*New Global Financial Trends: Implications for Development**

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ONE of the most dramatic political-economic changes over the last 15 years has been the shift in patterns of international finance. At the beginning of the 1980s, a select group of prosperous Third World nations had privileged access to an enormous volume of commercial bank credit. They could also attract fairly important levels of direct investment. For all practical purposes, finance was no longer a binding constraint on the development strategies of this group of countries. Although poorer developing nations could not rely on private credit or investment, many of them had access to substantial amounts of funds *via* bilateral donors and the multilateral institutions. The

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industrial world relied, to much greater extent, on its own domestic capital markets to meet its financial requirements.

By the latter half of the 1980s, in contrast, Third World countries from Latin America and Africa had become largely marginalized from global capital flows, which were increasingly circulating among industrial nations. Insofar as they were still available to developing countries, capital inflows were swamped by amortization and, especially, by burgeoning interest payments. Indeed, a significant number of developing countries had become exporters of capital. The result was a reversal of what development theorists had traditionally argued were the appropriate roles for developed and developing economies. The former were supposed to save more than they spent and export more than they imported, while the latter were supposed to consume more than they were able to save and import more than they exported. As a result, capital flows would go from developed to developing countries.

In the early 1990s, a third pattern has emerged. Although developed countries continue to absorb the vast majority of funds, an increase in the total amounts in circulation, in the context of reforms in developing countries and lower international interest rates, has led to a massive return of private flows to Latin America and some other developing countries. Unlike the 1970s and early 1980s, this inflow is coming mainly *via* portfolio and direct investment rather than commercial bank lending.

This article explores this financial reallocation to document its characteristics, explain its occurrence, and examine its consequences. It provides data on the shifts in suppliers and recipients of foreign capital. To account for these shifts, it looks at structural changes in the financial markets themselves, the underlying macroeconomic and trade patterns in the industrial countries, the debt crisis of the 1980s, and changes in the economic policies of developing countries. It next focuses, in more detail, on financing patterns in different parts of the Third World, including return of private capital to several of the developing nations in the early 1990s, as well as the costs and

benefits of the different patterns. The conclusion discusses implications for development strategy and outcomes in different regions of the Third World in the years ahead.

CHANGING FINANCIAL STRUCTURES AND PATTERNS

A. Trends

WHILE there is no doubt that both suppliers and users of foreign capital changed during the 1980s and early 1990s, it is not easy to provide a systematic picture of these changes. Most analysts have been interested either in flows among industrial countries or flows to and from the developing countries; thus the relevant data are rarely presented in a form comparable for all countries. Moreover, the International Monetary Fund (IMF) — which does collect information on all countries — has discovered large discrepancies when trying to aggregate data for the entire world.[1] Keeping these problems in mind, we first present data on long-term capital flows by recipient region during the 1980-92 period (Table 1) and then turn to data on the composition of capital flows (Table 2) and suppliers of funds (Table 3).

Four sub-periods can be identified in the period analyzed. The first was 1980-82, the years before the debt crisis erupted, in which trends present during the 1970s were largely continued. The second encompassed 1983-86, the period of early adjustment to the debt crisis and the "flight to quality," which involved a new preference for low-risk investment in highly creditworthy, borrowing nations. The third period covered 1987-90, when the overall volume of capital flows increased dramatically following the 1985 Plaza Accords, which raised the value of the yen and led to increased Japanese investment abroad, but with the emphasis on quality investment continuing. The last period was that of 1991-92, when total capital flows continued to increase very rapidly, but the share of flows

Table 1. Long-term Net Inflows and Net Transfers of Foreign Capital by Recipient, 1980-92
(annual averages in billions of dollars and percentages)

Recipient	1980-82		1983-86		1987-90		1991-92	
Total net inflows[a]	257	(100.0%)	288	(100.0%)	540	(100.0%)	845	(100.0%)
Industrial nations[b]	147	(57.2)	210	(72.9)	458	(84.8)	700	(82.8)
Developing nations[b]	110	(42.8)	78	(27.1)	82	(15.2)	145	(17.2)
Africa[b]	16	(14.5)	11	(14.1)	17	(20.7)	19	(11.7)
Asia[b]	24	(21.8)	27	(34.6)	30	(36.6)	55	(37.9)
Western Hemisphere[b]	44	(40.0)	19	(24.4)	20	(24.4)	49	(33.8)
Other[bc]	26	(23.6)	21	(26.9)	15	(18.3)	22	(15.2)
Total net transfers[d]	69	(100.0)	78	(100.0)	206	(100.0)	530	(100.0)
Industrial nations	33	(47.8)	84	(107.7)	217	(105.3)	488	(92.1)
Developing nations	36	(52.2)	-6	(-7.7)	-11	(-5.3)	42	(7.9)
Africa	7	(19.4)	1	e	3	e	3	(7.1)
Asia	9	(25.0)	8	e	6	e	19	(45.2)
Western Hemisphere	12	(33.3)	-21	e	-19	e	14	(33.3)
Other	8	(22.2)	6	e	-1	e	6	(14.3)

Source: Calculated from IMF, *Balance of Payments Yearbook*, Vol. 2, 1987, 1991, and 1993 issues.
a - Net inflows = flows into region (of types shown in Table 5.2) minus repayments
b - Categories as defines by IMF
c - Other = Middle East and "non-industrialized" Europe
d - Net transfers = Long-term net inflows minus income on long-term investment (authors' estimates based on World Bank figures; see note b, Table 2)
e - Percentages not meaningful because of negative total for developing nations

Table 2. Long-Term Net inflows and Net Transfers of Foreign Capital by Type of Flow, 1980-92
(annual averages in billion of dollars)

Type of flow	1980-82 Ind.	1980-82 Dev.	1980-82 Total	1983-86 Ind.	1983-86 Dev.	1983-86 Total	1987-90 Ind.	1987-90 Dev.	1987-90 Total	1991-92 Ind.	1991-92 Dev.	1991-92 Total
Official transfers	23	15	38 (14.8)[a]	26	16	42 (14.6)	51	20	71 (13.1)	97	26	123 (14.6)
Direct investment	37	18	55 (21.4)	43	14	57 (19.8)	138	23	161 (29.8)	109	45	154 (18.2)
Portfolio investment	48	4	52 (20.2)	112	3	115 (39.9)	188	6	194 (35.9)	374	37	411 (48.6)
Other Long-term capital	32	56	88 (34.2)	17	12	29 (10.1)	78	-7	71 (13.1)	119	8	127 (15.0)
Exceptional financing	7	17	24 (9.3)	12	33	45 (15.6)	3	40	43 (8.0)	1	29	30 (3.6)
Total net inflows (LT)	147	110	257 (100.0)	210	78	288 (100.0)	458	82	540 (100.0)	700	145	845 (100.0)
Investment income[b]	114	74	188	126	84	210	241	93	334	212	103	315
Total net transfers	33	36	69	84	-6	78	217	-11	206	488	42	530

Source: Calculated from IMF, *Balance of Payments Yearbook*, Vol. 2, 1987, 1991, and 1993 issues.
a - Figures in parentheses are percentages of total net inflows
b - Long-term investment income for loans is approximated by using the relevant percentages for long and short-term interest payments provided in World Debt Tables.

