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INTERNATIONAL CAPITAL FLOWS:

The Brazilian Experience

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Introduction

After being almost excluded from world capital markets during the debt crisis, Brazil such as many others developing countries have experienced large capital inflows during the past 5 years. The challenges that these inflows pose for domestic policy in recipient countries have generated substantial discussions.

The objective of this paper is to take an overview of these challenges, describing: the integration of financial market and environmental changes, the characteristics of the new capital inflows to developing countries, more specifically to Latin American countries, and the evolution of capital flows to Brazil in the 1970s and 1990s.

The main questions addressed in this paper are the following: First, What the new challenges in the global capital market? Second, How developing countries have responded these challenges? Third, How Brazil managed the recent capital flows?

1. Integration of Financial Market and Environmental Changes

The financial markets around the world are rapidly transforming into an interconnected capital market, and developing countries are increasingly part of this process. The process that is being driven by advances in communications and information technology, deregulation of financial markets, and the rising importance of institutional investors that are able and willing to invest internationally.

The developing countries are attracting private capital flows by improving macroeconomic policy and by establishing institutions and regulatory regimes that have increased creditworthiness and promise a more stable environment.

Moreover, investors are also becoming more sophisticated in differentiating among countries and their economic fundamentals (country credit rating, secondary bond prices, price-earnings ratio in domestic stock markets).

After the Mexican crisis of 1994-95, the international community has realized that more should be done to reduce volatility and risks in international financial markets by improving market disclosure and strengthening coordination among national authorities

However, the management of private capital flows has not proved to be easy, it is not just the volume of flows, but the speed at which such investment pours in, and can be withdrawn, that present particular challenges to these economies.

Governments had to build the kind of macroeconomic, regulatory, and institutional environments that channel this private capital into broad-based and sustainable growth. They created the conditions to attract private capital and now they are taking care about to not using them to finance large fiscal deficits or consumption booms.

Flows of foreign financial capital to developing countries had been occurring irregularly in the past few decades. The period 1973-81 witnessed massive capital flows to countries in many parts of the developing world, largely in the form of private syndicated bank loans directed to the public sector. Such lending effectively dried up for many developing countries during the period of the debt crises, 1982-89.

But in recent years several developing countries around the world have again begun to receive substantial flows of foreign capital. The flows are notable because of their magnitude and because they represent a break from the period of the debt crisis for many of the recipient countries.

While the cyclical downturn in global interest rates provided an important impetus for the resumption of private capital flows to developing countries in the 1990s; these flows have now entered a new phase, reflecting structural forces that are leading to progressive financial integration of developing countries into world financial markets.

The two primary forces that are driving investor interest in developing countries are the search for higher returns and opportunities for risk diversification. Although these forces have always-motivated investors, the responsiveness of private capital to cross-border opportunities has gained momentum as a result of internal and external financial deregulation in both industrial and developing countries and major advances in technology and financial instruments.

This process of financial integration is still unfolding. Even in the more regulated economies, growing economic sophistication means that financial integration will increasingly not be a choice for government of make. *Markets are making the choice for them.* Therefore, the financial integration of developing countries is expected to deepen and broaden over the coming decade against a background of increasing global financial integration.

As part of this process, gross private capital flows may be expected to rise substantially, with capital flowing not only from industrial to developing countries but also, increasingly, among developing countries themselves and from developing to industrial countries.

The higher expected rates of return in developing countries, and the underweighting of emerging markets in institutional portfolios have generate a large capital flows to developing countries.

The rate of growth, though, will inevitably diminish. There will undoubtedly also is considerable variation among countries, depending on the pace and depth of improvements in macroeconomic performance and creditworthiness. Basic factors as domestic politics, the availability of resources, and the level of development that has been attained are bound to affect the flow of capital and the process of financial integration.

With changes in the international financial environment, there are likely to be considerable year-to-year fluctuations in private capital flows to developing countries. These nations are, and will continue to be, highly susceptible to both domestic shocks and changes in the international environment, such as global interest rates.

The main risks of volatility and large reversals lie at the individual country level and stem from the interaction of domestic conditions and policies with international factors.

The experience of nations that have successfully managed financial integration suggests that the benefits of this process are likely to be especially large for developing countries. The direct advantages are two: these countries can tap the growing pool of global capital to raise investment, and they can diversify risks and smooth the growth of consumption and investment.

The most important benefits of financial integration, however, are likely to be indirect. These include knowledge spillover effects, improved resource allocation, and strengthening of domestic financial markets.

The challenge for developing countries is how to exploit the growing investor interest in their markets and so to enter a virtuous cycle of productive financial integration rather than a vicious cycle of boom and bust. In a virtuous cycle, integration and access to external private capital lead to increased productive investment, it is a momentum to take policy and institutional reform.

2. The new challenges in the global capital market:

Two primary forces are driving investor interest in developing countries and leading to their increased integration: the search for *higher returns* and the *opportunity for risk diversification.*

Although these underlying forces always have motivated investors, the responsiveness of private capital to cross-border opportunities has gained new momentum as a result of internal and external financial deregulation in both industrial and developing countries and major advances in technology and financial instruments.

In industrial countries, two important developments have increased the responsiveness of private capital to cross border investment opportunities:

- Competition and rising costs in domestic markets, along with falling transport and communications costs have encouraged firms to look for opportunities to increase efficiency by producing abroad;

- Financial markets have been transformed in the last two decades from relatively insulated and regulated to more globally integrated market.

