

Nunnenkamp, Peter

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Economic Policies and Attractiveness for Foreign Capital The Experience of Highly Indebted Latin American Countries

Peter Nunnenkamp *)

1. Introduction

The 1980s have commonly been labelled the lost decade for developing countries. High foreign indebtedness has been blamed for economic stagnation and decline of Latin American countries in particular. The dismal picture is sometimes projected into the future. Given the fiercer worldwide competition for foreign capital, it is feared that Latin America's position in international capital markets may be further eroded in the 1990s.

As argued in the following, such an undifferentiated assessment neither held for the past, nor does it provide a reasonable forecast for the rest of this century. Significant differences between individual countries are evident. After the outbreak of the debt crisis in 1982, real GDP growth per annum more than doubled the Latin American average (1983–1991: 1.9 per cent) in Chile (4.6 per cent) and Colombia (4 per cent) [ECLAC, 1991, p. 37]. By contrast, economic growth was considerably below average in Mexico (1.4 per cent) and even more so in Argentina (0.6 per cent). The private investment ratio recovered most impressively in Chile in the 1985–1990 period (by 129 per cent),² whereas this ratio decreased by 41 and 53 per cent in Argentina and Venezuela respectively [Pfeffermann, Madarassy, 1992, p. 4].

The economic policies of debtor countries were of major importance as concerns the degree and speed by which debt problems could be alleviated. The future attractiveness for foreign capital is also likely to depend on internal reform efforts in the first place. This proposition is discussed from different angles in the following. Cross-

*) Prof. Dr. Peter Nunnenkamp, Kiel Institute of World Economics, Department IV, Kiel.

² This represented the highest increase within a sample of 35 developing countries of various regions.

country estimates on the role of domestic economic policies with regard to the availability of foreign capital are summarized in Section II. Section III provides a short overview on the policy options which heavily indebted countries faced after the outbreak of the crisis. Section IV analyzes the reform process in selected Latin American countries and its consequences for capital inflows. The focus is on Argentina, Brazil, Chile and Mexico, which all belonged to the most heavily indebted economies in Latin America, but differed remarkably in their policy reactions to the debt crisis. Section V summarizes and concludes.

2. Domestic Policies and International Capital Flows: Cross-Country Evidence

The determinants of different types of international capital flows are not necessarily the same. The subsequent summary of empirical studies differentiates between debt flows and foreign direct investment (FDI) in order to reveal similarities and differences in the behavior of foreign creditors and investors. The presentation concentrates on results indicating how credit constrained countries, such as the major Latin American debtors, may contain capital outflows and regain access to international capital markets.³

2.1. Determinants of International Creditworthiness

Even after the risk illusions of lenders had been destroyed in the early 1980s, it continued to be heavily debated whether the access to foreign loans could be encouraged by favorable domestic policies and good economic performance. Conflicting hypotheses may apply to different lending regimes. Most importantly, a distinction has to be drawn between voluntary lending and defensive lending (which is sometimes called "involuntary" lending):⁴

- Ample evidence suggests that the borrowers' economic policies figured prominently in determining whether external debt became unmanageable in the

³ Therefore, lending to non-constrained borrowers is not considered in the following.

⁴ Defensive lending is defined according to Watson et al. [1988]. This lending regime comprises countries for which concerted credit extension, i.e., equiproportional increases in loan exposure coordinated by bank advisory committees, took place. The lending to countries without such concerted credit extension is considered voluntary.

early 1980s.⁵ Hence, better performing countries should have had easier access to voluntary lending recently.

- Under conditions of defensive lending, however, favorable policies and better performance may even lead to reduced, rather than increased bank lending [Krugman, 1988; 1989]. It may be in the banks' interest to provide loans "involuntarily" to problem debtors in order to protect existing claims. According to this reasoning, the incentive of banks to orchestrate new loans is weakened if the market valuation of the inherited debt improves due to policy reforms and better economic performance of the debtor.

