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**SELECTED INTERNATIONAL POLICY ISSUES ON
PRIVATE MARKET FINANCING FOR DEVELOPING COUNTRIES**

EDMAR L. BACHA

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Edmar L. Bacha

Pontificia Universidade Católica, Rio de Janeiro, Brazil

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1. INTRODUCTION¹

After a decade of stagnation, a small but important group of middle income developing countries, mostly in Latin America, has witnessed a remarkable turnaround in access to private finance. This was led by a dramatic increase in gross portfolio investment flows, almost trebling to US\$ 21 billion in 1991, compared to 1989, and projected around US\$ 27 billion in 1992. The aggregate volume of portfolio flows now exceeds net flows of official finance for middle-income countries and reflects the growing dominance of the private sector in international finance. A sharp increase in foreign direct investment (FDI) was also observed, to a projected US\$ 38 billion in 1992 on a net basis (from US\$ 24 billion in 1990), thus furthering its strong upward movement since the mid-1980s².

The boom in private capital inflows has raised new issues of macroeconomic and financial management for economic policymakers in the developing countries. First, how best to manage the macroeconomic effects of large capital inflows manifested in terms of real exchange rate appreciation or the monetary implications of substantial reserves accumulation. And second, how to hedge against the dislocation that might be caused by changes in external financial conditions and a sudden withdrawal of these flows³.

Beyond such concerns, for the developing countries as a group an important issue is to

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² For detailed information on the new capital flows to developing countries, see World Bank (1992). For the case of Latin America, see El-Arian (1992), and Griffith-Jones, Marr and Rodriguez (1992).

³ On these topics, see Akyuz (1992), Bacha (1993), Calvo, Leiderman, and Reinhart (1992a), Collyns et al. (1992), El-Erian (1992), Fry (1992), Fischer and Reisen (1992), Griffith-Jones and Culpeper (1992), Griffith-Jones, Marr, and Rodriguez (1992), Jaspersen (1992), Mathielson and Rojas-Suarez (1992), Szymczak (1992).

develop policies, both at the domestic and international levels, which might contribute for these new capital inflows to take more sustainable, less speculative, form and also reach a larger group of recipient countries.

There is a tendency in the Washington community, as reflected for example in recent IMF official reports, to maintain, first, that "the causes of the inflows to Latin America and Asia are largely domestic and reflect development in the economies of these regions⁴"; and second, that the key to sustained inflows is "to persevere with domestic market reforms to increase the attractiveness of developing country securities to foreign investors⁵".

Contrariu sensu, Calvo, Leiderman and Reinhart (1992a) point out that, while domestic reforms are a necessary ingredient for capital inflows, they only partially explain Latin America's forceful reentry in international capital markets. For instance, domestic reforms alone cannot explain why substantial capital inflows are occurring in countries that have not undertaken substantial reforms - such as Brazil - or why they did not occur until only recently in countries where reforms were introduced well before 1990 - such as Chile. Calvo et al. then proceed to a careful statistical analysis to substantiate their guarded conclusion that "some of the renewal of capital inflows to Latin America is due to external factors, like recession in the United States and lower international interest rates...From a historical perspective then, the present episode may well be an additional case of financial shocks in the Center that affect the Periphery⁶".

Sustainability of the capital inflows will thus depend not only on the course of domestic policies in developing countries but also on international economic policies, as adopted by the multilateral forums, the industrial countries, and the international financial institutions. The next section surveys selected international policy measures which might contribute to the sustainability of the capital inflows to developing countries. Section three summarizes the recommendations.

2. INTERNATIONAL POLICY ACTIONS

The survey in this section of recommendations for international policy actions designed to strengthen the inflow of foreign capital to the developing countries is divided in four parts. The first comprises decisions concerning the multilateral economic policy making machinery.

⁴ Cf. IMF (1992: 37).

⁵ Cf. Collyns (1992: 32).

⁶ Cf. Calvo, Leiderman and Reinhart (1992: 1-2).

The second, the economic policy making process in industrial countries. The third, the actions of the international financial institutions. The fourth, the cases of the small developing countries and the low income countries which remain without access to the international financial markets.

2.1. Multilateral economic policy making

This group of recommendations includes decisions related to a developing countries' representation in the G-7, a multilateral foreign direct investment facility, an international official debt restructuring agency, and an international tax on short-term capital flows.