Table 3. Long-term Net Outflows of Foreign Capital by Supplier, 1980-92
(annual averages in billions of dollars and percentages)

Supplier	1980-82		1983-86		1987-90		1991-92	
Industrial nations	185	72.0%	260	83.3%	528	86.6%	675	81.8%
United States	39	15.2	37	11.9	51	8.4	95	11.5
United Kingdom	29	11.3	38	12.2	62	10.2	82	9.9
Germany	25	9.7	32	10.3	75	12.3	103	12.5
France	21	8.2	16	5.1	44	7.2	69	8.4
Japan	22	8.6	77	24.7	153	25.1	94	11.4
Other	49	19.1	60	19.2	143	23.4	232	28.1
Developing nations	39	15.2	5	1.6	20	3.3	45	5.5
Africa	1	0.4	1	0.3	1	0.2	1	0.1
Asia	1	0.4	3	0.9	9	1.5	16	1.9
Western Hemisphere	2	0.8	1	0.3	4	0.7	7	0.8
Southern Europe	1	0.4	1	0.3	1	0.2	-	-
Middle East	34	13.2	-1	-0.3	5	0.8	21	2.5
International organizations	33	12.8	47	15.1	62	10.2	105	12.7
Total net outflows[a]	257	100.0	312	100.0	610	100.0	825	100.0

Source: Calculated from IMF, *Balance of Payments Yearbook*, Vol. 2, 1987, 1991, and 1993 issues.

a - In principle, total net inflows and outflows for tables 5.1-5.3 should be identical (except for the inclusion of international organizations in Table 3); as has long been observed in practice, however, there are serious statistical problems in reconciling international accounts. See endnote 1 for a source on this issue.

going to developing countries started to grow again due, in the main, to a rise in the share of capital going to Latin America.

Table 1 presents data on these four periods for average net long-term capital flows to industrial and developing countries and on net transfers.[2] As can be seen, the industrial countries' share of net capital flows increased from 57% in 1980-82, to 73% in 1983-86, and then up to 85% in 1987-90.[3] A parallel shift took place within the developing world. The Asian countries, which were perceived as the best credit risks in the Third World, increased their share of those diminished financial resources still available to nonindustrial nations from 22% in 1980-82 to 37% in 1987-90. This increase in resources going to Asia during the 1980s came primarily at the expense of Latin America and the Middle East (included in "other" in the table). The share going to Africa actually increased a bit during the 1980s, largely as a result of the response of the industrial governments to the serious crises and emergencies taking place in that region.

During the early 1990s, the pattern shifted in significant ways. The share of capital flows going to industrial nations fell slightly from the 1987-90 peak, declining from 85% to 83%, though still remaining very high. Among the developing regions, the share going to Asia continued its climb upward even as other regions underwent major changes. The absolute value of capital inflows to Latin America more than doubled, while the share going to the region rose, in percentage terms, from 24% to 34%. The main loser was Sub-Saharan Africa, whose share fell: from 21% down to 12% of total capital inflows. The "other" regions also saw a decline, though smaller, in percentage share: from 18% to 15%.

The trend in net transfers was even more dramatic, as the industrial nations went from 48% of the total in 1980-82 to 105% in 1987-90.[4] The latter was possible because developing countries became exporters of capital in the last half of the decade. A disaggregation among the developing countries highlights the particularly negative situation that afflicted Latin America in the 1980s. The region experienced heavy net outflows, on the order of 4% of GDP, while the Asian nations

continued to receive large net inflows. Though net transfers to the African countries fell sharply after 1982, they never became negative. The most important change in the early 1990s was that the developing countries, as a group, again became importers of capital, i.e., they again had positive net transfers. The change was due mainly to the Latin American countries, whose net transfer position shifted from one of fairly large negative flows to that of large positive ones.

Table 1 also shows the increase in overall volume of capital flows circulating among countries. The average more than doubled (in nominal dollar terms) from $257 billion in 1980-82 to $540 billion in 1987-90; it again increased very significantly — to $845 billion — in 1991-92. This represents an annual average rise of nearly 15% over the 12-year period. Discounting for inflation, the increase, in real terms, was around 10% per year,[5] well above the growth rate of the gross domestic product (GDP) for even the fast-growing Asian region. This would seem to offer evidence that the fear, in the late 1980s, of a worldwide capital shortage was not valid, despite the fact that a large proportion of the capital flows among countries does not involve investment or trade but, rather, activities such as foreign exchange speculation. The allocation of capital between developed and developing countries is a separate issue that may be a cause of greater concern.

Table 2 highlights the changing composition of capital flows during the period analyzed. Overall, the most important increase was in portfolio investment, which rose from 20% to 49% of the total. Direct investment, which had increased from 21% to 30% in the 1980s, declined sharply — to only 18% — in the early 1990s. "Other long-term capital," mostly commercial bank loans, but also including official (bilateral and multilateral) loans at commercial rates, fell in absolute, as well as relative, terms in the 1980s: declining from 34% of total capital flows in 1980-82 to just 13% in 1987-90. The share increased somewhat in the early 1990s.

For industrial nations, virtually all types of capital flows increased substantially during the 1980s, although the most

important increases were in direct and portfolio investment. In the early 1990s, direct investment going to industrial countries fell; at the same time, portfolio flows to industrial nations doubled.

During the 1980s, the developing countries experienced a drop in net inflows, most of which is attributable to the decline of commercial bank credit. Only exceptional financing (flows resulting from debt restructuring) showed a large increase. Even adding together new bank loans and restructuring components, however, there was still a significant drop-off in bank credit, which had been *the* dominant component of international finance for developing countries during the 1970s and early 1980s. Although the flow of direct investment to the developing countries increased sharply in the early 1990s, the flow of portfolio investment to those countries increased far more, growing by more than 500% between 1987-90 and 1991-92. In this latter respect, flows to developing countries in the early 1990s began to follow trends similar to those in the industrial world during the 1980s. Another significant development was that commercial bank credit extended to the developing countries, as a whole, again turned positive, signalling the improved outlook for the debt problem. Nonetheless, the fact that there were still substantial amounts of financial restructuring (although less than in the second half of the 1980s) showed that some countries, especially those in Africa, continued to suffer a severe debt crisis.

One particularly surprising trend, noted in Table 2, is that official transfers (grants and concessional loans) to industrial countries increased dramatically, both in absolute terms and as a proportion of total transfers. While official transfers going to developing nations increased from $15 billion in 1980-82 to $26 billion in 1991-92 (less than double), official transfers to industrial countries increased from $23 billion in 1980-82 to $97 billion in 1991-92 (a fourfold increase). It should be noted that the latter figure includes an extraordinary onetime item: the large transfers to the United States, by countries like Saudi Arabia and Kuwait, that were linked to the Gulf War. If these

are excluded, official transfers to industrial nations reached around $75 billion in 1991-92, a level more than triple that of the 1980-82 period. The unexpected fact that official transfers to developed countries grew far faster than those to the developing nations seems to be explained by an important increase in official transfers within the European Community (EC). Indeed, the decision to establish the Single European Market (SEM) and the third enlargement of the EC provided the catalyst for a major increase in the European Commission's expenditure on the so-called Structural Funds. Consequently, the resources allocated through those funds almost doubled, in real terms, between 1987 and 1993, reaching ECU 62 billion ($77 billion) in 1993 (see Griffith-Jones and Stevens, 1992).

