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Comments by **Roberto Zahler**

The paper by Michael Mussa and Alexander Swoboda is a very complete and up to date contribution to a major topic in international finance.

I have two general comments. First, the paper is centred principally on issues related to and steps to be taken at the **international or systemic level**. And here a basic consideration, not analysed in the paper, is that liberalisation of capital movements is not the same as trade liberalisation, both in theoretical as well as in practical terms[1]. From another perspective, the institutional framework, including supervision and regulation of financial and assets markets at the international level presents a higher degree of imperfection that at the national level. From a narrower point of view, although booms and busts are endemic in all financial markets, recent experience suggests that these international swings need to be brought under certain control.

Second, the paper deals more with **capital outflows** from emerging market economies **and** with **crisis management** rather than with **crisis prevention**. And experience also shows that by moderating the booms (**capital inflows**) that precede them can busts be prevented. In short, there is a need for a stronger regulatory framework at the international level.

Therefore, further research should consider specific measures aimed at increasing, for both lenders and borrowers, the (private) cost of short-term international finance, so as to **internalise the externalities that currently exist in international capital markets**. It also seems appropriate to concentrate the analysis on issues arising from "excessive" **capital inflows** and on **prevention** as well as on actions that might be taken by **individual countries**, both capital importers and capital exporters, directed to moderate the boom - bust pattern of capital flows.

Scope appears to exist to increase risk-awareness, and therefore the cost to foreign creditors regarding the domestic economies of developing countries. In this regard the biggest challenge appears to be how to improve prudent regulation in the creditor countries, particularly in relation to short-term bank loans as well as on portfolio flows[2].

This is important because experience tells as that **there is an asymmetry in the way foreign lenders tend to assess risk in emerging economies**. In fact, creditors tend to see the benefits they may rip from developing economies, in the way of high interest rates (including exchange rate and country risk) and/or low asset (mainly share) prices. And the challenge here lies in creating means to incentive better allocation of potential foreign lenders risk in emerging economies. For example, how can exchange rate depreciation be incorporated in the behavioural pattern of would be international lenders? Similarly, the elimination of "guarantees" perceived on certain (financial) assets located in these countries as well as less bail out by the IMF and/or governments from industrial countries should be internalised in the behaviour and decision patterns of creditors.

Responsibility in this area relies with creditor countries and with international financial institutions. The improvement and homogenisation of information standards, better data on countries aggregate exposure, and more in-depth analysis of country-risk and exchange rate risk --by rating agencies and international financial institutions--may contribute to a more adequate and realistic approach of the supply of private international finance to developing economies.

Before considering measures that individual capital recipient countries could apply towards reducing the boom - bust trend of international capital movements, I would like to highlight two main conclusions of the paper.

On the one hand, when analysing possible measures to moderate the boom - bust characteristic of international capital movements the authors conclude that **"...there is no universally applicable, first-best approach**" to deal with the problem[3].

On the other hand, they say that "...there is a trade off in policies that tend to maintain a relatively closed capital account, which presumably provide significant protection against international financial crises while they substantially impair a country's ability to take advantage of the efficiency gains from broader participation in the global financial system." The paper asserts that "the terms of **this trade off** can be made worse by imprudent measures of capital market opening, and it **can be improved by a gradual and prudent approach" to the opening of the capital account of the balance of payments**[4].

Measures that individual capital importers countries could apply towards reducing the boom - bust trend of international capital movements

Benefits and costs of financial opening - up

For emerging economies greater financial integration with the rest of the world offers significant opportunities. These include the possibility of using external savings to finance investment, the chance to deflect temporary terms-of-trade shocks and the ability to diversify risk and sources of national income. All of this makes it possible to smooth out trends in consumption and utilise comparative advantages more fully through a further integration of the country into the international economy. Additionally, **when capital movements are the outcome of well-informed decisions, they contribute to impose discipline on policy makers**, especially in emerging market economies.

Greater financial openness also entails risks that need to be considered, however. There are both permanent and transitional costs. The loss of degrees of freedom in the management of monetary policy and the eventual destabilising effects that short term capital movements can have in a small economy are some of the permanent costs of increased financial openness. The risks associated with the adjustment involved in switching from what has traditionally been a closed capital account to an open one are transitional costs.

