

Capital Flows to Latin America and Asia in the 1990s and the Role of Japan

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I. Introduction

Many of the developing countries in Asia and Latin America have experienced large capital inflows in the 1990s. Impelled by better economic prospects in those countries, lower international interest rates, and a slowdown of economic activity in the capital-exporting countries, capital inflows provided financing much needed to stimulate economic activity. In general, developing countries' reentry into the international capital markets has been perceived as a positive development. But the recent surge of inflows has not been taken as an unmitigated blessing. Policymakers have expressed concern about the potentially detrimental side effects of capital flows and voiced fears that the inflows could be abruptly reversed, doing considerable damage to the domestic financial system. Such fear was substantiated by the Mexican currency crisis of December 1994. In fact, the run on the peso highlighted the volatility of many forms of recent capital flows to developing countries. Notwithstanding fears of widespread spillovers of liquidity problems in Mexico the crisis seems to have passed without causing any long-lasting damages to major capital importing countries' domestic financial market, "Brady bond" prices, investment grading or capital inflows. Thus, capital flows to developing countries recovered substantially as early as in the second half of 1995, reaching a record of \$200 billion for the whole year. The inflows gathered further momentum in 1996 and seem likely to exceed the record level of 1995.

What are the prospects for another "peso crisis"? And what steps might be taken to avoid such a calamity? The purpose of this paper is to examine what is currently known about the new episode of capital inflows to developing countries. The next section presents the overview of the patterns of capital flows to developing countries in 1990s, analyzing the trends and describing the composition of flows. The third section compares the experience of capital inflows to Asia and to Latin America, focusing causes and suggested policy responses on the part of recipient countries in the literature. Putting the 1990s surge of capital flows into a broad regional perspective may be useful as Asia may offer valuable policy lessons to Latin America. The fourth section examines the role of Japan as a major exporter of capital in the world in light of its importance as a source of investment in developing countries. The fifth section addresses policy measures to smooth flows of capital, to prevent crises, and to minimize a risk at the time of crises, not only on the side of capital importing developing countries but also on the side of multilateral and bilateral creditors.

II. Overview of Recent Capital Flows to Developing Countries¹

i) A New Episode of Capital Inflows

ii)

The recent surge in capital flows to developing countries contrasts sharply with the experience of the mid-1980s, when most developing countries attracted very little foreign capital. It

also contrasts with the experience of the 1970s and the early 1980s in that a substantial part of total flows is now private, non-debt-creating capital. Annual average net flows to developing countries fell from \$51 billion during the 1978-82 period to \$45 billion during the 1983-88 period, driven by more than a 60% decrease in private capital inflows, but they have subsequently risen significantly to an average of \$134 billion during the 1989-95 period (Table1). Foreign direct investment (FDI) has increased steadily over the past decades and now constitutes the largest component of aggregate flows to developing countries. But the most dramatic change is the growth of portfolio investment flows which have grown by a factor of ten since mid-1980s. Long-term borrowing, classified as "other net investment" by the IMF, which constituted the bulk of capital inflows in the 1970s and early 1980s virtually dried up in mid 1980s, but recuperated to an average of \$35 billion during the period of 1989-95. By contrast, net official flows, which stayed at almost the same level as the private flows during the 1970s and early 1980s and accounted for 62% of total capital inflows into developing countries in the mid-1980s, constitute only about 12% of total net capital flows during the period of 1989-95.

In addition to changes in the composition of capital flows to developing countries, there have been changes in the geographic allocation. During the 1970s and in the early 1980s, Latin America was by far the main recipient of capital inflows, accounting for almost two thirds of all developing countries. The share of Latin America in total capital flows fell sharply to 18% during the five years following the 1982 debt crisis, mainly due to a reversal of commercial bank lending. In the subsequent period, although the region experienced strong reflows of private capital, its share in total capital flows to developing countries remained at around 30%, about half of the pre-debt crisis level. During the same period Asia's share of total flows increased steadily, reaching more than 50% in the mid-1990s. Africa has lost its importance as a capital recipient since 1970s as the region experienced much smaller increase in private capital inflows than Asia and Latin America. Countries in Europe and the Middle East, many of which are major oil exporters (thus able to recycle their large current account surpluses to other developing countries during the 1970s), turned into net importers of capital during 1983-1988, mainly in the form of portfolio and other investments.

ii) The Aftermath of The Mexican Financial Crisis

Despite a sharp decline in the immediate aftermath of the Mexican financial crisis, net capital flows to developing countries recovered strongly in the second half of 1995, partly due to interest rate declines in the major industrial countries and partly due to the favorable reaction of financial markets to policy tightening in many developing countries. But the magnitude of the so-called "tequila effect" differed among regions. Some Latin American countries, especially Argentina, were hit by the strongest "tequila effect," while Asian developing countries saw only short-lived contagion effects. The Middle East, Europe, and Africa did not experience severe impact from the Mexican crisis.

In fact, Asia received a record level of capital inflows of \$104 billion in 1995. While some countries, such as China, Indonesia, and Vietnam are major recipients of aid, particularly from Japan, private flows dominated the regional trend. The rising trend for foreign direct investment continued. China received \$38 billion in 1995, by far the largest recipient of FDI. Portfolio flows to the region increased by \$4 billion in 1995 over 1994 in spite of the Mexican crisis. There was a continued recovery in commercial banking flows directed to project financing in infrastructure, often supported by guaranteed export credits, especially vis-à-vis Korea and Thailand.

In Latin America, aggregate flows increased 25% in 1995 over 1994. Private capital flows fell by 24% in 1995, while net official flows swung from a deficit of \$4 billion to a surplus of \$20 billion due to the rescue package for Mexico². The fall of private capital flows to the region was

driven by a fall of 74% in portfolio investment. Although private capital flows decreased in the region as a whole, private inflows to individual countries other than Mexico and Argentina exceeded the levels attained in 1994, with a particularly sharp increase in Brazil. Even in Mexico and Argentina capital inflows recovered relatively quickly as both countries came back to the international financial markets in the second half of 1995.

The Middle East and Europe experienced a strong recovery in capital flows. Flows to Africa remained essentially unchanged over 1994.

III. Capital Flows to Asia and Latin America in the 1990s

i) Characteristics of Capital Flows

Asia

Table 2 documents the sharp increase in net capital flows into Asian developing countries in the 1990s. Between 1988-90, long-term net inflows into the region averaged \$32 billion per annum. Since 1991 they continued to increase sharply, peaking in 1995 at about \$121 billion and accounting for 52% of total net resource inflows to all developing countries. In terms of GNP of the region, capital inflows, which averaged 2.7% over 1988-1990, jumped to an average of 5% over the next five years.

The noteworthy features of the capital inflow surge into Asia are as follows:

- Long-term private capital inflows increased sharply from \$12 billion in 1988 to \$104 billion in 1995. During the same period, the share of private flows in the region's net capital inflows nearly doubled, rising from 46% to 86%.
- FDI and portfolio equity investment (country fund, depository receipt, direct purchase of shares by foreign investors), the non-debt components, have become increasingly important forms of private capital inflows, accounting for an average of 64% over 1993-95. Largely in response to a record of sustained superior economic growth and management by several countries, the region has attracted large amount of FDI which has increased almost fivefold over 1990-95. Portfolio equity investment inflows have also grown at a rapid rate, rising from \$0.8 billion in 1989 to \$20 billion in 1993. Although 1994 and 1995 witnessed a fall due to the contagion effects of Mexican peso crisis, it remained at a healthy level of \$14 billion in 1995.
- Multilateral and bilateral official sources of finance have been virtually unchanged but their share in long-term capital flows declined sharply in the 1990s from 43% in 1990 to a mere 14% in 1995.
- The region has attracted substantial short-term capital flows---mainly in the form of bank lending---in the 1990s, averaging a little over \$10 billion per annum. This reflected both a need for trade financing and growing intermediation of foreign borrowing through local banking systems.
- Asian countries have accumulated foreign exchange reserves at a rapid rate; these have risen from an annual average of \$7 billion between 1973-82 to \$52 billion between 1994-95.

The above mentioned characteristics of the composition of capital inflows are more salient in East Asia and Pacific. The sub-region attracted about an average of 85% of the net long-term capital inflows to Asia in the 1990s, rising sharply from 2.4% of GNP in 1988 to 7.4% in 1995. Private capital flows have been dominant, accounting for about 85% of the inflows; and of these, FDI has been the main component. The share of official financing has dropped steeply. Borrowers in East Asia and Pacific accounted for virtually all of the expansion of net short-term inflows (Table 2a).

By contrast, the South Asian economies remain dependent largely on official sources of finance. Long-term official inflows met about 65% of their external resource requirements in the 1990s. However, in recent years, with several South Asian countries liberalizing their trade and payments regimes, as well as introducing improvements in the functioning of the capital markets and making their FDI regimes more attractive, private capital has started flowing into these economies too. Between 1993 and 1995, almost half of the long-term capital inflows in these countries was from private sources, mainly because of a sharp rise in portfolio investment. FDI has increased in the last couple of years, but is currently a relatively small component. While the magnitudes of private capital inflows in South Asia have so far been small, the prospects for attracting on the progress that these countries make in sustaining the pace of economic reforms, increasing growth rates, and maintaining political stability.

