Instituto Cultural Minerva

The George Washington University

Institute of Brazilian Issues- IBI

Washington, D.C.

SHORT-TERM CAPITAL FLOWS TO LATIN AMERICA IN THE 1990s

By Celso Barbosa de Almeida

Spring 1997

Introduction

During the past ten years, international financial markets have become increasingly interlinked. The volume of capital flows worldwide has been augmenting significantly. Large amounts of capital circulate around the world searching for the best available risk-adjusted rates of return. As developing countries often offer better rates of return to investors, they have been receiving large amounts of capital, which can be very advantageous for their economies.

However, the recent integration of emerging countries into global markets indicates that they can be also more vulnerable to disturbances in OECD major markets. The advantages and disadvantages that may occur as a result of this process is a challenge to policymakers working in the financial area in emerging countries.

The objective of this paper is to analyze the major shifts that have been occurring in international financial flows in the 1990s, particularly the benefits and threats of volatile capital that has been flowing to emerging countries. This study will focus in the recent increase of capital flows to Latin America.

The paper is set out as follows: Chapter I provides a general analysis of the recent changes in the financial markets in OECD countries. Chapter II describes the recent increase of capital inflows to developing countries, particularly to Latin America. Chapter III analyzes the effects of capital flows to developing countries. Finally, Chapter IV briefly overviews some noticeable policies adopted by developing countries face to the recent surge of capital inflows.

Chapter I

New financial environment in OECD countries

Recent developments in OECD countries have been shaping the way that financial flows are circulating worldwide. This chapter is going to briefly analyze the major changes that have been occurring in the financial markets in OECD countries as they affect directly the financial sector in developing countries.

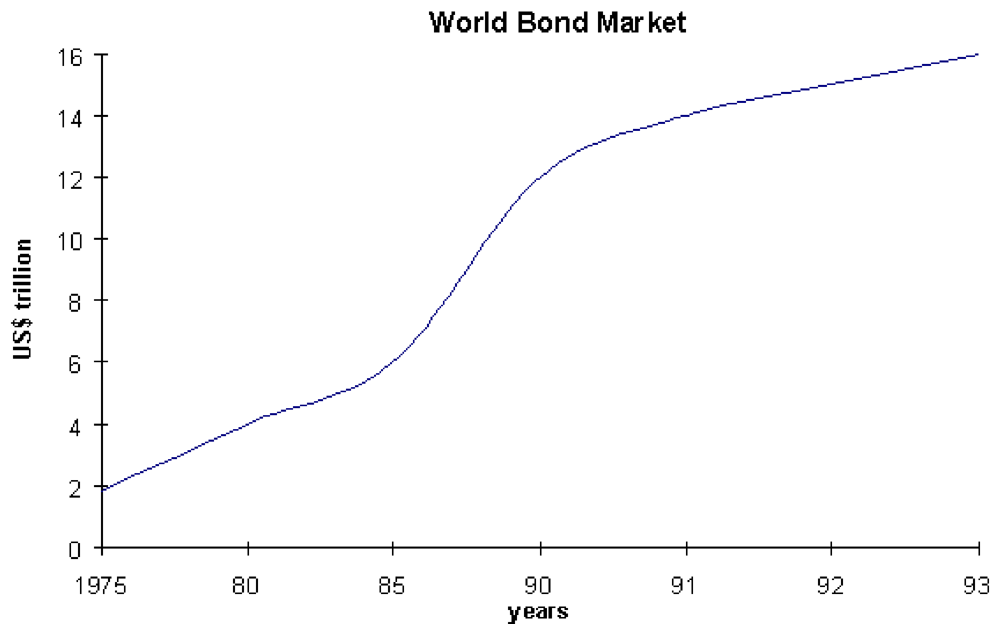
Financial markets have been changing considerably in the last two decades in OECD countries. Technological changes in telecommunications and in information systems have been improving the capacity of financial institutions to obtain and diffuse information on financial matters from/to several countries around the world rapidly, i.e. promoting the globalization of financial markets. At the same time, new information systems have been allowing the creation and use of new complex financial services and products. As a result, there has been an exponential increase in capital flows exchanges around the world.

Deregulation and liberalization processes of financial markets occurring in OECD countries are setting the framework for this increase. The liberalization process of several capital markets reflects an increasing adoption of market-oriented policies in OECD countries as opposed to the previous official guidance.

. Deregulation also promoted an increasing competition in the financial sector. Financial institutions, get particularly banks, which were protected by government regulations in the past, had to adapted to a more competitive environment. Throughout the process of liberalization of financial markets, a significant convergence of banking systems was observed in OECD countries, as these markets became increasingly integrated. At the same time, in several countries it has been observed a tendency to the enforcement of large financial groups offering a full range of financial services, as banking, securities, leasing, etc. Thus, large competitive financial institutions have been increasingly prevailing over small firms in this new financial environment.