Additionally, due consideration should be given to the **size of capital movements**. In fact, a very small percentage of total assets of a bank or pension or investment fund in the industrialised countries may have a significant impact in the foreign exchange and in the capital market of small emerging market economies. And for those financial institutions, having little at stake, it may be "rational" not to allocate enough time or resources towards a rigorous evaluation of the current and future evolution of small emerging market economies. But in that process, what tends to predominate, are "herd" and "contagion" effects, which although "rational" from the point of view of the individual creditors, may prove very harmful to capital importer countries. And that **type of creditors behaviour has very little to do with disciplining countries with weak macroeconomic management and/or rewarding those with sound macroeconomic management**.

Also, due consideration should be given to the **time dimension of capital movements.** Differently from foreign direct investment (FDI) for some financial capital movements time is not measured in terms of years, but of months, weeks, and sometimes days and even hours. The very short time period of some sizeable capital movements adds an additional challenge to policy makers in debtor countries. And this is because the latter should have a medium and long term time horizon for their policy decisions and usually lack the adequate instruments and/or the necessary flexibility required to counterweight the significant short term effects of some capital movements.

A third element that aggravates the destabilising and potential harmful effects of huge and short term capital inflows relates to **the usual practice of the de facto bail out of many of the participants in the international financial markets.** That bail out has some systemic and international rationale[5]. And although it may contribute to regain quick access to world capital markets for countries in problems, in practice it has validated, when not stimulated, the undesirable aspects of the behaviour of some huge short-term international financial movements.

Financial opening - up in the nineties

Emerging economies access to external finance, which had become extremely limited after the Latin American debt crisis of the 1980s, changed dramatically in the 1990s. The perception of a lower level of country-risk, low interest rates in industrialised countries and widespread financial flows to emerging economies significantly increased the available supply of external funds during the first half of the 1990s. Within this context, some countries found themselves in a situation in which, after adjusting for country-risk and for changes in exchange-rate expectations, the domestic rate of return on capital exceeded the external cost of funds[6].

In the past, that situation could either not be altered at all or would take quite a long time to change, because perceived country-risk and a lack of confidence in local currencies limited international arbitrage. In the early 1990s, however, the unrestrained openness of the financial market would have attracted a voluminous inflow of short-term finance in a very short period of time. That would have destabilised domestic spending and asset prices as well as key prices such as the real exchange rate and the interest rate itself.

The path that the economy would take if this trend were to continue is well known. Given the size of these flows, the first stage of the transfer process is an **economic boom**: asset prices and wages rise, consumption and investment increase, the currency appreciates and imports become cheaper. This stage is a difficult one in terms of its macroeconomic management. The inflationary pressures generated in domestic markets have to be curbed and policy-makers have to be on guard in order to head off financial bubbles, which accentuate the movement of prices away from equilibrium levels, and to forestall the arrival of even greater amounts of short term foreign financing.

This expansionary phase of the cycle sows the seeds for **a subsequent contractionary phase**, however. As the balance-of-payments current account deficit grows and external liabilities accumulate, the perceived level of country-risk begins to rise, the supply of external funds starts to shrink, the volume of external transfers decreases and, as a result, prices and expenditure start moving back in the direction they had come from.

Ideally, inflows are gradually reversed and adjustments in key prices are accomplished smoothly, without generating any major disequilibrium in the economy's performance. The most likely and realistic scenario, however, is one in which capital inflows come to a halt and may even reverse direction suddenly, thereby triggering a traumatic adjustment[7]. In this context, **an economy is in a very vulnerable position when it has a high level of indebtedness and a large current account deficit, and this is aggravated if its external financing is mainly short term**. Increases in international interest rates, a deterioration in the terms of trade, or simply a change in external and/or domestic expectations can set off a sudden confidence crisis that puts an abrupt halt to the external transfer of resources. The external debt crisis that overtook Latin America in the 1980s and the turbulence that arose in international financial markets in late 1994 and in 1995,

as well as more recently with the Russian crisis in August of 1998 clearly illustrate these risks.

In this latter scenario, the necessary adjustment involves a dangerous mix of high domestic interest rates, a downswing in domestic asset prices and a steep depreciation of the real exchange rate. These will inevitably cause serious problems in domestic financial markets and create inflationary pressures. In addition, a significant increase in unemployment and a decline in the level of economic activity are to be expected as a consequence of the friction generated in financial and labour markets, along with a sharp drop in expenditure. Once again, the Latin American experience in the early 1980s and the more recent crisis in Mexico, East Asia and Russia have demonstrated that this pessimistic scenario is highly probable.