Latin America

The inflow of capital to the region recommenced in 1990 and peaked in 1993 (Table3), surpassing the peak reached in the earlier episode of the 1970s. The surge of capital inflows was attributable to a notable growth of net portfolio investment (debt and equity). In 1994 both components dropped, while FDI grew more than 30% over the previous year. As a result, net flows of private capital decreased nearly \$9 billion from 1993. In 1995, private capital flows fell further driven by an estimated 52% fall in portfolio equity flows and a 32% decline in private loans because of the reversal of capital flows immediately after the Mexican peso crisis. The sharp rise in net flows from official sources attributable to the rescue package for Mexico offset much of the decline in private capital flows, so the final result was a 5% fall in aggregate flows to the region.

The principal characteristics of specific capital flows into the region may be summarized as follows:

- The share of private capital of long-term net flows increased significantly, from 25% in 1989 to 97% in 1995. On average, private capital accounted for 84% of total net capital inflows to the region between 1991 and 1995.
- FDI and portfolio equity investments have represented almost 60%, with the former representing a third and the latter representing a fourth of long-term capital inflows. Equity portfolio investments reached their peak in 1993 and dropped substantially following the Mexican crisis, while FDI remained at a relatively high level in 1995. The importance of direct and portfolio equity investment reflects, in part, the significance of privatization during this period.
- Portfolio debt investments (bonds, CPs, CDs, etc.) accounted for nearly a fifth of capital inflows in the 1990s. The bonds issues were concentrated in three countries: Brazil, Mexico and Argentina.
- Net short-term capital inflows averaged \$11 billion per-annum between 1990 and 1995, up from \$3 billion the preceding two years, reflecting the rapid growth of international trade.
- A high proportion of the capital inflows were added to central bank international reserves. In 1991 nearly all of the capital inflows were accounted for by reserve accumulation. As time passed, however, reserve accumulation as a percentage of GDP declined. In 1993 about 30% of capital inflows were used to finance reserve accumulation, with the other 70% financing the region's growing current account deficit. In 1994 the region's reserves actually fell, as the somewhat larger current account could not be financed by the reduced flow of international capital.

During 1991-94, Mexico received nearly half of the capital inflows to the region. The other big recipient was Argentina, which received almost 20% of the flows. Brazil, on the other hand, did not have a large participation, especially compared to the late 1970s, presumably because high inflation³ and a relative lack of privatization activity made the country a less attractive place to invest. Relative to GDP, the countries that received the largest inflows during the whole episode were Guyana, Honduras, Mexico, Nicaragua and Paraguay, where these inflows represented more than 8% of GDP per year. In 1994 Mexico dropped out of this group, and was replaced by Peru.

ii) Similarities and Differences

Latin America and Asia share a number of similarities in their experiences of capital inflows in 1990s. First, the relative importance of private capital flows into the both regions has increased. Second, there has been a shift away from debt instruments in favor of non-debt creating instruments. Third, portfolio debt flows have increased in importance. Fourth, within bank lending, syndicated bank loans are relatively unimportant and the short-term component has been predominant. Fifth, a substantial part of these net flows that has gone into foreign exchange reserves.

Beneath the surface, however, important differences loom large for the composition and sources of private capital flows. A first difference is Latin America's heavier reliance on inflows of portfolio capital, rather than FDI. Not only is FDI more stable, but it can also help to stabilize the current account over the time by expanding capacity in the tradable goods sector.

The second difference is the nature of FDI flows. In Latin America it has mainly taken the form of privatization (in the form of debt/equity swaps in 1980s), which do not necessarily generate additional capital formation⁴. Between 1988 and 1993 almost a third of total FDI in Latin America was related to these operations (Table 4). This raises the questions about the durability and further expansion of FDI in Latin America in the future, as major countries have already sold most of the companies that could be privatized⁵. In Asia, by contrast, FDI has mostly involved the setting-up of new or joint enterprises. The different composition of FDI determine its macroeconomic consequences: in Asia it is more likely to add to domestic investment and it is also more likely to be skewed towards export sector than in Latin America (BIS 1995). Regarding the source of investment, in both regions increasing amounts of FDI have come from other countries within the region, but in Asia Japan has played a much less important role than the United States has in Latin America (Table 5a). In Asia intra-regional FDI, notably by residents of Hong Kong and Taiwan, has grown significantly. For every ASEAN country and for China, the Asian NIEs as a group were the largest investors in 1990s (ADB 1996).

INSERT TABLE 4 & 5

Third, the share and the nature of portfolio flows differ between the two regions. In 1989-95, in Asia, portfolio flows accounted for 18% of net capital inflows, compared with 46% in Latin America (Table 1). In Latin America nearly half of portfolio investment were borrowings in international capital markets, while in Asia only a third consisted of portfolio debt flows (Table 2, 3). With respect to the investor base for Latin American countries, the importance of the United States as a source of portfolio equity investment has increased substantially from the 1980s to the 1990s. For Asian countries, by contrast, Japan has played a less important role in recent years than in 1989-90 (table 5b). This does not reflect a decline in Japanese investment, but an increase in portfolio capital flows within the region and from the rest of the world. Portfolio flows also are likely to come from more stable sources such as pension funds and insurance companies in Asia than in Latin America. This is because pension funds and insurance companies often limit their investment towards countries that have been assigned investment-grade credit ratings by rating

agencies. Currently, only Chile and Colombia in Latin America carry the investment grade, while in Asia the grade is enjoyed by China, India, Indonesia, Malaysia, Thailand, and the NIEs.

A fourth difference is that lending classified as "other long-term private capital," i.e. suppliers credit, etc., by the World Bank has been negative in Latin America, while Asia received an average of \$4 billion during the period of 1991-94 (Table 2, 3).

Fifth, in Asia the share of the net capital inflows which went into the build-up of foreign exchange reserves rose from about 50% in 1978-82 to around 80% in 1989-95, while in Latin America capital inflows were not sufficient to close the gap on current account of balance of payments in 1978-82 and only a third of capital inflows went to the build-up of international reserves in the 1990s.

Finally, indicators related to net capital flows suggest that Latin American economies are more vulnerable than those of Asia to a sudden reversal of capital flow. This is because of differences in the ability to earn foreign exchange, as reflected in the net capital flows/export ratios and the external debt/export ratios. Between 1991-95, the size of capital flows as a portion of export in Latin America was 28.4% compared with 20.3% in Asia, while Latin America's total external debt/export ratio was more than twice as high as that of Asia (Tables 2, 3).

iii) Causes of Capital Inflows

The assessment of causes of inflows is important for two major reasons that have to do with policy design. First, forecasting the likely evolution of the inflows requires the identification of causal factors; second, choosing instruments of response, and thus designing effective public policy, depends on the nature of the underlying causes. Here, a domestic-foreign causal dichotomy is relevant. If causes are external, they are by definition exogenous, and only indirect, compensatory policies can be considered. If causes are domestic, however, more direct measures may be feasible (See "v. Policy responses" for further discussions). Capital inflows in any specific case are likely to be associated with a combination of causes, complicating the task of identification as well as that of formulating an optimal policy response. Any simple rules-based categorization of causes and policy responses can therefore be of only limited practicality, and individual country circumstances will necessarily have to be taken into account.

In the literature there are two views on the causes of capital inflows: the "push view" and the "pull view". The "pull" view holds that inflows are attracted to the recipient countries because of an improved domestic policy environment, i.e. pursuit of prudent macroeconomic policies and achievement in considerable success in stabilization and structural adjustment measures. Schadler (1994) stresses that external developments did not always coincide with surges in inflows, and that domestic factors must have played a role as well. Among these, she stresses structural changes that improved potential productivity, improved fiscal policies, and a tightening of domestic credit policies. Chuhan, Classens, and Mamingi (1993) also find that while the foreign environment matters, domestic factors were the primary determinants of the magnitude of Asian capital inflows. The strongest arguments for pull factors rely on the observed geographic variation in the distribution of capital inflows, suggesting that country-specific factors have played a role. But this reasoning can be problematic. Although it is true that not all countries have been recipients of the new inflows, it is also true that flows have not been restricted to countries with well-established track records of macroeconomic and structural adjustment. Both Peru and Brazil, for instance, received substantial inflows in 1992, a year in which both countries confronted severe macroeconomic imbalances⁶.

The "push" view emphasizes the role of lower returns available in the creditor countries, depressed economic conditions, and a relative dearth of profitable investment opportunities in the industrial countries. Regulatory changes and the development of information technology in the

main financial centers since early 1990s also strengthened the incentives for diversification and globalization of investment portfolios. Calvo, Liderman, and Reinhart (1993) present evidence that external factors played a dominant role in the pattern of capital inflows in Latin America. The widespread and persistent nature of the inflow phenomenon would seem to favor global, persistent factors and rule out idiosyncratic, volatile factors. Consistent with the push view, aggregate private capital inflows to all developing countries exhibit a strong negative association with U.S. interest rates (Figure 1- Figure 4). Thus plausible cases can be made for either perspective. The two explanations are not mutually exclusive: the issue is assessing their relative empirical importance⁷.