These hypotheses were tested by running separate (pooled cross-country) regressions for 14 developing countries for which defensive lending was orchestrated in the 1980s and for 12 developing countries not benefiting from such lending [Nunnenkamp, 1990]. The empirical results strongly contest the notion of bad policies inducing further lending [see also Lensink, van Bergeijk, 1991]. The estimates rather indicate that private creditors honored favorable policies by relaxing credit constraints. The access to international credit markets was improved, e.g., by higher investment ratios, better world-market performance and real exchange rate devaluation.⁶ This result also held for developing countries for which defensive lending took place, as was the case for major debtors in Latin America. This provides a first indication that it was a losing proposition if Latin American countries attempted to attract more (defensive) lending by unfavorable economic policies.

Cross-country evidence also indicates, however, that narrowly defined adjustment programs were an insufficient condition for a resumption of commercial bank lending. This qualification is particularly relevant for Latin American economies where sovereign risk and credibility problems have become evident since the early 1980s [El-Erian, 1991].

The estimates support standard sovereign-risk arguments, according to which rational lenders will consider the borrowers' incentives to default when deciding on

⁵ For a discussion of domestic policies with regard to debt problems, see e.g. Baneth [1986]; Khan and Knight [1983]; Nunnenkamp [1986] and Zaidi [1985].

⁶ The latter result indicates that real exchange rates were overvalued in many developing countries [Edwards, 1989].

further credit extension (for an analytical overview, see Eaton, Gersovitz, Stiglitz [1986]). Voluntary lending was hypothesized to be negatively related to the benefits to be reaped from defaulting on external debt, and positively related to the potential costs of such debtor behavior.⁷ The evidence on the approximated costs of default turned out to be inconclusive, which may indicate that the threat of sanctions by creditors was not credible. However, net transfers were negatively related to the potential benefits of default [Nunnenkamp, 1990].

The counterhypothesis was clearly rejected, namely that the expectation of default may induce, rather than prevent further lending to constrained borrowers once debt-servicing problems have emerged [Krugman, 1988; Cohen, Sachs, 1986, pp. 539f.]. Defensive loan disbursements did not improve the borrowers' access to international credit markets in terms of net transfers. Hence, it was not very promising for Latin America to threaten with default in order to stimulate further bank lending.

2.2. Determinants of the Attractiveness for Foreign Direct Investment

With hardly any new lending forthcoming, expectations were pinned increasingly on FDI to alleviate foreign debt problems. The chances to induce FDI can only be assessed realistically, however, if sovereign risk considerations, the impact of political and economic instability as well as the host country's attitudes towards FDI are considered as possible determinants in addition to the traditional set of explanatory variables⁸ [Agarwal, Gubitz, Nunnenkamp, 1991].

Major results from pooled cross-country regressions for the 1980s that are relevant in a Latin American context can be summarized as follows. First, foreign investors accounted for risks originating from difficulties of developing countries to service their external debt. Under conditions of a debt overhang, foreign investors refrained from further engagements (for an opposing view, see Perasso [1992]). The underlying fear was that income from productive investment may decline due to higher future taxes (in order to service the inherited debt) [Sachs, 1989] and stagnating markets.

⁷ The borrowers' benefits from default primarily depend on the contractual debt-service burden [Eaton, Gersovitz, 1981, p. 302]. When considering the default costs, the borrowers have to take into account the sanctions that may be imposed on them by the creditors [Sachs, 1984, pp. 17f.].

⁸ The latter include: trade relations, the size and the growth of the host countries' domestic markets, currency valuation, and labor costs.

Consequently, overindebted countries in Latin America are likely to face difficulties in attracting further FDI unless debt problems are overcome.

Secondly, the expectation of continued political and economic instability rendered it more difficult for entrepreneurs to undertake cost-benefit analyses for investment projects. Hence, it is not surprising that instability clearly reduced the attractiveness of a country for foreign investors (see also Edwards [1991]; Schneider, Frey [1985]).