Finally, Table 3 suggests some of the shifts that took place in the major suppliers of foreign capital. At the beginning of the decade, the United States was the single largest exporter of capital to the rest of the world: between 1980 and 1982, it provided 15% of all capital. Other large industrial country suppliers were the United Kingdom (11%), Germany (10%), and France and Japan (8% each). In addition, the Middle East (mainly Saudi Arabia and Kuwait) also served as a major supplier, providing 13% of the total volume of foreign capital during the 1980-82 period.

By the end of the 1980s, however, the picture had shifted in several ways. The share of capital supplied by the United States had fallen to 8%, while that from the United Kingdom and France declined only marginally (to 10% and 7%, respectively); meanwhile, the Middle East had nearly disappeared as a supplier of capital (less than 1%). Indeed, between 1983 and 1986, the Middle East had become a net importer of capital. The other side of this picture was the increased role of Germany (who accounted for 12% of total capital) and, especially, Japan (25%). Among the developing countries, Asia had come to surpass the Middle East as a source, supplying 1.5% of the total capital export. The international financial institutions (the World Bank and the regional development banks, excluding the IMF) increased their share of net capital flows between

1980-82 and 1983-86 from 13% to 15%, which subsequently fell (to 10%) during the latter part of the decade since new loans by the multilateral banks failed to keep up with repayments on older credits (Feinberg, 1986).

Even though the United States increased its share of capital supply to 11.5% of the total in the early 1990s, it was still only the second largest supplier, with Germany being the largest, at 12.5%. At the same time (early 1990s), Japan's share fell sharply, to just 11%, reflecting (1) a fall in Japan's direct investment in the United States and in Japanese purchases of US Treasury Bonds, and (2) an unprecedented economic crisis in Japan itself — both of which caused a strong portfolio shift to shore up domestic businesses.

In sum, then, four major changes in international capital flows occurred during the period analyzed. *First*, the overall volume of flows increased significantly. *Second*, a major change in recipients shifted money away from the developing countries and toward the industrial nations during the 1980s, a trend that was only partially reversed in the early 1990s. Within the developing world, from the mid-1980s onwards, Asia replaced Latin America as the largest recipient of foreign finance and investment. *Third*, direct investment and portfolio investment displaced commercial bank credit as the major types of capital flows. *Fourth*, as of the late 1980s, Japan and Germany came to displace the United States as the largest supplier of capital. By the early 1990s, then, the three were functioning at roughly the same level, as US capital exports rose and those of Japan fell.

B. Explanations

These four changes — increased volume of capital in circulation, increased absorption by industrial countries, increased importance of direct and portfolio investment, and increased role of Japan and Germany as suppliers — are interrelated. The various explanatory factors, taken together and discussed below, account for this set of changes in patterns of global financial flows during the 1980s.

One of the most important of these factors involved changes in the structure of the financial markets. Such changes had actually begun in the 1960s with the emergence of the Euromarkets. These offshore financial markets grew very rapidly, from an estimated $100 billion in 1970 to over $800 billion in 1980. The reasons for this growth are well known: lack of regulation of the Euromarkets in general (including lack of reserve requirements) supplemented by petrodollars deposits after the 1973-74 and 1979 oil price increases.[6]

Initially, these new international markets remained separate from the domestic capital markets in the industrialized nations. Gradually, however, this wall began to break down as governments of the industrial countries liberalized access and major markets became more integrated. Liberalization had several manifestations. One was the dismantling of barriers to cross-border financial flows. This involved elimination of taxes, exchange controls, and various types of restrictions on access to domestic markets. Second, as a result of the new access, banks began either to set up branches, or to buy other banks, in industrial countries. This trend was especially noteworthy in the United States, where Japanese and European banks became important actors. With the acceleration of European integration, branching became popular in Europe as well, although greater obstacles to foreign banking remained in Japan. Once branches were established, they had to justify their existence by increased lending. Third, many new financial instruments were developed, which also speeded up growth in capital markets. In general, securitization became more important at the expense of bank loans, assets were packaged into tradeable securities, and futures and options gained popularity. Swaps were added in the 1980s, and international mutual funds brought individual investors into the market, increasing available capital. In the early 1990s, international bond markets were again opened to developing nations, and American and global depository receipts (ADRs/GDRs) provided their companies with access to the stock markets of industrial countries.[7]

During the 1970s, these innovations had led to greatly increased access to international finance for some developing countries *via* the Eurocurrency market, and a subset of middle-income developing countries became favored clients of the international banks. In the 1980s, however, financial innovations, in conjunction with other developments, led to a greater concentration of capital flowing to the industrial countries.

One of these developments was the debt crisis, which erupted in August 1982.[8] When the Mexican government declared it could not continue to meet its payments on the previously-agreed schedule, the bubble burst on Third World debt. Thus, bankers — as a group — decided to stop loans to virtually all the nations in Latin America plus the few in Africa that had been able to borrow on the private markets. However, because Asian borrowers (with the exception of the Philippines) were viewed as more creditworthy, they continued to have access to commercial bank finance. Loans of the 1970s and early 1980s had been voluntary since the banks had eagerly sought out borrowers in order to increase their profits. It was these voluntary loans that ended for Latin America and Africa.

In their place came "involuntary" loans, but the volume of the latter was significantly lower than those they replaced. Involuntary loans were one component of the package deals that international financial institutions and governments of industrial countries put together to deal with the debt crisis. That is, banks were forced to provide new loans, equivalent to a certain percentage of their exposure, in order to obtain the help needed to secure their existing loans. These loans were combined with ongoing negotiations to reschedule amortization payments falling due. Although euphemistically referred to as "new money," the involuntary loans mainly served to enable debtor countries to maintain interest payments on their debts.

The *quid pro quo* for the rescheduling and new loans to Latin America and Africa was the imposition of policy conditions, designed to free up resources for servicing the debt. These policies were formulated in close collaboration with the IMF and World Bank, which also provided their own loans to

help with debt service and to offer incentives for policy change. Initially, the new policies involved typical IMF-designed measures to cut domestic spending. The resulting recession served to reduce imports, which, in turn, generated trade surpluses that allowed the large net transfer of financial resources to take place. During the course of the decade, however, policies evolved toward so-called structural adjustment, whereby governments cut back on their own role in the economy, liberalized their domestic markets, and lowered the barriers to foreign trade and capital flows.

The results were mixed. During the 1980s and, in particular, the early 1990s, some Latin American countries experienced renewed growth while others (especially in Africa) remained mired in recession or even depression. The Asian countries, by contrast, grew rapidly, quickly overcoming whatever debt problems they had. The change in Latin American economic policies combined with the upsurge in regional growth rates in the early 1990s served to revive the interest of international investors to the point of reversing the negative flow of resources that had characterized much of the developing world throughout much of the previous decade. Nevertheless, and as will be seen below, interest rate trends in the industrial countries were also an essential complement to events internal to the Third World, leaving the durability of the new capital flows open to some question.

At about the same time (early 1980s) that many of the developing countries were first running into the severe debt problems that led to capital outflows, industrial world trends were moving in directions that served to increase capital inflows to those countries. Specifically, fiscal and trade deficits began to grow. The United States, of course, was by far the most prominent case. During the Reagan/Bush years, the US budget deficit increased from $76 billion in 1980 to $219 billion in 1990, while the current account of its balance of payments went from showing a surplus of $2 billion in 1980 to a peak deficit of $160 billion in 1987, which subsequently fell off to $92 billion in 1990.[9] Given the low (and declining) rate of savings

by the private sector, the only way the country could sustain such large deficits was through foreign borrowing. By 1984, therefore, the United States had become the world's largest debtor as foreigners became major purchasers of the US government securities used to finance the growing budget deficit. These funds functioned, simultaneously, as the counterpart of the trade deficit (IMF, 1988).