A consistent story about the factors driving and directing the recent surge in capital inflows should feature some combination of push and pull factors. One such story would proceed as follows. The combination of low interest rates and recession forced low rates of return on industrial-country assets, creating an incipient capital outflow as investors in these countries sought higher-yielding assets for their portfolios. The restoration of perceived creditworthiness was necessary for potential debtor countries to have access to these funds, and thus capital flowed initially to those countries whose creditworthiness was not severely impaired during the 1980s--largely the rapidly growing countries in East Asia that never suffered a debt crisis. The Brady Plan, announced in mid-1989, broadened the geographic scope for such inflows to include the heavily indebted countries in Latin America, in part by writing down the face value of debt, in part by supporting policy adjustments, and in part by providing information externalities that led to bandwagon effects. Where none of these factors have come into play--that is, in most of Sub-Saharan Africa--capital inflows have not materialized.

iv) The Use of Capital Inflows

Large net private capital inflows have tended to reduce domestic interest rates, raise aggregate expenditures, increase inflationary pressures, and widen current account deficits in all the major recipient countries. Concerns about these adverse effects of massive capital inflows have presented many recipient countries similar policy dilemmas. However, there had been marked differences in macroeconomic performance and in how the recent capital inflows have been utilized between the major recipient countries in Asia and Latin America.

Although increased inflows of private capital have been associated with widening current account deficits in most recipient countries, the domestic counterparts of larger current account deficits have developed differently. The set-up in capital inflows into Asia was associated with a pronounced increase in the already high ratio of fixed investment to GDP. In Asian countries, the ratio of private investment to GDP rose by over 3 percentage points in the first half of 1990s compared with the second half of 1980s. However, the ratio of private consumption expenditure to GDP declined by 2.4 percentage points and the ratio of private saving to GDP virtually unchanged (Table 6). In most Latin American countries, by contrast, private investment ratio has remained broadly similar to the level of the latter half of 1980s, (low by both historical and international standards)⁸, while the ratio of private consumption to GDP increased by almost 3 percentage points and that of private saving declined almost 3 percentage points in the 1990s compared with the 1980s. Thus, the capital inflows have tended to become a substitute for private sector saving. Although Latin American countries have made substantial progress in reducing fiscal deficit, the improvement in public saving has been insufficient to offset the decline in private savings.

In most of Latin American countries capital inflows have been accompanied by a considerable real exchange rate appreciation, yet in Asia, real exchange rate actually depreciated in the first half of 1990s though at a slower pace than in the second half of 1980s. While the reasons for these differences in the response of the real exchange rate are likely to be numerous, above mentioned differences in the composition of aggregate demand may play a key role in determining

whether the real exchange rate appreciates or not. If the increased investment in Asia is tilted more toward imported capital goods, and the increased consumption in Latin America has an imported domestic component, other things equal, this would work in the direction of generating stronger real exchange rate depreciation in Latin America. The behavior of public sector expenditure is another element influencing the real exchange rate by affecting the level and composition of aggregate demand. Other things being equal, the more contractionary the behavior of fiscal expenditure is at the time of capital inflows, the weaker the extent of real exchange appreciation is likely to be. Several Latin American countries have had major fiscal adjustment programs, yet these predated the surge in capital inflows. In contrast, there were fiscal spending contractions in several Asian economies at the time of the inflows (Group of Thirty, 1994).

v) Policy Responses

The abrupt halting or even reversal of capital flows to some emerging markets in the wake of Mexican currency crisis gave particular point to the debate about how policymakers should respond to a major and perhaps temporary surge in capital flows. But there are few hard and fast rules about how they should react to such flows. The appropriate policy response depends on a number of factors, including the causes of the inflows -- whether they are largely driven by external factors or by domestic fundamentals. If, for example, capital inflows are associated with an autonomous increase in the demand for money (due to, for example, a successful inflation stabilization program), the expansion of the domestic money supply will not be inflationary and in this case the inflows should be accommodated. The appropriate policy response may also depend on the composition of the inflows -- whether they largely comprise portfolio flows or other flows that are easily reversible or debt creating -- and on the capacity of domestic financial institutions to intermediate large foreign inflows. The potential inflationary impact of capital inflows will also greatly depend on the exchange rate regime in the recipient country and the extent to which monetary authorities are able to sterilize the effect of the capital inflows on domestic liquidity. With a flexible exchange rate, large capital inflows should not give rise to inflationary pressure but are likely to lead to an appreciation of the real exchange rate. Under a fixed exchange rate, capital inflows will tend to increase domestic demand, raise domestic prices, thereby also leading to a real exchange rate appreciation. Only by allowing the exchange rate to rise, the authorities can avoid unwanted reserve accumulation. Thus, desirable policy responses will be country specific⁹. Nevertheless some generalizations can be made in light of the experiences of capital-recipient countries in Asia and in Latin America.

Monetary and Exchange Policy

Capital inflows often give rise to a dilemma for monetary policy. With open capital accounts and fixed exchange rate, the scope of monetary policy in general is limited. It is harder to sustain interest rate differentials in relation to international markets. This limits the range of independent monetary policy actions a country can effectively use. Reducing interest rates may reduce the country's attractiveness to interest-sensitive portfolio flows but is likely to result in the expansion of domestic credit, which could lead to real appreciation, an investment boom, or an appreciation of assets, including real estate. If this results in overheating, monetary contraction would be in order, reducing investment but possibly attracting portfolio flows by high interest rates.

A capital-receiving country may opt to let the nominal exchange rate appreciate in response to a capital inflow. This option has three main virtues. First, it insulates the money supply, domestic credit, and more generally, the banking system from the inflows. Second, because of a pass-through from the exchange rate to prices it may help inflation at a time that achieving

disinflation is high on the policymaker's agenda. Third, allowing the exchange rate to fluctuate introduces some uncertainty that may well discourage some of the purely speculative (and highly reversible) inflows. The main disadvantage of a pure float is that massive capital inflows may induce a steep nominal and real appreciation of the domestic currency. Resultant real appreciation tends to hurt the tradable sector, leading to a widening of the current account deficit. The question is whether the available instruments are adequate for achieving objectives for both the balance of payments and inflation.

Increasing the range of permitted exchange rate movements increases the risks faced by international investors and tends to reduce incentives for capital flows, particularly short-term speculative flows. A reasonable amount of flexibility in monetary policy can be maintained by broadening the intervention bands on the exchange rate and forcing short-term investors to face more uncertainty. If exchange rate fluctuations are relatively short term and have the property of mean reversion to a central rate or trend, a surprising amount of short-term room for monetary policy maneuvering can be attained by widening the intervention bands. Short-term exchange fluctuations will likely tend to discourage speculative flows but will not significantly deter FDI or long-term portfolio investment, provided that the fundamentals remain in place.

There have been wide cross-country differences in the degree of exchange rate flexibility in the present episode. However, common ground appears to be that all Central Banks intervene in the foreign exchange market to some degree and no country has operated under a free float¹⁰.

Controls on Capital Flows

In some circumstances, controls on capital inflows may help to prevent excessive increases in liquidity¹¹. Controls on capital inflows can be designed to discriminate between investment that helps make the economy more productive and responsive to the world market (e.g. FDI and long-term equity purchases) and potentially volatile investment motivated by considerations of short-term gains. Many countries restrict non-resident purchases of short-term paper or require non-resident investors to hold securities for a minimum period before resale is permitted. Some countries also limit foreign borrowing by domestic enterprises. Restrictions on short-term inflows have perhaps more common in Asia. It would appear that the absence of large non-resident holdings of short-term domestic paper, and limited participation of foreign banks in the domestic markets, made sharp rises in interest rates in some Asian markets in early 1995 particularly effective in deterring short selling of the domestic currency and thus in warding off speculative pressures.

Tax on Short-term Inflows

Taxes on short-term borrowing abroad were imposed in some countries, such as Chile and Israel. Such policies can coexist with policies that encourage a different type of inflow, specifically FDI. Unlike other measures, it attacks the problem at the source. However, although this form of intervention could be effective in the short run, experience suggests that the private sector is quick to find ways to dodge those taxes. Further, initial conditions are not always conducive to implementing a policy that adds barriers to international capital movements. If a stabilization program has recently undertaken and the authorities enjoy less than full credibility, the imposition of any capital account barrier may be interpreted as a signal that policies are reverting, and thus potentially undermine the success of the program.

Sterilized Intervention

During the early years of the recent surge in capital inflows, most countries attempted to limit the monetary effects arising from the accumulation of reserves through sterilization.