Thirdly, FDI inflows were negatively affected by overly restrictive attitudes of host countries towards foreign investors. In the 1980s, many countries moved towards more liberal ownership regulations, non-bureaucratic approval procedures and favorable rules on the repatriation of profits and capital [UNCTC, 1988]. This trend impaired the attractiveness for FDI of host countries that maintained relatively strict regulations (for the case of Brazil, see Funke, Nunnenkamp, Schweickert [1992]). Moreover, sovereign risk considerations influenced the behavior of foreign investors in relatively restrictive countries. Potential benefits from expropriations – proxied by the ratio of FDI stocks over GDP – discouraged further inflows to such countries [Agarwal, Gubitz, Nunnenkamp, 1991]. By contrast, high FDI stocks induced even more flows to countries with favorable attitudes towards FDI. The latter result indicates that a liberal treatment of FDI and a cooperative stance of host countries towards foreign investors help to enhance the attractiveness for FDI through reputation building.

Furthermore, government interventions in goods and factor markets hindered the inflow of risk capital [Hiemenz, Nunnenkamp et al., 1991]:

- Discriminatory taxes and subsidies, administrative price fixing, and similar measures interfered with the relative profitability of production among sectors. Empirical evidence also suggests that excessive trade interventions induced an inefficient use of resources, which ultimately undermined a country's position in the international competition for risk capital (see also Krueger [1990, Part III]). This result challenges the widespread belief that import protection is a promising means to attract FDI.
- A country's competitive position in international capital markets was further affected by unfavorable capital and labor market conditions. Financial repression characterized by low or even negative real interest rates discouraged domestic

savings and the transmission of savings into loanable funds. Complementary domestic capital required to attract FDI remained insufficient. Notwithstanding relatively low unit-labor costs, a country was unlikely to become an attractive investment location if a particularly poor endowment with human capital was a binding constraint for economic development, or ineffective collective bargaining arrangements led to excessive labor market disputes.

All in all, foreign investors responded to restrictive regulations, policy induced distortions and transfer risks in a similar way as did foreign lenders. Parallel behavior of capital suppliers has as a consequence that the chances of debt-ridden Latin American countries to restructure their external financing are limited at best unless the attractiveness for both types of foreign finance is restored.

3. Debt Strategies of Major Debtors in Latin America

The cross-country evidence presented so far supports the proposition that the attractiveness of developing countries for foreign capital critically depends on their own economic policies. Locational advantages were enhanced if macroeconomic instability and government interference into goods and factor markets were kept to a minimum. A cooperative stance vis-à-vis foreign capital suppliers signaled the government's willingness to contain sovereign risk and added to its credibility. However, it may prove difficult to regain access to international capital markets once the creditworthiness of debtor countries and the credibility of governments have been seriously eroded, as was the case for major Latin American countries.

Governments in Latin America faced a critical choice after the sudden reversal of international capital flows in the early 1980s.⁹ The chances to contain capital outflows in the short run and the longer-term consequences on the attractiveness for foreign capital were of utmost importance in deciding on the appropriate debt strategy. None of the major Latin American debtor countries grasped the most radical option, i.e., outright debt repudiation. It was feared that this strategy would have resulted in

⁹ In 1980, Latin America received net transfers (including aid, commercial credits and foreign direct investment) of US\$ 7.2 billion. By contrast, annual outflows in the order of US\$ 15–21 billion were recorded in the 1984–1989 period. Subsequently capital outflows decreased, but still remained significant (1990: US\$ 6.3 billion; 1991: US\$ 8.6 billion) [World Bank, 1991a].

persistent isolation from international capital markets and the discontinuation of multilateral financial assistance.

The majority of countries rather followed a muddling-through approach which was characterized by partial default, temporary and unilateral debt-service moratoria, and protracted debt renegotiations with foreign creditors. Initially, a thorough review of misguided economic policies to tackle the internal causes of payment problems figured low on the agenda.

