

PROSPECTS FOR AVOIDING CRISES WITH LIBERALIZED CAPITAL FLOWS

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Abstract

The history of Latin America's relations with the international capital market has not been a happy one. Debt crises have recurred with monotonous regularity ever since the 1820s, about three years after the first loans were contracted by newly independent countries. Despite the theoretical benefits that we all know capital flows can bring, it is easy to believe that Latin America's history would have been happier had the region never borrowed a penny. The liberalization of capital flows will make the region more rather than less exposed to such crises. Are there nevertheless any reasons for believing that the future may be happier than the past? I shall argue that there are in fact three such reasons: the changing composition of capital inflows, the possibility that countries will learn by experience, and the analogous possibility that capital markets will also learn by experience and come to take a longer term view.

Síntesis

La historia de las relaciones de América Latina con los mercados internacionales de capital no ha sido feliz. Las crisis de deuda externa se han repetido con una regularidad monótona desde los años 1820, tres años después que el primer préstamo fuera efectuado a los nuevos países independientes. A pesar de los beneficios teóricos que pueden tener los flujos de capital, es fácil creer que la historia de América Latina hubiera sido más feliz si la región nunca hubiera pedido un centavo a préstamo. La liberalización de los flujos de capital hará que la región quede más expuesta a estas crisis. ¿Existen, sin embargo, razones para creer que el futuro será más feliz que el pasado? Argumentaré que tres razones hacen pensar que la respuesta es positiva: el cambio en la composición de los flujos de capital, la posibilidad de que los países aprendan de la experiencia y la posibilidad análoga de que los mercados de capital también aprendan de la experiencia y tomen un punto de vista de más largo plazo que en el pasado.

1. DEBT VERSUS EQUITY

The first reason for hoping that the post-1990 recovery in capital inflows to Latin America may prove more sustainable than previous episodes is that a

much greater part of the inflow has consisted of equity instead of debt. Table 1 compares the composition of gross capital inflows to the region for 5-year periods from 1976 to 1995. It can be seen that the two categories of inflow where the foreign investor obtain an equity claim, namely foreign direct investment (FDI) and purchase of local shares, have increased monotonically from 17 percent in the late 1970s to no less than 61 percent in the 1990s.

Why is this so important? The reason is that an equity claim has much better risk-sharing characteristics than a loan. A loan involves a legal contract to pay a stream of debt service irrespective of the borrower's capacity to pay, which may be an exceedingly onerous requirement if conditions turn out to be adverse, as the debt crisis demonstrated all too clearly. In contrast, most enterprises will become less profitable if a country encounters macroeconomic difficulties. This will mean that the subsidiary of a multinational will usually make less profits, and hence attempt to remit less cash back to its parent. Similarly, companies will tend to pay smaller dividends, which will reduce the sum to be remitted abroad to foreign holders of shares. Obviously this stabilizing behavior is not a certainty, and if most foreign investment went into pawnbroking the odds would go the other way, but the need to resort to this fanciful example emphasizes the likelihood that variations in profit or dividend remittances will tend to stabilize the balance of payments.

Nor is it just the flow of payments to service the debt principal that theory suggests is more likely to vary in a stabilizing way for equity than for debt. The debt crisis was caused not just by high interest rates magnifying the interest payments due, and by the reductions in export earnings with which to service the debt, but most immediately and powerfully by the cutoff in new lending without any similar curb on the requirement to pay amortization. Most people would take it as axiomatic that FDI will be less subject to sudden withdrawal of principal on a large scale,¹ because factories are unlikely to be sold because of short-term difficulties.