In general, the liberalization of financial markets is promoting a greater reliance on capital markets than in the past. In the last years, securities and derivatives' markets of OECD countries undergone a period of rapid expansion. Volumes of new securities issues and secondary market trading increased considerably, equity indices rose, and in most OECD countries securities markets gained in importance as conduit for financial intermediation. Thus, the intensification of competition in a more deregulated environment, combined with the use of new telecommunication and information technologies, set into motion a process of innovation in which new financial instruments are being developed rapidly.

The development in securities markets was notable in the last few years. At the end of 1993, the total amount of traded bonds was around $ 16 trillion, representing a considerable increase compared to the figure at the end of 1980 (Chart 1). One of the main reasons for this growth was the increase of OECD countries' issuance of bonds, as they needed to secure balance of payment financing. The growth of bond markets also occurred to a certain extent because of the rise in real interest rates since the 1980s. In addition, more recently, developing countries became important issuers in the international bond markets. Such capital market operations often replaced traditional credit lines of banks contributing to the process of disintermediation of financial operations and reducing costs of financial operations.



In the last twenty years, the use of derivative products (futures, options, swaps, forward rate agreements and other hedging instruments) has also increased significantly. In the beginning, these instruments were used only by sophisticated market participants, but they are currently used by a growing number of participants, in particular institutional investors, banks and major corporations. In general terms, derivative markets have in OECD countries grown around 800 per cent in the period from 1986 to 1992, far above the growth rate of other financial instruments. At the end of 1993, the outstanding notional amount was around US 15 trillion. In the next future, it is expected that the markets in derivative products may expand at least as fast as cash markets.

The general tendency towards a more internationalized securities market is also observed in equities' markets, even though these markets are lagging behind money and bond markets. Foreign demand and cross-border portfolio investment in shares have become important elements in the price determination process of equities. It is estimated that total gross cross-border equity holdings in Europe, the United States and Japan increased from $ 800 billion in 1986 to $ 1300 billion in 1991. Also the issuance of new stock has increasingly included an international portion. Thus, placement of new international equities increased from US 23 billion in 1990 to $ 44.9 billion in 1994. Finally, an increasing number of large companies is often listed on different international stock exchanges. Some developing countries have been recently placing equities successfully abroad, as Telebras - Telecommunications of Brazil.

According to the OECD, in addition to new technologies and deregulation of financial markets, the following major determinants of the growth of equities' markets can be distinguished:

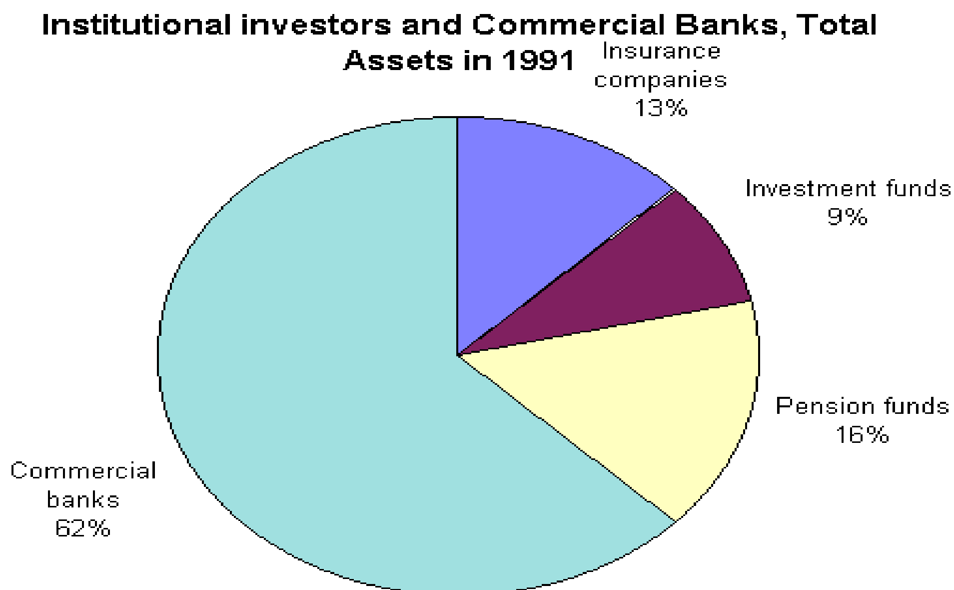
(1) Institutional investors have been diversifying their portfolio through the purchase of foreign shares, which are becoming easier to trade as a consequence of deregulation of financial markets.

(2) Some large companies are diversifying their equity base, in particular through more placements on stock markets worldwide.

(3) Privatization programs undertaken in several OECD countries and in an increasing number of developing countries have been promoting the growth of international capital markets.

Several trends that have been characterizing the securities markets in the last two decades - such as securitisation, the increasing growth and sophistication of bond markets, the use of derivatives, highly leveraged corporate restructuring, the growth of equities markets - developed to a large extent in response to the demands of the institutional investor community. In fact, institutional investors (investment funds, pension funds and

insurance companies) have been playing an important role as generators of large amounts of international capital flows, including flows of portfolio investment.