2.1.1. LDC representation in the G-7

The G-7 is the most important focus of international macroeconomic policy coordination in the world, but macroeconomic policy issues of direct interest to developing countries are only marginally taken into account in this forum. Moreover, the increased trade and financial openness of developing countries are transforming many of them (the larger countries as a matter of fact, and the smaller ones in the measure that they join regional groupings) into relevant players in the international economic arena. Time may thus have come to pressure the industrial countries to allow LDC representation into the G-7 level of international policy coordination. This would in particular facilitate the consideration and implementation of the recommendations to follow.

2.1.2. Multilateral foreign direct investment facility

In the context of the Enterprises for the Americas Initiative, the Interamerican Development Bank recently established two facilities - the Investment Sector Loan Program and the Multilateral Investment Fund - respectively designed to provide adjustment loans to countries committed to removing impediments to investment and fostering open investment regimes, and to facilitate the adoption of comprehensive investment reforms. Earlier on, the European Community launched in September 1988 the Investment Partners facility, designed to enable participating developing countries to realize the potential of foreign direct investment (FDI) in their development process.

In view of the importance of FDI as a source of sustainable externally financed growth in the developing countries, and of the relative success already attained by the meritorious but limited efforts of the IDB and the EC, the UN-CTC proposed in his 1992 report (UN, 1992: 287-91) the establishment of a multilateral FDI facility with a view to providing loans to

developing countries to promote development through FDI. Such facility would consist of a capital investment fund and of a fund through which other activities would be financed. The capital investment fund would provide credit to developing countries for the establishment of export processing zones, science parks, service parks and similar facilities that would help attract FDI to a country. Finance for other activities would cover technical assistance, information activities, the preparation of country assessment studies and the establishment of contacts between potential foreign investors and host country firms. A special window of the facility could be devoted to the promotion of outward FDI by TNCs from developing countries.

Other international measures designed to facilitate the inflow of foreign direct investment into developing countries would be as follows:

(i) Official debt relief. Heavily indebted low and middle-low income countries and the former CMEA countries and the Soviet republics may find it particularly difficult to attract foreign investment given the considerable uncertainty about the extent to which their earnings will be taxed, given the current and prospective budgetary difficulties of these countries. One important way to improve the climate for capital inflows, according to Dooley and Isard (1992), would be to act to reduce sources of prospective strains on fiscal budgets, thereby reducing fears of higher effective tax rates on capital income. It is in this context that official debt relief could play an important role in reducing such fiscal strains, thus opening the way for foreign investment inflows.

(ii) Open markets. A factor that significantly affects the climate for direct investment inflows, as pointed out by Dooley and Isard (1992), is the perceived attitude of the industrialized countries toward opening their markets to imports from the developing and the transforming economies. For example, a clear invitation to other Latin American and Caribbean countries besides Mexico to eventually join the North Atlantic Free Trade Area, and a similar invitation for the transforming Eastern European and former Soviet economies to eventually join the European Community, could significantly stimulate foreign direct investment flows into export-oriented activities in those developing countries - particularly if the invitations are accompanied by a commitment on the part of NAFTA and the EC to keep trade barriers low in the interim.

2.1.3. International official debt restructuring agency

Deploring the absence during the debt crisis of a legal mechanism similar to the Chapter XI proceedings under the U.S. bankruptcy law, John Williamson (1992) recently proposed the creation of a debt agency linked to the Bretton Woods institutions, to provide a mechanism for the revision of international debt contracts. This Agency would act essentially as a mediation

and conciliation institution, having its legal powers confined to those needed to impose on the dissenting creditors revised terms agreed by the debtor and a qualified majority of its creditors. Alternatively, this Agency might take the form of a tribunal with the power to award debt relief through arbitration even against the wishes of the majority of the creditors. Such a tribunal would need to have its awards based on agreed criteria as to the circumstances in which a country should be entitled to debt relief. These criteria would be intended to provide an incentive for the lenders to behave responsibly, as well as to identify circumstances in which efficiency considerations would indicate a need for debt relief.

Williamson's proposal was criticized by Mitsuhiro Fukao (1992) who pointed out that the government of a defaulting country cannot be treated as defaulting company because it enjoys sovereign immunity. The implication is that Williamson's scheme could only be made operative if developing countries' governments were prepared to yield their sovereign rights to an international debt tribunal, which is rather unlikely. But if this were not the case, Williamson's debt agency would simply become a debt relief agency, perhaps not a bad idea to clear up the debris of the last international debt crisis, but hardly a harbinger of substantial private capital inflows into the developing countries in the near future.