An important phase of this globalization of capital markets has been growing importance of institutional investors who are both willing and able to invest internationally. According to World Bank statistics, the total assets of pension funds at the global level are estimated to have increased from $ 4.3 trillion in 1989 to $ 7 trillion in 1994. At the same time, the share of nondomestic investment in their portfolio rose from 7% in 1989 to 11% in 1994.The total international investments by pension funds rose from $302 billion to $790 billion in the same period.

In developing countries, the environment is also changing rapidly. Since 1986, several countries have embarked on structural reform programs and increased openness of their markets and removal of restrictions on capital movements, and the implementation of privatization programs. There have been major improvements in fiscal performance and the sustainability of external debt.

Although the perceived risks of investing in emerging markets remain relatively high, the more stable macroeconomic environment, growth in earning capacity (output and exports), and a

reduction in the stock of debt in many countries (following the implementation of the Brady Plan) are leading to decline risks and increase the expected rates of return in the major recipient countries.

The second force behind the structural trend in private capital flows is investors' desire to diversify portfolio risks. Investors can benefit from holding emerging market equities because returns in markets tend to exhibit low correlation with industrial country returns.

Developing countries have begun to offer investors significant opportunities for risk diversification that arise from the low correlation between rates of return in emerging markets and industrial countries. This opportunity for portfolio diversification in emerging markets is relatively recent phenomenon.

2.1 - The internationalization of financial market

The internationalization of financial market began in 1970s, after the collapse of the Bretton Woods system of fixed exchange rates in 1973. But the internationalization of bond markets gathered momentum only during 1980s, when the low inflation and positive real interest rates and yield curves made long-term bonds appealing to investors.

At the same time, banks funding costs rose for a variety of reasons. The general deflation in the 1980s and the international debt crisis placed pressures on the performance of bank's assets and resulted in a slip in their credit ratings and a rise in their funding costs.

Together with their high intermediation costs associated with reserve requirements, capital and overheads, this resulted in relatively high lending rates (Honeygold 1987).

Prime borrowers such as governments and large corporations found it cheaper to raise funds directly from investors through the securities markets began with the strengthening of the offshore Eurobond market.

Because Eurobond market was exempt from many of the regulations of domestic markets, especially with regard to taxation, prime issuers could usually raise funds at lower costs than in domestic markets, while investors often received higher rates of return than they did in their own regulated domestic markets.

Largely in response to market pressures, governments began to deregulate domestic financial markets by the mid-1980s. This contributed to greater convergence of issuing costs between offshore and onshore markets, thereby encouraging corporations and governments to seek capital in the international market.

The measures adopted by industrial countries were:

- Japan - relaxed regulations on the Samurai market in 1983, issued the first Shogun bond in 1985, and relaxed restrictions on the holding of domestic and Euro Yen commercial paper by nonresidents in 1988.
- United States - eliminated its 30% withholding tax on foreigners' interest income in 1984;

- Germany - in 1984 it stopped taxing foreign investor's income from bonds. It also allowed foreigners to buy federal bonds in the primary market in 1988 and a year later the country eased restrictions on deutsche mark bonds.

Financial innovations during the 1980s and 1990s also have played a key role in the internationalization of financial markets. In the last two decades we have seen the growth equity-related foreign exchanges and fixed income and, more recently, equity-related derivatives.

These innovations can lower funding costs, enhance yields, or unbundled some of the risk, and liquidity, to tailor portfolios to the needs of different investors to hedge price, interest rate, and exchange rate risks. As a result, these innovations have made it more attractive for borrowers to raise capital in foreign markets and for investors to make cross border investments.

Technological advances have reinforced the effects of deregulation and financial innovations in internationalizing markets by increasing efficiency in gathering and disseminating information and in processing transactions.

2.2 - Growing Investments and Financial Integration:

Because of the financial integration, particularly the developing countries have seen a strong surge in private capital flows of all kinds. Foreign direct investment has responded most vigorously to the improving economic environment in these countries.

The nature of the foreign direct investment has changed. In the 1970s and early 1980s, resource extraction and import substitution were the primary motives for foreign direct investment in developing countries.

In contrast, a high proportion of foreign direct investment flows now going to developing countries can be characterized as being efficiency seeking associated with the globalization of production. Commercial bank lending, which accounted for the bulk of private flows in the late 1970s and 1980s, has also made a strong comeback.

Among institutional investors, mutual funds have led the increase in investments in emerging market inequities. According to Word Bank, in 1986 there were 19 emerging market country funds and 9 regional and global emerging market funds. By 1995 there were over 500 country funds and nearly 800 regional and global funds. The funds increased from $ 1.9 billion in 1986 to $ 132 billion at the middle of 1996.

More than 30% of new international investments by US mutual funds went to emerging markets during 1990-94. The exposure of US open-end mutual funds to emerging markets rose from $1.5 billion in 1990 to $35 billion in 1995, or 14% of the international exposure.

In the 1970s, the investors found these mutual funds an attractive alternative to the regulated deposit rates of commercial banks when market interest rates rose.

In the 1980s, following the success of money market funds, mutual funds began to invest in bonds (domestic and international), and gradually in domestic equities.

Pension funds have followed the same trend; they invested through mutual funds or directly on their own account. As with mutual funds, most pension fund investments in emerging markets are in the form of portfolio equities.