From the standpoint of the internal equilibrium the role of the domestic real interest rate and how it influences the mode and speed of a financial opening-up process is an important consideration. The level and growth rate of domestic spending has to be compatible not only with a prudent use of external savings but also with the level and growth of the economy's production potential. This generally requires domestic interest rates to be higher than the interest rates prevailing in the main industrialised economies.[8] This is why in the 1990s certain countries, **in order to uphold and consolidate macroeconomic discipline and external equilibrium, undertook a prudent, gradual and selective liberalisation of the capital account of the balance of payments**.

Capital inflows to and outflows from emerging market economies

In the current functioning of international financial markets, "excessive" capital inflows - the boom - have been a major cause of balance of payments, financial sector problems and recession in emerging economies. In fact, **it has mainly been the reversion of those short-term inflows - the bust - which has aggravated the high domestic adjustment costs** in terms of negative economic growth, unemployment and a fall in profits and real wages.

Capital Outflows

As a norm, capital outflows should be free. This means that all natural persons as well as the bulk of the enterprises should be able to spend, i.e., consume and invest abroad. The major exception to this norm applies to financial institutions, such as banks, pension funds and eventually insurance companies, if they operate with a de jure or de facto total or partial government backing or guarantee.

For these financial institutions, prudential considerations suggest a strategy of gradual and selective opening up. Banks typically have an explicit or widely recognised implicit government guarantee on most of its domestic and foreign liabilities. If banks located in

emerging markets would like to invest abroad by buying other banks, special consideration should be given to banks accounting and financial consolidated balance sheets in the country of destiny. Additionally, external ratings of financial institutions and, especially, adequate regulatory framework and supervisory practice in third countries, together with bilateral agreements between regulators should be required. Furthermore, experience suggests that initially a maximum percentage of a bank capital and reserves should be allowed to be invested abroad, percentage that could be increased through time as knowledge and experience with business in third countries accumulate.

A similar gradual and selective approach toward pension funds investment abroad, regarding countries, financial assets and currencies, appears to be advisable, again due to the fact that usually there are "contingent" fiscal resources compromised. These transfers, although usually excluded from the traditional and accounting definition of fiscal spending, as well as from parliamentary discussion and approval, de facto **increase private sector expected wealth and affect their spending decisions**. This "imperfection" had a major impact in Latin America's foreign (and domestic) debt crisis of the early eighties and is a good example of the above. A more recent example was Mexico's "tequila crisis" of December 1994 and some of the countries in the Asian crisis of 1997.

These contingent fiscal transfers should include an appropriate percentage of implicit, and certainly explicit banking deposit insurance schemes, as well as of exchange insurance and other contingent support typically given by governments to banking system depositors, creditors and/or borrowers when facing a banking sector crisis. Similarly, the government, even when dealing with reformed and privatised social security capitalisation schemes, usually guarantees minimum pension funds.

If these contingent transfers were taken into account **public sector liabilities,** appropriately measured, **would have been growing at a faster rate than what official statistics show.** This transparency in information would have beneficial effects on the economic authorities' evaluation of the soundness and sustainability of macroeconomic policy and the consequent need for the adoption of proper and timely corrective measures.

Capital inflows

A first distinction should be made between FDI, which is usually anticyclical and of a long-term nature, from other sorts of foreign financing.

On the other hand, short-term financial as well as portfolio inflows tend to be procyclical. But also, and perhaps more importantly, these inflows usually are of a **magnitude, time dimension and speed that may contribute to create and/or amplify macroeconomic and financial disequilibrium in emerging country economies**. From a more practical and empirical point of view, it was these flows that have been associated with the recent

crisis in Mexico, Asia, and Russia and with creating problems of overvaluation of domestic currency and loss of competitiveness in other emerging markets.

From a macroeconomic perspective, perhaps the most direct way to analyse this is recognising that the current account of the balance of payments, as well as the short term foreign debt, matter, and matter a lot, especially in emerging markets. Then, by definition, **if the net capital account surplus is "too big", and especially if it is of a short-term nature, there will most probably be a "capital inflow problem" for certain countries**[9].

Although this problem may apply to countries that have a mismanaged economic policy or wrong institutional (guarantees and financial regulation and supervision) set ups, it **is more probable to affect those countries with strong and sound macroeconomic management**.