Purchasing foreign exchange and issuing domestic bonds (or carrying out any equivalent series of transaction of the money supply) to absorb the liquidity thereby created help to prevent rapid expansion of the money supply and to protect the exchange rate from appreciation. The difficulties experienced by monetary authorities in conducting sterilization operations have been much discussed. While sterilized intervention through open market operations appears to be the most common response to capital inflows¹², its use appears to diminish over the course of an extended capital inflow episode. In Asia, for example, the share of capital inflows, which became increase in reserves has declined over time (Khan and Reinhart 1994). This may reflect the problems associated with prolonged sterilized intervention noted by Calvo, Leiderman and Reinhart(1993). First, sterilization requires governments to purchase low-yielding foreign securities despite the fact that they are often paying high interest rates on external debt. This process obviously places a burden on the recipient country government. These "quasi-fiscal costs" have been estimated to amount up to one-half percent of GDP in Latin America (Kiguel and Leiderman 1993). Second, by preventing a decrease in the interest rate differential between domestic and foreign assets, sterilized intervention fails to eradicate the conditions, which led to the capital inflow.

Reserve Requirements

An alternative to sterilizing increases in liquidity from capital inflows is to increase bank reserve requirements and curtailing access to rediscount facilities. This would especially relevant in those countries where capital inflows have taken the form of substantial increase in local bank accounts. An increase in marginal reserve requirements (an option used by Chile and Malaysia) clearly lowers the capacity of banks to lend. In this case, no quasi-fiscal costs are incurred. A drawback of this reserve-requirement policy is that over time it may be promote disintermediation, as new institutions may develop so as to bypass these regulations. Moreover, increasing bank reserve requirements amounts to a reversal of the underlying trends of financial liberalization in developing countries, which have recently resulted in sharp reduction in these requirements, and their convergence toward levels observed in industrial countries.

Increasing Domestic Saving

Increasing domestic saving would be a most appropriate macroeconomic remedy for excessive inflows because it tends to depress domestic interest rates and at the same time act to reduce the current account deficit. Funded pension or other saving schemes has been the choice of a number of countries, including Chile, Malaysia and Singapore. Such compulsory saving schemes do not appear seriously to erode voluntary saving, which remains high in these three countries. Improvements in fiscal positions---including in some countries, the establishment of fiscal surpluses---would help to reduce demand pressures and also reduce the risk of abrupt reversals of capital flows. There was a significant fiscal adjustment both in Asia and Latin America (Table 6)¹³. In practice, however, macroeconomic policy response to large capital inflows and overheating has typically consisted largely of monetary tightening, in part because fiscal policy instruments are not sufficiently flexible to be used for short-run macroeconomic management.

IV. The Role of Japan in International Capital Flows

This section deals with the role of Japan in international capital flows in light of its importance as a source of investment in developing countries. In fact, Japan has played a crucial role as the largest supplier of funds in the world by recycling its current account surplus since the mid-1980s. The major recipient of captial outflows from Japan has been Asia; especially South East Asia followed by North America. It is quite understandable that geographical, historical, political, and economic ties with Japan's neighbors drove the government, manufacturers, and

banks into Indonesia, Korea, Thailand, China etc., while US provided the biggest market for Japanese firms. Other regions such as Latin America and the Middle East only came to their attention when shifts occurred in global economic structures. However, as discussed below, from the standpoint of developing countries other than those of Asia, “Japan money,” especially official flows, directly through by lateral assistance or indirectly through multilateral development banks (MDBs) contributed to their economic and institutional development.

Before examining capital outflows from Japan item by item (i.e. bilateral ODA, FDI, portfolio investment, and private bank lending), it will be useful to examine briefly the current situation of the Japanese economy and its prospect for external balance.

i) Recent Development of Japanese Economy

The pursuit of growth was an overriding element of Japanese economic policy for most of the post-war period. From the mid-1950s until the breakdown of a fixed exchange rate (Nixon Shock) and the first oil crisis in the early 1970s, the economy grew rapidly, at rates averaging around 10% per year. Although the oil crisis triggered a fall in real GDP in 1974, as well as a surge in inflation and a current account deficit, the economy quickly recovered thanks to tight monetary policy, cost-cutting by the manufacturing sector and non-traditional service industries. Consequently Japan weathered the second oil crisis and the world recession at the end of 1970s.

In the subsequent period, Japan's international competitiveness strengthened, Japanese corporations internationalized their operations, and it accumulated a huge trade surplus. As a result, economic friction between Japan and U.S./Europe escalated in the areas of trade, finance, and services.

The year 1985 was the turning point for Japan's economy. In that year Japan became a creditor nation and the US a debtor nation. In August G7 governments agreed to allow the US dollar to depreciate vis-à-vis major currencies such as the yen and the mark ("Plaza Accord"). The yen's appreciation, following the Plaza Accord, hit the export sector hard although an easing of monetary policy soon allowed for a surge in private consumption and private capital investment. Yet real economic growth was generally higher than that in other OECD countries in 1987-91. However, alongside rapid expansion in the real economy went alarmingly high inflation in land and stock price. When monetary policy was tightened in 1990 in an effort to deflate the excesses of the bubble economy, stock prices fell sharply and economic growth began to decelerate. The balance sheets of many financial institutions deteriorated as they became burdened by huge amounts of non-performing loans. Declining consumer and business confidence led to a prolonged downturn in the economy. Real GDP growth decelerated to just 0.1% in 1993, largely on account of falling investment in new plant and equipment. There was a mild recovery between 1994 and 1996, but this fell far short of initial expectations. Economic recovery will continue to be slow in 1997 due to tighter fiscal policy, falling housing investment, and slowness of easing bad-loan problem in financial sector. In fact, the government's projection of real GDP growth rate for the year is only 1.7%.

ii) Movements of Japan's Current Account of Balance of Payments

Japan has a current account surplus since FY 1981 (Table 8)¹⁴. But the amount of surplus has fluctuated sharply. The surplus in terms of GDP rose rapidly in the first half of 1980s reaching a peak of 4.4% in FY 1986. From FY 1986 onward, the ratio declined to 1.1% in FY 1990 mainly due to appreciation of the yen against US dollar and an expansion of domestic demand since 1987. After expanding during the first two years of a recession period between 1991-95, current account surplus again began to shrink in 1993 and in 1996; it is estimated to stay in the range of 1-1.5% of GDP.

A breakdown of balance of payments (Table 9) shows that the decline in current account surplus in recent years could mostly be attributed to

- A decline in trade surplus against the background of: an increase in import volume in accordance with gradual recovery of economic activity in Japan
- A decrease in total amount of exports and an increase in import volume due to the appreciation of yen
- An increase in Japan's foreign direct investment mostly in Asia since 1994, which caused export substitution and a rapid increase in imports of manufactured goods from Japanese subsidiaries in Asia. A service balance also deteriorated reflecting a sharp rise of deficit in tourism due to yen's appreciation.

A consideration of the future developments in current account needs an analysis of saving-investment balances, as current account surplus equals aggregate net saving by definition. Saving and investment balances between 1970-95 are shown in Table 8. Three points must be mentioned. The first is a cyclical factor affecting saving/investment ratios. A fall in current account surplus in the second half of 1980s is explained mainly by a growth of net investment by Japanese firms as the net investment (deficit)/GDP ratio increased from 4.2% in FY 1986 to 10.4% in FY 1990.

The second point to be considered is a relation between current account and budget deficit. Between FY 1990 and FY 1995, there has been a substantial deterioration in public finances, with the combined central and local government saving/investment balance swinging from an approximate balance to a net investment of over 6% of GDP, due to the stagnation of tax collection associated with a economic slowdown and stimulatory fiscal policy. Although a continued large social security surplus is partly used to finance the investment of local governments and public corporations, this surplus in terms of GDP continues to shrink rapidly from a peak of 3.7% in FY 1991 to 2.7% in FY 1995. A further deterioration of public finances is likely to result from the rapidly aging population, which should eventually turn the social security surplus into a deficit.

A third important aspect is a correlation between current account and households saving ratio. Assuming that domestic investment ratio is determined mostly by cyclical factors, and given a slow progress in fiscal consolidation, medium- and long-term determinants of current account behavior should be movements in households saving ratio. It is widely believed that Japan's households saving ratio will continue to fall as a result of such factors as aging and an increase in unemployment rate, which will contribute to a further decline in current account surplus. In fact, according to one private think-tank projection, Japan's current account/GDP ratio will stay at 2.7% in 2000 and will decrease to 0.3% in 2010 (Japan's Economy in 2020, Nippon Keizai Kenkyu Center, Feb. 1995). However, as a projection prepared by the IMF shows (Table 10), in the short term at least, Japan is likely to continue to have the largest current account surplus as a country, and to be a largest capital exporter in the world.

iii) Recycling Current Account Surplus Official Development Assistance (ODA)¹⁵

The first sector to recycle capital is the official one. Until the mid-1980s Japan's official development assistance (ODA) was fairly small. During the mid-1980s the simultaneous rise of Japan as the world's largest creditor, with surpluses approaching \$100 billion at the time, and descent of developing countries into the debt crisis provided an opportunity for Japan to address both problems at once: by recycling the surplus to debtor nations. Thus, Japan came to place greater emphasis on ODA and it has been the world's largest aid donor since 1991, replacing the US (Graph 1). According to the findings of a survey published by the Development Assistance Committee (DAC) of the OECD, the dollar value of the ODA disbursement by Japan in 1994

amounted to \$13.24 billion. This accounts for 22.9% of the total amount of aid given by DAC countries. More than 150 countries and regions are receiving Japan's ODA, and the number of countries for which Japan was the largest donor of ODA rose to 34 in 1993.