Pension funds are likely to be a major force in the demand for portfolio equities from developing countries. Today pension funds hold about $70 billion of emerging market assets. This amount could rise very considerably over the next decade.

The growth in pension assets was especially stimulated by changes in pension and tax laws. The US, for example, allows companies to deduct their contributions to employee pension plans from their taxes.

Moreover, employee contributions are only taxed when they are taken out, and interest on pension assets is not taxed until retirement. Therefore, both employers and employees have an incentive to save through a pension plan, as opposed to other forms of savings, which are taxable.

Given the long-term nature of their commitments (that is to pay retirements benefits), pension funds tend to invest in long term instruments, including corporate equities and long-term bonds

2.3 - Gains and Risks of the Financial Integration:

The gains of financial integration arise in two main ways:

1. **On the production side -** integration permits greater international specialization and facilitates of scarce resources to their most productive uses independent of location. It can increase growth, by raising the level of investment and by improving the returns on investment, through knowledge spillover and market efficiency effects;

2. **On the consumption side -** integration allows individuals to insure themselves against adverse developments in their home economies by diversifying their assets and tapping global markets to smooth temporary declines in income;

The risks of Financial Integration:

Despite the large potential gains, there is widespread concern among policymakers that growing financial integration and increased confidence on private capital flows might render emerging markets more susceptible to volatility, including large reversals in capital flows.

Such fears have not foundation, especially for countries with weak fiscal policies, badly managed or overprotected banking systems, and highly distorted domestic markets.

The sustained increase in private capital flows in the face of recent shocks, Mexican crisis, suggests that markets have entered in another phase. Government has demonstrated an awareness of and ability to respond promptly and aggressively to changes in markets conditions. However, in the individual country level, volatility of flows and potential vulnerability to reversals remains a serious concern.

Surges - during the 1990s surges have been extremely large in relation to the size of the economies; many countries received annual inflow averaging more than 4% of GDP.

Reversals - Turkey and Venezuela were the first experience major capital flow reversals in the 1990s, in both cases following a loss of investor confidence in government policies. The reversal of private capital flows in the case of Mexico was notable in two respects: its size and its violent reaction reversals in several other countries, most considerably in Argentina and Brazil.

Volatility - The main international sources of volatility are changes in asset returns (interest rates and stock market returns) and potential investor herding and contagion effects. Country condition is the main determinant of volatility.

Latin American Countries Position in terms of Financial Integration

	1980s	1990s
Argentina	Medium	High
Bolivia	Low	Low
Brazil	Low	High
Chile	Medium	High
Peru	Low	Medium
Venezuela	Low	Low

Developing countries have been adopting a wide range of policies in dealing with surges in the capital inflows, such as: new capital controls in the face of large inflows, with at least some degree of effectiveness in reducing the magnitude of inflows and altering their composition;

- sterilized intervention - virtually all countries to offset the impact of reserve accumulation on monetary aggregates are using this policy. Sterilization appears to have been generally successful in curbing the growth of base money, but less effective in preventing asset inflation;

- fiscal measures - there are a group of countries that are resisting real exchange rate appreciation and, placed greater emphasis on fiscal tightening;

- exchange rate control - In the other hand there is another group of countries that used the nominal exchange rate as a nominal anchor, with relatively greater reliance on monetary rather than fiscal policy. These countries has experienced both consumption booms and larger real exchange rate appreciation

A heavy reliance on fiscal policy, supported by sterilization and some nominal exchange rate flexibility, and in extreme cases by temporary taxes or controls on inflows, can be effective response to overheating and also improve the balance between domestic investment and consumption and

reduce the risks of on overappreciated real exchange rate and an unsustainable deficit in the current account.

3. How developing countries have responded these challenges?

The most important prerequisites for successful financial integration are a sound macroeconomic policy framework, in particular a strong fiscal position, the absence of large domestic price distortions (those arising from import protection). A good domestic banking system with an adequate supervisory and regulatory framework, and a well-functioning market infrastructure are desirable too.

All these essential elements have helped the developing countries to pursuit the financial integration, for several reasons:

1. Progress on these prerequisites have improved a country's creditworthiness and attractiveness to foreign investors;

2. These preconditions have encouraged capital flows (such as foreign direct investment) based on long-term fundamentals rather than short-term returns;

3. Fulfillment of these preconditions have ensured that capital inflows are well used, determining whether countries can get the benefits from financial integration and avoid its risks;

4. The more robust a country is about these preconditions, the greater will be its margin in responding to surges and volatile flows.

Countries have typically used a combination of policies to respond to large surges of capital inflows, such as:

Capital controls - when combined with other policies appear to have been at least partially successful in reducing the magnitude of inflows and altering their composition;

Sterilized Intervention - it has been the most widely used instrument and has been generally successful as an initial response in curbing the growth of base money and building up reserves

Appreciation exchange rate policy - countries that have resisted to adopt real exchange rate appreciation by placing greater emphasis on fiscal tightening have tended to have lower current account deficits, a mix of absorption oriented toward investment, and faster economic growth.

Generally, countries are likely to suffer a loss of investor confidence when the real exchange rate is perceived to be out of line. The government's debt obligations are large in relation to its earning capacity and external reserve position. The fiscal adjustment is perceived to be politically or administratively infeasible, or the country's growth prospects are weak.

The banking system plays a dominant role in the allocation of capital in a developing country, and the health of this system largely determines whether a country will be able to exploit the benefits of financial integration and avoid its pitfalls.