There seems however to be a broad consensus - as expressed by Griffith-Jones, Helleiner and de Vries (in Teunissen, 1992: 118) - that the Paris Club machinery for resettling official debt contracts is a rather awkward and outmoded one, and that a new more agile institutional machinery is badly needed. In this context, if both creditor country and debtor country governments were willing to surrender their sovereign prerogatives to a new international debt agency (a more likely move in such a symmetrical situation, where both parties are sovereign), Williamson's proposal might be a much welcome replacement to the Paris Club.

Once in place, this new Official Debt Restructuring Agency could serve as a natural international locus for an early recognition of an eventual future debt crisis involving private creditors. In the 1980s, it took too long for the international community to recognize that liquidity was only the visible tip of the debt problem of the developing countries, in part because of the lack of an appropriate international forum where the emerging insolvency problem could be properly evaluated by an independent third party.

2.1.4. International taxation of short-term flows

The enormous volatility and massive amounts of short-term international capital flows pose at times unsurmountable difficulties for the economic policy making of industrial and developing countries alike. It is in this context that Gerry Helleiner in comments to Griffith-Jones and Culpeper (in Teunissen, 1992: 56-7) proposed to submit these short-term capital flows to systems of monitoring and surveillance similar to those adopted for money flows

related to the drugs trade.

At a minimum, an improved system of international statistical information should be developed to adequately measure such capital flows. Proper measurement may however require that the identity of both counterparties to the capital flow be clearly identified. This may frequently pose problems in countries where customer identity and bank secrecy are overly protected. In the end, an international convention may be necessary, building on the lines of the December 1988 Basle Committee's statement of principles concerning money laundering.

That statement was directed at four aspects of banks' operations: firstly, banks should make reasonable efforts to determine the true identity of customers using any of their services; secondly, banks should ensure that laws and regulations pertaining to financial transactions are adhered to and high ethical standards are observed, withholding their services in case of transactions believed to be linked to money laundering; thirdly, within the constraints of customer confidentiality, banks should cooperate fully with national law enforcement agencies; and, fourthly, banks should see to it their staff adhere to the above principles.

Banking secrecy and customer confidentiality are potential impediments to the achievement of the objectives of these principles. It is however noteworthy that the task force of 15 countries established to combat money laundering by the Economic Summit of the Group of Seven in July 1989 not only endorsed the Basle Committee's statement, but also urged banks to notify law enforcement agencies of suspicious activities by their customers. Implementation of the latter recommendation would require changes in the laws concerning banking secrecy in many countries.

The Economic Summit of July 1989 also decided in favor of the convening of a financial action task force, whose mandate was "to assess the results of cooperation already undertaken in order to prevent the utilization of the banking system and financial institutions for the purpose of money laundering, and to consider additional preventive efforts in this field, including the adaptation of the legal and regulatory systems so as to enhance multilateral judicial assistance⁷".

Such measures are specifically addressed at curbing the drug trade, but it would be in the best interests of the international community, and particularly of the developing countries' governments, that they be extended to include capital flight associated with corruption activities and tax dodging⁸.

In this context, measures leading to an international harmonization of tax treatment of nonresident deposits would appear as a priority topic for developing country governments.

⁷ For more details on the work of the Basle Committee on Banking Supervision, see UNCTAD (1992: 79-94).

⁸ On capital flight from developing countries, see Helleiner (1992), Rojas-Suarez (1992), Salenhou (1992).

Equally important would be a serious international discussion of the oft-cited but never implemented 1978 Tobin's proposal for an international transfer tax on foreign-exchange transactions. Such a tax hopefully could be designed to make short-term currency speculation less attractive without doing much harm to long-term international investment. Interest on this tax has recently increased, as a consequence of the turbulence in European foreign exchange markets since September 1992. A working group of officials of the G-7 has apparently been created to consider the feasibility of instituting international controls as a possible remedy for these flows of hot money⁹

2.2. Industrial countries' domestic policies

Industrial countries' domestic policies could critically affect the availability of capital flows to developing countries in at least two respects: public sector savings and regulation of domestic financial markets.

