side policies in the United States, in Latin America it was widely maintained that capital inflows and currency overvaluations were, in reality, only a reflection of greater efficiency resulting from the market-based reforms.

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