28/1/05
(2.149w)

IX. THE RETURN OF PRIVATE CAPITAL TO LATIN AMERICA: A WORD OF CAUTION, IN 1992, FOR 'SUCCESSFUL' COUNTRIES[*]

Optimism has replaced pessimism, as Latin America has seen improvements taking place in the past few years, particularly since 1991. Budget balances have been improved, the printing of money moderated, inflation reduced, and investment projects better evaluated. But there are also many persistent problems. Private and public investment is low and public wages are far below market levels. Poverty and income concentration has increased in many LACs, reaching even worse levels than those exhibited before the debt crisis of the early 1980s. Therefore, despite clear improvements in some policy areas, crucial problems remain.

The financial arena has seen significant changes since the early 1990s. A large number of LACs faced a sharp rise in their access to international capital markets, particularly to new financing sources. Thus, they acquired access to abundant external savings.

Two questions are raised by this phenomenon, both relevant to developed as well as LDCs: first, what is happening with overall savings, not only financial savings, but total savings of the world and the national savings of developing countries? Second, how much new productive capacity is being created and what is happening to the average rate of use of existing capacity?

The analysis of these issues is unavoidable, since financial growth is not an objective in itself. It is a means of lubricating and accelerating real economic growth, by increasing investment and its productivity, enhancing the capacity to consume, and creating possibilities for higher wage-levels and the provision of sustainable productive employment.

In Latin America, the 1970s and 1980s provided examples of both good and bad financial reforms. In some cases, increased financial activity was associated with increased economic growth, a rise in investment and better quality of investment. In others, financial reform was

---

[*] Published in R. Ffrench-Davis, *Reforming the reforms in Latin America: macroeconomics, trade, finance,* Palgrave and St Martin´s Press, London and New York, 2000. This *counter-cyclical* advise was published in J. Williamson, et al., *Fragile Finance*, edited by J.J. Teunissen, FONDAD, Den Hague, June 1992, over two years before the explosion of the *Tequila Crisis*. We added two phrases referring to Chile and improved the editing.

connected with diminishing national savings and low rates of investment, along with a decline in the rate of use of capacity. Chile was an outstanding example of that outcome in the 1970s (see Ffrench-Davis, 2002, chaps. 1 and 4). During most of the 1980s, several LACs operated far below the production frontier. That is quite inefficient (see chapter II), implying that effective *ex post* productivity is lower than the potential.

I will concentrate now on what I consider to be some crucial features of 1991 and these few months of 1992.

I think the fact that Latin America does not find itself in the European financial area but in the US area is very significant. It is true that world financial markets are becoming ever more integrated, but they are not fully integrated in the sense of having 'one price' and homogeneous access. There is a large gap between the price of money in Europe and North America: interest rates diverge widely, and, *ex post*, the gap has not been closed by exchange-rate movements. The external interest rate faced by LACs is not the 9.5 per cent prevailing in Europe but the 3.5 per cent or 4 per cent LIBOR in US dollars. This, and the current low demand for funds in the USA, has important implications for LACs. Both investment and consumer lending in the USA were abnormally low in 1991. This meant that a large volume of funds became available to Latin America and other regions.

Changes in some of the domestic economies of Latin America complemented this trend. These included privatization (in several cases involving a very high rate of return in the short run), the low cost of foreign funds, together with high returns in the domestic stock exchange (averaging roughly 100% in US dollars in 1991 in Argentina, Brazil, Chile, Colombia, Mexico and Venezuela). These price gaps have been perceived by economic agents as trends, which would continue for some time; combined with low demand in the USA, they generated a remarkable flow of funds towards Latin America.

On the domestic scene, what has resulted? First of all, foreign exchange constraints have been reduced or eliminated. Until 1990, lack of external finance was the dominant binding constraint on economic activity in several countries, keeping them far below the production frontier. Since 1991, however, LACs could increase actual GDP faster than their productive capacity because they had underutilized capacity. So, in spite of low domestic investment, the relaxation of the foreign exchange constraint allowed the effective GDP to recover. Some countries show annual increases in GDP as high as 8 per cent, notwithstanding low investment.

Actually, it is not that low investment suddenly became highly productive, but simply that previously the available capacity to generate output had been constrained by a shortage of foreign exchange. But money inflows in 1991 have been much greater than the foreign financing actually absorbed in the domestic economies of LACs. Thus, roughly one-half of the net capital inflow, totalling some $40 billion, has been used to build up reserves.

What does this imply? That the absorptive capacity of domestic economies was limited. Nonetheless, capital kept flowing. Why? Not because Latin America needed more capital for macroeconomic balance, but because short-run interest rate differentials or profit rate differentials were wide and were expected to remain so by operators of "hot money". So these signals of the market kept drawing capital into LACs, with large reserve accumulation leading to pressures for exchange-rate appreciation.

If we look at the 18 main LACs in 1991, we see that 15 domestic currencies appreciated in real terms –by between 1 and 20 per cent– compared with the average for 1990. Most of these currencies continued to appreciate during the first half of 1992, in spite of efforts by several governments to prevent this so as to avoid discouraging exports, which required low (depreciated) exchange rates. But, in general, the official efforts were unable to match the appreciating market pressures.

