International Capital Flows to Latin America and the Caribbean;

their impact on income distribution[1]

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I Introduction

The main feature of the "new economic model" in Latin America is its' outward orientation through both trade and capital account liberalisation. The opening of the capital account, accompanied - or often preceded - by domestic capital market liberalisation, (as well as other market reforms), create the pre-conditions for large capital flows from abroad. These flows will then take place if and when the international economic circumstances are favourable and if the particular countries are broadly seen to have achieved macro-economic stability.

In the context of "the new economic model" such foreign flows on a large scale are welcomed. They are seen as mobilising external saving, which it is expected will mainly supplement domestic savings, and therefore raise investment and boost growth; they are also seen as contributing to smooth out expenditure over time, for example if a country faces a sharp deterioration of its' terms of trade; also, these flows are expected to increase the micro-efficiency of production, by causing lower intermediation spreads between lenders and borrowers. In the case of foreign direct investment flows, micro or sectoral efficiency is expected to be boosted by the transfer of technology and management know-how, which it is expected accompanies such foreign direct investment.

Some analysts had therefore euphorically welcomed the surge of private capital flows to Latin America in the 1990's and have used it as a key indicator or even proof of the success of the "new economic model". Indeed, Williamson (1993) has cautioned that, particularly in the Latin American context, we should not equate access to external financing with success as on several occasions in the past the region had access to abundant financing for a time, only to end up in a crisis. Unfortunately, warnings of the risk of volatility of capital flows to Latin America (see Ffrench-Davis and Griffith-Jones 1995), were dramatically confirmed by the Mexican crisis that started in December 1994.

It is therefore a fact that the introduction of "the new economic model" (and particularly the liberalisation of domestic capital markets, of the capital account and the process of privatisation) created important pre-conditions for attracting foreign private capital, and are therefore an important determinant of the large surge of capital flows to the region in the early 90's. However, it needs stressing that international factors (and particularly relaxed US. monetary policy and low US. interest rates) played a very important role in enabling these flows (Calvo, Leiderman and Reinhart, 1993), as have new global trends, such as the "securitisation of flows (Griffith-Jones, 1993). This raises the issue, as well as the danger, of potential volatility of such flows, and - more crucially - of the impact which such volatility will have on key macro-economic variables, of the Latin American economies in the medium-term. The Mexican crisis illustrated the scale and the speed with which capital in the 1990's can move out of countries.

It is in this context that we shall examine the impact of external capital flows on income distribution and poverty. We shall distinguish in this analysis that related to the first phase, with massive capital inflows into the region, and a later stage, where there is uncertainty both about the sustainability of those flows and of their development impact.

In the next section (II), we will outline the main features of the surge in capital flows to the Latin American region, that have occurred in the early 1990's. We will also discuss in more detail some of the benefits, as well as the risks of future instability for such flows.

In section III, we shall attempt to examine the mechanism by which these surges in capital flows influence income distribution and poverty. Section IV provides conclusions, and some policy recommendations.

II The surge in external capital flows to Latin America and the Caribbean

A. Massive scale of flows

The first feature of the capital flows to the Latin American and Caribbean (LAC) region in the early 90's was their massive scale. As can be seen in Table 1, for the 1992-93 period, they reached an annual average of around US$ 62 billion. (If the 1990-93 period is considered, the annual average was $45 billion.) This is in sharp contrast, and implied an abrupt turnaround from what occurred during the 1983-90 period, when on average only US$ 10 billion of net capital entered the LAC region, as it faced its external debt crisis.

The large scale of the net capital inflows is also reflected in its' high proportion of GDP. For the 1992-93 period, net capital inflows reached 4.7% of GDP, which is slightly above the previous historical peak, at 4.5% in 1977-81, and well above the 1983-89 average, at 1.3% of GDP (see again Table 1).

Particularly dramatic has been the sharp increase in flows to Mexico. Thus, net capital inflows into Mexico were slightly above zero in the 1983-90 period, but rocketed to 8% of GDP for the 1991-93 period, a ratio well above their previous peak during 1977-81 (at 5% of GDP). Capital flows into Mexico also represented a very large part of total inflows into the region. While it generated a quarter of the output of Latin America and the Caribbean, Mexico absorbed over 50% of the capital inflows to the region in the 1990-93 period. Argentina had also been a very important recipient of capital in the early 90's with levels of over 4% of GDP, similarly, Chile, Peru and even some the of the smaller countries like Guatemala and Costa Rica have received very large capital inflows in the early 1990's. (ECLAC, 1994)

Table 1. Net capital flows to Latin America and Caribbean (annual averages)