Furthermore, institutional investors are increasing the share of foreign securities in their portfolios. This trend is expected to continue and it is estimated that the share of foreign assets in the portfolios of the world's 300 largest pension funds will reach about 12 percent in the next few years. This increased participation of institutional investors in international financial markets is particularly important to developing countries, as they are an important source of financing.

Institutional investor's holdings of foreign securities

Countries	Companies and funds	1980	1985	1990	1993
Canada	Insurance	2.2	2.3	2.4	3.1
	Pension	6.1	6.6	7.0	10.6
Japan	Insurance	8.1	23.2	29.9	22.3
	Life insurance	0.0	6.7	11.6	12.3
Netherlands	Insurance	6.9	22.9	20.2	26.0
	Private pension	26.6	28.1	36.6	36.9
	Public pension	14.7	9.9	16.6	20.2
United States	Mutual	-	-	-	8.0
	Private pension	-	-	4.1	7.1

Source: OECD

The total asset of institutional investors - excluding hedge funds - in 10 European countries, Japan and the United States at the end of 1991 was estimated to have been around $ 11.6 trillion. During the period from 1981

to 1991, the growth of life insurance companies, pension funds and investment funds was 17 percent (above the growth rate of commercial banks). It is estimated that the assets of the 200 leading funds amounted to around $ 8 trillion at the end of 1991.

The major changes observed in the new financial environment in OECD countries are briefly summarized below:

(1) The volume and the size of financial transactions have grown exponentially;

(2) The deregulation of financial markets has promoted competition among categories of institutions that were formerly not direct competitors;

(3) Lower profit margins have been accelerating the process of concentration in the banking sector;

(4) Several banks started to work with new types of financial instruments to compensate for the loss of traditional business. The new financial instruments are often more riskier and more profitable than the traditional ones;

(5) Stronger linkages among the different sectors of the financial service industry have been strengthened. As a result, it has been increasingly difficult to measure the financial conditions of individual banks;

(6) There was a structural change in the sources of funding. In certain countries, money market instruments are becoming relatively more important than bank deposits. Bank deposits can be expected to grow more slowly than assets of institutional investors (insurance companies, mutual funds or pension funds);

(7) Capital market activity is growing at a faster pace than traditional bank lending. Several large businesses have been increasingly using capital markets to

obtain a substantial part of their external financing requirements;

(8) The use of derivatives by several financial institutions have become very important.

Chapter II: Capital flows to Latin America

The financial environment in several developing countries has also been changing considerably in the last few years. As a result, capital flows to developing countries have been increasing exponentially. The objective of this chapter is to present general statistics on the increase of capital flows to developing countries, particularly to Latin America; evaluate the composition of these flows; and analyze the major causes promoting increasing inflows of capital to developing countries.

Capital flows to developing countries have increased considerably since the end of the 1980s and the beginning of the 1990s. The liberalization of cross-border financial transactions and the progressive integration of global capital markets have promoted the access to international capital and banking markets for firms and financial institutions in several developing countries.

According to the IMF, from 1990 to 1994, about US 460 billion of foreign capital has flowed to developing countries in Asia was and Latin America. This amount of capital represented about 3.5 times the US 113 billion of the previous five years, when there was a debt crisis and many of developing countries had limited access to international capital markets. From 1990 to 1995, total net capital inflows increased around 350%. During the same period, capital flows to Latin America increased by 285%, in spite of the 1994 Mexican crisis (see table below).

Capital flows are very important to the economic development of developing countries. IDB studies demonstrate that there is a strong correlation between economic growth and flows of capital in Latin America. Between 1976-1982, when there was a high level of capital inflows to Latin America, the region’s economy grew nearly 4

percent a year, while receiving net capital flows of nearly 5 percent of GDP. After the 1982 crisis until the end of the 1980s, capital inflows were very limited, and the region's GDP growth fell to less than 1.5 percent a year, while net capital flows to the region declined to less than 1 percent. Between 1991 and 1994, growth of about 3.5 percent a year was accompanied by capital inflows amounting to 6 percent a year.

The composition of capital flows is often categorized as follows: foreign direct investment, portfolio investment, and others (short- and long-term trade credits; loans-including use of IMF credit; currency and deposits; and other accounts receivable and payable). Foreign direct investment, the most desirable form of capital inflow, is a long-term investment in the productive capacity of a country. Portfolio investment is more commonly a short and medium term investment, sometimes volatile and related to high levels of interest rates. Portfolio investments consist of international placement of bonds, issues of equities in international markets, and purchases by foreigners of stocks and financial market instruments in developing countries' domestic markets.