The trade deficit stimulated capital flows into the United States in at least two other ways as well. On the one hand, the most conspicuous imbalance in the US trade deficit was with Japan, which brought forth growing calls for protection against Japanese imports. In response, "transplants" were established, in which Japanese firms set up production facilities (especially in the automobile and electronics industries) in the United States as a substitute for exports. [Nonetheless, the high level of imported inputs used by these plants served to keep the US deficit high.] On the other hand, attempts to cut the trade deficit led to the Plaza Accords in the Fall of 1985 which were designed, in part, to lower the value of the dollar in order to make US exports more competitive. The higher value of the yen resulted in more Japanese investment abroad. Although some of this investment went to Asia, most wound up in the industrial countries, and in the United States in particular, thereby only reinforcing the trend toward transplant industries (see Gereffi, 1995).

Other industrial countries also ran large fiscal deficits in the 1980s, as expenditures grew and revenues failed to keep pace. At the time, virtually all of these countries ran deficits on their central government accounts, while all but Japan also had deficits on the broader, general government accounts. Not only did these governments exhibit differences in both the pattern and size of their deficits but also, and more importantly, in their ability to finance the deficits and domestic investment through private savings. With the exception of Germany and Japan, all of the major industrial countries turned to external savings during the 1980s, whereas this was true only of the United Kingdom and Canada during the 1970s.[10]

It is generally acknowledged that the budget deficits racked up under the Reagan administration (1980-88) were a crucial factor in pulling the US economy out of the recession that marked the early 1980s. Indeed, unlike the situation in the earlier postwar period, the United States grew faster — from 1983 to 1988 — than did the major European countries, or even Japan. Under the Bush administration (1988-92), however, US growth fell off due, at least in part, to attempts at cutting the deficit. The counterpart of this effort was a drop in interest rates, which fell from relative highs in 1989 to postwar lows in 1993 before turning up again. It was this decline in interest rates that led US investors, subsequently followed by the Europeans when their rates began to fall as well, to look abroad for better returns; Asia and Latin America appeared especially attractive in this context.[11]

As noted earlier, these international financial trends, and the factors propelling them, are exceedingly complex and intertwined. The increase in volume of the international capital flows derived from shifts that took place on both the supply side (changes in market structure) and the demand side (increased deficits in the industrial countries, especially the United States). Although demand for capital in the Third World continued, inability to pay rendered this demand ineffective in most countries outside Asia up until the early 1990s. Sources of supply moved toward the nations with big surpluses in their current accounts: these were no longer members of the Organization of Petroleum-Exporting Countries (OPEC) but, rather, Japan and also Germany (until reunification absorbed the German surplus). The type of capital exported changed from an emphasis on bank loans to direct, and portfolio, investment as a consequence not only of demand in the industrial countries but also of the interests of suppliers. Thus, the preference for bank deposits of the OPEC governments was replaced by German and Japanese private-sector preference for equity shares, real estate, and production facilities, as well as for government securities. In the early 1990s, the countries of Latin America began to join their East Asian counterparts as participants in these new forms of international finance.

CONTRASTING PATTERNS OF EXTERNAL FINANCE FOR THE THIRD WORLD

THE flows of capital to different regions of the developing world in the 1980s and early 1990s have displayed significantly different features in terms of their stability and composition. The most positive pattern was found in Asia, where not only did net inflows increase gradually over time but also where the largest volume of inflows was directed. By comparison, Latin America experienced a very volatile pattern of capital inflows: high at the beginning and end of the period under discussion, but low in between. Meanwhile, Africa's access to external finance stagnated, remaining at a relatively low level.[12]

Table 4 provides details on these diverging patterns. The most dramatic, by far, was found in Latin America. The average capital flows going to Latin America in 1980-82 were nearly twice as high as those going to Asia, and three times as high as those directed to Africa. By the middle of the decade, following onset of the debt crisis, these flows had collapsed to only 40% of their previous levels where they remained — well below the inflows to Asia — through to the end of the 1980s. By the beginning of the 1990s, however, the flows more than doubled, rising to figures that exceeded those received before the debt crisis began; nonetheless, these still remained less than the flows going to Asia.

There were several determinants behind these fluctuations. Most obvious, in the beginning, was the behavior of commercial bank loans (the major component of the "other long-term capital" category). By the early 1980s, these loans had come to account for over half of all capital inflows to Latin America. They became negative after 1983 as lenders refused to roll over the maturing credits. To some extent, the outflows were compensated for by restructuring loans ("exceptional financing"), but the totals for the two types of finance fell from an average of $33 billion in 1980-82, down to $11 billion in 1983-90, and, finally, to just $5 billion in 1991-92. It should be

Table 4. Long-term Net Inflows of Foreign Capital to Developing Countries by Region, 1980-92
(annual averages in millions of dollars)

Type of Flow	1980-82	1983-86	1987-90	1991-92
Western Hemisphere				
Official transfers	1,231	1,571	2,219	2,831
Direct investment	6,719	3,470	6,081	13,545
Portfolio investment	2,364	- 616	3,980	26,988
Other long-term capital	26,660	-8,971	-18,271	-2,803
Exceptional financing	6,891	23,426	25,597	8,214
Net long-term flows	43,897	18,879	19,606	48,775
Asia				
Official transfers	3,121	3,382	3,908	4,022
Direct investment	3,859	5,043	13,896	24,005
Portfolio investment	1,431	2,771	343	6,219
Other long-term capital	15,299	15,253	11,610	18,863
Exceptional financing	681	866	693	1,453
Net long-term flows	24,391	27,314	30,449	54,562
Africa				
Official transfers	4,077	4,261	6,898	9,806
Direct investment	1,316	900	1,616	2,523
Portfolio investment	-305	47	-422	1,091
Other long-term capital	7,846	1,696	-480	-4,600
Exceptional financing	3,410	4,392	9,176	9,910
Net long-term flows	16,344	11,296	16,817	18,730

Source: Calculated from IMF, Balance of Payments Yearbook, vol. 2, 1987, 1991, and 1993 issues.

noted that bilateral and, especially, multilateral loans (the other main components of "other long-term capital") increased in importance during the 1980s crisis, only to drop off again in the early 1990s.[13]

More positive from the point of view of volume of capital inflows were direct foreign investment (DFI) and portfolio investment. Although direct foreign investment in Latin America also fell in the immediate aftermath of the debt crisis, it had returned to earlier levels by the end of the decade — and then more than doubled in the early 1990s as transnational firms regained confidence in the region. Portfolio investment followed a similar, but more pronounced, trend, becoming negative in the mid-1980s before rising to unheard-of levels: an average of $27 billion per year by 1991-92. The boom in portfolio investment was also the result of an increased confidence in Latin America, although an equally important "push" came from low interest rates in the United States on the one hand, and from opportunities to obtain onetime profits in Latin American stock markets on the other. Despite the fact that official transfers doubled between the early 1980s and the early 1990s, they remained a very small share of external finance overall.