There is, however, no similar confidence that foreign purchase of equities on the stock market will not be suddenly reversed in the presence of some adverse shock. People point to the ability to sell stocks quickly, and infer that all the foreign money that has come in could go out again even more quickly than it arrived, if and when foreign investors become concerned about a country's prospects. What this ignores is that foreign holders have to obtain domestic money for their stocks before they can demand foreign exchange from the central bank, and this means finding other buyers. If the buyers are other foreigners, there is no net pressure on the foreign exchange market. Only if the purchasers are predominantly local can such a problem arise. But then the question is: why should local investors not react just as strongly to an adverse shock as foreigners? If they do, the reaction will be a fall in stock market values, not pressure on the exchange market.² Note that this is exactly what did happen

¹ It is possible, and quite likely, that multinationals will seek to reduce their working balances in the currency of a country in macroeconomic difficulties, and that will show up in the balance of payments as an outflow of FDI, but this will involve only a limited withdrawal of funds.

² This assertion has to be qualified to the extent that the initial reaction to selling pressure tends to be a buildup in the holdings of market-makers, who are by definition local, but it is surely a minor qualification since they will resist any substantial accumulation of stock.

TABLE 1
COMPOSITION OF CAPITAL INFLOWS TO LATIN AMERICA AND THE CARIBBEAN, 1976-95

	Average 1976-80		Average 1981-85		Average 1986-90		Average 1991-95	
	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total	Millions of dollars	Percentage of total
Net Resource Flows	24662	100.0	27890	100.0	14509	100.0	45758	100.0
Net Flows on Long-Term Debt	20072	81.4	21676	77.7	5218	36.0	14607	31.9
Public and Publicly Guaranteed	16329	*	18938	*	6889	*	6367	*
<i>official creditors</i>	2800	*	5593	*	5470	*	3609	*
multilateral	1015	*	3148	*	3335	*	1374	*
concessional	196	*	309	*	242	*	420	*
bilateral	1334	*	2445	*	2135	*	2234	*
concessional	477	*	1007	*	1419	*	959	*
<i>private creditors</i>	13529	*	13345	*	1419	*	2758	*
bonds	1400	*	554	*	-1216	*	2833	*
commercial banks	11028	*	11335	*	1303	*	1261	*
other private	1102	*	1455	*	1333	*	-2027	*
Private Nonguaranteed	3743	*	2737	*	-1672	*	8240	*
bonds	...	*	...	*	...	*	7526	*
commercial banks	...	*	...	*	...	*	1669	*
Foreign Direct Investment (net)	4071	16.5	5112	18.3	6655	45.9	16276	35.6
Portfolio Equity Flows	0	0.0	27	0.1	357	2.5	11793	25.8
Grants (excluding technical coop.)	520	2.1	1075	3.9	2280	15.7	3082	6.7

Source: World Debt Tables.

Italicized figures are averaged over four years (91-94).

during the tequila crisis in 1995: stock markets fell sharply almost throughout Latin America, but only in Argentina and Mexico was this accompanied by any sizable pressure on the currency, and it seems that this was a counterpart to the sale of bank deposits and short-term bonds (notably Tesobonos) rather than stocks.

It is true that many equity purchases are made by mutual funds, which have the reputation of being fickle holders, and might therefore satisfy the criterion of being more anxious to get out at the first hint of bad news than local investors. But the biggest buyers are pension funds, which are much more likely to invest for the long term, and probably less inclined to sell in a panic than local investors. Hence I see no presumption that foreign sales of equities are likely to pose a particular threat. The fundamental point is that there is a price that can adjust to any adverse shock, thus avoiding the incentive to liquidate asset positions, with all the destabilizing implications that such liquidations have. The same is true of long-term bonds, where the price can also adjust to avoid the liquidation of existing holdings. A much more difficult problem may be to find mutually acceptable terms for refinancing bonds that mature (a problem that does not arise with equities), but when most bonds are long-term this problem affects only a small part of the outstanding stock of assets each year.

A different line of attack on the claim that equity is a more stable source of finance than short-term capital has been launched by Claessens, Dooley, and Warner (1993). They examine the time-series properties of various types of capital flow and conclude that they are essentially indistinguishable, and in particular that an inflow of FDI is as likely to give way to an outflow in the following period as is an inflow of short-term capital. As already noted in a footnote, it is certainly true that multinationals have scope to vary where they hold their liquid assets, which they assuredly use when they are offered opportunities for virtually riskless gains because governments follow stupid policies of defending disequilibrium exchange rates. However, in his discussion of the Claessens-Dooley-Warner paper, Guillermo Calvo argued that standard measures of volatility such as those presented in the paper might not address the real issue, which is the fear of occasional large changes rather than of frequent small changes. Hence he argued that one needed measures of volatility that placed a larger weight on "spikes" and "outliers" than the standard measures do.