2.2.1. Increased public sector savings

One means of increasing the external resources that could potentially be made available to developing countries would be to increase the level of public sector savings (or decrease the level of public sector disavings) in the industrial countries. The extent to which a reduction in these fiscal deficits would increase the resources available to developing countries would depend on the developing countries' access to international financial markets¹⁰. If their access remains limited, a reduction of fiscal deficits would result in lower interest rates but also in a decline in industrial countries' GDPs, which would reduce developing countries' exports. Thus, to guarantee maximum benefit it would be important to act on measures both to reduce fiscal deficits in industrial countries and to expand the access of developing countries to their domestic financial markets.

2.2.2. Financial market regulatory changes

The reentry of developing countries in the financial markets of the industrial world poses an important challenge to financial market regulators and supervisors of these countries: how to meet genuine prudential concerns for protecting the integrity of their financial systems,

⁹ Cf. *The Economist* (1992).

¹⁰ Cf. IMF (1991a: 42).

while implementing sufficient regulatory flexibility to avoid undue credit rationing and excessive borrowing costs for developing country borrowers.

El-Arian (1992b) - noting that similar issues arose in the context of the Brady Plan, when regulators worked closely with debtors and creditors to clarify the applications of regulatory rules and, where appropriate, provide guidelines on the treatment of specific issues as they arose - identifies the following regulatory moves that could positively influence the nature of private market flows to developing countries:

(i) **Graduation from loan loss regulatory provisioning regimes.** Several industrial countries regulatory authorities require, as an element of prudential policy, that banks maintain loan loss provisions against loans to a wide range of developing countries that have previously defaulted or whose debt has recently been restructured. In making new loans to such borrowers, banks would normally be required to increase their level of reserves, and this would raise the cost of lending - a requirement that does not apply to nonbank investors. In several industrial countries, regulatory provisioning requirements are determined by backward looking factors (particularly reschedulings and or arrears) and tend to respond with a lag to a recovery in debtors' prospects (typically involving a five year rule). An example of increased flexibility, which could be followed by other countries, is provided by the Canadian system, where the Superintendent of Financial Institutions may at his/her discretion remove a country from the provisioning list two years (rather than the standard five years) after the most recent rescheduling if the country has shown ability to raise funds of over one year maturity on international capital markets. Another example is the U.K. system, which bases provisioning decisions on a matrix that incorporates leading indicators of countries' creditworthiness. By contrast, Japan maintains a five year minimum period since the most recent event of restructuring of default; and Belgium and France have not established procedures for "graduating" borrowers from the provisioning requirements. Finally, in some countries, such as Germany, provisioning is encouraged by favorable tax treatment of provisions, as a result of which, in practice many banks have actually exceeded their regulatory provisioning requirements.

There is thus scope for modifying regulatory regimes that discourage the holding of bank claims on countries reentering international markets. Collyns (1992) identifies the following specific actions. First, in certain regimes there is scope to allow more flexibility in setting provisions by asset type, taking into account payment history, extent of security, and other factors. In particular, short term trade related claims and interbank credits are likely to carry a lower risk than unsecured medium and long term loans. Project lending, where special arrangements are made to provide additional security, could also be reviewed on a case by case basis. Second, countries that review provisioning standards only after a lengthy period, could

make more frequent assessments, which would allow a closer tracking of a country's debt service and policy implementation record. Third, more weight might be given to the great divergence in macroeconomic and structural policies across countries in varying provisioning requirements across individual cases, rather than applying a general requirement to an entire group.

(ii) Determination of appropriate risk weights for computing banks' adherence to regulatory capital adequacy requirements. Several middle-income countries have maintained full debt servicing throughout the 1980s - for example, Algeria, Botswana, China, Colombia, Hungary, India, Indonesia, Republic of Korea, Malaysia, Pakistan, Thailand, Tunisia, Turkey, and Zimbabwe. But their good repayment record is not adequately recognized in the BIS bank capital adequacy guidelines, where claims on all developing countries outside of the OECD are treated uniformly. That is, under the Basle Accord, loans to developing countries that are not members of the OECD or lenders under the General Arrangements to Borrow carry a 100 percent risk factor in the determination of the capital asset ratio; other sovereign loans carry a zero risk factor.

This regulatory requirement discourages bank lending to developing countries, particularly if banks are capital constrained and the spread on the loans do not offset the cost of raising the incremental capital required. It would thus need to be adjusted in a timely fashion to reflect sustained improvements in developing countries' debt-servicing capacity.