	Total net flows (US$ Billion)						Percentage of GDP					
	1977-81	1983-89	1990	1991	1992	1993	1977-81	1983-89	1990	1991	1992	1993
Latin America and Caribbean	29.4	10.1	21.6	37.0	59.4	64.2	4.5	1.3	2.0	3.2	4.7	4.7
Mexico	8.2	0.8	11.6	21.9	24.7	28.5	5.1	0.3	4.8	7.6	7.5	8.3

Source: Ffrench-Davis, R., and Griffith-Jones, S., (1995), based on ECLAC figures

B. Change in the nature of flows

A second significant trend in these capital inflows into the LAC region has been the change in their composition, as compared with the previous major inflow in the seventies. As can be seen in Table 2, the share of FDI doubled between 1977-81 and 1991-92, portfolio equity emerged as a new source of finance for the LAC region, bonds also saw their share increase significantly (trend which accelerated very much further in 1993, the year in which the region raised US $24 billion in bond finance, see Table 3), while the share of commercial bank lending fell quite dramatically.

Table 2. Latin America and Asia: Capital Flows[a]
(as a % of total, unless otherwise stated)

	1977-1981	1989-1992
Latin America and Caribbean		
Foreign Direct Investment	10.6	24.0
Portfolio Equity	-	6.3
Bonds	4.5	6.3
Commercial Bank Loans	66.9	14.7
Suppliers and Export Credits	6.2	7.7
Official Loans	11.2	35.9
Grants	0.6	5.1
Total in Billions of US Dollars	49.5	42.8
Total in Billions of Constant Dollars[b]	57.8	34.8
Asia		
Foreign Direct Investment	6.1	18.4
Portfolio Equity	-	3.6
Bonds	1.4	4.4
Commercial Bank Loans	32.1	23.5
Supplies and Export Credits	14.8	13.3
Official Loans	35.5	30.9
Grants	10.1	5.9
Total in Billions of US Dollars	23.2	66.5
Total in Billions of Constant Dollars[b]	24.3	53.4

[a] Gross long-term flows.
[b] Deflated using unit value of total imports in US$ (1985 = 100).

Source: IMF World Economic Outlook, October (1993).

It is interesting to note that similar, but less dramatic changes occurred to the structure of flows to the Asian countries. For example, for the Asian countries the share of commercial bank lending fell, but far less dramatically than for the LAC region; the share of portfolio equity increases, but only to 3.6% of total capital flows. On the other hand, the share of FDI flows to the Asian region rose faster, as did that of bonds (see again Table 2). The argument has been made that the different composition of capital inflows into Latin America and Asia have important effects on both the impact and reactions to such flows (see Calvo, Leiderman and Reinhart, 1993 b as well as Griffith-Jones and Stallings, 1995). Thus, for example the different composition of capital flows, as well as the different historical stability in the evolution of such flows, helps to explain why concerns over "hot money" and the risk of a sudden reversal are more prevalent among Latin American policy makers than among their Asian counterparts.

Finally, an important point to make - and one which is often forgotten in discussions in Latin America itself - is that trends in capital flows to the LAC region follow very closely global trends. In particular, the main dynamism for borrowing both by Latin American countries and globally comes from securities (both bonds and equities). On the other hand, syndicated loans (which were the main source of borrowing both globally and for the LAC region in the 1970's) play a far smaller role in the early 1990's. (Compare Tables 3 and 4). A comparison

Table 3. Borrowing by Latin American Countries (US$B)

Instruments	1989	1990	1991	1992	1993
Bonds	-	1.0	4.6	8.2	23.7
Equities[a]			4.4	4.5	5.5
Syndicated loans	1.9	3.3	0.9	1.0	2.2
Committed Borrowing Facilities	0.1		2.8	0.3	
Non-Underwritten Facilities[b]			1.2	6.1	6.8
TOTAL OF LATIN AMERICAN COUNTRIES	2.0	4.3	13.9	20.1	38.2
% OF LATIN AMERICAN COUNTRIES OF TOTAL BORROWING OF LDCs	9.2	15.0	30.1	42.5	45.3

[a] New issues and initial public offerings of common and preferred shares.
[b] Including Euro-commercial paper and medium-term note programmes.

Source: OECD; Financial Market Trends; Vol. 54, 55 and 57; February 1993, June 1993 and February 1994; elaborated on the basis of the statistical Annex.

Table 4. Borrowing on the International Capital Markets (US$B; %)

	1989	1990	1991	1992	1993
Securities[a]	263.8	237.2	321.0	356.2	521.7
Loans	121.1	124.5	116.0	117.9	130.1
Committed Back-Up Facilities	8.4	7.0	7.7	6.7	8.2
Non-Underwritten Facilities[b]	73.2	66.2	80.2	127.9	150.5
TOTAL	466.5	434.9	524.9	609.7	810.5
Year-on-year percentage change	+2.8	-6.8	+20.7	+16.2	32.9

[a] Includes both bonds and equities.
[b] Including Euro-commercial paper and medium-term note programmes.