For many years, people looked back on the international capital market as it functioned before 1914 as something of a golden age. The reason usually given was that capital flows largely took the form of long-term bond finance, which was contrasted with the short-term speculative flow that emerged in the inter-war years. The medium-term bank loans that dominated capital flows in the 1970s may have been marginally better, but the variability of interest rates had the potential to impose insupportable burdens on the borrowers, a potential that was realized in 1982. I have argued that the shift from bank loans with variable interest rates in the 1970s to a large equity component in the 1990s is likely to be an important stabilizing factor, and would argue that the new mode of financing may well prove even better than the long-term bonds of the golden age.

To give an example of why it could be so much better, consider Perú's experience with the financing of the trans-Andean oil pipeline constructed in the mid-1970s to bring to the coast the oil deposits that had been found in the Amazon region of Peru. The pipeline was financed by a standard sovereign

loan from a consortium of banks with a floating interest rate. It turned out that the oil deposits were less than had originally been anticipated, so that the capacity of the pipeline was never fully utilized, but the cost of debt service nonetheless had to be paid in full. Indeed, the cost of debt service escalated in the late 1970s as international interest rates rose. Had the pipeline been built by foreign oil companies, as would certainly have been possible in a climate that was less hostile to foreign investment, those companies might have been more cautious in terms of the size of the pipeline constructed. But, even if they too had succumbed to excessive optimism, their profit remittances would have been lower than expected when less oil was pumped, and would not have increased just because world interest rates rose. Peru would unquestionably have been less vulnerable to the debt crisis.

This is not to deny that equity financing has a disadvantage to the host country: it is normally more expensive. Because the foreign investor carries risks that are borne by the host under sovereign borrowing, the expected rate of return sought by the foreign investor will be larger than that required by banks. It is of course important to avoid allowing foreign investors to make excessive profits, which can in principle immiserize a country (Brecher and Diaz-Alejandro, 1977), but the solution to that danger is to ensure that the economy is competitive and that foreign investors do not receive excessive protection, not to exclude the foreign investors. The risk-sharing characteristics of equity investment are worth paying something for, in terms of a higher expected cost of capital.

In fact the cost does not seem to be that excessive: estimates of the rate of return on US direct investment abroad over the period 1986-90 show a return of 10.3 percent per year on investment in South America and 7.5 percent in Mexico, though with higher returns in other regions except Canada, up to a maximum of 22.3 percent in East Asia (Graham 1996, table 2.3b). For these payments, the host country gets the benefits of the technological and managerial expertise of the foreign investor, and often of access to world markets, as well as the capital. Moreover, a substantial part of the cost of both direct and portfolio equity investment tends to be deferred into the indefinite future, in the form of retained earnings plowed back into new investment in the case of direct investment, and capital gains in the case of portfolio equity. If one accepts that discount rates are currently high in developing countries and can be expected to decline over time as development proceeds, this delay offers a very real welfare benefit.

In my view this leaves a strong presumption that the shift from debt to equity is to be welcomed. At a significant but not inordinate cost, part of which will be delayed into the indefinite future, countries get significant protection against the sorts of risk that have led to crises in the past.

2. LEARNING FROM EXPERIENCE

The shift from debt to equity is not the only reason for hoping that the future may be less crisis-prone than the past. Another factor is the ability to learn from past experience. Of course, countries do not always learn from experience, especially the experiences of others: history is replete with cases where the dictum that those who do not learn from history are condemned to repeat it is all

too apt. But there is surely also ample evidence for believing that countries often do learn from the experiences of others: for example, most people believe that the superior economic performance of East Asia was an important factor in influencing Latin America's shift toward more market-oriented policies in the late 1980's. One would expect this effect to be especially pronounced when the countries are near neighbors and the contrast in the outcomes is sufficiently vivid.