The above is especially relevant if a country faces significant short-term "voluntary" capital inflows. In fact, recent experience shows that in many cases **capital importer country authorities may be "tempted" to rationalise the existence and persistence of consequent large current account deficits on the ground that they are not being "originated" in excessive (public) domestic spending, but on private spending "financed" by voluntary capital inflows.** Even more, it is asserted that the associated significant current account deficits are a sign of a "healthy" economy, with plenty investment opportunities and with a good credit standing in the international markets.

Macroeconomic response to "excessive" capital inflows

In the first place, **fiscal policy** should be tightened. Here, both the fiscal deficit/surplus as well as the rate of growth of fiscal absorption should be looked at, and improved. However, in practice reduction of fiscal deficits or increases in its surplus has limits, since <u>fiscal policy tends to be quite rigid</u> and there is a scarce availability of adequate fiscal instruments to compensate for significant short-term capital inflows.

Exchange rate policy plays also an important role regarding short-term inflows. In particular, exchange rate flexibility, with its associated uncertainty of the future value of the domestic currency, contributes to disincentive short - term capital flows. However, the <u>magnitude of capital inflows</u> vis a vis the domestic foreign exchange market <u>may require wild exchange rate fluctuations to disincentive those flows</u>. And given the elementary development of future and derivative markets in developing countries, frequent and significant exchange rate instability may create serious problems to the tradable sector activity.[10]

Thirdly, **international reserve policy** can also contribute to compensate for the effect of capital inflows on the domestic currency appreciation and on the widening of the current account deficit of the balance of payments. However, reserve accumulation is usually

associated to an <u>increase in the Central Bank quasi-fiscal deficit</u> and its efficiency is therefore limited.

Fourthly, to contribute to moderate capital inflows **monetary policy** should be relaxed so as to lower domestic interest rates and reduce the wedge between the latter and international rates. However, control of aggregate domestic spending aimed at reducing both inflation and the current account deficit of the balance of payments usually requires <u>higher internal than international interest rates</u>. Furthermore, from a more structural perspective, capital - labour ratios in emerging markets as well as its "natural" excess demand for investment also indicate the need for "high" marginal productivity of capital and interest rates in those countries. Therefore, unless fiscal policy is extremely tight, <u>there is almost no room for monetary policy to contribute to moderate capital inflows to emerging markets economies</u>.

From a financial and especially a **banking sector perspective**, significant short-term capital inflows are also a matter of concern. This occurs because most short-term foreign debt is transmitted to the domestic economy through the banking system. If the latter is not properly supervised and regulated, <u>the increase in its liabilities tends to be transferred in the form of excessive and too risky (related, concentrated and/or mismatched) credit to the domestic economy</u>. The outcome, in addition to the weakening of the banking sector, is to generate macroeconomic disequilibrium. And this occurs not only because of the increase in overall spending but also due to the economy's vulnerability to foreign sector and exchange rate developments, considering that under conditions of overabundant liquidity, lax credit standards tend to be the norm in the financial sector resource allocation.

From another perspective, significant short-term capital inflows may <u>disrupt monetary policy</u>, by the monetization of foreign debt, with the consequent increase in money supply and/or lowering in domestic interest rates. This stimulates domestic spending over and above what was initially contemplated in the monetary and fiscal programming.

Capital inflows may <u>disrupt also the working of the foreign exchange markets</u>, especially given their size, speed and short - term nature. Excessive capital inflows appreciate the domestic currency, generating a short term "equilibrium" exchange rate of a very unstable and unsustainable nature when compared to the long run equilibrium value of the real exchange rate. This appreciation tends to trigger a relaxation of monetary and fiscal policy, due to its effect on reducing (temporarily) domestic inflation, while at the same time it stimulates a bigger balance of payments current account deficit.

Excessive capital inflows may also <u>disrupt the functioning of domestic financial markets</u>. As mentioned, emerging markets high level of domestic real interest rates, especially if foreign creditors do not have a proper evaluation of country-risk and/or exchange rate change risk, tend to attract massive external financial inflows, much of which is usually intermediated by the domestic banking system. Under those conditions domestic spending increases, putting pressure on the (temporary) appreciation of the currency, widening the current account deficit, while at the same time **domestic bankers tend to**

relax their credit standards and lending policies, thus deteriorating the quality of their loan portfolio.