In many developing countries, banking systems have only recently been suffering more strict regulatory supervision. Since reforms of the banking system will take time to implement, it will probably be necessary to curb the lending booms associated with capital inflows by using macroeconomic policies, as well as more targeted restrictions, such as rising reserve requirements or adopting risk-weighted capital adequacy requirements. This will help alleviate overheating pressures resulting from increment in capital inflows and will reduce the vulnerability of the banking system.

Investors are concerned with the unreality of emerging markets in three main areas:

1. **Market infrastructure -** where the consequences include high transaction costs, frequent delays in settlement, and out-right failed trades;

2. **Protection of property rights -** in particular those of minority shareholders;

3. **Transparency -** disclosure of market and company information and control of abusive market practices.

Unfortunately, there are no simple solutions to preparing capital markets for financial integration, which requires concentrated action across a broad pattern of areas to improve market infrastructure and the regulatory framework.

International standards for market infrastructure provide excellent medium-term benchmarks for emerging markets, although they need to be tailored to fit individual country circumstances.

A regulatory model based on disclosure and self-regulation is gaining wide acceptance in emerging markets because it has strong advantages over direct government regulation. However, government regulation and oversight are still essential, and the state can play a crucial role in capital market development in partnership with the private sector, providing the basic legal structures.

Emerging markets should also promote the development of domestic institutional investors. By mobilizing significant amounts of resources, these investors can seen as a counterweight to foreign investors and reduce the vulnerability of domestic capital markets to foreign investor perceiving. Their presence also reassures foreign investors about the nation's respect for corporate governance and property rights.

Despite the increased worldwide interconnection of financial markets, the authority of regulators has remained mainly national in scope. In a global market, it is difficult to assess the risk exposure of financial intermediaries, and such complex operations as derivatives trading make risk evaluation even more uncertain.

To address these problems, regulatory authorities from industrial countries are increasingly cooperating and coordinating with one another. In addition, to reinforce market discipline, these regulators are emphasizing the supervision of the quality of risk management by financial firms and improved disclosure practices.

Net private capital flows to developing countries exceeded $ 240 billion in 1996, nearly six times greater than they were ate the beginning of the decade, and four times more than the peak reached

during the 1978-82, commercial bank lending boom.

Private capital flows now undersized the official flows in terms of relative importance. They are now five times the size of official flows. This is remarkable, since only five years ago official flows to developing countries were larger than private flows.

Asset and Sectoral Composition of Private Capital in Developing Countries - net flows (%)

ASSET AND SECTOR	1978-81	1982-89	1990-93
FOREIGN DIRECT INVESTMENT	18.0	38.7	47.6
PORTFOLIO EQUITY	0.1	2.3	20.1
PORTFOLIO DEBT	3.3	7.6	17.8
OTHER DEBT	78.7	51.4	14.5
EQUITY	18.1	41.0	67.7
DEBT	81.9	59.0	32.3
TO PRIVATE SECTOR	38.3	40.7	83.4
TO PUBLIC SECTOR	61.7	59.3	18.6

Source: World Development Bank Indicators Database.

The composition of assets acquired by external creditors during the current inflow stands in stark contrast to what occurred during the period of the debt accumulation before 1982. As indicated in the table above, there is a shift away from debt instruments in favor of equity instruments, both direct and portfolio within debt flows, syndicated banks loans are relatively unimportant, and in contrast to the period of 1978-89, portfolio flows have increased in importance.

The last two rows of table above suggests that there has been a drastic change in the Sectoral composition of capital inflows during the recent episode, relative to the period of the debt crisis. Recent capital inflows have been directed to the private sector of the recipient countries.

Developing countries are now a much more important destination for global private capital. Their share of global foreign direct investment flows is now almost 40%, compared with 15% in 1990, and their share of global portfolio equity flows is now almost 30%, compared wit around 2% before the start of the decade.

The importance of private flows has also increased markedly in economies of developing countries, from 4,1% of domestic investment in 1990 to almost 20% in 1996.

There has been a remarkable broadening in the composition of private capital flows. Whereas traditional commercial banks, lending used to account for more than 65% of all private flows. Foreign direct investment has now emerged as the most important component of private capital flows. Portfolio flows, both bonds and equities, have increased sharply so that they now account for more than a third of total private capital flows.

The flow of private capital has also shifted on the recipient side away from governments to the private sector. Borrowing by the public sector now accounts for less than a fifth of total private flows, so that the bulk of these flows to developing countries are passing through market channels.

Private capital flows to developing countries have proved to be surprisingly resilient. Despite the increases in US interest rates in 1994 and the Mexican crisis in 1995, private flows increased a further 340% during the past five years.

CAPITAL FLOWS TO DEVELOPING COUNTRIES
US$ BILLION

	1990	1995
TOTAL NET CAPITAL INFLOWS	43.5	193.7
NET FDI	18.6	71.7
NET PORTFOLIO INVESTMENT	18.3	37.0
OTHER	6.6	85.1
IMF	-1.9	12.2

Source: IMF, World Economic Outlook Database.

4. Structural Forces Drive Private Capital to Developing Countries

In developing countries, the environment has changed rapidly after 1986, several countries have embarked on structural reform programs and have increased the openness of their markets, through the progressive lowering of barriers to trade and foreign investment, the liberalization of domestic financial markets and removal of restrictions on capital movements, and the implementation of privatization programs.