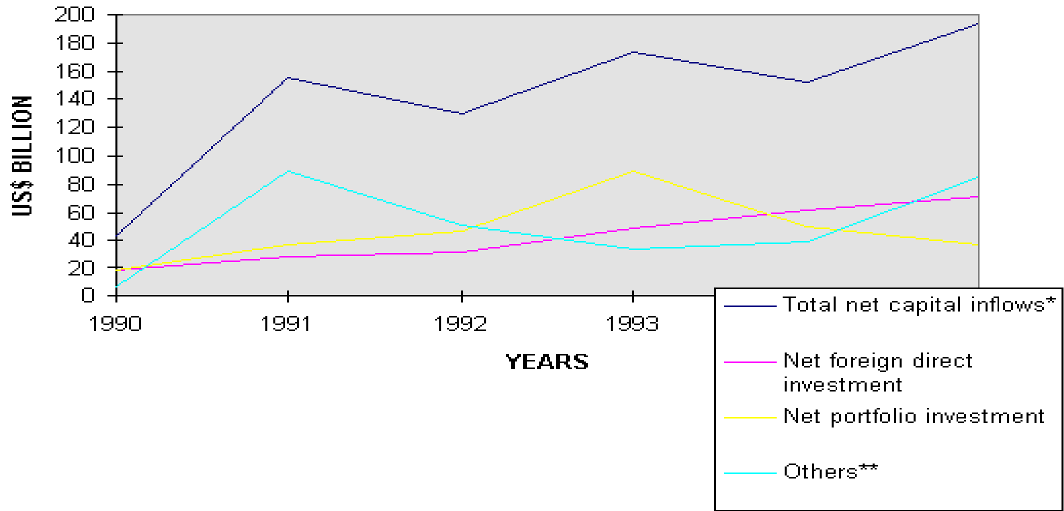
The mechanisms through which capital flowed to developing countries, differed in the 1990s from those in the previous two decades. Commercial bank lending was the dominant form of international financing to several developing countries from the mid-1970s to the beginning of the 1980s, accounting for two-thirds of total flows to Latin America. However, in the 1990s, the two major sources of financing to Latin America were the return of flight capital by residents and the purchase of bonds and equities by international investors.

More recently, foreign direct investment has been playing an increasingly important role. In the 1990s, foreign direct investment is becoming relatively more important than portfolio investment. In general terms, foreign direct investment to developing countries increased from US 18 billion in 1990 to US 71.7 billion in 1995, while portfolio investment increased from US 18.3 billion to US 37 billion during the same period.

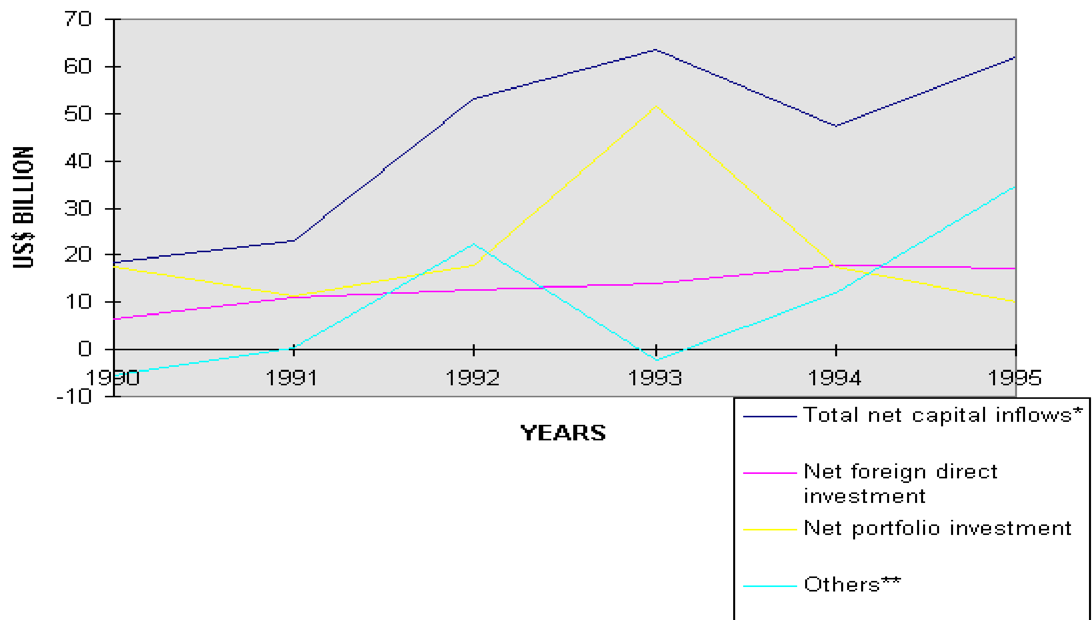
Although, foreign direct investment became the most important source of capital to developing countries, portfolio investment represented until recently the most significant portion of capital inflows to Latin America. In 1993, for instance it represented around 80 percent of total net inflows. From 1994 to the present moment, however, foreign direct investment has been the most important source of capital to the region.