Non-bank financial markets, on the other hand, are usually less developed than the banking sector and lack adequate deepening and liquidity, as well as regulation and supervision. When an important part of net short term capital inflows are directed to the stock exchange and/or other (non tradable) stock markets, like land and urban property, it usually translates in an inflated price of these assets, i.e., **stockmarket and property price bubbles**. This further stimulate domestic spending, due to (perceived although unrealised) wealth effects, leading to a higher current account deficit and increasing the odds of a currency crush even if the banking sector is strong. But the higher asset prices also distorts, by biasing upwards, banks collateral valuation, and so they **also contribute to bank's loan portfolio weakness**.

In short, because of their **size and short-term nature**, **capital inflows may contribute to create and/or amplify macroeconomic and financial disequilibrium** in developing countries, **even when their economies are well managed**.

The opening - up of the capital account of the balance of payments

The above analysis suggests that even **if macroeconomic policies are well designed and properly implemented, and even if countries have sound banking systems and regulatory bodies, when facing significant short-term capital inflows they may incur in a major risk[11].** This is because they may easily engage in excessive domestic spending, increased current account deficits and significant build up of short term foreign debt, all of which contributes to generate macroeconomic disequilibrium and increases the country's vulnerability, thus becoming much more subject to foreign sector volatility. Under those circumstances **countries should, for macroeconomic reasons[12], attempt to regulate capital inflows, whatever the state of their banking system.**

If the financial and specifically the domestic banking system are weak, this will add another problem to policy makers, with quite probable macroeconomic impact. The improvement of the functioning, regulation and supervision of financial markets should address this issue. However, given that that takes time, if most short-term capital inflows are intermediated by the domestic financial (banking) sector then there is **an additional argument**, due to financial prudential considerations, **for regulating capital inflows[13].**

In synthesis, well-managed emerging economies should consider a **prudent approach to financial opening-up**. This can be done by reducing the speed at which domestic agents can get indebted abroad and/or by increasing the cost of short term foreign financing[14]. In this way the economy can slow the pace of overall foreign indebtedness while at the same time reduces its vulnerability to foreign financial shocks. The latter occurs by changing the composition of the capital account of its balance of payments, with incentives being given to risk capital (FDI) as compared to external debt, and to long term foreign debt as compared to short-term foreign debt.

In view of the above, the adequate course of action at the individual capital importer country level should be, **first of all**, **to design and implement appropriate fiscal, monetary, exchange-rate and international reserve policies as well as financial sector policies.**

If, in that context, short-term foreign financing nevertheless continues to flow into the country, it is essential to slow down that process in order to prevent an "excessive" foreign exchange inflow from undermining domestic (higher inflation) or external (larger current account deficits) equilibrium. Under those conditions **the correct course of action is to move towards greater financial integration with the rest of the world**, but to do so **prudently, gradually, selectively and with a sequence and at a pace in keeping with the objective of overall macroeconomic equilibrium.**

It may be interesting to briefly describe the type of policies implemented by Chile in mid 1991 since its liberalisation and opening-up of the capital account of its balance of payments was carried forward within the abovementioned strategy[15].

A variety of mechanisms were employed in the implementation of this policy. On the one hand, during the first half of the 1990s **capital outflows were significantly liberalised.** Exporters were allowed to dispose of the whole of their foreign-exchange earnings and were freed of any obligation to bring them into the country. But liberalisation measures were adopted in a variety of other areas as well. For example, the minimum amount of time that must elapse before capital brought into the country by non-residents is eligible for repatriation was reduced from three years to one year. The issuance of bonds and equities abroad (American Depository Receipts, or ADRs) was authorised, with the requirements in this respect gradually being relaxed as time went by. In addition, all restrictions on outflows of investment funds originating from external debt swaps (a mechanism linked to the debt crisis of the early 1980s) were lifted. And liberalisation measures were implemented regarding the prepayment of external debts and the minimum percentage of external credit that has to accompany any FDI.

A complementary measure regarding capital outflows, of the utmost importance, was the complete liberalisation of foreign investments made by Chilean individuals and firms, which made it possible for investors to diversify their risks more fully. Steps were also taken to encourage national (especially institutional) investors to increase the international diversification of their portfolios. The capital outflow liberalisation of banks, pension funds, insurance companies and mutual funds was also pursued, although at a gradual pace, partly due to legal restrictions and partly because of prudential considerations having to do with levels of systemic risk and contingent fiscal liabilities.