In the international environment, three factors in particular are seen as having potential for creating significant volatility in private capital flows to developing countries:

1. **Movements in international interest rates and other asset returns -** especially movements in industrial country stock markets. Private capital flows to emerging markets are considered to be particularly affected by changes in these factors because investors regard these markets as marginal;

2. **Investor herding behavior -** the new investor base in developing countries, dominated by institutional investors, is widely thought to be prone to herding behavior, arising from its incentive structure and the relatively information available on developing country investments;

3. **Contagion or spillover effects -** which arise when events in one emerging market, cause investors to change their investment decisions in other emerging markets.

4.1 - The Structural Character of Private Capital Flows in the 1990s

Private capital flows to developing countries began to increase in the early 1990s, coinciding with declining global interest rates; it was generally assumed that these flows were being driven primarily by cyclical conditions in industrial analyses.

The persistence of these flows in spite of global interest rate increases in 1994 and the Mexican crisis in 1995, however, suggests that they be being driven by more than international cyclical factors. We can realize the following trends:

1. **Countries with the strongest economic fundamentals -** such as a high investment to GDP ratio, low inflation, and low real exchange rate variability - These factors can affect long-term rates of return to investors, have received the largest flows as a proportion of domestic GDP.

2. **Global interest rates -** even though they are not significant in explaining foreign direct investment flows, they have the largest component of private flows to developing countries.

3. **Movements in Global and domestic interest rates -** the portfolio remain quite susceptible to these cyclical or temporary factors.

4. **The globalization process of Production -** in the eighties and in the nineties we have witnessed the progressive globalization of the production process. Competitive pressures from unilateral and successive rounds of multilateral liberalization, and stagnant demand combined with rising costs at industrial countries, have encouraged firms to seek new markets and increase efficiency.

4.2 - The main structural forces that have been driving private capital flows to developing countries

1. **Higher expected rates of return -** we can say that if the level of capital stock is relatively low, then, the marginal product of capital will be high;

2. **Opportunities for risk diversification -** investors can benefit from hold in emerging market equities because returns there tend to exhibit low correlation with industrial country returns;

3. **Changing enabling environment in industrial countries -** industrial countries have seen changes in two broad areas:

a. **In the real sector -** increasing competition and rising costs at home, combined with falling transport and communications costs;

b. **In the financial markets -** a self-reinforcing process of competition, deregulation, technological advances, and financial innovations has increased the responsiveness of investors to international investment opportunities.

We assume that investors know the average return and the return they are saving. The investor must determine for themselves (from their market knowledge and intuition) what the average returns and variability.

The higher level of investments do not guarantee one rapidly growth, the composition and the quality of these investments, the human capital, and the technologic knowledge are fundamental. In all over the world, the growing rapidly and sustainable is directly linked in high levels of savings and investments. According to IMF, in the rapidly periods of growing the average saving is equal 25% of GNP and the investment is 30%.

The foreign investment has its benefices but it cannot substitute the internal investment. The way that the government has to increase the internal savings in the efficient investment is establishing improvements in macroeconomics performance and creditworthiness.

Firms are looking to invest in markets that offer macroeconomic stability, supportive regulatory framework, well-developed infrastructure (transport and telecommunications), low costs in relation to productivity of the labor force, and more open trade regimes.

As a result, a significant proportion of current global foreign direct investment flows can be characterized as efficiency seeking. This trend can be evident in the sales of foreign affiliates to the parent transnational corporation or other affiliates, the sales of them increased somewhat over the past decade.

5. The prospects for private capital flows to developing countries:

The structural changes underlying capital flows to developing countries are continuing to open at both the domestic and the international levels, and there are several reasons to believe that they will continue to grow towards financial integration and expansion in the years ahead:

- structural reforms are taking placing in developing countries, in some cases, just beginning to produce positive results;
- technological change and financial innovation will continue to reduce transaction costs and make distant markets more accessible;
- financial deregulation and competitive pressures will lead to greater emphasis on maximizing returns and diversifying risks;
- Demographic changes are becoming a major factor behind the long-term movement of capital from the industrial to developing world.

1. **Surge in Private Capital Flows in Latin America Countries - 1990s**

NET CAPITAL FLOWS INTO LATIN AMERICA COUNTRIES - US$ Billion

COUNTRY	1990	1991	1992	1993	1994
ARGENTINA	-1.9	3.6	11.2	10	10.5
BRAZIL	5.3	0.8	8.8	9	13.1
CHILE	3	0.8	3.5	2.8	3.1
COLOMBIA	0	-0.8	0.2	2.2	3.1
MEXICO	8.2	24.9	26.5	30	11.5
PERU	0.9	0.5	2.7	2.7	6
VENEZUELA	-6	1.2	2.5	1.7	-5.2
LAC TOTAL	14	33.8	61.7	65.1	56.6

Source: IMF for 1990 and 1991 / ECLAC for 1992 to 1994.

After 1991, Latin America and the Caribbean showed the most market improvement into capital inflows. The very strong performance of foreign direct investment and portfolio flows reflecting the continued improvements in macroeconomic policy and debt management in the region.

In the 1990s, private capital flows to developing countries have channeled though both equity and debt instruments.