Source: OECD; Financial Market Trends; Vol. 54 and 55; February 1993, June 1993, and
February 1994

of tables 3 and 4 also shows that the increase in global international borrowing between 1989 and 1993 has been very large (as it has almost doubled during those four years); clearly the growth of borrowing by Latin America has been far more dramatic, and is therefore to an important extent explained by factors relating to the region; however, the fact that borrowing is also growing so rapidly globally would seem to indicate that at least in part the overall increase in Latin American international borrowing is responding to these global trends.

C. Macro-economic impact of capital inflows

The sudden surge in capital inflows, even though having initially very positive effects, has brought to light an important policy dilemma as regards efforts to restore economies to a situation of growth. They have provided the financing needed to continue, in a more socially efficient way, the structural adjustment programmes initiated by several countries in the 1980s. However, they have posed challenges as regards introducing safeguards designed to prevent them from triggering financial crises, guarantee the stability and sustainability of macroeconomic equilibria and promote investment.

For the region as a whole, the entry of capital had positive Keynesian-like effects, in that it has reduced the foreign exchange constraint, enabling existing productive capacity to be used more fully and production, incomes and employment to pick up as a result. The lifting of the external constraint, (which was the dominant restriction to growth during the 1980's), since the beginning of the 1990s contributed to the recovery of economic growth, whose annual rate for the LAC region increased from 1.6% in 1983-90 to 3.4% in 1991-93, (see table 5). The contribution to growth of capital flows would have been higher, if an deterioration in the terms of trade had not occurred during that period.

Table 5. Latin America: Macro-economic indicators

	1976-81	1983-90	1991-93	1991	1992	1993
Rate of growth of GDP (1980 US$)	4.6	1.6	3.4	3.8	3.0	3.4
% of GDP						
Investment	24.2	16.9	17.5	16.6	18.1	17.9
External Savings (net capital inflows minus change in reserves)	3.9	0.9	3.1	1.8	3.2	4.0

Source: ECLAC (1994)

The recovery of output was based largely on the fact that the greater availability of foreign savings has made it possible to finance the larger imports associated to an increased use of existing productive capacity; this, through its effect on output and income, reactivated aggregate demand. The expansive effect was general throughout the region, and particularly strong for some countries (for example Argentina and Chile); nevertheless, there were exceptions. Thus Mexico -while experiencing a particularly large influx of private capital- had not seen such a recovery of growth during the period. The extent to which private capital inflows lead to growth is greatly influenced by the existing gap between actual GDP and productive capacity, the nature of domestic economic policies, particularly macroeconomic ones, expectations of economic agents, political developments, and external factors such as the terms of trade and levels of debt service.

Since 1990, net capital inflows surged, reaching an annual average of around US $ 62 billion in 1992-93 (see again table 1). About half of these net inflows in 1991 went to build up depleted international reserves; this share has steadily decreased to 30% in 1993, *pari passu* with the increased absorptive capacity of the region.

The investment rate for the whole region, for its part, only in 1992 achieved a level above the 1983-90 average. Furthermore, for only some few of the countries in the region, which have received large capital inflows, such as Chile, this increase in capital inflows has been accompanied by a comparatively high investment rate. In all, if we compare 1983-90 with 1991-93, net external savings (capital flows minus the increase in reserves) rose by slightly above two percent of GDP, while the investment ratio increased only by 0.6 percent of GDP. The remainder has gone to consumption or to compensate worsening terms of trade.

Together with economic recovery, the speed with which capital inflows had closed the external gap and generated a surplus of foreign funds was reflected in a tendency towards exchange rate appreciation, a rapid reduction in trade surpluses and an increase in the current account deficit (see ECLAC, 1994). These trends reflected, initially, the recovery of "normal" levels of aggregate demand, imports and the real exchange rate, all of which were conditioned by external constraints during the period 1983-89. However, the continuing abundance of capital tended to maintain these trends over time, and confronted the economic authorities with a dilemma crucial to future stability, in that, if capital inflows fall, the levels of aggregate demand and imports and the exchange rate clearly would not be sustainable in the medium term.

During 1991-93: i) a larger proportion of capital inflows was devoted to the accumulation of reserves than in the 1970s, thereby moderating the impact of these resources on the region's economies; ii) national savings were crowded-out by external savings, as reflected in the fact that the increase in total investment was lower than that in external savings (see table 5).