Examining at the geographical distribution of bilateral ODA (Graph 2), Asia has been the largest recipient region, accounting 54.4% of total Japan's ODA in 1995. In that year, apart from Asia, 12.6% of total ODA went to Africa, 10.8% went to Latin America, and 6.8% went to the Middle East. Although Asia's share decreased from 98.2% in 1970 to a 50% level in the 1990s, this reduction in the percentage of total aid to Asia does not reflect a downgrading of it as a priority for Japan. Rather, the drop in the proportion of aid to Asia represents an attempt at greater balance, for while the percentage decreased, the absolute amount increased greatly. Asian nations maintained their positions on the top-ten list of aid recipients, dominated usually by South Asian and Southeast Asian nations plus China (Table 11).

The change of composition in aid allocation reflects the changes in Japan's ODA policy in the 1980s. Until the 1970s the main objective of Japanese ODA was to restore good relations with Asian victims of wartime aggression. Throughout the 1960s, Asia received nearly 100 percent of Japan's ODA. However, by the 1980s, Japanese ODA policy became less regionally focused. After oil shocks of the 1970s, Japan's search for alternative sources of energy led beyond the Middle East to Africa and Latin America. Thus, ODA flows to these regions showed a marked increase as Japan attempted to avoid keeping its energy sources in one basket and by the end of the 1970s, the Middle East, Latin America, and Africa equally shared roughly 30 percent of the ODA budget. By the end of the 1980s, the share of Asia dropped to the 60 percent range and by the early 1990s, Asia's share hovered around 50%.

It should be noted that although Latin America account for only a small portion of the recipient region of Japan's ODA, Japan is the second largest donor to Latin American countries (Table 12). Moreover, the share of Japan as a donor for Latin America has increased from 14% in 1990 to nearly 20% in 1994 due to a decrease of importance of the United State as a top donor for the region¹⁶. Major donors for Asia other than Japan such as France, Germany, and the United States also tended to increase assistance to the region, but they have played a much less important role than Japan has in Latin America.

Foreign Direct Investment (FDI)

In the latter half of the 1980s, there was a large increase in the stock of overseas direct investment by Japanese firms. In 1989, Japan became the world's largest FDI supplier, recording an annual outflow of \$44 billion (balance of payments concept). As the background of this FDI boom, there was 1) a deepening sense of crisis over trade friction with the US and other leading industrial countries, 2) Japan's continued loss of international competitiveness (which accompanied the yen's appreciation in the decade after the Plaza Accord in August 1995), 3) deregulation in financial and capital markets, and 4) a sharp rise in land and stock prices. Reflecting these factors, Japanese manufacturers ambitiously expanded production capacity in North America, Western Europe and Southeast Asia. Non-manufactures, on the other hand, increased direct investment in the financial, insurance, and real estate industries in the US, Europe and in Oceania.

With the collapse of the bubble in 1990, Japanese firms have had to face higher capital costs, a slowdown in domestic demand, and increasing competition from other production networks in Asia. Consequently, Japan's outward FDI flows decreased in the following years. However, the second *endaka* (strong revaluation of yen against US dollar), that began in February 1993, set the stage for a surge of Japanese activities in Asia. Thus, FDI bottomed out in 1993, and despite the overall sluggishness of the economy, it has continued to recover since then.

Looking at the geographical distribution of Japan's outward FDI during the 1990s, around 45% has gone to the United States (Table 13)¹⁷. The share of Europe as a destination of total Japan's FDI declined from 25% in FY 1990 to 15.3% in FY 1994¹⁸. By contrast, Asia increased its share and surpassed Europe as the second largest recipient of Japanese FDI, following North America. In FY 1995 Asia accounted for 24% of Japan's total FDI flows, thanks both to its low wages and its market-growth potential. Among Asia, significant increases were made in China and ASEAN. Japan's FDI to China expanded 37% in FY 1994 and 61% in FY 1995. ASEAN countries increased 45% in FY 1994 but were almost unchanged in FY 1995. In FY 1995, investment to Thailand increased 60%, while FDI to Indonesia and Malaysia decreased significantly. Although their share in total Japanese FDI is fairly small (0.4% and 0.3% respectively), FDI to Vietnam and India also expanded sharply. For the manufacturing sector only, the share of Asia exceeded that of the US for the first time in FY 1994, and in FY 1995 almost half went to Asia, a third to the US and 10% to Europe. Latin America had received around 8% of total Japanese FDI during the 1990s. In 1994 the region saw a short period of investment surge due to investment in Mexico made by the auto parts industry in the wake of NAFTA. Japanese firms' investment in Latin America has concentrated in countries such as Panama, Cayman Islands, and Bermuda because of tax incentives in these countries (Ministry of Finance).

It is likely that Japanese firms' will continue their shift to Asia. According to a survey conducted by Keidanren (Japan Federation of Economic Organizations; group of leading business enterprises) in 1995, although many Japanese firms consider Latin America as the second most rapidly growing and prosperous region following Asia, the region is not in a condition to grow rapidly. Hence they remain cautious about investing in the region, expressing "expectation with reserve." Another survey of Japanese companies conducted by the export-import Bank of Japan (JEXIM) in 1994 and in 1995 reveals that China is the country judged most promising for medium- and long-term FDI. Other frequently cited countries lie in Asia, i.e. ASEAN countries, Asian NIEs, and other countries such as Vietnam, India, and Myanmar (JEXIM, 1996). Judging from these surveys, one can imagine that Japanese FDI in the developing countries will continue to flow mainly toward Asian countries, while the order of priority toward Latin America will remain low due to perceived disadvantages such as:

- the higher wage level
- the difficulty of local parts procurement
- the small scale of the market; the inferior infrastructural condition
- and the high rate of worker turnover.

Portfolio Investment (Securities)

Until the 1980s Japanese institutional investors' portfolio investments were directed towards foreign currency-denominated bonds issued by OECD government entities. However, between 1990 and mid-1995 due to the substantial exchange losses incurred by the outstanding balance of their foreign investment portfolios, Japanese investors shifted their investment from foreign currency-denominated securities to yen-denominated bonds. At the same time, Japanese investors showed new interest towards investing in emerging markets. For developing countries, yen-denominated instruments have become attractive due to: the low interest rates prevailing in Japan¹⁹; the lower spread at which Japanese investors were ready to purchasing yen-denominated bonds compared to US investors; deregulation of the international yen-denominated bond market²⁰; and the willingness of the issuers to accept the higher currency risk in order to benefit from the immediate fiscal impact of lower nominal debt-servicing cost. As a result, yen-denominated bond issues by developing countries---Euroyen issues or Samurai bonds issued in Japan²¹ -- have

become increasingly popular instruments for raising funds. And in international bond markets there has been the shift in currency denomination of developing country issues from the dollar to the yen as well as the deutsche mark (Table 14). In 1995, 26% of new bond issues by developing countries were issued in yen, amounting to \$15.3 billion, compared with 13% in 1994.

A noteworthy change in recent years was a penetration of Latin American countries into the yen-denominated bonds market. In 1995 Latin American countries' yen-denominated bond issue has sharply increased, amounting to \$52 billion, larger than the amount issued by Asian countries. Argentina and Mexico were major issuers, selling the equivalent of \$1.7 billion and \$1.6 billion, respectively to Japanese investors. In 1996 yen-denominated bonds issuance by Latin American countries surpassed that of 1995. Between January and November the largest sovereign issuer was Mexico (equivalent of \$2 billion) followed by Argentina (\$1.5 billion), Brazil (\$0.7 billion) and Colombia (\$0.4 billion).²²

Private Bank Lending

One of the main strategies Japanese banks pursued during the 1980s was international banking operations. Globalization has accelerated since 1980 through the implementation of the revised Foreign Exchange Law. However, since the second half of the 1980s Japanese banks have curtailed their lending activities in developing countries. The retrenchment of Japanese banks from the international market was accentuated more recently by stronger competition derived from the financial deregulation of the domestic market, pressure from their own authorities to deal with doubtful loans (through transfers to specialized agencies and write-offs), concerns about credit quality on the part of the banks themselves (resulting from the burst of the bubble)²³, and capital requirements imposed by the BIS²⁴. Japanese banks are now more selective in their international operations. Yet, Japanese banks have the largest share in outstanding claims of BIS reporting banks on "outside-area" countries,²⁵ accounting for 19% in 1995 (Graph 4).