Trends in Asia differed from those that characterized Latin America in many ways.[14] First, overall flows to Asia started out (early 1980s) at a much lower level than in Latin America, gradually increasing by modest amounts throughout the decade. In the early 1990s, Asia witnessed a substantial jump in foreign capital inflows, although the percentage increase was less than that in the Western Hemisphere.

In terms of the composition of these flows, several important differences with respect to Latin America should be noted. The first of these differences concerns commercial bank lending. With the exception of the Philippines, the Asian nations did not confront serious debt crises in the 1980s. Korea had a debt/GDP ratio similar to that of Brazil and Mexico, but the high level of its export revenues meant that the debt could be serviced without serious problems. Furthermore, banks "regionalized" their perceptions, withdrawing credit from all

Latin American countries but sustaining it in Asia, even in those cases where the economic indicators were fairly similar. As a consequence, the Asian nations never lost their access to commercial bank finance even though the amounts dipped somewhat, in absolute terms, in the late 1980s. The counterpart of this situation is that restructuring finance never reached high levels either. Also important in the Asian context were bilateral non-concessional loans, especially from the Japanese government, as well as some multilateral credits.[15]

Second, DFI in Asia increased steadily throughout the period. The rise was slow until the Plaza Accords in 1985 raised the value of the yen with respect to the dollar, thus driving up costs in Japan and lowering the competitiveness of Japanese exports abroad. Japanese firms countered by moving some of their plants to Southeast Asia (mainly Thailand, Malaysia, and Indonesia), from which they imported a portion of the resulting manufactured items and exported the rest to third countries. A second phase of this process occurred in the latter 1980s when the currencies of South Korea and Taiwan were also allowed to appreciate, and they too began to invest in Southeast Asia. Portfolio investment in Asia also increased substantially in the early 1990s, compared to the 1980s, but it did not reach nearly the volume of similar flows into Latin America. Though official transfers were slightly larger than in Latin America (going mainly to the South Asian nations of India, Pakistan, and Bangladesh), they were not very significant in overall terms.

Finally, Africa illustrates yet a third pattern of capital flows. The debt crisis in Africa, like that in Latin America, led to a drop in total flows to that continent during 1983-86. By the latter part of the decade (1987-90), flows returned to the levels of the early part of the decade, experiencing only a slight rise in the 1990s. In other words, Africa has not participated in the current foreign investment boom enjoyed by Latin America and Asia.

Differences in the composition of capital inflows to Africa, compared to other developing areas, are indicated in Table 4. The most obvious difference is the role of official transfers. These grants and concessional loans represented 25% of total

external finance to Africa in the early 1980s. A decade later, the figure had risen to over 50% as the deep crises of growth and development, and several major emergencies, led bilateral and multilateral donors to respond. The debt crisis meant that commercial bank and other non-concessional lending became negative by the second half of the decade, and restructuring finance increased concomitantly. Figures for both categories in the early 1990s — unlike the situation in Latin America — suggest that the debt crisis in Africa still remains serious. Even in Africa, however, DFI and portfolio investment have increased in the last few years, but the levels are quite low compared to the rest of the third world.

In addition to examining differences in the composition of capital flows over the entire period, it is important to focus specifically on the situation as of the early 1990s, since this is the principal basis for projecting future trends. The current composition of flows varies substantially across regions, as seen in the last column of Table 4. The dominant component of Asian flows is DFI (44% of the total), followed by commercial bank and non-concessional public-sector loans (35%). For Latin America the situation is roughly reversed: the most important item is portfolio investment (55%) with DFI in a distant second place (28%). In Africa, official transfers and restructuring loans are of roughly equal importance.

These differences in the kinds of flows have important implications for development prospects. In financial terms, the official transfers from bilateral aid agencies and special programs in multilateral organizations are the most favorable type of flow, since they either do not have to be repaid at all (grants) or carry very low interest rates and long maturities (concessional loans). Precisely because they have such favorable terms, however, such funds are available only to the very poorest countries in the Third World, located mainly in Sub-Saharan Africa and South Asia. Although Africa receives the large majority of such flows within the Third World, these have generally been insufficient to stimulate much growth given the overwhelming problems in the region (see Stallings, forthcoming: Chapter 10).

Next in favorability of financial terms have traditionally been the bilateral and multilateral non-concessional loans. The former have usually been export credits tied to the purchase of the exports of the donor nation. In the case of Japan, however, a new type of "untied" loan for middle-income countries was introduced in the late 1980s as part of Japan's attempt to recycle its large trade surplus and to dampen complaints by the United States. Although these credits, whether bilateral or multilateral, have shorter maturities and higher interest rates than concessional loans, they nonetheless tended, in the past, to carry more favorable terms than those of commercial banks or the bond markets. In the early 1990s, however, very creditworthy developing countries have been able to raise private funding at a lower cost (albeit with shorter maturities) than they could obtain *via* multilateral loans.

Commercial bank loans, on the whole, have higher interest rates (and other fees) and, above all, shorter maturities. They also tend to have floating interest rates, which complicates calculation of service requirements and increases the instability of debt service. Nonetheless, during the 1970s, Third World governments thought they offered significant advantages in comparison to other types of finance. Commercial bank loans were seen as superior to bilateral and multilateral loans because they did not have conditions attached, and they were regarded as better than DFI because recipient governments could exercise more control over their use. Once these loans expanded to the point where they could not be serviced, however, multilateral conditionality reappeared, as discussed earlier.

Direct investment, shunned in the 1970s in favor of bank loans, came to be viewed in a more positive light in the 1980s. Several factors probably accounted for this change of opinion on the part of developing countries in addition to the fact that bank loans were no longer available except in Asia. First, these flows are perceived as more stable because it is difficult to withdraw fixed capital assets. Second, profit outflows vary with the economic cycle, so that servicing direct investment is easier than servicing loans. Third, direct investment is a way to import

technology and know-how. And, fourth, direct investment can facilitate exports. Southeast Asian countries provide good examples of these advantages, as the DFI from Japan and the East Asian NICs has gone heavily into the production of manufactured exports. The relationship between DFI and exports, however, is less clear in other regions.

Finally, there is the new portfolio investment. These flows can be divided into various categories, as seen in Table 5. The largest is bonds, which has accounted for well over half of all portfolio investment in recent years. Bonds have the advantage of being mainly at fixed interest rates, but the average maturity for bonds issued by developing countries in the 1990s is very short (at around four years for Latin America, for example). This implies that a large portion of the stock of bonds could be fairly rapidly withdrawn, should the bonds not be renewed in the future. Less dramatic, but also cause for concern, is the risk that, even if the bonds are renewed, the cost of borrowing may increase significantly; since maturities are so short, the risk of cost increases could arise fairly soon.