(iii) Flexibility in the use of cut-off credit rating standards and other regulatory restrictions for mobilizing funds on industrial country securities markets. Pension and insurance funds are a potential important source of long term capital for emerging market countries. But regulatory considerations have greatly influenced the investment activities of institutional investors. Thus, an easing of restrictions on pension and insurance funds' asset composition - particularly in Germany and also in the U.S., where restrictive state laws prevail on public pension funds - would tend to increase these institutions' investments in foreign securities including those of developing countries.

This easing of restrictions would build on recent regulatory changes in industrial countries, that have facilitated developing country access to international bond markets. Thus, in June 1991 the Japanese authorities took steps to ease the credit rating standards for public placement of bonds in the Samurai market. In the United States, regulatory changes were implemented in 1990 to reduce the transaction costs and liquidity problems facing developing country issues in U.S. capital markets. In June 1991, the SEC additionally issued proposals that would exempt foreign companies from certain disclosure and accounting regulations provided that these companies met equivalent regulations in their home countries. In Canada,

the Ontario Securities Commission has already adopted such a measure with respect to Mexican companies. Finally, the minimum rating requirements for foreign bond issues in the Swiss market were abolished in January 1991 ¹¹.

2.3. International financial institutions policies

The recommendations for new actions of the IFIs, designed to further capital flows to developing countries, comprise the establishment of a developing country currency convertibility facility jointly sponsored by the IMF and BIS, a multilateral new debt enhancement facility, measures designed to improve risk assessment of developing countries by international capital market participants, and technical assistance to developing countries in financial engineering and domestic financial market reforms.

2.3.1. IMF/BIS convertibility guarantee

Lack of currency convertibility is a major deterrent of capital inflows to developing countries. It is however very risky for these countries to sponsor a convertibility program of their own, for in this case experience indicates that only very short term and easily reversible capital flows can be attracted. For this reason, Mitsuhiro Fukao (in Teunissen, 1992: 114) proposed that the IMF supports the maintenance of convertibility of LDC currencies more vigorously. One possible procedure would be that the IMF gives a very generous stand-by compensatory and contingency financing facility, in return to a very tight guarantee of the convertibility similar to the establishment of a currency board. If the BIS capital rule could be tied to this facility by giving a lower risk weight for those countries with this agreement, bank loans could be encouraged besides other flows.

The importance of this recommendation is dramatized by the current experience of Argentina, which is holding on to a far-reaching convertibility program, temporarily financed by the foreign exchange proceedings of massive privatizations. Faced with a disturbing currency overvaluation, Argentina is now being advised by foreign experts to generate a massive fiscal retrenchment to force domestic prices and wages down. If, instead, the Argentine government had access to Fukao's "very generous" convertibility facility, it could attempt resolving the overvaluation problem through non-deflationary means (either through a credible one-shot devaluation or a Mexican-type crawling peg).

¹¹ For more information, see Goldstein et al. (1992: 45).

2.3.2. Debt enhancement through collateralization

In the case of Mexico, part of the reentry strategy into international financial markets was its acceptance that enhancement of debt instruments by the public sector may be required in the initial stages of the reentry process. Enhancements such as collaterals, put options, and equity conversion rights were used as means to improve the marketability of debt instruments and to reduce risk premiums through overcoming extreme initial perceptions of counterparty credit and transfer risks. Szymczak (1992: 70) estimates that the use of collateralization techniques by Mexico has lowered borrowing costs by between 100 to 200 basis points.

Other countries with sufficiently attractive natural resources, well developed export sectors, or large domestic markets may be able to develop these financial enhancements by themselves (even in this case, technical advice from the multilateral institutions would be welcome). Many other developing economies would need more direct financial support from the multilateral institutions, which, with their participation in the Brady Plan deals, should by now have overcome their long-standing aversion to the provision of guarantees and other debt-enhancement facilities.

Such internationally-based provision of guarantees should obviously not be used indiscriminately or for an unduly long period, for in this case they might impair rather than improve a country's ability to borrow on an unsecured basis over the medium term. It is for this reason that Mexican public sector borrowers have reduced the frequency of collateralized borrowing, and used it in only two instances in 1991¹².

2.3.3. Improved international risk assessment of developing countries

To sustain spontaneous capital flows to developing countries, it will be important to broaden the investor base for the securities of the reentrant countries, both in terms of type of investor and geographical location. A narrow base raises the possibility that investor portfolios may become saturated, a development already reported in certain segments of the market. Moreover, a narrow base implies excessive sensitivity to events affecting particular groups of investors, such as, for example, movements in U.S. interest rates.