The liberalisation of capital inflows was carried forward on a gradual, selective basis and was combined with efforts to discourage those of shorter-term nature. This type of liberalisation entailed the implementation of certain specific controls on capital inflows. Steps were also taken to screen capital inflows more carefully in order to reduce the economy's exposure to the volatility associated with short-term financial flows, to give monetary policy-makers more autonomy and to check the formation of

bubbles in the stock market. These measures were intended to make it more expensive for foreign financing (especially short-term funds) to enter the country, to limit the total volume of external inflows and to improve the "quality" and lengthen the maturities of Chile's external liabilities.

First, a one-year time requirement for the repatriation of FDI capital acted as a disincentive for inflows into equity markets, since funds liquidity was constrained. That helped to prevent a price bubble on the stock exchange. It should be reiterated that the reduction of the time requirement for repatriation of FDI from three years to one year constituted a step towards capital account liberalisation in relation to the pre-existing situation.

Second, the speed at which Chilean firms could obtain financing on foreign markets was reduced. This was because of the minimum amounts and certain other requirements related to international rating agencies that had to be met before a firm could place bonds or equities on foreign markets. These requirements varied, depending on the credit standing of the firms or the ratings of the instruments they wished to place on international markets. This measure contributed to limit the number of firms and the speed with which they could obtain financing on international markets and thereby helped to avoid excessive inflows of foreign exchange. Another advantage of this strategy —considering the fact that before 1990 no Chilean firms were trading on international bond or equity markets— was that the solvency and stature of the first companies to venture into these markets created a positive externality for those that came after them. A disadvantage of this measure is that, in practice, it favours large firms rather than small businesses or individuals.

Third, a non-interest-bearing reserve requirement was established, covering the first year that foreign credits and other forms of external finance were held in the country, regardless of their effective duration. This is a "market friendly" direct and flexible[16] way of raising the cost of bringing in short-term capital.[17] And it gave monetary policy more scope and autonomy so that, ideally, all economic agents would face the same interest rate set by the Central Bank with a view to domestic equilibrium. This requirement was also intended to curb the volatility inherent in extremely short term foreign financing and reduce opportunities for interest-rate arbitrage.

From a more general standpoint, this package of gradual, selective foreign financial liberalisation policies made it possible to change the structure or composition of external claims on Chile. It induced an increase in the share of risk capital (FDI) relative to external borrowing and, within the latter, the share of long-term indebtedness relative to short-term debt. This helped to reduce the economy's vulnerability to the vagaries of the world economy, to the procyclical behaviour usually found among external creditors and to changes in the expectations of international economic agents.

Between 1992-1996 GDP grew at an average annual rate of 8.6%. Gross fixed capital formation increased at an annual rate of 16.3% (nearly twice as fast as GDP growth). The fiscal surplus amounted to 2.2% of GDP and fiscal saving totalled 5.2% of GDP. The real

annual interest rate on bank loans for terms of between 90 days and one year averaged 8.9%. Annual inflation averaged 9.7% (Chile's lowest mean rate for any five-year period in over fifty years), going from 27.3% in 1990, through a descending trend quite similar to the Central Bank's yearly inflation targets, reaching 6.6% by the end of 1996. The Chilean peso appreciated at a real annual rate of 4.4% (the smallest appreciation rate among all major Latin American countries during that period) while exports grew by 10.5% per year in real terms. The average annual deficit on the current account of the balance of payments amounted to 3.7% of GDP. Both inbound and outbound FDI hit record levels. Net international reserves were equivalent to 23% of GDP and to one year's worth of merchandise imports. The external debt totalled an average of 39.1% of GDP (16.1% of GDP, net of international reserves). Long and medium term debt represented 93.4% of the accumulated debt during the period, with short-term debt contributing to only 6.6% of that total.

I would like to make two final comments. First, it is often said the Chile's strong macroeconomic performance during the early 1990s was chiefly attributable to its high domestic savings rate rather than to its macroeconomic strategy. It should be noted, however that domestic saving is not a constant, independent of macroeconomic strategy in general or of external finance strategies in particular. Empirical studies and experience suggest that "naïve" policies regarding foreign inflows usually lead to a situation in which external savings end up financing excessive expenditure on domestic consumption and reducing domestic saving.