Recent Japanese bank loans to developing countries have focused on Asia, with a 21% increase in the stock of claims outstanding between the end of 1994 and end of 1995. Also in terms of debt stock Asia is by far the largest debtor region, with two thirds of the total outstanding claim of Japanese banks owed by the region (Graph 5). Excluding offshore banking centers, Thailand, South Korea, Indonesia, Australia, and China were the 5 largest debtors to Japanese banks as of end of 1995 (See table 16, A large proportion of the funds provided to Asia by Japanese banks has been channeled through non-bank entities domiciled in Hong Kong.) A clear regional concentration of Japanese private sector activities in Asia comes partly in response to the international economic trend. Between 1990 and 1995 outstanding of international bank lending to Asia more than doubled, while Latin America's debt stock has increased by only 20%, and that of Eastern Europe virtually unchanged (Graph 6). In addition to an increasingly strong demand for foreign capital on the part of Asian developing countries,²⁶ Japanese manufacturers' production base shift toward these countries has been a driving force for banks to expand business in Asia. Traditionally, Japanese banks have established their branches abroad in order to serve the international business of their domestic clients.

On the other hand Japanese banks are reluctant to expand businesses operating in Latin America despite the region's economic recovery and reflows of foreign capital. Japanese banks' strong reservation towards the region's alleged economic boom reflects a combination of economic and social factors peculiar to Japan. One such factor is the tax treatment of LDC loans, which is an issue of enormous complexity in Japan. Since FY 1984 banks have been allowed to set aside a reserve for possible losses on sovereign loans to "heavily indebted countries" up to 5% of outstanding loans, of which 1% is tax-deductible (*Tokkaisai* or special foreign reserve). These reserves are used in cases where governments and similar bodies are late in repaying principal or in

paying interest by more than a month and apply to the countries that have concluded rescheduling agreements during the past 5 years or wish to do so. In addition, banks can set aside reserves for possible overseas loan losses on loans to both sovereign and private sectors, but these special reserves are not tax-deductible. Since FY 1989, there has been no ceiling on the reserves that can be put into this account. Currently, banks have, on average, such reserves of about 35% against loans to heavily indebted countries. Consequently, it has been virtually impossible for Japanese banks to extend new loans to countries which agreed with commercial banks on debt reduction operation under the scheme of Brady Plan in late 1980s and the 1990s (Mexico, Venezuela, The Philippines, Costa Rica, Argentina, Brazil, Ecuador, Peru, Panama, etc.).

Perhaps the memory of debt crisis in the 1980s is the most important factor of Japanese banks' reluctance to expand their operation in Latin America, when Japanese banks were so badly burned by their lending experience with the region. Life time employment, limited personnel mobility, and consequent loyalty to firms, all of which are said to contribute to Japan's long-term future view, also create long-term memories of their past experience. In fact, most Japanese bankers involved in international operation stress that the aforementioned of debt crises and repeated failure of their businesses in Latin America make them hesitant to expand their operation in that region any time soon.

V. Implications for Smooth Capital Flows

Although reduced access to foreign savings was once perceived, as a serious constraint to growth for many developing countries, the recent surge of inflows has not been seen as an unmitigated blessing. Indeed, the surge of inflows has triggered a new literature investigating the policy response of the recipient countries. The urgency of this issue increased following the Mexican financial crisis. However, few observers treat policy issues that may arise either in the creditor countries or for the international financial community in association with capital movements. This section deals with policy measures to smooth flow of capital, to prevent crisis, and to minimize risk at the time of crises, not only on the side of capital-importing developing countries but also on the side of multilateral and bilateral creditors.

i) Capital Importing Developing Countries

The appropriate policy response will depend on the objectives of the authorities, the exchange regime, and the domestic institutional constraints and, most important, on what factors drive the inflows. In practice, however, it is difficult to identify early on the underlying causes of inflows, or to distinguish between temporary and more durable inflows, so that judgments have to be made on the basis of limited information. Capital inflows in any specific case are likely to be associated with a combination of causes, complicating the task of identification as well as that of formulating an optimal policy response. Nevertheless, the framework outlined here provides some general principles and guidelines.

First, to pursue sound economic policies and promote structural reforms are a *sine-quo-non* for any capital importing country in order to maintain investor confidence. In fact, post Mexican crisis effects illustrate how fundamentals in the host country matter: the Tequila effect was uneven and caused less distress in those economies with a stronger set of fundamentals.

Second, debtor countries must take policy measures to strengthen their domestic financial system including: establishing a regime of supervision and prudential regulation to ensure that the banking system is robust enough to cope well with shocks; strengthening the central bank's enforcement powers and independence from government interference; promoting the deepening and sophistication of financial markets so that they work as shock absorbers. Since the short maturity of financial assets and the extreme volatility of capital flows are typical characteristics of developing countries' financial systems, small economic shocks are often amplified into crises. If

problems emerge in one of the regions' banking system, investors' lack of confidence may cause both significant withdrawals of private funds from banks and a reduction in the official sectors' access to capital markets. This was the case of Mexico and Argentina in the wake of 94/95 liquidity crises in these countries. Banking crises in Venezuela and Brazil have also contributed to economic uncertainty. These problems have peaked but are not yet over.

Third, strengthening fiscal position and promoting domestic savings are very important. In Latin America (except Chile), domestic saving rates are low by international, especially Asian, standards and need to be higher if economic growth is to be sustained. Capital inflows can supplement domestic savings, but they cannot substitute for them on any scale. While in principle it may be possible to make up for low savings with efficient allocation of capital, in practice it is often the countries with high savings rates that utilize their resources best. Although major improvements have been noted both in Latin America and Asia in this respect, recently the fiscal position deteriorated in some countries due to structural problems such as weak tax enforcement. Thus there is further room to lower deficits and move toward structural surpluses, to raise domestic savings rates. To encourage private savings, ways should be explored for increasing incentives to save and invest through institutional arrangements, and through changes in taxation and expenditure patterns. Several countries have reformed their pension systems by establishing private pensions, insurance and mutual funds. Where they have not been implemented already, mandatory contributions to such funds should be considered. Also taxation and expenditure patterns should be structured so as not to discourage individuals or families from saving.

Fourth, host countries should encourage more stable and lasting non-debt creating capital inflows, particularly FDI, with its promise of access to new technologies and markets as well as job creation. In order to encourage direct investment, host countries should provide labor force and management staff, at the same time they are required to establish infrastructure in such areas as power and water supply, and road and port construction. They should also establish a legal system for facilitating direct investment, including easing of limitation on foreign capital participation, remittance of money to their home countries, and protection of intellectual property rights.

ii) Multilateral Institutions

The role of multilateral institutions is important both to preventing crisis and to its handling and solution. In today's highly integrated markets, reliable and comprehensive information about policies and economic conditions are particularly important for both purposes. At present, the IMF is seeking to refine its methods of surveillance, through which governments can encourage one another to adopt sound macroeconomic, structural and debt management policies. Greater details are now available in press releases on IMF programs and in other published forms. These steps may help to enhance market discipline.

Progress has also been noted with respect to crisis handling. The Mexican crisis led to a call at the G-7 summit (Halifax, June 1995) for an examination of two specific areas where there was felt to be a need for improvement. First, consideration was given to ways of enhancing the General Arrangement to Borrow, so that funds raised from non-G-10 countries could also be put at the disposal of the IMF in times of crisis. The second issue was the possibility of establishing more orderly procedures for working out sovereign liquidity crises. While negotiations on the first issue are still in progress, a report dealing with the second issue made some suggestions about how current practices could be improved to account for the growing importance of bonds and other types of debt that have been exempt from rescheduling in the past (Group of Ten, 1996). Specifically, it was suggested that official support be given to a market-led process to develop contractual provisions in sovereign debt instruments that would, in the event of a crisis, facilitate consultation and cooperation between debtors and creditors, as well as among creditors themselves. The report concluded, however, that it was neither desirable nor practicable to establish more

formal workout ("bankruptcy") procedures for highly indebted sovereign countries. The particular issue of countries heavily indebted to international financial institutions is being addressed directly.

iii) Industrial Countries and Japan

For industrial countries, the reduction of structural budget imbalances is particularly important. This is in order not to crowd out developing countries' capital requirements and also to keep world interest rates at reasonable levels. Second, the industrial countries should ensure open access for developing countries' goods and services in their home markets. Third, the way needs to be paved for smooth technological transfer to developing countries. The recent rapid technological advancement left many developing countries far behind developed countries in industrial technology. In order for them to catch up, developing countries should be given added technical assistance from these countries. Fourth, industrial countries need to share with developing countries the know-how on institutional improvement and policy management which they lack in addition to capital and technology.

In order to facilitate the outflow of capital from Japan, easier access to the Tokyo market as well as the wider use of the yen in international transactions should be encouraged. Until the yen shot up to a record Y79.75 against the US dollar in spring 1995, the Japanese currency was making sedate progress as an international unit of exchange and store of value. But since then, Asian countries that have traditionally linked their currencies to the dollar have allowed an increasing correlation with the yen²⁷. On the other hand, the Japanese Finance Ministry has for the first time given formal support to the wider international use of the yen and called for closer cooperation with other Asian monetary authorities²⁸. Practical examples of closer coordination between Asian central banks has ensued, as shown by the recent accord between Japan, Singapore and Hong Kong, under which their central banks would intervene in currency markets on the Bank of Japan's behalf.