Thus, the short-term or Keynesian effect of this surge in capital flows was reflected in a short-term rise in the growth rate, caused by a reduction of the foreign exchange constraint and higher demand for locally produced goods. Furthermore, the surge in foreign finance had allowed domestic spending to increase faster than output (for data, see ECLAC 1994). However, it needs to be stressed that to the extent that the foreign capital inflow is temporary, this Keynesian boom is also temporary. Once - and if - an external financial crisis starts investment and growth of output falls, debt servicing would grow, and the rate of growth - or the level - of national income could fall even more than output (see Corden, 1990).

This short-term Keynesian effect of surges in capital inflows needs to be carefully distinguished from the second, more long term effect, which is on the growth of capacity. It is crucial in this second type of effect what proportion of the external flows goes to investment, how productive such investment is, and what proportion of it is - directly and/or indirectly - converted into tradeables. If enough efficient investment takes place and output rises sufficiently (and is converted into tradeables in a large enough proportion), it is more likely that future debt service or other flows generated by the original inflows can be financed without problem. The increase in foreign debt and investment will not have been a problem; indeed, it will have increased the rate of growth and made the country better off. If foreign capital not only increases investment, but also raises its' productivity, the long-term positive effects on growth could be even larger.

However, there is also a less rosy scenario. If increased investment proves insufficient or inefficient, and if not enough production of tradeables is generated, then the initial output growth may be followed by a debt problem, leading possibly to reductions in total absorption, below levels that could have been sustained in the absence of the earlier surge. Thus, in this negative scenario, the total effect (through time) of the surge in capital flows on countries' retained income could be negative, even if the initial Keynesian effect on output was initially positive.

Though it is still rather early to evaluate the impact of such flows on productive capacity, the preliminary macro-economic evidence presented above does give cause for concern, as for the LAC region as a whole, the increase in the investment rate has been smaller than the growth of external savings (see table 5). The results naturally vary from country to country, and some countries (like Chile) have seen their rate of investment increase significantly in the early 1990's.

Furthermore, for some countries (especially those which have very over-valued exchanged rates, resulting to an important extent from the capital surge itself and the form in which the government's economic policy has reacted to such a surge), there is some indication that only a relatively low share of the investment linked to foreign capital inflows is going into tradeables. This is a second cause of concern, and it is also an area where far better monitoring and data collection is urgently required.

D. The financial risks of the new capital flows

The benefits of interaction with private capital flows for the development of recipient economies is partly dependent on stable and predictable access to financial markets. The risk of abrupt restrictions in supply and/or inordinately sharp increases in cost and shortening of the maturity terms of external liabilities are partly determined by perceptions of risk and hence host country policies. But from the standpoint of Latin America economies access also can be heavily conditioned by exogenously determined supply-side dynamics, related to industrialised country policies in the areas of macroeconomics and prudential regulation.

As the Mexican 1994 crisis illustrated, there are considerable risks of volatility regarding the new financial flows of the 1990s. Firstly, there is a degree of consensus that one driving force behind the new inflow of capital in the early 1990's was exogenously based in a conjunctural relaxation of monetary policy in the OECD area, and a consequent dramatic decline in international interest rates, especially US. ones. The increased differential yields on investments in the region attracted investors that had become accustomed to a decade of relatively high real interest rates in the low risk OECD area. Moreover, given the special conjunctural setting in Latin America -recovery from a deep and protracted recession and especially profitable opportunities, linked to privatisations - investors were able to capture high returns, with low informational costs, as the need to discriminate among countries and firms was not great. Significant rises in international interest rates, as occurred in 1994 induced a reversal in the flow of some of the less committed investors.

In addition to more systemic risks, countries should also be aware of the potential specific risks of the particular modalities through which capital flows to Latin America in the nineties. This would allow them to maximise benefits and minimise potential costs of private flows.

A major source of the new flows to Latin America are bonds, (see table 3). These have the advantage of being mainly at fixed interest rate. However, as discussed in Griffith-Jones (1994), the average maturity for those bonds in the 1990s is very short (around four years). This implies that a high share of the stock could be rapidly withdrawn, should bonds not be renewed. The problem was far more serious in Mexico, where such a high proportion of Treasury Bills were both very short-term and in the hands of non-residents; this made the problem of non-renewal of these Bills a major one during the financial crisis. Less dramatic, but also a cause of concern, is the risk that, if renewal of bonds is possible but with higher interest rates, the average cost of borrowing would significantly increase fairly soon, as maturities are so short.

A new form of external private funding for Latin America is equity investment. This has the advantage of a cyclical sensitivity of dividends. However, equity flows also carry important risks for recipient countries. Foreign financiers could, for different reasons, stop investing in equities, and even try to sell their stocks very quickly, if they feared a worsening prospect in the country. This could either lead to pressure on the exchange rate and/or lead to price falls in the domestic stock exchange. Though the latter effect would diminish the risk of a large foreign exchange outflow, it could have a negative impact on aggregate demand -via a wealth effect- and on the domestic financial system, especially if banks and securities activities are closely integrated either through cross holdings or investor leveraging. To the extent that a growing part of foreign investment in Latin American shares originate in institutional investors, who seem to allocate their assets using more long-term criteria, the risk of large reversals of flows is smaller. But as long as markets are moved in an important proportion by players which specialise in short term yields, and equity markets remain relatively thin, the risks of great volatility are inherent in this new modality of external financing.