Second, it is interesting to mention that although during the nineties there were other countries that implemented more "liberal" or aggressive financial opening-up policies, their domestic interest rates were higher than Chile's and the spreads between them and international interest rates were wider. This apparently paradoxical situation is chiefly explained by the fact that these countries had higher levels of country- and/or devaluation risk than Chile. Thus, it is not a foregone conclusion that just because a country carries out a complete and quick financial liberalisation programme it is necessarily going to insert itself in a permanent place in international capital markets. In sum, the extent to which a country is "more fully integrated" into the international economy does not depend so much on how "liberal" it is. But rather on the quantity, cost, quality and continuity of the capital transfers actually available to it, all of which is usually linked to how much confidence the rest of the world has in the prospects and management of that economy.

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[1] See J. Bhagwati:" The Capital Myth: The Difference between Trade in Widgets and Dollars", *Foreign Affairs*, Vol. 77, No. 3. May/June 1998

[2] See, for example, H. Reisen, "After the Great Asian Slump: Towards a Coherent approach to Global Capital Flows", *OECD Development Centre Policy Brief* No. 16 (1999) and S. Griffith - Jones and J. Cailloux, "Encouraging the Longer term: Institutional Investors and Emerging Markets", *UNDP Office of Development Studies, Discussion Paper* # 16, January 1999.

[3] Related to this "second best" approach to deal with the structure and functioning of international financial markets see P. Krugman "Start taking the Prozac", *Financial Times*, Personal View, April 9, 1998 and O. Blanchard, "Le faible coût des garde-fous", *Liberation*, Débats, Paris, France September 14, 1998.

[4] Regarding this conclusion, see also S. Fischer, "IMF and Crisis Prevention", *Financial Times*, Personal View, March 30, 1998

[5] However, it contributes to moral hazard at the international level.

[6] This differential in rates of return is the result of historical circumstances and structural reforms affecting the productivity of an economy, which has little to do with monetary policy. Given the relative endowment of capital and human resources in LDC's, the limited access to external financing that these economies had until recently and their traditionally low rate of domestic saving, it is only natural that the domestic rate of return on productive capital (as distinguished from the rate of return on financial capital) in those countries should be higher than in industrialized economies. See R. Zahler, "Seminario 70º Aniversario del Banco Central de Chile" in *Estudios Monetarios XII*, Central Bank of Chile, June 1996.

[7] See C. Wyplosz, "Globalised Financial Markets and Financial Crisis", in *Finance and the Real Economy: Issues and Case Studies in Developing Countries* (edited by Y. Akyuz and G. Held), United Nations University/World Institute for Development Economics Research, ECLAC and UNCTAD, September 1993.

[8] The real interest rate needs to be fairly consistent with the rate of return on productive capital. In time, high investment rates and further increases in domestic saving ought to make it possible to gradually close the gap in interest rates.

[9] This was the case of Latin America in the late seventies and early eighties, Mexico in 1994, the Czech Republic in early 1997 and some of the countries in East Asia in that region recent crisis.

[10] Additionally, in some cases there is a fundamental related real exchange rate time path, for example, a trend appreciation of the domestic currency. This may have its origin in differential rates of growth and/or of productivity in the country exportable sector vis a vis those of its main trading partners, and in this case exchange rate flexibility will be less effective to hamper capital inflows.

[11] Two different approaches of how to deal with this risk can be found in L. Summers, "Go with the Flow", *Financial Times,* Personal View, March 11, 1998 and J. Stiglitz, "Boats, planes and Capital Flows*",* *Financial Times,* Personal View, March 25, 1998.

[12] Well managed small developing economies can gradually ease capital inflows regulations as the expansion in its capital stock lowers the marginal productivity of capital and brings the interest rate closer to that of the industrialized countries.

[13] See B. Eichengreen, "Building on a Consensus", *Financial Times*, Personal View, February 2, 1999.

[14] It is implicitly assumed that the macroeconomic and prudential benefits of short-term capital inflow regulations outweigh their microeconomic and distributive costs.

[15] An extended version of this strategy can be found in R. Zahler, "The Central Bank and Chilean Macroeconomic Policy in the 1990's, *CEPAL Review* # 64, April 1998

[16] The magnitude of the "tax" on short-term capital should vary according to the (appropriately measured) differential between domestic and relevant international interest rates. Currently in Chile the reserve requirement is zero, but the instrument remains active.

[17] For a detailed analysis of the rationale and implementation of this measure see R. Zahler, "Monetary Policy and an Open Capital Account", *CEPAL Review* # 48, December 1992 and G. Le Fort, "Monetary

Policy, the Real Exchange Rate and the Reserve Requirement on Capital Inflows: A Simple Analytical Model", *Central Bank of Chile Working Paper* # 36; December 1998.