The equity instruments includes:

- Country Funds - which allow foreign investors to pool resources and invest in the emerging stock market;
- American Depository Receipts (ADRs) are negotiating equity-based instruments. They are issued by a bank in the United States, containing shares in the US securities markets, and backed by a trust containing shares of a non US corporation;
- Global Depository Receipts (GDRs) are similar to ADRs but can be simultaneously issued in securities exchanges all over the world.
- Direct Purchases of Shares by Foreign Investors

The debt instruments includes:

- International Bond Issues - They have been made successfully by public and private enterprises in developing countries.
- Commercial Paper - are short-term instruments, which have, been issued by corporations in developing countries both in the euromarkets and in the US.
- Certificates of Deposits - used to raise resources in the international markets. Their maturities are generally greater than those of CPs are, but smaller than bonds.

Private Capital flows are being directed increasingly to the private sector, especially blue-chip companies, which have a good credit rating in the international capital markets.

7. Historical Perspective of Capital Flow in the Brazilian Economy in the 1970s

During the 1970's Brazil, like many other countries in Latin America, absorbed excessive liquidity from US, European, and Japanese banks. Huge capital inflows were directed to infrastructure investments and state enterprises were formed in areas that were not attractive for private investment. The result of this capital infusion was impressive: Brazil' s Gross Domestic Product (GDP) increased at an average rate of 8,5% per annum from 1970 to 1980 despite the impact of the 1970's oil crisis.

In the 1970-90 period, Brazil transformed itself from one o the fastest growing economies on earth to one of the biggest problems in terms of financial debt.

The dramatic decrease in the rate of economic growth has been the most striking result of the external debt crisis for the Brazilian economy in the eighties. As seen in table 1, annual GDP growth slowed from an average rate of 8,4% between 1970 and 1980 to only 1,55% from 1980 to 1990.

From the early 1970 to the mid-80s, the Brazilian economy suffered a series of important external shocks. These had a great impact on public sector accounts because the federal budget absorbed the

brunt of the effects of external difficulties and domestic pressure faced by the Brazilian economy during the period.

In the seventies, the public sector played an important role as an investor in the leading sectors, as a source of long term financing for the import-substitution and export-promotion program, which was the core of a long term strategy of adjusting Brazilian economy to the oil shocks.

High inflation, deindexation effort, frustrated attempts at external debt negotiation and consequently inconsistent growth was the hallmark of the late eighties. Overburdened by increasing interest payments and 1988 constitutional commitments, federal budget became unsustainable.

The behavior of aggregate investment in the Brazilian economy in the past 20 years has been a significant decrease in investment as a proportion of GDP in real terms (as we can see in the table 2). Public sector investment also has decreased substantially in the eighties, especially the investment of public enterprises.

The decrease in investment with the overall slowdown of Brazilian economic growth in the 1980s cannot be analyzed without addressing the separation between public and private investment during the decade. A breakdown of total investment from 1970 to 1990 as we saw in the above table.

Most public investment in Brazil is carried out by public enterprises and not by the government. However, official national account data on aggregate investment in Brazil treat investment expenditures by public enterprises as private sector investment.

The national accounts consider government investment to be simply public administration capital expenditures. Independent data, however, allow for an estimation of federal enterprise' investment, which comprises most of total public enterprises' investment.

In the first part of the table 1 we can see the evolution of aggregate savings as a proportion of GDP in the period. The rise in total investment and savings in the first half of the seventies occurred mainly because of an increase in foreign savings.

Abundant foreign finance permitted the sharp rise in the current account deficit because of the first oil shock, which was financed by increased foreign transfers of resources. There was a slight decrease in public savings and practically no increase in private savings as a proportion of GDP.

There has been a growing interest in the subject of foreign direct investment in Brazil in recent years. This might be due in part to the possible contribution it might offer to the country's balance of payments difficulties.

However, this contribution is significant, its effects on the Brazilian industrial structure and technological base have a great magnitude. The success of several sectional import-substitution programs, and the positive export performance archived in these sectors suggested that the foreign involvement in the process was crucial for the development of competitiveness in a short period of time.

Most early perceptions of the Brazilian adjustment strategy towards the first oil shock characterized it as postponing adjustment through debt, or simply evading the issue.

Brazil's government did not choose the conventional reduced absorption real devaluation mix; its response to the new conditions was the launching of an extraordinary ambitious multi year investment program explicitly designed to adjust the economic structure to the situation of oil scarcity, and to a new stage of industrial evolution.

The core of the program was in fact a new round of import-substitution, with special emphasis on energy, basic imputes, capital goods, and transportation, designed to correct imbalances in the industrial structure and to save currency.

One can hardly take this option to mean non-adjustment, for what ultimately redresses the transformation frontier is investment. It has been lately recognized that sustained adjustment to the new strained external circumstances requires longer-term restructuring of production towards exports and imports substitutes rather that continued repression of income and demand. This restructuring requires more, not less, investment.

The motivation behind the initiative reveals a sophisticated understanding of the nature of the process of structural adjustment. The role assigned to foreign capital by the program was very substantial. The new strategy was likely to consolidate a Brazilian model of industrial capitalism. Brazil would sustain a pragmatic and realistic position as regards multinational enterprises, from which there would follow an equilibrium between state sector and foreign interest.

Some of priority sectors such as, energy, transport and communications were hardly controlled by state enterprises, but in other sectors, the state would stimulate the formation of joint ventures to undertake the new projects. This kind of organization would have many advantages: it prevents full foreign capital; it increases opportunities to enter international markets and it accelerates the transfer of technology. The results of the Brazilian adjustment plan were quite impressive by all standards.