As regards FDI flows, on the whole, these seem to be more stable and long-term. It is therefore desirable that a far higher proportion of capital inflows to Latin America, than in the 1970s, come in the form of foreign direct investment.

Less encouraging was the fairly high proportion of short-term capital flows going to Latin America. (Exact figures are not available). Such short-term flows, by their very nature, pose higher threats of volatility. Indeed, statistical analysis in ECLAC (1994, ch. IX) confirms that short-term flows have been quite volatile in the 1950-92 period. Again the Mexican crisis confirmed these dangers

III The likely impact of capital surges on income distribution and poverty

A. Methodological Issues

The evaluation of the impact of capital surges, (CS) on income distribution and poverty involves several conceptual problems, most of which are similar to those encountered in other chapters, see in particular Fitzgerald, (1995). Similarly as in the analysis of the "new trade regime", the analysis of the impact of capital surges (CS) is complex and hard to observe (as several changes are occurring simultaneously), furthermore, the analysis is made more complex because the impact is both on the "primary" income distribution and on the redistributive mechanisms, which affect secondary income distribution; also, it would be too complex and possibly too biased by the theoretical approach used by the author to model the impact of CS, via simulation models that compare the economies with and without CS and their impact on income distribution. Finally, the lags between CS and their distributional consequences vary considerably. In fact, this is particularly true for the case of capital surges, where we will distinguish two phases for our analysis: a) the current phase of the initial capital surge and its' impact and b) the following future phase which, as we shall analyse below, can imply either "rosy" or "grey/black" scenarios. The fact that part of our analysis will be based on likely future developments increases the complexity and uncertainty of their impact on income distribution and poverty. To reduce this uncertainty, we firstly rely on alternative scenarios; secondly, our analysis of the "grey/black" scenario is made somewhat "easier" by our knowledge of the impact of the debt crisis of the 1980's on income and distribution and poverty, (see, for example, Cornia and Stewart, 1990).

Though the approach here is based mainly on economic analysis, it would be helpful if the country studies could attempt to test empirically some of the hypothesis made here.

B. Analysing the impact

As pointed out above, it is analytically very helpful to distinguish two phases: i) first and ii) second one; the latter will have two scenarios.

i) First phase

The capital inflows in their first phase have two types of major effects that affect the primary distribution of income. Firstly, as already outlined, a reduction in the foreign exchange constraint has allowed an increase in the demand for locally produced goods; both have led to an increase in output (the expenditure increasing effect). In fact Latin America's GDP has grown 3.1% in the 1991-93 period, which is higher than the 0.9% growth rate of GDP during the debt crisis years of 1983-90. The share of imports in GDP has risen from 9.0% in the 1983-89 period to around 12.0% in the 1990-92 period. (ECLAC 1994). As a result of more rapid output growth, existing productive capacity has been used more fully, and both employment and real wages grew; therefore, the income of the poor would be expected to rise quite significantly due to this factor. Indeed, there is evidence that the increase in the employment will particularly benefit the poorest. As Bulmer-Thomas (1995) shows, in most Latin American countries, the people in the bottom quintile are far more likely to be unemployed than the average, and therefore will benefit more from employment growth/

Secondly, the capital inflows have an expenditure switching effect, due to a revaluation of the exchange rate. Indeed, according to ECLAC (1994), of <u>18</u> countries in the Latin American and Caribbean region, <u>16</u> have experienced exchange rate appreciation between 1990 and mid-1994.

The extent of the appreciation varies significantly from country to country, depending on the magnitude and composition of the capital inflows, on other trends in the balance of payments, and on the policy response of governments to their inflows. To a certain extent, this shows that there are quite significant variations within the new economic model, and indeed that some countries deviate more than others in some aspects from a "pure" approach. Thus, some countries (exemplified by the case of Argentina) have chosen a more pure market approach to capital inflows following the path of what is called non-sterilised intervention. This involves a more passive monetary policy, and a tendency towards greater revaluation of the exchange rate. Other countries (for example Chile) have followed a more active stance, including sterilised intervention (which allows the country to have a more active monetary policy, thus avoiding excessive expansion of aggregate demand and excessive appreciation of the real exchange rate). A more active policy stance can also include measures to restrict or discourage certain capital inflows, for example via reserve requirements on some credits from abroad and various quantitative controls (e.g. minimum maturity periods, minimum volume for bond issues). Though again Chile seems to have been most persistent in this latter type of measure, other countries, such as Colombia, Brazil and Costa Rica also have taken this type of measure. (See Ffrench-Davis and Griffith-Jones, 1995). It is noteworthy that several Asian countries e.g. Malaysia and South Korea, have - like Chile - actively discouraged short-term capital flows.