The most effective means of broadening investor participation will be to reduce associated risk, both by decreasing underlying uncertainties and ensuring increased provision of information. In this context, the IFIs, which have close contact with the countries concerned, could study with the interested developing country governments means by which they could

¹² See Szymczak (1992) for details.

make information on the these countries' economies more regularly available to potential investors in industrial countries.

Additionally, the IFIs could extend special credit lines to help the developing countries to pay for the services of bond rating agencies, in the understanding that, independently of the rating obtained, this would provide greater certainty and assurance to potential investors, thus increasing the net proceeds of the country at the time of issue¹³.

2.3.4. Technical assistance in financial engineering and domestic financial market reform

Financial engineering. One characteristic of modern international financial markets is the extreme complexity of instruments and operations, as well as the apparently unlimited supply of resources available to those countries (as Chile) fortunate enough to have fallen in the grace of international finance. For this reason, Chile's Finance Minister Alejandro Foxley (in Aspe et al., 1992: 20) points out to the need for international organizations to offer technical assistance in financial engineering so that countries will not be amateurish players in a truly sophisticated world capital market. This would be an important job for the World Bank, a point which Foxley already brought to the attention of the Development Committee.

Of particular importance would be technical advise on financial engineering designed to reduce the developing countries' vulnerability to external shocks, as could be achieved by the use of hedging techniques to protect against external interest rate or commodity price fluctuations.

Domestic financial market reform. According to Collyns (1992: 32), domestic market reforms that have contributed to the gradual restoration of access to voluntary financing for developing countries have included: (i) stock market reforms and associated regulatory changes; (ii) increased opportunities for investors through privatization; (iii) banking sector reforms affecting the level and structure of interest rates and the allocation of credit among sector or types of borrowers; and (iv) tax policy changes to encourage the use of equity financing by commercial enterprises.

Much information and experience is available in the IFIs concerning financial market reforms, particularly after the learning process that they themselves went through, first with the disastrous financial deregulation and opening processes in the Southern Cone of Latin America in the late 1970s, and more recently with the dramatic experience with the ongoing

¹³ On the real function of bond rating agencies in international bond markets, see Wakeman (1984).

restructuring of the financial sectors in the transforming economies of Eastern Europe and the former Soviet Union¹⁴. This experience could profitably be passed on to developing countries that are still struggling to reform their domestic financial sectors, as required for a mutually profitable involvement with private international capital flows¹⁵.

2.4. The majority case of the developing countries without market access

As pointed out by Drag Avramovic, among other participants in the 1992 FONDAD The Hague seminar on the international monetary system (Teunissen, 1992: 58), "there are 120 indebted countries who still can't borrow". The external financing problem of these countries need to be addressed with the realization that they are not part of globalization of the monetary system and of the international financial markets occurring in the 1980s and 1990s.

2.4.1. Special treatment for small countries

Latin America's reentry into international securities markets has been the almost exclusive prerogative or large, well known, creditworthy companies of the large countries in the region. Smaller companies in the large countries may gain indirect access to international funds through the intermediation provided by the large, well connected, banks of these countries. Small countries in the region, with fewer and less well known companies and banks, do not seem to be able to attract in large scale the type of new private inflows that are now coming to the large countries. In this sense, Griffith-Jones and Culpeper (1992) point out the importance that smaller countries:

(i) get strong support from the IFIs in reaching soon a favorable debt settlement with foreign commercial banks, as the banks have little incentive to incur the administrative costs of regularizing these countries' debts, for which they are heavily provisioned, discounts are high, and exposure is relatively small;

(ii) continue to have significant access to official capital flows; and

(iii) benefit from special efforts by IFIs and industrial governments, perhaps through guarantee mechanisms, to encourage new private flows to them.

¹⁴ On the lessons from the Southern Cone, see Diaz-Alejandro (1985); and from Eastern Europe, see Dooley and Isard (1991).

¹⁵ On the need for domestic financial reform previously to external financial opening, see Fischer and Reisen (1992).

2.4.2. The case of the low income countries

One lesson of the international debt crisis was that external finance for investment in low income countries cannot come from private banks, the lending functions of which need to be limited mostly to trade and project financing. Long term finance to low income countries must come largely from official concessional sources, for many of these low income countries are structurally weak and cannot count on attracting private capital for their development needs.