From 1968 to 1973, the Brazilian economy entered a period of unprecedented growth, with moderate inflation, led by the industrial sector, which was to be partially interrupted by the first oil shock. However, manufactured products were gaining an increasing weight in Brazilian total export, soybeans had emerged as an important primary export.

After 1974, there was no immediate adaptation to the new energy environment, in spite Brazil's heavy dependence on oil imports, resulted from a transportation system largely based on motor vehicles. The country continued to grow until 1979 based on an increasing external indebtedness towards commercial banks, while foreign direct investment gain an extreme importance in the whole decade. There was a new phase of import substitution, now involving capital goods and intermediate products.

After the second oil shock of 1979-80 and the interest rate shock that followed, Brazil's external situation worsened, and the country entered in recession with high inflation rates. External problems would culminate with Mexico's suspension of payments in 1982, which soon led Brazil to renegotiations of its external debt.

The energy problem was partially faced through an increasing use of alcohol as fuel and by the increase in domestic oil production. The country continued in recession and conditions only began

to improve after 1984. Since 1983, Brazil has resumed rapid growth but foreign direct investment has not recovered. It has been renegotiating its external debt, a process that has entered a new phase with the suspension of interest payments on the medium and long-term debt held by commercial banks.

From 1970 to 1985, Brazil's foreign public debt grew on the average by more than 20% per year. Such a high indebtedness implies a heavy burden on society. In 1985 Brazil total debt accounted for more than half of GNP, public debt alone for more than a third servicing of the latter absorbed more than a quarter of the country's exports of goods and services, that of total long term bets more than a third. Therefore, factor incomes paid to foreigners accounted for more than 5% of GDP.

In early 1980's, however, a sudden, substantial increase in interest rates in the world economy coinciding with lower commodity prices started Latin American's debt crisis. Brazil was forced into strict economic adjustments, which brought about negative growth rates. The unexpected suspension of capital inflows reduced Brazil's capacity to invest. The burden of its debt affected public finances and contributed to an acceleration of inflation. In 1987, the government suspended Brazilian interest payments on foreign commercial debt.

1. The new surge of Capital Flow to Brazil in the 1990s:

The 1980's crisis signaled the exhaustion of Brazil's import substitution model and it contributed to the opening up of the country's economy.

In the early 1990's Brazil's economic policy centered on three main areas: economic stabilization; moving country away from protectionism toward to a more open, market driven economy; normalizing relations with the international financial community.

The role of foreign capital is likely to be important in this framework, and the tendency is to extension of the successful joint-venture experience to the new priority sectors. However, we have to consider the following aspects:

- The direct investment, and its relations with the debt issue;
- The magnitude of the contributions of direct investments flows to the balance of payments;
- The great importance that direct investment has played in recent years.

The positive side of the external account data is that the quality of foreign financing is improving. This change is due to the growth of direct investments, which is reached US$ 9,5 billion in 1996 and should surpass US$ 12 billion until the end of this year (1997). In addition, Brazil has succeeded in extending the term of its foreign debt in the international average plus the Brazil risk.

BRAZIL INFLOW OF EXTERNAL RESOURCES - US$ Million

Itemization	1996	1997 *
T O T A L	79,999	80,787
Investments	35,152	36,773
Portfolio	24,684	25,864
Direct	9,580	9,966
Fix Income Funds	12	68
Privatization Funds	779	781
Real State Funds	92	91
Others	5	3
Currency Financing	28,078	22,448
Com. Firce nr.10	2,626	2,859
Resolution nr.63	376	575
Resolution 2.148 - Rural Financing	4,866	4,401
Resolution 2.170 - Real State Financing	5	4
Resolution 2.312 - Export Financ.	631	95
Commercial Paper	633	125
Bonds and Notes	18,046	14,186
Securitization	297	56
Revews	598	147
Financing	6,828	13,210
Leasing	1,868	2,473
Pre Export payment	7,073	5,883

Source: Boletim do Banco Central do Brasil - Setembro 1997.

In other words, it would be very difficult for Brazil to have real interest rates that are lower than the current levels, which indeed are lower than in previous years but still excessively high. The impact of this situation on the fiscal area is evident in the increase in the federal debt, which practically tripled since the implementation of the Real Plan and has surpassed R$ 180 billion.

The combination of the external and fiscal deficits creates a trap that impedes sustainable growth. The foreign sector has become the main constraint on Brazil's growth. On the other hand, the affect of interest rates on the public accounts and on the productive sector will inhibits the growth on investments needed to increase the necessary level of jobs to reduce unemployment.

BRAZIL ECONOMIC INDICATORS

	1980-85	1986-90	1991-96
Real GDP Growth Rate %	2.5	2.0	2.8
Current Account Balance % of GDP	-3.2	-0.4	-0.8
Gross Domestic Investment % of GDP	19.9	22.1	20.3
Gross National Savings % of GDP	16.7	21.7	19.5
Rate of Unemployment %	6.6	3.8	5.2

Source: World Development Indicators Database.

The process of substituting new technologies and imported products for domestically goods will continue to stimulate imports. This trend implies further trade deficits, with negative impact on the current account, and an increase in the country's external vulnerability.

Brazil likes others countries in Latin America adopted policies of import substitution, seeking to create an industrial base behind protective tariff barriers. This process started to change in the 1980s.

Reductions in the size of the public sector and trade liberalization are the two hallmarks of modern policy-making. Government finance are being reformed though more efficient tax collection, expenditure rationalization and privatization. Inflation has come down and the liberalization of trade and foreign investment regimes is forcing companies to become more competitive.