These different policy approaches are therefore an important factor for explaining the differentials in exchange rate revaluations.

It is interesting to note in this context, that although large capital inflows are seen - and to an extent are - a key favourable outcome of the new economic model, they also (especially if not properly managed) pose an essential contradiction within the model, by putting pressure on revaluation of the exchange rate which, if excessive, may discourage exports, which are such a key aspect of the model. Thus, an exchange rate revaluation caused in this case by "financial Dutch disease", that is a surge of capital inflows, will make exports less profitable. This may have negative long-term effects on output (and on the income of the poor), as it may discourage investment in exports, and thus undermine the logic of the model which is based on export-led growth, and needs to generate exports to help service the capital that is flowing in . Furthermore if an overvalued exchange rate leads to a rapidly growing current account deficit, and if external capital becomes - as is likely - unwilling to fund this deficit, the resulting crisis, if it occurs is very damaging for the poor (see below).

As regards the distribution of income, in the short-term, the bias against exports will bring about changes in the demand for factors of production. If the exportable sector is relatively labour intensive, as in Costa Rica, (see Bulmer-Thomas, 1995), then a revaluation of the exchange rate will have a negative effect on income distribution and poverty. However, if the exportable sector is relatively less labour intensive than the rest of the economy, as in the case of Brazil, there can be a positive effect on income distribution from the switch in demand for factors of production.

A real revaluation of the exchange rate also reduces the cost of imports. Because this implies a reduction in the price of some wage goods, and because more generally this will lead to lower inflation, real wages can be expected to increase as a result of these inflows. As wages are a significantly higher proportion of the income of the lower decile strata (see Bulmer-Thomas, 1995), this will imply an improvement in income distribution and a reduction in poverty.

However, capital inflows also can be expected to have an effect on the income derived from capital. For example, the liberalisation of domestic capital markets and privatisation (which are an important part of the new economic model) had already led to an important expansion of the stock market, as well as to increases in the prices of these stocks; however, the massive entry of foreign equity flows in the early 1990's, (both by foreigners purchasing shares locally and by the placement of Latin American shares in New York and globally) has greatly accelerated this trend. As a result, capital inflows caused share prices to rise significantly. As the property of shares is very concentrated amongst the top deciles, and as such an important share of the income of the top deciles is derived from income from capital in Latin America (see again Bulmer-Thomas, 1995), this could have a fairly important effect on increasing the income of the rich and the concentration of income.

To the extent that large capital inflows lead to a significant reduction in real interest rates (which seems to be the case in some Latin American countries, such as Mexico, though falls in real interest rates are smaller than conventional theory would lead us to expect, see Rodriguez, 1994), this will imply a smaller return on financial savings. As this income will tend to be concentrated amongst the upper deciles, (though perhaps somewhat less than stocks and shares), the decline in interest rates should reduce income disparities. It is noteworthy in this context that, as Rodriguez op. cit shows, though deposit interest rates (expressed in dollar equivalent) have declined in the late eighties and early nineties in Latin American countries, their level remains fairly high (with the exception of Chile). Indeed, for 1992, the average for Argentina, Bolivia, Chile, Colombia, Mexico, Peru and Uruguay was 8.1%, with several countries having interest rates above 10%.

Finally, it should be mentioned that, especially initially, an important part of the private capital flowing in was return of domestic capital that had previously fled. To the extent that average returns on capital are currently higher in Latin America than in other parts of the world (e.g. the US), this would imply increased concentration of income, as the income of the rich capital returners would increase. However the fact that the income would now be taxed domestically, rather than abroad (this capital whilst abroad may not have been taxed at all or may have been taxed at a lower rate) may reduce post-tax income on this capital. Furthermore, if the increased tax is spent by governments in a progressive manner (that favours more the relatively poorer), then it would seem to become even clearer that the return of capital would reduce income inequality somewhat.

In introducing the impact of taxes and government expenditure, we are examining secondary income distribution. Perhaps the most important effect in this category relates to the impact of the surge in capital flows on government spending. As mentioned above, one of the effects of foreign capital inflows is the lowering of domestic real interest rates. In particular, domestic government debt can on the whole be placed at lower real interest rates, as the supply of savings is increased via foreign capital. Furthermore, this coincides with the lowering of the level of the external debt that occurred in Latin America as a result of the Brady deals in the late eighties and early nineties, and the decline in US interest rates; as a result, government servicing of external debt also declined significantly. Furthermore, to the extent that debt equity swaps were used to sell shares in state enterprises abroad (which was quite common in countries like Argentina and Mexico), again government debt service requirements were lowered as a direct result of foreign capital inflows.