It happens that exactly such a contrast is on display in Latin America today. I refer to the contrast between the experiences of Mexico and Colombia in 1994-95. Both countries were very popular with the capital markets in the early 1990s, Mexico because it was the standard-bearer of the policy reforms that were sweeping Latin America, and Colombia mainly because of the large oil discoveries in Cusiana. Both countries were subsequently buffeted by severe adverse shocks. The 1994 rise in US interest rates hit both. Mexico suffered the Chiapas revolt, and the Colosio and Ruiz Massieu assassinations, in 1994. Colombia experienced political trauma a few months later, in mid-1995, when allegations that President Samper had knowingly financed his election campaign by narco-money surfaced.

The economic outcomes of these interest-rate and political shocks were very different. In Mexico, when the capital inflow ended there was no alternative way of financing the large current account deficit, some 8 percent of GDP, that had emerged. The unconstrained capital inflow had financed a large expansion in bank lending that had left the banking system exposed, which made the Mexican authorities hesitant to tighten monetary policy when reserves started to decline. (Doubtless the proximity of a presidential election was a further factor that reinforced their reluctance). By December 1994 they had pretty much run out of reserves, and were therefore forced to abandon their previous categorical insistence that they would never devalue, an event that destroyed confidence and led directly to the subsequent crisis.

Colombia's policies when faced with comparably strong capital inflows were very different. To maintain a competitive real exchange rate the authorities bought and sterilized reserves, and placed reserve requirements against foreign loans with a maturity of less than 5 years. There was still some real appreciation, but it was limited with a view to supporting the growth of exports and curbing the size of the current account deficit. This did actually reach over 5 percent of GDP in 1995, but with a clear expectation that it would fall substantially in the not-too-distant future as the Cusiana oil fields came on stream. Colombia thus faced its political crisis in a much less vulnerable situation: its current account deficit was significantly smaller, and on unchanged policies it was expected to fall, and its banking system had not been weakened by excessive capital inflows. Of course, the political crisis certainly had an impact in the foreign exchange market: the exchange rate went to the weak edge of the band, and has been close to the weak edge ever since, but the authorities had no difficulty in defending the band. Political crisis did not lead to economic crisis.

In making this comparison I have deliberately picked Colombia in 1995 rather than Chile in 1982, because Colombia not only was being fiscally virtuous (as was Chile) and not only had the same opportunity to make itself vulnerable by allowing a current account deficit as large as the capital inflow the markets were willing to finance (which Chile also had), but in addition it suf-

ferred a severe political crisis (which Chile did not). That it did not succumb to that crisis, but survived it virtually unscathed, is a reflection of the difference between the policies that Mexico and Colombia had followed in the preceding years.

The key question is whether other countries will draw the right conclusions from the contrast between Mexico and Colombia. One would like to be able to give a categorical yes to this question, but that would doubtless be too facile. As Paul Krugman (1995) remarked at the end of his article predicting that the Washington consensus was likely to be repudiated in the wake of the Mexican debt crisis, "to suppose that bad ideas never flourish is to ignore the lessons of history". The case for optimism is that Krugman's pessimism has so far been proved wrong. In fact, the one Latin American country that did vote for a populist in the early 1990s, namely Venezuela, has done a U-turn far more quickly and with far less damage to its economy than that experienced by Peru in the 1980s or by Chile in the 1970s.

On macro policy, there seems to be a similar change in intellectual positions. While one can still find hard-line monetarists who will argue that Argentina's currency board provides the model for the whole continent, it is increasingly common to find those prepared to laud "Keynesian" Chile and Colombia as the model instead. Even in Mexico there is now talk of making sure that the peso does not succumb to a new overvaluation as and when capital inflows resume.