A new form of external private funding is international equity investment, composed of direct equity investment, American and global depository receipts (ADRs/GDRs), and investments *via* mutual funds. As Table 5 shows, these have, together, provided about a third of the portfolio investment going to developing countries between 1989 and 1993. Like DFI, these international equity flows have the advantage of a degree of cyclical sensitivity of dividends, but they also carry important risks for the recipient countries. For various reasons, investors could stop investing in equities, and even try to sell their stock quickly, if they feared worsening economic or political prospects in a country. This could lead to pressure on the exchange rate and/or falls in prices on the domestic stock exchanges. Although 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 bank and security activities are closely integrated through cross holdings or

Table 5. Portfolio Investment in Developing Countries by Instrument, 1989-93
(millions of dollars)

Instrument	1989	1990	1991	1992*	1993*
Foreign equity investment	3,485.7	3,773.6	7,552.2	13,073.1	13,190.6
Closed-end funds	2,199.4	2,867.4	1,196.0	1,344.1	2,737.3
ADRs/GDRs	0.0	138.0	4,902.2	5,933.0	7,252.0
Direct equity investment	1,286.3	768.2	1,454.0	5,796.0	3,201.3
Debt instruments	4,030.4	5,555.0	12,723.2	23,736.7	42,600.0
Bonds	3,543.1	4,683.0	10,193.5	21,244.7	39,190.0
Commercial paper	327.3	225.0	1,380.0	851.0	1,610.0
Certificates of deposit	160.0	647.0	1,149.7	1,641.0	1,800.0
Total	7,516.1	9,328.5	20,275.5	36,809.8	55,790.6

Source: World Bank, World Debt Tables, 1993-94, Vol. 1, p. 21.
* estimated

investor leveraging. To the extent that a growing part of investment in Third World stock markets originates with institutional investors, who seem to allocate their assets using more long-term criteria, the risk of large outflows is reduced (Griffith-Jones, 1995; see also Corbo and Hernández, 1994).

It has been argued that the composition of capital inflows into Asia and Latin America has important effects for the impact of, and reactions to, such flows (Calvo, Leiderman, and

Reinhart, 1993). One such impact concerns the relationship between capital inflows and investment in the recipient country. Specifically, DFI is directly linked to investment, while other types of flows may go for other purposes. Thus, the fact that DFI predominated in flows to Asia seems to be an important reason why recent capital inflows have been associated with increased investment, whereas the lower proportion of DFI to Latin America in the same period may be an important factor explaining why the surge in foreign capital has not been matched with a corresponding increase in investment. It is interesting to note, in this context, that Chile, one of the Latin American countries that has attracted a higher proportion of DFI, has also seen its level of total investment increase far more than the rest of Latin America during this period.

The different composition of flows also helps to explain the differential macroeconomic impact of such flows. As Calvo, Leiderman, and Reinhart (1993) show, the recent surge in capital inflows in Latin America has been accompanied by appreciation of the real exchange rate; whereas in Asia such an appreciation is less common. Excessive appreciation of local currencies is undesirable because it discourages the production of tradeable goods. Such appreciation has been partially avoided in Asia because DFI has led to higher investment, which requires large-scale imports of capital goods (in a far higher proportion than do increases in consumption).[16]

Direct foreign investment would also seem to pose fewer problematic effects for the conduct of monetary policy. Since DFI is not usually intermediated through the domestic banking system, there is no accompanying expansion in domestic credit and, therefore, the difficult issue of sterilization of such monetary expansion is less important (see Devlin, Ffrench-Davis, and Griffith-Jones, 1995). Thus, the differences in the composition of capital flows, as well as differences in the historical stability in evolution of such flows, may help explain why concerns over "hot money" and a sudden reversal are more prevalent among Latin American policymakers than among their Asian counterparts.

In addition to their possible impact on investment and macroeconomic policy in recipient countries, financial flows also have an impact *via* conditionality. In the 1980s, an important by-product of the debt crises in Latin America and Africa was the increased role that the IMF, World Bank, and regional development banks played in assembling the restructuring packages for countries in those two regions. As discussed earlier, attached to these packages were a large number of policy conditions that greatly affected the conduct of economic policy in those countries.[17] Some analysts even referred to an "explosion" of conditionalities.[18]

At least three types of conditionality need to be distinguished briefly here. First are macroeconomic conditions, oriented primarily towards eliminating deficits in the budget and balance of payments. While economists in the international financial institutions (IFIs) had long advocated the imposition of macroeconomic conditions, their impact became much more pervasive in the 1980s as a consensus on their advisability emerged among donors, both public and private. In the previous decade, private creditors had undermined the influence of the IFIs by providing large amounts of finance to the wealthier developing countries in Latin America and East Asia with virtually no strings attached. Consequently, only the African region was generally subject to strict conditionality in the 1970s. During the debt crisis of the 1980s, however, the Latin Americans joined the queue for conditioned finance, though most of the Asian countries did not. Again, in the early 1990s, IFI conditionality to Latin America was weakened by increased access to private sources, as several Latin American countries became "reluctant borrowers" from the IFIs.

The second type of conditionality involved structural reform, which was designed to create market-oriented economies in recipient countries. Particular emphasis was placed on opening up Third World economies to international trade and capital and on limiting the role of the state. While the latter was related to the shrinking of fiscal deficits mentioned earlier, it

extended to liberalization, deregulation, and the sale of state firms as well. These structural conditions had been part of IFI programs for Africa throughout the 1980s, but they did not become generalized to other regions until the announcement of the Baker Initiative in the Fall of 1985. With this initiative, then-US Secretary of the Treasury James Baker also tried to move debt policies beyond austerity and toward growth. The basic idea was that freer markets and an active role for the private sector would function as the motor for renewed growth. The main instrument for these policy conditions became the structural adjustments loans (SALs) of the World Bank.

A brief review of the main policy conditions advocated by the IFIs and others in Washington, as seen by an influential think-tank, will serve to summarize the *quid pro quo* that accompanied official loans in the 1980s.[19] Later we will discuss the likelihood that they will continue in the 1990s. The policy conditions were said to include: (1) elimination of large fiscal deficits, mainly through a reduction in government spending; (2) reorientation of public spending, especially toward education and health and, perhaps, infrastructure; (3) establishment of a broad tax base with moderate rates; (4) market determination of interest rates, preferably at a positive, but moderate, level; (5) maintenance of a competitive exchange rate, so as to promote exports and bring about a current account that could be financed; (6) promotion of exports, especially non-traditionals, and liberalization of imports; (7) encouragement of direct foreign investment to provide capital, skills, and technology; (8) sale of private enterprises, both to relieve the demand for subsidies and because private ownership is believed to be more efficient; (9) deregulation to increase competition and make it easier for the private sector to engage in economic activities; and (10) guarantee of property rights in order to stimulate private investment, both domestic and foreign.

Finally, a third type of conditionality has emerged in the 1990s that goes beyond economic performance.[20] Typical of this new trend are conditions to encourage policies that are pro-

active for the poor, that reduce military expenditures, that encourage respect for human rights, good governance, democracy, and protection of the environment. These conditions were mainly introduced by bilateral donors; the IFIs have been somewhat more reluctant. There is much less consensus with respect to these noneconomic goals, and individual donors emphasize different aspects. The United States, for example, has placed special stress on democracy, while some Europeans (the Dutch and Scandinavians in particular) have emphasized alleviation of poverty. Japan and Germany have taken the lead in trying to reduce military expenditure. According to a recent analysis, the process also varies with the "new" conditionality (see Nelson and Eglinton, 1993: especially Part IV). Most importantly, both bilateral and multilateral donors have placed more stress on persuasion than on conditionality *per se.* When conditions are used, they have been selective, focusing on cuts in aid to particularly egregious offenders or rewards to outstanding performers. Not surprisingly, the results have been mixed.