There is clear evidence, (see Griffith-Jones, 1993b and Cornia and Stewart, op. cit), that in the eighties, the dramatic increase in debt service payments (both domestic and external) within government budgets, displaced resources from spending on the social sectors, that is on spending that benefits mainly the poor. This was general throughout Latin America, but particularly dramatic in Mexico.

The recent trends described above for the early nineties - to an important extent caused by large foreign capital inflows - lead to a significant reduction in the proportion of government spending going to external and domestic debt servicing. As a result, potentially there was room for fairly large increases in spending on the social sectors (e.g. education, health, low income housing) that benefit relatively more the poorer section of society. There is indeed evidence that the share of government spending on the social has began to increase in the early 90's; however, it would seem more could be done in this field. In this context, it would be interesting to examine in some detail in the case studies the extent to which government social spending has increased, and the extent to which governments, have range of manoeuvre so more could be done in this aspect.

In any case the increase in social spending that occurred in the early 1990's is likely to reduce poverty and income, inequality. (We assume here that on average government spending on the social sectors has a progressive impact on income distribution.)

On balance, it would seem that the current impact of the capital surges tends to reduce somewhat income inequality and, above all, poverty, with the most important effect probably being created by the Keynesian recovery of output, employment and real wages, but with significant positive effects also derived from the indirect positive impact on greater government spending in the social sectors. One effect of capital inflows that does lead to greater income concentration is the impact of such inflows on an increase in the price of shares.

ii) Second phase

As mentioned above, it is also important to analyse the future impact of the second phase of its capital surge, especially because both history, including recent one (particularly in the case of Latin America) and economic analysis show us that there is no guarantee that such large inflows can be sustained.

We will therefore distinguish two scenarios. In the first, "rosy" scenario, a number of conditions have to be met: the foreign flows are mainly channelled to increase investment (and therefore domestic savings does not fall too much), a high proportion of investment goes into tradeables, this investment is efficient and no major external shocks occur or if they do occur the economy will be able to adjust to them; finally, external capital flows need to be sustained at current levels, or taper off relatively slowly.

In this "rosy scenario", output would continue to rise, the exchange rate would continue to stay at a more revalued level (if flows taper off slowly, there would be a gradual devaluation). In this scenario, income distribution would consequently continue to improve and poverty to decline, as basically the current situation would be continued. In mid-1995, Chile and Colombia basically continued in this favourable scenario.

However, as discussed above there is unfortunately the risk of a less favourable outcome, the "grey/black" scenario, exemplified by events in Mexico in late 94 and early 95. This would occur if too small a part of the foreign flows lead to an increase in investment and too low a proportion of that investment goes into production of tradeables; this could lead to an insufficient increase in the production of tradeables, to allow foreign exchange to be available for debt servicing and / or profit remittances to take place. The situation could be made more serious if this trend interacted with an abrupt reduction or even a large reversal of capital inflows. The outcome of this latter scenario (including its' impact on income distribution) would naturally depend on how the situation would unravel, which in its' turn would be related to the speed and the timing of events, and the mechanisms used by governments to handle any balance of payments problems/crises that could occur. We can however reach some tentative conclusions, and attempt to analyse their likely impact on income distribution and poverty.

In this "grey" or "black" scenario, there would be first an expenditure reduction effect, that would imply a reduction in output, which would imply declines in employment and in real wages. Declines in output, wages and employment will tend to be highest in companies that are heavily indebted (as interest rates rise sharply) and in those that sell mainly or exclusively in the domestic market; on the other hand, wages and employment in firms producing tradeables may rise especially if firms that were not heavily indebted. This is clearly shown in the 1995 evolution in Mexico. The history of the 1980's seems to show how in such critical situations, the poorer groups of the society are less able to protect themselves from the direct and indirect effects of adjustment.

Secondly, there would be an expenditure switching effect, as the response to a sharp reduction or reversal of capital inflows would be a devaluation of the exchange rate. This would lead to higher inflation. Both trends would tend to make income distribution more unequal. In particular, higher and more fluctuating inflation is widely regarded to have a regressive effect on income distribution, see for example, Cardoso, Barros and Urani (1993).

The impact of the devaluation on income distribution and poverty will also naturally depend on whether the export sector is more or less labour intensive than the average. Here the inverse of the analysis made above for revaluation applies.