In addition to the influence of external funds on the short-term foreign exchange market, there was the justified concern with reducing inflation. When you have a large inflow of dollars, and the day-to-day market is pressing for appreciation, it is hard for authorities to supersede this short-run market trend because it contributes to reducing inflation. The most relevant question, however, is: how much of this appreciation is a movement towards equilibrium or away from equilibrium due to an overadjustment?

One could argue that some part of this might be a movement in the right direction. Obviously, the debt crisis of the 1980s led to significant real depreciations, which were needed after the appreciation of the 1970s, when abundant and cheap bank loans had caused most Latin American currencies to appreciate. In the 1980s, the trend was reversed, and sharp depreciations resulted. Chile, for instance, more than doubled the real exchange rate between 1982 and 1988. In both decades, there seems to have been an overshooting (from a long-run perspective) of exchange-rate adjustments, in response to short-term market pressures.

At the present time, therefore, there is some room for appreciation without the danger of subsequent imbalances. However, the space is limited. Following Stephany Griffith-Jones and Mohamed El-Erian, one must observe with great care how this develops in the future. What will happen with current account deficits, real exchange rates, and the response of the output of exports?

Tradables include not only exports, but also importables. In 1991, many LACs reduced restrictions on imports, in most cases correctly. But one has to take into consideration what happens in the real economy in order to conduct an efficient restructuring. If a country is appreciating the exchange rate, *pari passu* with reducing import barriers, it will be giving two negative signals for import-competing economic activities, which may result in a strong negative adjustment. Every economy will adjust to market signals, but the crucial matter is that they should adjust in the direction of creating more capacity and increasing its rate of utilization, becoming more productive, encouraging people to invest more and better. If a country reduces tariffs and appreciates the exchange rate at the same time, it runs the risk that the positive incentives to exports are smaller than the negative incentives to imports during the transition toward a new equilibrium (see ch. III). Fiction? No, it is the history of the 1970s, of the countries that launched strong import liberalization policies together with exchange-rate appreciation. Chile and some other LACs provide clear examples of the productive inefficiency involved in that policy mix (Ffrench-Davis, 1983; 2002, ch. 3).

So, in evaluating the welfare effects of financial flows, it is very important to examine what is happening in the real world, because what matters in the end is producing more with a higher level of efficiency and equity (ECLAC, 1992). Efficient financial markets are crucial to this effort. Now, what to do when a given country or region faces a renewed access to capital flows that are partly associated with a recession in the USA and abnormally high returns in LACs? It then becomes necessary to manage or influence capital flows in such a way that they contribute to future stability.

Macroeconomic management, and exchange-rate policy in particular, are crucial for stability to be sustainable. This explains why several countries in Latin America have been trying to influence the composition of capital inflows, so that they become tied to the (long-term) investment process. Priority should be given to long-term flows associated with the productive investment process, such as FDI and imports of capital goods. First, FDI is only one component

of capital movements. Given its present volume, it can be said that it is not the part that creates the appreciating trends. These are more closely linked with the much larger short-run and portfolio flows which result from interest rate or profit rate differentials.

A second element is (and Mohamed El-Erian and John Williamson emphasized this) the regulation and surveillance of domestic financial markets. Some people may think, as they mistakenly did in the 1970s, with a heavy cost to Chile, that, since private agents conduct most flows, there is no risk of crisis. But history proves that this is a gross error; either the public or private sectors can create imbalances. For example, Chile in the 1970s had a budget surplus and was reducing public sector debt. Nonetheless, the deficit on current account had climbed to 17 per cent of GDP by 1981.[1] This figure implies that while there was a surplus in the public sector, the private sector had a deficit exceeding 17 per cent. The crisis in Chile, in 1982-83, recorded the sharper GDP drop in all Latin America. This was the result, among other variables, of wrong prices (an outlier appreciated exchange rate), large supplies of loans by foreign banks, and generalized myopia on the part of lenders and borrowers; of course, all this was built before the crisis, in the period of abundance of external financing.

The surveillance of domestic capital markets needs a rebalancing, and several of our economies should be subjected to notably more careful monitoring, with more emphasis on keeping close track to the quality of portfolios. Some few countries have been very tough on this matter. In several others, the job is pending.

The third element is macro-management: how to conduct this so that the volume of capital flows does not disturb the performance of the real sector, especially via a destabilizing influence on the exchange rate and aggregate demand. Here, I think, there is an unavoidable dilemma, with macroeconomic and microeconomic implications. One alternative is a policy that aims to achieve sustainable macroeconomic equilibrium by regulating the exchange rate and controlling short-run capital flows. On the other hand lies the possibility of implementing an across-the-board liberalization of the capital account, geared to give full freedom to economic agents' decisions; this move tends to lead to outlier exchange rates as a likely consequence, after a while followed by sharp shifts in the balance of payments and macroeconomic cycles. The history of crises, and present events, very clearly signal that one has to make a choice. Chile made a choice in 1991, in view of the abundant supply of external funds recorded during that

year, introducing regulations which discouraged short-term capital inflows. The implementation of an adjustable reserve requirement on capital inflows in 1991, proved later, during the 1994 Mexico crisis, to have been quite a proper decision to move against the approach in fashion (see ch. X, and Ffrench-Davis, 2002, ch. 10).

[1] Depending on the method of measurement, the deficit averaged between 14 and 21% of GDP in 1981.