There is, however, one significant remaining barrier to the greater foreign use of the yen. The high costs and regulations involved in doing business on the Tokyo financial markets make it hard for foreign central banks and investors to buy the Japanese currency. Bond issuance cost at two and a half times European levels, securities transaction taxes and a financial market judged in a recent survey by JCIF to be little more sophisticated than Singapore's continue to mar Tokyo's attractiveness to foreign investors²⁹. It is expected that with the implementation of the plan "Rebirth of the Tokyo market 2001" announced by the Japanese government in November 1996 (which aims to complete liberalization of Japan's capital market by the year 2001³⁰), deregulation of Tokyo market and yen's internationalization will be accelerated. At the same time, increasing amount of flows will be channeled into overseas markets by institutions that manage Japan's Y240 trillion(\$2 trillion) pension fund system. In 1996 rules governing how much can be directed towards equities and foreign securities have been relaxed, and corporate pension funds -- the fastest growing area with about Y40 trillion under management -- could place up to half their funds with the new "independent" groups (fund management arms of major domestic securities houses and foreign asset management groups), which are usually likely to seek opportunities. Part of this investment will go to developing countries³¹.

With respect to official flows, Japan should continue to be a major donor to the world as expressed explicitly in its aid plan for the five years beginning in 1993. The shift to market-oriented economic development models and the surge in private capital flows to developing countries appear to have resulted in the misperception that aid is no longer needed or desirable. However, it is important not only for low-income countries that still lack access to private capital markets but also for recipients of private capital in support of public investment programs. The

five year aid plan aims to increase the total amount of Japanese ODA to over \$70bn, which would represent a rise of 40-50% over the previous five year period. Under the new five-year plan there will also be an increase in grants, especially to the least developed countries. Fundamental guidelines approved by the cabinet in 1992 link Japanese aid to de-militarization in recipient countries and to the promotion of environmental protection, market economies and democracy. In the plan emphasis is also placed on aid for basic human needs, for tackling the population growth problem, and for promotion of women's participation in development.

VI. Some Conclusions

Considerable changes have occurred in the international financial environment in the past decade. Liberalization of capital markets and financial and technological innovation have greatly increased the size and volatility of capital flows. While foreign direct investment flows to developing countries have surged over the past decade, the most dramatic development has been the growing importance of bonds and other securities. The increase in net flows of portfolio investment to the emerging economies of Asia and Latin America has been more pronounced than to any other part of the world. These changes in the nature and size of capital flows to developing countries have been accompanied by significant changes in the composition of the investor community. Institutional investors have become a notable source of funds for borrowers in emerging market economies, though their claims on these countries still account for only a small proportion of total assets. By contrast, commercial bank loans to developing countries, which were a main source of finance in the 1970s, have increased only slowly during the 1990s.

The surge in capital flows and the Mexican crisis of 1994/95 illustrate the potential size, speed and severity of liquidity crises in the event of reversal of capital flows in these new circumstances. They have important implications for policies in all actors of international financial markets. For the developing countries, the key lesson is that foreign capital can complement domestic resources but cannot substitute for sustained efforts at mobilizing and efficiently investing domestic savings. To encourage private savings, ways should be explored for increasing incentives to save through institutional arrangements and through changes in taxation and expenditure patterns. To reduce the risk of disruptive changes in the financial market sentiments, capital importing countries should strengthen the domestic financial system by establishing a regime of supervision and prudential regulation, by strengthening central bank independence, and by promoting the deepening and sophistication of financial markets. In practice however, policy response to large capital inflows has typically consisted of direct intervention in money and exchange markets (such as controls of capital inflows, tax on short-term inflows, sterilized intervention, and raising reserve requirements), because fiscal policy instruments aimed at promoting domestic savings are not sufficiently flexible to be used for short-run macroeconomic management. But policy makers should keep in mind that the effectiveness of monetary instruments tends to diminish over the course of extended capital inflow episode. On the side of industrial countries, eliminating structural budget imbalances is very important. This is in order not only to crowd out developing countries' capital requirement but to keep international interest rates at a reasonable level. Also, industrial countries should ensure open access for developing countries' goods and services in their home markets, ensure smooth technological transfer to developing countries, and share with developing countries the know-how on institutional improvement and policy management. With respect to the role of multilateral institutions in the prevention of crisis, providing creditors with reliable and comprehensive information about policies and economic conditions in debtor countries is particularly important.

As for managing financial crises when they do occur, lessons drawn from the experience of both developed and developing countries are germane. Financial difficulties should be dealt with quickly and decisively, recognizing that the fiscal costs to all the principal parties will be

substantial but less than those resulting from delay. A cooperative approach should be taken so as to produce an orderly and more expeditious resolution of the crisis and to help contain any contagion and systemic effects and minimize the costs of the crisis to all the principal parties involved. However, it should be noted that it is widely believed that a quick and large scale rescue package such as the one organized by the IFIs and industrial countries in the wake of Mexican crisis is unlikely to be assembled in the event of another "peso crisis." In fact, there were strong opposition and criticism within the US Congress and from a number of EU member governments against the unprecedented amount of the rescue package. Thus, the debtor country has the primary responsibility for retaining the confidence of the financial markets, by informing the other parties of emerging difficulties, involving multilateral institutions early on in the resolution of its problems, and adopting strong domestic measures to deal with the crisis ahead of any other action. Still, in the absence of new financing, the degree of adjustment required to meet international obligations may impose such a high cost that it is not in the interest of either the debtor or the international community as a whole. Thus, there would be a platform for official and private creditors to provide new loans or accept payment suspension and for IFIs to lend to a debtor even when it is likely to remain in arrears on its debt obligations to certain private creditors.

Notes

1. This section does not deal with "28 countries in transition" defined by the IMF, which comprises of states of the former Soviet Union, central and eastern Europe, and Mongolia. Capital flows to the countries in transition increased sharply in 1995 to \$30 billion, up from \$11 billion in 1994.
2. A \$52.8 billion rescue package, which consists of \$17.8 billion from IMF, \$20 billion from US Exchange Stabilization Fund, \$10 billion from BIS, \$1 billion from Canada, \$3.0 billion from commercial banks, and \$1million from Latin American countries, was organized immediately after the Mexican peso crisis.
3. Inflation stabilized dramatically since the onset of "Real Plan", exchange rate based stabilization program in July 1994, and CPI inflation is expected to be around 10% in 1997.
4. In the case of debt/equity swap, creditor banks received physical assets as payment for the loans they had granted. Existing companies were purchased, generally at lower prices. The same problem may arise in investment related to privatization.
5. Depending on the terms of sale, the new owner may be required to undertake a certain amount of new investment or renovate existing equipment.
6. It should be noted that in many circumstances large capital inflows have occurred while countries are in the course of a stabilization effort, and also that some countries have received capital inflows despite having poor fundamentals. However, it would be difficult to construct a manageable framework that considers all possible initial conditions and imbalances in the policy mix.
7. Some research suggests that, while domestic factors have tended to be the dominant influence behind flows of capital to Asia, external factors---such as the level of interest rats and cyclical conditions in the industrial world---have dominated flows to Latin America (BIS 1994).
8. The main exception is Chile.
9. See table 7 for the use of policy measures adopted by selected countries.
10. Measures of real effective exchange rates based on consumer prices suggest substantial appreciation between 1991 and 1994 in the case of Argentina and Hong Kong (both with US dollar peg), Mexico (with a dollar band), as well as Singapore (where the nominal US dollar exchange rate rose steadily), Colombia and India. The currencies of most other Asian countries as well as Brazil and Chile depreciated or remained stable on balance (IMF 1995).
11. In general, IFIs, including the IMF cast doubt about effectiveness and express concerns about potential adverse side effects of controls on capital flow. They argue, that the liberalization of restrictions on capital inflows, and other measures to liberalize the exchange and trade system, are likely to be more effective in reducing pressures arising from capital inflows (IMF 1996a).
12. There has been some tendency for sterilization to be greater in Asia as a whole than in Latin America. One indicator of the scale of the sterilization is the rise in monetary authorities' gross foreign assets in

relation to the increase in the monetary base. It suggests that sterilization operation were very large in early 1990s in Indonesia, Malaysia, Singapore and Thailand (BIS 1995).