Capital flows to Developing Countries								
(In billion of US dollars)								
	1990	1991	1992	1993	1994	1995		
All developing countries								
Total net capital inflows*	43.5	155	130	173	152	194		
Net foreign direct investment	18.6	28.4	31.6	48.9	61.3	71.7		
Net portfolio investment	18.3	36.9	47.2	89.6	50.4	37		
Others**	.6	89.6	51.3	34.5	39.8	85.1		
Latin America								
Total net capital inflows*	18.5	23	53.1	63.4	47.2	61.8		
Net foreign direct investment	6.6	11.2	12.8	13.9	17.7	17.1		
Net portfolio investment	17.4	11.4	17.8	51.6	17.4	10		
Others**	-5.5	0.5	22.5	-2.1	12.1	34.7		
* Not including reserve assets								
** Short- and long-term trade credits; loans (including use of IMF credit); currency and deposits; and other accounts receivable and payable.								

CAPITAL FLOWS TO DEVELOPING COUNTRIES



CAPITAL FLOWS TO LATIN AMERICA



The increasing flows of capital to developing countries are driven by internal and external factors. Internal factors, closely related to developing countries' domestic policies, are more often responsible for an increase in investment from foreign investors. Stabilizing fiscal and monetary policies, as inflation stabilization programs diminish macroeconomic risks and promote capital inflows. The liberalization of the domestic capital market, tax reforms and open trade policies may also promote a similar outcome.

Since the end of the 1980s, most developing countries in Asia and in Latin America initiated/enhanced economic reforms adopting market-oriented programs. At the same time, most of these countries started to improve their relationships with creditors. With these policy actions came improvements in the domestic economic climates of several developing countries. These developments promoted a better environment for foreign investments, as the perceptions of country risks lowered.

Some of these economic reforms were undertaken in order to strengthen their domestic financial systems. Reforms to liberalize their financial markets were the establishment of lower reserve requirements on bank deposits, removal of interest rate controls on bank assets and liabilities, and reduction in asset allocation regulations, as rules specifying the percentage of total credits that must be directed to specific economic sectors. For instance, reserve requirements on domestic currency deposits in several Latin American countries are currently lower than they were in the 1980s. The objective of these reforms has been to encourage to a certain extent market forces, rather than intervening directly on banks extensively.

In addition to attracting foreign-owned capital flows, domestic reforms also attracted capital from residents in developing country emerging markets that were placed abroad, i.e. return of capital flight. As these investors tend to be closer to sources of information about domestic economic environment, they were the first investors back into the market. They brought back flight capital and attracted the attention of foreign investors for new investment opportunities.

Last but not least, domestic policies often affect the composition of capital inflows. When these policies are not completely credible, they often attract speculative capital. Countries with sound monetary and fiscal policies often attract larger amounts of capital, and a relatively higher volume of long-term investment, particularly foreign direct investment.

In addition to domestic economic reforms in most developing countries, a series of external factors influenced an increase of capital flows to emerging markets and also the composition of these flows. According to the IDB, external variables explain roughly half of the bond and equity flows from developed countries to the most important Latin American countries; while for Asia, external factors account for about one third of bond and equity flows into the region.

Some of the external factors influencing capital flows to developing countries are the following: first, international interest rates have declined in the beginning of this decade. Net flows to developing countries, particularly to Latin America, are highly correlated with the world interest rate. Lower international interest rates, diminished the debt-servicing costs of developing countries, contributing to the reduction of country risks. More importantly, interest rates in developing countries were/are very often higher than those of developed countries. Thus, foreign investors became more interested in investing in capital markets of developing countries.

Second, favorable current accounts of OECD countries influenced directly an increase of capital flows to developing countries. A comparison of capital flows to developing countries and the current account surplus of several developed countries also highlights the link between fluctuations in the availability of international capital and capital flows to the region. For instance, it was observed that capital flows to Latin America were low in the 1980s, when the large industrial countries were running current account deficits, and that the surge of inflows to Latin America during the 1990s was associated with a sharp reduction in the G7 current account deficit.

Third, changes in regulations of OECD financial markets, as mentioned in the previous chapter, notably the relaxation of restrictions on private security placements in the United States, also facilitated access by developing countries to international capital markets.

Fourth, global diversification of portfolios is becoming an increasingly important trend. In fact, in addition to the return of flight capital that left several developing countries in the 1970s and 1980s, new investors became very important sources of capital to developing countries. Since the late 1980s and early 1990s, institutional investors began to invest larger amounts of money in the securities of certain developing countries diversifying their portfolios. As mentioned previously, institutional investors began to expand their investment activities in developing country securities. Most of these mutual funds are located in the United States and in the United Kingdom, but they attract money from investors throughout the world. As, developing countries are forecast to grow relatively faster than developed countries, their share of international flows from institutional investor may increase considerably.