Moreover, for some of the most severely indebted low income countries, the debt to export ratios remain unsustainable, even after the application of Trinidad terms and assuming all their bilateral concessional ODA loans are forgiven. Thus, restoration of their external viability will require additional action by official and commercial creditors. Included in this group are a few countries, such as Mozambique, Somalia, and Sudan, whose problems go well beyond debt, but who certainly cannot serve their debts.

3. CONCLUSIONS

In spite of the marked improvement in some developing countries' access to international finance in the last few years, the financing outlook for these countries is still fragile. The decline in U.S. and international interest rates have been critically important in the new wave of private financing to middle income countries. Some countries, now with an avalanche of foreign savings, such as Chile, were unable to attract such investment before, even though they had healthy economies. The drastic resurgence of private flows may overestimate the degree to which successful severely indebted middle income countries have regained sustained market access. In fact, Latin American history is full with episodes where lack of credibility and a short term financial bubble were associated with large inflows of "hot money" from abroad. Moreover, portfolio debt flows, especially short term deposits, are more volatile than long term commercial banks loans and trade financing. Likewise, portfolio equity flows in emerging markets can be taken out fast at low costs. The risk of such reversal is heightened by the volatility of international interest rates.

Action of the international community would thus seem badly needed, particularly now that, under a new administration, the U.S. seems prone to an economic recovery which should improve domestic investment prospects and increase short term interest rates, thus tending to attract developing countries' "flight capital" back to their off-shore bases.

The recommendations for international action designed to strengthen and give sustainability to international capital flows to developing countries were divided into four groups, respectively addressed to the multilateral decision making process, the industrial

countries, the international financial institutions, and to the problems of the majority of developing countries without access to private capital markets.

Multilateral decision making. The G-7 is the centerpiece of multilateral economic policy making and time is overdue that a developing country delegate be permanently included in its deliberations. Foreign direct investment is one of the most interesting forms of external private financing for developing countries: the establishment of a multilateral FDI facility, official debt relief, and opening the industrial country markets to imports from the developing and transforming economies would significantly affect the climate for direct investment inflows to these countries. The Paris Club is a cumbersome institutional machinery for restructuring official debt contracts: an official debt agency linked to the Bretton Woods institutions could replace it a profit for both developing and industrial countries. The massive amounts and enormous volatility of short term capital flows poses at times unsurmountable difficulties for the economic policy making of industrial and developing countries alike: serious consideration should be given to the imposition of transactions taxes on trades in short-term securities, as a possible remedy for the flows of hot money.

Industrial country domestic policies. One means of increasing the external resources that could be made available to developing countries would be to increase the level of public sector savings in the industrial countries. But it would be important to act on measures both to reduce fiscal deficits and to expand the access of developing countries to the domestic financial markets in the industrial countries. Among the regulatory changes needed to achieve this objective, one would include: graduation from loan loss regulatory provisioning regimes; determination of appropriate risk-weights for computing banks' adherence to regulatory capital adequacy requirements; and flexibility in the use of cut-off credit rating standards and other regulatory restrictions for mobilizing funds on industrial country securities markets.

International financial institutions. The recommendations for new actions of the IFIs include the establishment of a currency convertibility facility jointly sponsored by the IMF and BIS; a new facility to provide new debt enhancement through collateralization and other financial techniques; measures to improve the quality of developing countries' risk assessment by international financial markets; and technical assistance to developing countries on financial engineering and domestic financial market reform.

Small and low income countries. Most developing countries either because they are too small or too poor or both, cannot realistically expect to benefit from long term private capital inflows. The external financing problem of these countries includes a major debt overhang and can only be dealt with on the basis of substantially increased official flows.

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SUMMARY

This paper surveys selected international policy measures which might contribute to the sustainability of the recent capital inflows to some middle-income developing countries. The policy recommendations are divided into four groups, respectively addressed to the multilateral decision making process, the industrial countries, the international financial institutions, and to the problems of the small and low income developing countries without access to private capital flows.

RESUMO

Este artigo contém uma resenha de medidas seletivas de política internacional que poderiam contribuir para a sustentação dos recentes influxos de capitais para alguns países em desenvolvimento de renda média. As recomendações de política estão divididas em quatro grupos, respectivamente dirigidas ao processo de decisão política multilateral, aos países industriais, às instituições financeiras internacionais, e aos problemas dos países em desenvolvimento pequenos e de renda baixa que permanecem sem acesso aos fluxos privados de capitais.

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