Thirdly, there could be again an important negative impact due to : a) a reduction in the level of government spending (related to the adjustment), and b) a reduction of the proportion of it spent on the social sectors. As regards the latter, the reduction in capital inflows or its' reversal will tend to increase domestic interest which was very large in 1995 Mexico rates, and thus the servicing of public domestic debt. Devaluation will further increase the local currency cost of government servicing of external debt. This can also be increased if the government has to ex-post give its' guarantee (or take over) part of the private external debt. Furthermore, if there is some kind of domestic financial crises (or risk of it) linked to the abrupt change in foreign flows - particularly if these affect the domestic banking system, either directly or indirectly - then it is likely that the government may be involved in some bail out of the domestic financial sector. As a result of these trends and events, governments would be forced to reduce spending on the social sectors, as both the level of government spending would fall, as would the share of it "available" for social spending, which would increase inequality and poverty.

On the other hand, income from capital would also suffer to the extent that smaller inflows and/or outflows would very probably cause a fall (and possibly a sharp one) in the prices of shares. This could diminish income inequality. However, on the other hand, the likely increases in domestic interest rates would augment the income of capital.

On balance, a rapid outflow or even a reversal of external capital flows would tend to increase income inequality and, above all, poverty. These effects would be particularly strong if the previous inflow had not led to a significant increase in investment in tradeables, as higher levels of tradeables (and as a consequence a favourable trade account) could shelter the economy (and the poor) somewhat from shocks on the capital account.

iv Conclusions

Our analysis shows that the initial impact of the surge in capital flows to the LAC region on income distribution and poverty seems overall positive. This is mainly because of the short-term Keynesian effect, that allows - as the foreign constraint is lifted - for higher output, employment and real wages. The revaluation of the exchange rate further allows for an increase in real wages; its' medium-term impact on income distribution is less clear, as it depends on the relative labour-intensity of tradeables. The greater room for manoeuvre of governments to increase spending on the social sectors, partly allowed by changes brought about by the capital inflows, also should make income distribution more equal and lessen poverty; a similar effect should arise from lower real interest rates. One contrary effect - leading to greater concentration of income - is the significant increase in the price of stocks and shares associated to capital inflows as shares are owned mainly by the rich in Latin America.

Though the overall current impact on income distribution and poverty of the capital surges to the LAC region seems positive, there are serious concerns about the medium-term impact. Unless these flows lead to increased investment in tradeables, and unless they are sustained or taper off only slowly, they seem to pose serious risks for the sustainability of the growth that they have helped to spark off. Should growth falter, or even worse, output fall as result of a serious balance of payments crisis, then the effects on the poor and on income distribution can be very negative, as occurred in the eighties and in 1995 in Mexico.

A great deal seems to depend on how Latin American governments manage these capital surges. In the short-term, these flows seem to provide a valuable increase in the range of manoeuvre for governments to increase spending on social sectors, particularly that targeted on the poorest groups in the society. It is important that governments take this opportunity and that international institutions encourage them to do so.

Governments also face the challenge to follow policies that maximise the favourable current impact of capital surges, as well as minimise the risk that future volatility of capital flows could lead to damaging foreign exchange crises. This requires in several cases striking a complex, sophisticated and pragmatic balance in economic policy. The challenges include: a) the appropriate management of macro-economic policy, to sustain growth, and to avoid both excessive over-valuation of the exchange rate and excessive growth of aggregate demand; b) the management of capital account liberalisation, such that allows economies the benefits particularly of long-term capital inflows, but protects them from the volatility of short-term inflows, (the latter can, where appropriate, include the need to regulate or discourage such short-term flows); c) deepening of capital markets in ways that encourage higher productive investment, including hopefully also by smaller and medium enterprises, and d) greater prudential regulation of the financial system to protect it from external - or internal - shocks. This implies in particular to broaden regulations to cover new developments linked to the rapid capital surges. Finally, as appropriate basis for action, governments need to monitor capital inflows and their impact on the domestic economy (both macro and micro-economic) carefully, so they have precise information, on which to base their policy decisions.

There is growing evidence and acceptance that the impact of capital flows is most beneficial in the medium and long-term in those countries where governments use a wide range of policy instruments to manage such flows, and thus avoid serious distortions of key macro-economic variables, such as the exchange rate. This wide range of instruments includes both conventional measures (such as improving the fiscal position and liberalising imports as well as capital outflows) and less conventional measures (such as measures to discourage short-term capital inflows like the reserve requirements and taxes which were for example applied by the Chilean economic authorities). Though clearly not a panacea, measures to discourage short-term capital flows, can be a valuable ingredient in a policy package to manage capital flows in a way that: a) maximises long-term benefits for growth; b) maintains competitiveness, essential for the success of the NEM and c) avoids financial crisis, which are so costly to the economy as a whole, but particularly so for the poorest sectors in the population.

Thus, avoidance of future international and domestic financial crises is a crucial task for LAC governments. It is something which neither they, nor far more, the poor of the region, can afford to get wrong.

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