Moreover, increasing globalization of production, led by multinational corporations seeking lower costs of production, improved their interest in foreign direct investment in developing countries, particularly in Asia and in Latin America.

In sum, the increasing flows of capital to developing countries were driven by several internal and external factors. These are briefly summarized below:

(1) Many indebted countries improved relations with external creditors.

(2) Several developing countries began to adopt market-oriented policies that included trade and capital market liberalization. Financial sector reforms, particularly, facilitated their re-entry into international capital markets.

(3) Relatively slow economic growth in developed countries stimulated the flow of capital into emerging markets.

(4) The decline in interest rates in the industrial countries in the early 1990s contributed to investors having a greater interest in developing countries.

(5) There has been a trend toward international diversification of investments in major financial centers. Increasing amounts of funds managed by life insurance companies and mutual funds have entered emerging markets.

Chapter III

The effects of capital flows on developing countries

The objective of this chapter is to analyze the major effects of capital flows on developing countries macroeconomic indicators.

As analyzed in the previous chapter, developing countries started to receive larger amounts of capital inflows again since beginning of the 1990s. The recent increase of capital flows is a result of the liberalization and stabilization policies adopted by developing countries in previous years. It is beyond a shadow of a doubt that

capital inflows brought several benefits to developing countries. Capital inflows are important sources of international savings and they have been supporting development efforts of emerging countries.

However, in a general manner, abundant capital flows influence directly several economic indicators of developing countries, as their current accounts, exchange rates, interest rates, money supply, inflation, consumption and investment levels. The effects of capital inflows on the economy are an issue to be understood by policymakers.

Policymakers in developing countries observe that net capital inflows must be matched by central bank reserve accumulation and/or increased current account deficits, while net capital outflows are matched by a reduction in the level of foreign reserves and/or movement of the current account toward surplus. At the same time, an increase of current account deficits in most developing countries is often accompanied by substantial appreciation of the real exchange rate.

For instance, it was observed that in Latin America the real exchange rate was very appreciated during the early 1980s, when there were abundant capital inflows, and depreciated when the inflows slowed in the 1980s. In the beginning of 1990s, the real exchange rate appreciated, as inflows of international capital increased. Thus, Latin American countries started to present larger deficits in their current accounts as capital inflows increased.

Most Latin American countries accumulated considerable international reserves since the beginning of the 1990s. In a general manner, under fixed exchange rates regimes, capital inflows promote in the early stages the accumulation of foreign reserves. Under flexible exchange rates, without government interventions, capital inflows do not change the level of foreign reserves, as the exchange rate appreciates automatically. This appreciation in different manners promotes current account deficits, as imports increase relatively to the volume of exports. In the intermediate case, which is the most commonly observed in most developing countries, i.e. flexible exchange rates with intervention, the amount of reserve tends to accumulate, as it occurs in a fixed exchange rate system.

According to the IDB, most Latin American countries, with the exception of Mexico and Venezuela, accumulated reserves around 75 percent of the capital inflows during the 1990-1992 period, declining to about 40 percent in 1993 and 1994. Brazil accumulated large amounts of international reserves in the 1990s, keeping its level around US 55 billion since 1994. Reserve accumulation was low in Mexico and Venezuela. In Mexico, the central bank accumulated reserves on a large scale during the first years of the recent capital inflow's period, but lost a large amount of them in 1994 and in 1995, during its economic crisis. Venezuela has also faced a series of political and economic problems in the last few years.

It is worth mentioning that the optimal level of foreign reserves kept by developing countries depends to a great extent on the prospects for a reversal of capital inflows. If there is a high probability that the capitals that are currently flowing of into the economy leave in the near future, then it would be prudent to seek a higher level of reserves.

Exchange rate policies adopted by developing countries have also direct consequences on their monetary policies. In fact, fixed exchange rates promote both an accumulation of international reserves at the central bank and a rise in the money supply. The increases of money supply provoke an increase in consumption and investment levels.

An increase of money supply, raise the question of whether governments need to sterilize the change in reserves, or allow it to effect the domestic money supply. This degree of monetary expansion following a rise in capital inflows depends directly on sterilization of the inflows and the degree of exchange rate flexibility. In the short run, the expansion in the money stock will be smaller, the higher are the degrees of sterilization and of exchange rate flexibility. If the money supply is allowed to adjust to capital inflows, a series of consequences may be expected in developing countries' economies.

An increase in the domestic monetary base may reduce the level of interest rates and generate an expansion of bank credit. As a result, an increase in domestic consumption and investment can be expected. Alternatively, if a

country faces a decline of capital inflow the opposite is supposed to occur.

According to international financial organizations, consumption booms are to a large extent a result of the increase in the imports goods. As exchange rate appreciates, imports become cheaper, promoting an increase of consumption. Import composition varies among developing countries. In a general manner, it has been observed that Asia imported relatively larger amounts of capital goods than Latin America. However, recently, several Latin American countries have been also increasing their share of capital goods in their imports

Furthermore, in Asia, investment increased relatively more during the capital inflow's period than in most Latin American countries. In these countries, inflows, particularly in the beginning of the 1990s, were primarily associated with a decline in private saving and higher consumption. Thus, exchange rate appreciation has been more important in Latin America than in Asia.