13. Although the magnitude of fiscal adjustment appear to be larger in Asia than in Latin America, Latin America relied on privatization proceed more than Asia. Between 1990-1995 privatization revenue in Latin America amounted \$12 billion per annum, while in Asia the proceed was \$5 billion.
14. Countries with current account surplus in the world can be grouped into three. The first group is in Asia, which includes Japan, Singapore, Taiwan, and Hong Kong. The second group of constant suppliers of capital can be found in Europe, and includes Switzerland and the Netherlands as well as occasional surplus countries such as France and Italy. The third group used to be found in the Middle East. However, except for Kuwait, until the first half of 1996 most oil producers have recently turned to post deficits against the background of the stagnation of oil prices and increased government expenditures.
15. ODA consists of bilateral assistance and contribution to multilateral institutions. Increased emphasis on multilateral aid, especially assistance channeled through multilateral development bank (MDB), such as IBRD, ADB, and IADB, is one of the most significant developments in Japan's ODA policy since late 1980s(Multilateral aid accounts 28% of total Japan's ODA in 1993 and 1994). Japan is ranked as a top donor for ADB and the second largest donor for IBRD, EBRD, IDB, and AFDB. But its contribution is not limited to subscription to MDBs. For example, in the case of IBRD, Japan's funds flow to the Bank through subscriptions and contributions, bond issues in the Tokyo market, joint financing, and private investment. For further discussions see Dennis T. Yasutomo, *The New Multilateralism in Japan's Foreign Policy* (1995, St. Marni's Press)
16. It should be noted that loans provided by the export-import Bank of Japan (JEXIM), major component of OOF (other official flows, i.e. bilateral flows other than ODA) classified by DAC, has played a role in the commercial bank debt and debt service reduction operations of major Latin American countries under the Brady Plan. JEXIM made loan commitment to such countries as Mexico (1989 \$2 billion), Venezuela (1990 \$600), Argentina (1993 \$800 million), Ecuador (1995 \$200 million), and Peru (1996 \$100 million). JEXIM also offered Argentina \$800 million in order to cope with the liquidity crisis caused by "Tequila shock."
17. Notified basis in Yen, Ministry of Finance
18. Systematic statistical information on the amount of FDI by Japanese corporations are available only covering financial outflows from the headquarters and on the basis of notification of intention by them to the Ministry of Finance. This is a very imperfect data, but it is the only available source of annual series on the amount of FDI that provides industry and regional breakdown.
19. Following the burst of the bubble economy in 1990, the Bank of Japan had lowered official discount rate seven times from a peak of 6% in 1990 to 1.75% in September 1993. Discount rate was lowered further to 1.0% in April 1995 and to 0.5% in September 1995, which is the lowest rates in the history of the Bank.
20. Of particular importance is the elimination on January 1, 1994 of the 90-day lockup period before which sovereign yen-denominated Eurobonds could be sold to Japanese investors after initial placement, facilitating access by sovereign issuers to the domestic investor base. Another important deregulation was the elimination on January 1, 1996 of the minimum credit rating requirement for Samurai bonds and after August 2, 1995, of the 90-day lockup period on all other nonresident yen-denominated Eurobonds.
21. Samurai bonds are yen-denominated bonds issued by non-Japanese residents and sold to investors in Japan under Japanese regulations. This differentiates Samurai bonds from European bonds, which are issued in the international offshore market (usually in London) but most of the Euroyen bonds are said to be purchased by affiliated companies of Japanese financial institutions. There are also yen-denominated bonds issued by nonresidents through private placements in Japan---Shibosai bonds---but the volume are not large.
22. Those bonds are said to have been sold to new investors such as leasing companies, affiliates of agricultural co-operations, and individuals, who might not fully appreciated the credit risk of the issuers.

23. The rapid expansion of bank lending and the importance of land and stocks as assets in Japan's financial sector has exposed its financial institutions to the risks stemming from falling asset prices. Banks and other financial institutions have been rocked by the huge sums of non-performing debt, resulted from an earlier lending boom based on inflated land values as collateral. In the aftermath of the collapse of the bubble economy, many of the generous loans extended, especially to land and property developers, cannot be repaid or even serviced. In spite of huge write-offs, non-performing loans remain a heavy burden, especially for long-term credit banks, trust banks, regional banks and credit unions. As of end March 1996, private sector estimates of the amount of non-performing loans and restructured loans held by financial institutions are in the Y60-Y100 trillion range (\$500-800 billion), much higher than the Ministry of Finance's figure of Y35 trillion (\$300 billion).
24. According to the Basel Accord of July 1988, beginning 1993, internationally operating banks would have to maintain the minimum ratio of capital to risk-weighted assets of 8%. During the transition period of between March 1991 and March 1993 this ratio was 7.25% for Japanese banks. The deadline for complying with BIS capital adequacy requirements coincided with overall decline of Japanese stock prices. Due to Japanese banks' low self capitalization ratio, it became difficult for them to extend a large amount of loans.
25. The reporting countries comprise of the Group of Ten countries plus Austria, Denmark, Finland, Ireland, Luxembourg, Norway and Spain. Outside-area countries include all non-reporting countries located in Latin America, the Middle East, Africa, Asia and Eastern Europe, as well as a group of smaller developed countries.
26. There is a huge gap between demand and supply of capital in Asia. For example, the ADB's forecast at the beginning of 1996 estimates that the region would need \$6,900 billion of spending over the next 25 years to maintain the economic growth rates of recent years. However, in reality, many projects are not getting off the ground because of a lack of financing. In 1995 the volume of new project loans in Asia totaled \$9.34 billion, according to Project Finance International, a specialist publication. Although that amount is more than twice the \$4.24 billion lent in 1994, it is a drop in the ocean compared to the regional requirement of \$280 billion a year for the next 25 years forecast by the ADB.
27. For Asian countries, linking their currencies to a more stable yen would be one way of curbing imported inflation caused by an appreciation of yen against US dollar. For Japan's Asian debtors it is a effective risk reduction way to increase the proportion of foreign reserves held in yen and intervene in currency markets to reduce the volatility of their own currency against Japan's (Foreign currency equivalent of the yen debt of Asian countries nearly doubled over a decade to mid-1990).
28. One factor has been Japanese investors' huge foreign exchange losses deriving from it's unbalanced position as the world's largest creditor nation, holding most of its assets in US dollar. Another factor in the finance Ministry's policy change is the yen bloc might help Tokyo regain some of its loss of competitiveness as an international financial center.
29. Opinions and Strategies of Foreign Financial Institutions Regarding the Tokyo Money and Capital Markets (JCIF, December 1995)
30. Major components are: allowing banks, securities companies and insurance companies to freely enter each others turf; eliminating the legal distinctions between commercial banks, trust banks and long-term-credit banks; full liberalization of both stock commission and premiums for non-life insurance; allowing institutions other than commercial banks to provide foreign exchange services; and easing remaining restrictions on asset management, especially of pension fund money.
31. Traditionally, Japan's corporate pension funds have been obliged to direct funds to the so-called "general accounts" of major life insurance companies and trust banks, which run along very conservative and tightly controlled lines.

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Table 1. Net Capital Flows to Developing Countries¹
(Annual average, in billions of U.S. dollars)

	1973-77	1978-82	1983-88	1989-95	1994	1995
<u>Developing countries</u>						
Net private capital flows	10.1	27.4	17.0	117.8	140.4	166.6
Net direct investment	3.6	9.4	12.5	42.0	69.3	73.6

Net portfolio investment	0.2	1.8	4.0	41.3	47.8	35.7
Other net investment	6.3	16.3	0.5	34.5	23.4	57.4
Net official flows	11.1	23.4	27.8	16.4	17.2	28.9
Change in reserves ²	-20.2	-21.3	-8.5	-56.9	-59.8	-74.3

Asia

Net private capital flows	4.2	13.2	13.2	47.4	76.8	98.0
Net direct investment	1.4	3.0	5.4	25.4	44.6	50.3
Net portfolio investment	0.1	0.2	0.9	9.8	14.6	18.3
Other net investment	2.7	10.1	6.8	12.2	17.6	29.3
Net official flows	4.1	7.4	6.6	7.2	5.6	6.4
Change in reserves ²	-6.9	-6.7	-17.6	-37.7	-63.1	-41.3

Latin America

Net private capital flows	11.8	29.0	-1.9	34.2	51.2	38.9
Net direct investment	2.5	5.8	4.8	13.1	20.9	19.3
Net portfolio investment	0.0	2.0	-1.2	17.9	17.1	4.5
Other net investment	9.2	21.2	-5.5	3.2	13.1	15.0
Net official flows	2.3	4.4	9.8	4.6	-3.7	20.4
Change in reserves ²	2.2	2.4	-0.5	-11.6	8.9	-22.7

Africa

Net private capital flows	4.5	6.6	3.6	7.9	12.4	14.4
Net direct investment	1.0	0.7	1.0	2.2	3.2	2.8
Net portfolio investment	0.1	-0.2	-0.9	-0.2	0.5	2.0
Other net investment	3.4	6.2	3.4	5.8	8.8	9.6
Net official flows	2.4	5.1	4.8	5.3	5.3	3.8
Change in reserves ²	-1.4	0.7	0.1	-5.8	-5.8	-4.0

Middle East and Europe

Net private capital flows	-10.3	-21.5	2.1	28.3	0.0	15.4
Net direct investment	-1.3	-0.1	1.2	1.2	0.5	1.2
Net portfolio investment	0.0	-0.2	5.2	13.8	15.6	10.8
Other net investment	-9.1	-21.2	-4.2	13.2	-16.1	3.4
Net official flows	2.3	6.6	6.6	-0.7	10.0	-1.7
Change in reserves ²	-14.2	-17.7	9.5	-5.0	0.2	-6.4

Notes: 1. Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing.

2. The regional breakdowns of developing countries conform to the IMF's International Financial Statistics. The group of developing countries (132 countries) includes all countries that are not classified as industrial countries or as countries in transition. Industrial countries are 15 European Union countries plus Japan, Canada, US, Australia, Iceland, New Zealand, Norway and Switzerland.