3. LEARNING BY THE MARKETS

Once one has acknowledged the possibility that agents may learn by experience, it is natural to recognize also that it takes two to tango, and that the other party in the capital markets -the lending side- may also change their actions on the basis of experience. It has become a stylized fact that the markets have developed a destructive propensity to pour so much money into any country that implements a convincing reform program as to endanger the ability of the reform to deliver improved performance (McKinnon and Pill 1995). This is clearly bad for lenders as well as borrowers, even allowing for the possibility that they will be bailed out of the consequences of their mistakes like they were in Mexico. One would like to hope that improved analysis will help them to learn how much is too much, just as it can help governments to learn to avoid excessive borrowing.

Even though governments do not have direct control over the decisions of lenders, public policy can hope to encourage more far-sighted decision making in the private markets. The most straightforward way to influence such decisions is by curbing the danger of moral hazard created by an expectation of bailout. Policy is already moving in that direction: the G-10 Report on orderly workouts (Group of Ten, 1996) claimed that the group was rejecting all the radical proposals for "an international bankruptcy court", but its endorsement of the proposal to allow the IMF to lend into arrears in servicing bonds would give the Fund *de facto* power to authorize a standstill in debt service payments if and when it judges the circumstances to warrant a standstill. It thus seems unlikely that another bailout on the Mexican model will ever happen. To the

extent that the capital markets were relying on such bailouts, they are going to have to think again.

However, it is not clear that the expectations of such bailouts materializing is a major factor in driving the sort of overlending that happened in Mexico. Another explanation is that the managers of investment funds take a short-term view, perhaps out of a collectively inconsistent hope that if things start to go wrong then they will be able to get out faster than the average market participant, and perhaps because of a quite realistic assessment of where their personal interest as the agents of the investors lie. The fact is that the easy test of the agent's performance is whether he or she is doing better or worse than the market average. A fund manager who misses out on a boom is liable to be sacked, while one whose portfolio loses value in a crash along with everyone else is unlikely to be fired.³ It is therefore perfectly rational, from the standpoint of the individual agent (portfolio manager), to focus on whether he or she expected prices to go up or down before their next quarterly review assessment, rather than on whether they think the market is overvalued or undervalued relative to the long-term trend. The way to focus the attention of portfolio managers on the latter question would be to reform their remuneration practices, so that bonuses were paid (say) five years in arrears on the basis of how their fund had performed over that time horizon. This is obviously not a reform that can be effected by the governments of developing countries, and it is not one that is on the current agenda of the international community, but it may happen one of these days, if and when my diagnosis of the problem has become more widely accepted.

4. CONCLUDING REMARKS

I am therefore cautiously optimistic that Latin America will be less susceptible to debt crises in the future than it has been in the past. This is mainly because of the change in the form of the finance that is flowing to the region, which should make it less exposed to unfavorable shocks than it has been in the past. I also hope, though without enormous confidence, that the governments of the region may be less carefree in allowing their countries to become vulnerable to debt crisis in the future, as they learn from experience. An it is even possible that the capital markets will begin to take a longer term view, partly because future bailouts seem unlikely to be as generous as that in Mexico.

³ I recall meeting a banker in about 1984 who told me that he had been promoted twice within five years, the first time from building up a big portfolio of Peruvian paper during the boom years and the second time because he saw the crisis coming a few months sooner than his peers and therefore ran down the portfolio by 10% before his bank got locked in along with all the others.

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Síntesis

Este trabajo analiza el efecto del aumento de los flujos de capital extranjero hacia Chile en los años 1990. describe los puntos de referencia para introducir el régimen flexible y analiza los resultados de la condición de política en términos de la estabilidad con que los flujos fueron restringidos y de los efectos que los flujos han tenido sobre el crecimiento y la inversión. Apoyados en un modelo con 50 por ciento de los flujos han buscado la forma de inversión extranjera directa (IED) y el 45 por ciento restante ha estado constituido por flujos de cartera, credenciales de corto plazo e instrumentos de largo plazo por parte de hogares e empresas nacionales globales. Los flujos adicionales han incluido la importancia de un círculo de retroalimentación sobre el flujo de entrada de capital financiero a través de la tasa de interés.