Moreover, capital inflows are often associated with higher equity and real estate prices. This increase was observed in some of the largest recipients of capital inflows in Asia and Latin America, including Argentina, Brazil, Chile, Korea, Malaysia, Mexico, Philippines, and Thailand.

In spite of some undesirable consequences on certain macroeconomic indicators, capital inflows have been extremely important for developing countries. Several developing countries, particularly in Latin America, have been financing their current account deficits through capital account surplus. Some recent economic plans adopted in the region are based on a relatively fixed exchange rate, which often appreciates face to increasing capital inflows. Consequently, many Latin American countries, which have already been reducing considerably their tariffs to international trade in the last few years, have been facing trade deficits, as imports have been increasing relatively to exports.

In this manner, economies that rely on high levels of foreign reserves, as Argentina and Brazil, have been able to control inflation, thanks to capital inflows, as these counterbalance the relatively higher increase of imports, necessary to obtain new technologies for their industries. Interest rates in these countries remain high in order to diminish consumption and sterilize the increase in money supply.

In sum, the most commonly observed consequences of capital inflows in most developing countries are the following:

(1) The exchange rate tends to appreciate;

(2) Imports tend to increase and exports decrease;

(3) Countries may be able to increase their levels of international reserves

(4) Money supply increases;

(5) Sterilization of capital inflows may be needed in certain cases to avoid a considerable increase in money supply;

(6) Consumption tend to increase, either because there is more money circulating in the economy and/or because imports become cheaper;

(7) Foreign investors approve open economies and tend to augment further investments. If the economic environment of the recipient country is favorable, there is an increase of foreign direct investment instead of short-term investment.

Chapter IV

Volatile Capital Flows and Public Policies

Developing countries have been adopting policies to liberalize their economies. However, they have also been concerned with the effects of volatile capital inflows and outflows. The Mexican Crisis in 1994 was a recent example of the risks generated by large levels of short-term capital flows in the economy.

Large variations of capital flows require comprehensive macroeconomic adjustments. These adjustments that a country may face due to changes in the external financial environment are inevitable as the world is becoming increasingly globalized.

Policymakers in developing countries and in international financial organizations are particularly interested in the following questions:

(1) Should the monetary authorities accumulate large international reserves?

(2) Should the monetary authorities provide credit to the banking system?

(3) Can and should developing countries influence the magnitude and composition of the capital inflows they receive?

(4) What has been the impact of a possible large capital during inflows and outflows on domestic banking and financial systems?

(5) What exchange rate regime provides a better adjustment to sharp changes in the availability of foreign capital?

(6) Should fiscal policy expand or contract when international capital becomes more scarce?

(7) Can the regulatory environment within which domestic and international investors operate affect the magnitude of such shocks, and their impact on the economy?

(8) And what is the appropriate response of the international financial institutions?

(9) Should international monetary cooperation be enhanced in such a way as to ensure a better and more timely response to future crises?

The answers to these questions depend to a large extent on each developing country’s economic and social conditions. In a general manner, some of the most usual issues related a large change in capital inflows that affect economic policies are briefly described below.

BANKS SUPERVISION

The globalisation of financial markets brings new risks to countries in general. Banks have been particularly touched by these recent changes. For banks the traditional activity was lending. Nevertheless, lending now accounts for a smaller share of their total activity. Some of the newer activities are investment banking, trading and mergers. These activities may be more profitable, but may also bring more risks for financial institutions.

The dominant financial assets in several Latin American systems are liquid short-term paper issued by banks, central banks, and governments, which investors can readily sell if they expect uncertainty in developing countries economic prospects. Faced with a financial structure of this kind, some analysts have recommended controlling liquidity growth through reserve requirements. However, it has been observed in practice that there are many formal and informal manners by which investors can evade these policies.

International financial organizations have been proposing that the fundamental challenge to policymakers is to devise supervisory tools to control financial risk that can be enforced at the level of the individual institution. This set of tools could be the following:

(1) Imposing balance sheet and income reporting requirements on banks,

(2) Comparing reported accounting ratios across banks, and

(3) Checking accounting data against market signals of financial institution risk.

(4) Implementing an international standard for the ratio of a bank's capital to its risk- weighted assets. The current internationally accepted minimum standard is a ratio of capital to risk-weighted assets of 8 percent, with half of that capital being equity capital.

EXCHANGE RATE POLICIES

In addition to policies related to financial institutions, policymakers in developing countries have been particularly interested in adopting the most convenient type of exchange rate for their economies. In broad manner, under a flexible exchange rate regime, capital inflows may provoke a rapid appreciation of the exchange rate that may damage certain sectors of the economy, like non-traditional exports and worsen the current account balance. Thus, a flexible exchange rate may be associated with more volatility than a fixed exchange rate.