In the economic stabilization plan, the country has been following a strict fiscal discipline, adopting tax reforms and measures to enforce tax compliance, carrying out programs of deregulation and privatization and, reducing price controls. For the first time, Brazil adopted limits to its issuance of currency.

In the external relations, Brazil reached agreements with both public and commercial creditors rescheduling debt payments and exchanging the old debt for new bonds. With the implementation of these agreements in 1994, Brazil recovered access to international capital. Foreign investments in Brazil in 1997 reached US$ 9,96 billion in direct investment and $ 25,8 billion in portfolio investments.

FOREIGN INVESTMENTS IN BRAZIL
US$ Million

Period	Portfolio			Direct		
	Inflow	Outflow	Balance	Inflow	Outflow	Balance
1992	3,664	2,160	1,704	1,324	170	1,154
1993	14,971	8,380	6,591	877	480	397
1994	21,600	16,521	5,079	2,241	329	1,912
1995	22,559	17,806	4,753	3,285	315	2,970
1996	26,684	18,566	6,118	9,580	385	9,195
1997	25,864	17,763	8,101	9,966	311	9,655

Source: Monthly Report of Central Bank of Brazil - September 1997.

Brazil's balance of trade deficits are being well assimilated by the market, since volumous flows of foreign capital, including direct investment, have entered the economy, making it possible to finance the current account deficit.

BRAZIL CAPITAL FLOWS AND RESERVES
US$ Billion

ITEMIZATION	1980-90	1981-94	1995-96
NET PRIVATE CAPITAL INFLOWS	3.8	7.7	33.6
NET OFFICIAL CAPITAL INFLOWS	1.0	-1.0	-1.3
NET INCREASE IN RESERVES	-0.1	7.6	11.1

Source: Monthly Report of Central Bank of Brazil - September 1997.

(*) Sharp increases in private inflows to Brazil enabled the country to accumulate reserves and to repay official debt, but the current account imbalance persists.

This can be classified as a normal situation since developing countries are normally importers of capital. Besides this, the high level of reserves has made it possible to support occasional exchange deficits.

The government has suggested that the balance of trade adjustments will be based on increases in exports achieved though specific measures adopted to benefit the export sector and enhance productivity.

After de Mexican crisis, Brazil's stock market was severely affected. Brazil lost one-third of its dollar value between December 20,1994 and March 1995. Investors translated this into a loss of international reserves.

There are, however, a number of factors that strongly indicate that Brazil is in a more solid position than Mexico:

1. The longer maturity of Brazilian debt is more favorable;

2. When "Real Plan" was launched the currency was clearly undervalued, providing room for appreciation;

3. Substantial productivity gains took place up front;

4. The consumption boom that accompanies successful stabilization is only beginning, and the authorities are aware of the need to keep it under control;

5. International reserves are high (about US$ 56 billion); and

6. The current account deficit is being covered by a large sum of foreign capital flows.

BRAZILIAN GROSS FOREIGN INDEBTEDNESS (US$ Million)

Itemization	1993	1996	%
A - Total Debt (B + C)	145726	166741	14.42
B - Registered Debt/1	114270	133155	16.53
IMF Loans	305	103	-66.23
Renegotiated Debt Loans	8363	51418	514.83
Other Bonds	1907	2825	48.14
Import Financing	36282	34852	-3.94
Currency Loans	67179	45741	-31.91
Other Loans	234	216	-7.69
C - Nonregistered Debt	31456	31586	0.41
Credit line for petroleum imports	2366	3702	56.47
Other Credit lines	11	233	2,018.18
Commercial Banks (liabilities)	21981	27627	25.69
Special Operations	7098	24	-99.66

Note: 1/Data refers to capital registration in the Central Bank of Brazil. They correspond to medium and long-term debt and therefore, are not compatible with the balance of payments figures, that represents inflow and outflow effectively occurred in the period.
Source: Suplemento Estatistico do Banco Central do Brasil - Marco 1997.

In contrast to other countries in Latin America, Brazil's exchange rate have not been under prolonged pressure and capital flows have not been changeable. The interest rates had been stable, even though they are very high.

The accumulation of capital plays a fundamental role in the developing growth process. Countries that grow faster spend a higher proportion of their GDP to investment and have developed a capital market that helps channel these funds toward high return projects.

A faster rate of capital accumulation requires an increase in domestic savings rates. Low savings rates are, in fact, one of the most important issues that developing countries have to face in their effort to accelerate the growth.

Recent events, like Mexican and Asian crisis, have tried out a significant slowdown in capital inflows, providing that foreign savings are not a long-term reliable source of funds, or a substitute for domestic savings as a means for financing investment.

The most effective way to raise domestic savings is through higher public savings. This will have to be achieved through further improvements in fiscal positions. Recent studies made by the World Bank suggest that increasing government savings by 1% will generate an increase in aggregate domestic savings of around 0,5%.

Efforts to raise public savings should be supplemented by policies aimed at encouraging private savings. Improving the efficiency of domestic financial markets will go a long way toward achieving this goal.

Comparative studies have suggested that one country like Brazil have to improve its financial services, including an increased confidence in financial institutions, to improve the household

savings and, reform its region's social security systems to raise private savings.

In my opinion, the Brazilian government has been taken several measures to achieve these goals and I consider that the policies adopted are in the right way. This represents that the country is entering in new and mature phase of development.

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