IMPLICATIONS FOR DEVELOPMENT AND DEVELOPMENT STRATEGIES

HAVING examined trends in international capital flows in the 1980s and early 1990s, we now turn to our final task and ask about the impact of external financial trends on prospects for development for the rest of the decade. We start by outlining three types of influence that international financial flows can have on development strategies and prospects. Then we focus on regional differences among Africa, Asia, and Latin America.

A *first* way in which international finance has an impact on development strategy is *via* explicit conditionality imposed by the international financial institutions (IFIs). The most explicit conditions are those attached to loans from the IMF and World Bank, but other financial institutions, such as regional development banks and bilateral donors, also impose policy

conditions. In fact, the abundance of institutions and conditions involved, leading to what has been called "cross conditionality," often makes negotiations quite cumbersome (see, for example, Rodríguez and Griffith-Jones, 1992).

Among the varying types of conditionality reviewed in the previous section, it is the structural conditions that are particularly potent in shaping development strategies. They were designed to move Third World countries away from their traditional import-substitution industrialization policies — featuring high levels of protection and a strong role for the state — toward the market-oriented policies advocated by the IFIs. Although there is disagreement on how effective these conditions have been, and they are certainly not the only reasons for the shift, it is hard to deny that IFI conditionality has played a role in the dramatic change in development strategies that occurred in some parts of the Third World over the past decade. This role of IFI conditionality was particularly important in the early 1980s when there was often strong disagreement between the IFIs and developing country governments. By the late 1980s and early 1990s (particularly in Latin America), there was much more agreement between policymakers and IFIs. Conditionality has thus become both less controversial and less influential, but it is still very time-consuming for donors and recipients alike.

Although more low-key, the IFIs are likely to continue to influence policy for the rest of the 1990s. The IMF and World Bank, in particular, can be expected to continue their role as powerful advocates of market-oriented policies, both in providing incentives to new countries to undertake such reforms and, more especially, in trying to prevent "backsliding" among countries that have already done so. Nevertheless, these organizations are now providing a smaller proportion of external finance to developing countries than they did in the mid-1980s, so their direct influence may decline correspondingly, to the extent that such financial trends continue. For example, the IMF and the other IFIs provided slightly over 20%

of total external finance for Sub-Saharan Africa in 1992-93, compared to 40% in the mid-1980s. For Latin America, they provided 16% in 1992-93 *versus* 33% in the earlier period; for East Asia the figures were 7% and 14%, respectively.[21] Furthermore, there is a clear tendency toward a decline in the level and proportion of so-called program, or structural adjustment, loans made by both the World Bank and the regional development banks. As structural adjustment loans were the main mechanism through which development banks exerted conditionality, this is another indicator of the declining importance of conditionality in the early 1990s.

A *second* type of influence exerted by providers of foreign capital is what might be called implicit conditionality. This concept refers to the requirement by private investors and lenders that recipient nations follow certain kinds of policies in order to be deemed "creditworthy." Such requirements are rarely laid out in the explicit form assumed by agreements with the IFIs. Rather, they are the factors that transnational corporations, managers of mutual funds or insurance companies, and private bank officers take into account in allocating their investments.

It will be recalled that, during the 1970s, private banks were willing to lend to any Third World country that was growing rapidly and appeared able to service the loans. With the return of private capital through direct foreign investment, bond issues, and the stock markets, the possibility exists that investors will forget the problems of the 1980s and put their money wherever profit opportunities appear, regardless of policies. Our assumption, however, is that memories are likely to linger at least for the rest of the decade so that private investors will pay substantial attention to the policies of recipient countries. This seems particularly true for more long-term investors and for more prudent investors, such as the Japanese.

Some areas likely to be of particular concern are the macroeconomic context (especially the fiscal balance); the role of the state in the economy; tariff and other trade policies;

foreign investment regulations, including rules on profit remittance; and intellectual property codes, property rights, and other aspects of the legal framework. In addition, of course, investors are also concerned with political stability as well as stability in economic management. It should be mentioned, however, that for very short-term flows, these types of conditions are less important than the yield differentials that can be obtained.

If economic (and political) conditions change in ways that are perceived as negative by investors, it is now much easier for foreign money to be withdrawn, as witnessed by the recent outflow of funds from Mexico following an indigenous uprising, assassination of the leading presidential candidate, as well as the rise in US interest rates. Nonetheless, as already mentioned, some types of investment are more difficult to withdraw than others. While stocks can be sold quickly, direct investment projects are not susceptible to rapid liquidation. This is a major reason why countries prefer to attract direct foreign investment and are less enthusiastic about (or even discourage) very short-term flows.

Both explicit and implicit conditionality can have an important impact on the type of development strategies and policies selected by third world governments. In addition, however, the *third* way external financial flows can influence these strategies and policies is by helping to determine whether or not they are successful. Obviously the new market-oriented policies will not be continued indefinitely if they are not perceived as having a positive impact on growth rates and (at least in the medium term) on improving the lives of individual citizens in developing countries.

In this sense, external finance can promote success by providing additional resources for investment, channels for marketing abroad, technological know-how, and so on. Nonetheless, if financial flows are volatile, and especially if this volatility operates in a pro-cyclical fashion, their positive impact will be diluted. Likewise, if such flows lead to a significant appreciation of the local currency, they can undermine attempts

to increase exports, an important aspect of the new development models. Or, even more problematic, if they basically go to increase consumption or speculative activities, then they will distort local prices and make market-based decisions more difficult. Furthermore, in this case, they will not create the productive capacity that would help the country to service these flows in the future. This could risk a future debt crisis.

Therefore, the impact of foreign flows on long-term growth will depend not only on both the type of flows and their sustainability, but also, to an important extent, on how governments adapt their macroeconomic management to maximize the positive impact of those flows and minimize the negative effects, such as overheating of the economy and/or overvaluation of the exchange rate. Naturally, the range of maneuver for governments to define macroeconomic policy has become more limited by the very magnitude of these international financial flows and, more generally, by the process of economic globalization. This is not true just for the developing countries, but also for the developed countries as well. For example, very major changes in the European Union's monetary system (the ERM) were caused largely by private international financial flows.

In principle, all three types of influence — explicit conditionality, implicit conditionality, and influence on policy success — will impact the different regions of the developing world in similar ways. In practice, however, some important distinctions can be seen. For example, the numbers cited above on the percent of external finance provided by the international financial institutions varies significantly by region. Thus, we would expect the IFIs, with their explicit conditionality, to be most important in Africa, somewhat important in Latin America, and relatively insignificant in East Asia. This could change if, for example, Latin America saw its access to private funding dry up significantly — a development that seems unlikely at this writing, but not impossible.

With respect to the implicit conditionality associated with private investors, we need to look at the main sources of such investment to see if they embody different policy preferences. Here it makes sense to concentrate mainly on Asia and Latin America, since private capital is rare in Africa. On the other hand, most investment in the Asian developing countries comes from the region itself (Japan and the East Asian NICs) (see Stallings, 1995: Chapter 3, especially tables 3.3 and 3.4). In Latin America, by contrast, most investment, especially in the recent boom of the 1990s, has come from the United States, with Europe as a secondary source.