In order to diminish some negative effects of excessive fluctuations in the real exchange rate, several countries have adopted exchange rate bands that can be seen as an intermediate case between fixed and flexible exchange rates. This is the case of Argentina, Brazil and Chile. In any case, both fixed nor flexible exchange rates cannot eliminate completely the risks from sudden external shocks, but only minimize them.

MONETARY POLICY

Sterilization policies - the exchange of domestic bonds for foreign exchange - have been the most common monetary policy response to capital inflows in developing countries. The main objective of these policies is to reduce money supply and consequently inflation. It may also diminish exchange rate appreciations. However, it is not always clear that this policy can be always effective to avoid inflation. As the interest rate on domestic bonds is usually high, domestic public debt may increase in the long run.

FISCAL POLICY

A reduction of capital flows tends to increase fiscal deficits. As developing countries have already several difficulties to reduce their expenditures, a sudden reduction of capital inflows may be particularly harmful. Fiscal policy involves coordinated decisions between the executive and legislative branches and the passages of laws require long processes of discussion and vote in the legislative branch. As external shock demands rapid decisions, fiscal policies may have a limited role in certain situations.

However, it is important to highlight that, as a general rule, governments should finance themselves with medium- and long-term debt whenever it is possible. In order to be protected by potential negative effects of short-term debt, it is important that the central bank keep a significant proportion of the country's expected debt service (including amortization) in highly liquid and readily available international reserves.

Chapter V

Conclusion

Financial markets have been changing considerably in the last two decades in OECD countries. Technological changes in telecommunications and in information systems have been improving the capacity of financial institutions to obtain and diffuse information on financial matters from/to several countries around the world rapidly, promoting the globalization of financial markets. The volume and size of financial transactions have been growing exponentially in the last few years. At the same time, there was a structural change in the international sources of funding, as money market instruments are becoming relatively more important than bank deposits.

The financial environment in several developing countries has also been changing considerably in the last few years. Capital flows to developing countries have increased considerably since the end of the 1980s and the beginning of the 1990s. The increasing flows of capital to developing countries are driven by internal and external factors. Internal factors, closely related to developing countries' domestic policies, are more often responsible for an increase in investment from foreign investors. Stabilizing fiscal and monetary policies, as inflation stabilization programs diminish macroeconomic risks and promote capital inflows.

Domestic policies often affect the composition of capital inflows. When these policies are not completely credible, they often attract speculative capital. Countries with sound monetary and fiscal policies often attract larger amounts of capital, and a relatively higher volume of long-term investment, particularly foreign direct investment.

Although countries can adopt a series of policies to influence the composition of capital inflows, these will depend to a large extent on the general macroeconomic environment of recipient countries. The more stable the country, the larger the volume of foreign direct investment it will receive. Luckily, in Latin America, foreign direct investment has been playing an increasingly important role and it is becoming relatively more important than portfolio investment.

BIBLIOGRAPHY

ALVAREZ, Ana Maria, KALOTAY, K.(1994), *Emerging Stock Markets and the Scope for Regional Integration*, UNCTAD Discussion Paper, Geneva, Switzerland.

CALVO G, LEIDERMAN L and REINHART, C. (1994), *Inflows of Capital to Developing Countries in the 1990s: causes and effects*, Inter-American Development Bank, Washington D.C.

DELORME C., EKELUND R. And JANSEN (1994*), Intermediate Macroeconomics*, West Publishing Company, Minneapolis.

ECLAC (1996), *Preliminary Overview of the Economy of Latin America and the Caribbean 1996*, United Nations, Santiago.

HAUSMANN R. And ROJAS-SOAREZ (1996), *Volatile Capital Flows: Taming their Impact on Latin America*, Inter-American Development Bank, Washington D.C.

IDB (1996), *Relatorio Anual 1995*, Banco Interamericano de Desenvolvimento, Washington D.C.

IDB (1994), *Latin America: a new investment partner*, Banco Interamericano de Desenvolvimento, Washington D.C.

IMF (1996), *International Capital Markets: developments, prospects and key policy issues*, Washington D.C.

IMF (1995*), International Capital Markets: developments, prospects and key policy issues*, Washington D.C.

JASPERSEN F. And GINARTE J. (1993), *Capital Flows to Latin America 1982-1992: trends and prospects* , Inter-American Development Bank, Washington D.C.

MORTON, J. (1995), *The Financial Times Global Guide to Investing*, FT Pilman Publishing, London.

TURNER, P. (1995), *Capital Flows in Latin America: a new phase*, BIS Economic Papers, no 44, May 1995, Bank for International Settlements, Basle, Switzerland.

ZINI A. (1994), *Capital Flows, Monetary Instability, and Financial Sector Reform in Brazil*, Inter-American Development Bank, Washington D.C.