Asian investors, as well as their governments, tend to favor economic policies that are somewhat different from those advocated by the international financial institutions (IFIs). For example, in the last couple of years, the Japanese have begun to question some of the structural conditions typically attached to IFI loans.[22] Likewise, the policies associated with Japanese and other Asian investment have not been of the type advocated by the IFIs. Instead, they have included fairly high tariff barriers and have been promoted in various ways by active governments. If most of the foreign capital in the Asian region is provided by that region itself, then a bifurcated situation might well occur where IFI conditions are reinforced in Latin America and Africa, while other policies are followed in Asia. Moreover, these differences between Latin America and Asia (especially East Asia) are not only due to the different levels of IFI influence. Of increasing importance is the fact that many Latin American policymakers have become convinced of, and committed to, "pure" market development strategies, while Asian policymakers prefer a somewhat more active, though selective, role for the state. The empirical question of interest, then, is which of the sets of policies produces better results in terms of development outcomes.

A final source of regional differences focuses on the types of external finance and their impact on the success of whatever package of policies is chosen. Table 4 showed that a different

"profile" of financial flows characterizes Africa, Asia, and Latin America in the 1990s. Specifically, we saw that direct investment is the dominant form of external finance in East Asia, portfolio investment is the most important type of inflow to Latin America, while official transfers predominate in Africa. Insofar as these types of flows have different impacts on policy, we can expect additional regional variation.

We have argued that since DFI is more long-term, and uses more imported inputs, it is less likely to be subject to problems of volatility and to cause overvaluation of the exchange rate. It is also more closely associated with increased investment, possibly including investment in the export sector. Portfolio investment, by contrast, has a much greater chance of causing appreciation of the currency, since it is being used for purposes other than productive investment, and is entering and leaving the country in response to very short-term criteria. Although official transfers can also lead to overvaluation of the currency, they are not generally subject to the other problems mentioned above. Nonetheless, since they are frequently provided in the context of enormous economic, social and political problems, the mere lack of negative impact on policy instruments does not automatically lead them to have a clear positive impact on production or other outcomes. Nonetheless, the overall effect of official transfers is generally deemed to be positive.

In summary, external financial flows can be expected to continue to have an important influence on economic development prospects in the Third World. Based on the composition of flows as of the early 1990s and on the history of the last 15 years, our analysis of the future leads us to predict that foreign capital will play a somewhat more positive role in Asia than Latin America. From the purely financial characteristics of financial flows to Africa, the impact there should be even more positive, but it is likely to be more than offset by the deep-rooted structural problems facing that region.

NOTES

1. To study the growing discrepancies in balance-of-payments statistics, the International Monetary Fund (IMF) commissioned two reports: the first dealt with the current account (IMF, 1987); the second looked at the capital account (IMF, 1992).

2. Aggregate net resource flows are defined as loan disbursements minus amortization (net resource flows on debt) plus official grants and direct foreign investment. Aggregate net transfers are defined as aggregate new resource flows minus interest payments on loans and profit repatriation on direct foreign investment. Note that neither category nets out capital provided to other parts of the world, which is captured in Table 3 on supply of capital.

3. During the 1980s, short-term net flows were more biased toward industrial countries than long-term net flows. Thus, industrial countries received 86.5% of short-term inflows in 1980-82, 91.7% in 1983-86, and 97.4% in 1987-90. Total volume of short-term flows in nominal dollar terms are about the same size as long-term flows: an annual average of $272 billion in 1980-82, $252 billion in 1983-86, and $522 billion in 1987-90. When total net flows (long plus short-term flows), are examined, the percentages for industrial countries are the following: 72.3% in 1980-82, 82.1% in 1983-86, and 91.4% in 1987-90. In 1991-92, by contrast, short-term flows to industrial countries were negative because the Japanese banks were liquidating foreign assets to repatriate funds for use at home. [Sources and assumptions are explained in Table 1.]

4. Short-term net transfers are much larger than long-term figures shown in Table 1, but the industrial/developing country ratios are similar with the exception of the earliest period. The industrial countries received 87.3% of short-term net transfers in 1980-82, 100.1% in 1983-86, and 100.9% in 1987-90. On 1991-92, see note 3. [For sources and assumptions, see Table 1.]

5. Data are deflated by the consumer price index (CPI) for the industrial countries (see IMF, 1993a).

6. Data are from various issues of the Annual Reports put out by the Bank for International Settlements (BIS) on the history and structure of the Euromarkets, see Mendelsohn (1980) and Bell (1974).

7. For excellent analyses of the international capital markets, see that annual publication of the International Monetary Fund (IMF) entitled *International Capital Markets*, which provides both statistical data and information on structural changes.

8. The debt crisis continues to be the subject of analysis. Recent general sources include Cline (1994) and Eichengreen and Lindert (1990). On Latin America, see Devlin (1989); on Africa, see Lancaster and Williamson (1986). The major source of statistics (which also provides analysis of recent trends) is the annual publication of the World Bank: *World Bank Tables.*

9. Data come from various issues of *World Economic Outlook*, a semi-annual publication of the International Monetary Fund (IMF).

10. For an analysis of fiscal deficits and savings rates in industrial countries during the 1980s and projections for the 1990s, see IMF (1993b: Chapter 4).

11. It is interesting to note that Eastern Europe and the former Soviet republics have not become significant competitors for Latin America and East Asia despite fears to that effect at the end of the Cold War. As Fred Halliday argues, such competition has not emerged among private investors although there has been some shift among multilateral and bilateral donors (Halliday, 1995). The latter has involved a movement of personnel as much as of financial resources.

12. An earlier discussion of differences between the role of foreign capital in Latin America and East Asia is found in Stallings (1990).

13. The IMF data used to construct Tables 1 - 3 do not provide a breakdown of long-term capital by source. Based on World Bank figures, which do offer such a disaggregation, the ratio of commercial bank loan disbursements to those of official creditors was 4.7 in 1980, 0.5 in 1986, 0.6 in 1987-90, and 1.1 in 1991-92 (calculated from data in World Bank, 1994: 187).

14. In this article, Asia is defined to include all three sub-regions: East Asia, Southeast Asia, and South Asia. They have quite different patterns of foreign capital use. East Asia (especially South Korea and Taiwan) relied heavily on their own domestic savings. Southeast Asia, especially in the last decade, has received large amounts of direct foreign investment in the industrial sector from other Asian countries. Finally, the South Asian pattern is most similar to sub-Saharan Africa, although the absolute amounts are lower, even before taking *per capita* criteria into account.

15. Ratios of commercial bank disbursements to official credits for East Asia and the Pacific were 2.0 in 1980, 1.4 in 1986, 1.2 in 1987-90, and 1.6 in 1991-92 (calculated from data in World Bank, 1994: 179).

16. Other sources, however, suggest that a more important reason for lack of currency appreciation in Southeast Asia may be government purchase of foreign currency (see The Economist, 1994).

17. For different interpretations of the importance of conditionality, see both Kahler (1992) and Stallings (1992).

18. For a good discussion, see Killick (1987).

19. Taken together, these policies have been dubbed the "Washington consensus" and were first enumerated in the volume edited by Williamson (1990). Williamson later differentiated among these policies, viewing some as generally accepted and others as more controversial (Williamson, 1993).

20. Various types of political conditionality have been analyzed in an ongoing series published by the Overseas Development Council (ODC), including Nelson with Eglinton (1992); Ball (1992); and Williams and Petesch (1993). The series is summarized in the volume by Nelson and Eglinton (1993).

21. These percentages were calculated from data provided by the World Bank (1994); figures designated as mid-1980s correspond to the year 1986.

22. The most important early document is OECF (1991); see also World Bank (1993).

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