Brazil represents the most telling example of a non-cooperative debt strategy [Funke, Nunnenkamp, Schweickert, 1992]. Within two years (1983–1984), the government submitted seven letters of intent to the IMF. The result were two waivers, three modifications of targets, and two suspensions [Cardoso, Fishlow, 1989, p. 84]. Negotiations with the IMF broke down in late 1985, and Brazil declared a moratorium on interest payments to commercial banks in early 1987. Resumed IMF negotiations were again suspended in 1989 because of the government's failure to meet the targets on public sector deficits.¹⁰ Throughout the 1980s, frequent stabilization episodes were bound to fail because they were not based on sustainable fiscal consolidation. Interventionist government policies in goods and factor markets continued, e.g., in the form of price controls, bureaucratic control over imports and export permits,¹¹ highly selective access of enterprises to credit facilities, and labor market regulations [Carneiro, Werneck, 1989].

Similar to Brazil, Argentina did not adjust appropriately to the debt crisis, but rather accommodated the disappearance of capital inflows by printing money and creating domestic debt [Hiemenz, Nunnenkamp et al., 1991, pp. 119ff.; de Pablo, 1990]. Five stabilization plans failed during 1983–1989, largely because of insufficient adjustment in the public sector. Due to the lack of structural reforms, the private sector remained highly distorted. After having received bridge loans in 1983, the debt situation of Argentina continued to be unsustainable. The country began debt rescheduling at a

¹⁰ An agreement on soaring interest arrears (end-1990: US\$ 9.6 billion; World Bank [1991a]) with commercial banks was achieved in May 1991, which was again followed by negotiations with the IMF. In mid-1992, it was principally agreed to restructure a major portion of Brazilian bank debt on a longer-term basis under the umbrella of the Brady Plan [Frankfurter Allgemeine Zeitung, 7 July 1992].

¹¹ Since the late 1980s, import restrictions have been liberalized. Most importantly, the extensive system of discretionary non-tariff barriers has been tackled [EIU, a].

substantial scale in 1985, and various rounds of rescheduling took place in the subsequent years [World Bank, 1991a, Vol. 1, pp. 73ff.]. It was only in March 1991 that the government seriously attempted to restore its credibility [EIU, b, 1991, No. 2]. The convertibility of the domestic currency was guaranteed at a fixed rate to the US-dollar. It was announced that the monetary base would be backed entirely by dollar and gold reserves. This commitment was accompanied with numerous structural measures, including de-indexation of wages and prices, privatization, and import liberalization.

Mexico changed course much earlier than Argentina. Supported by the international community, the Mexican government implemented a growth-oriented adjustment program in 1987, which yielded considerable progress in trade liberalization, privatization of state enterprises and monetary control [Aspe, 1992]. The policy reforms strengthened the tax base, reduced public sector deficits, and encouraged non-traditional exports. Previously, Mexico (the first large debtor country that defaulted in August 1982) represented another example of the preferred muddling-through approach. Various debt reschedulings and myopic adjustment measures, including import compression, were ingredients of this strategy. In the early 1980s, Mexico was a classical case of public overspending [Kaufman, 1990, p. 95]. First attempts at macroeconomic stabilization remained futile and basically restricted to cutting public investment.

Underlying the widespread muddling-through approach was the agreement among most Latin American policy-makers that if they had to choose between servicing the external debt and domestic economic growth, they would choose to grow. It is extremely doubtful whether there was such a simple choice. Foreign capital continued to be required to fully exhaust Latin America's growth potential. *Ceteris paribus*, any unilaterally decreed or enforced reduction of debt-service payments saves the debtor country resources which could be invested productively. However, the second-round effects of this option on total investment funds may not be too different from outright debt repudiation:

- Capital outflows from Latin America were due to dramatically reduced credit disbursements, rather than a higher debt-service burden.¹² This indicates that resources retained through partial default may be overcompensated by forgone inflows of new credits.
- The cross-country evidence presented in Section II suggests that the adverse effects of non-cooperative debt policies are not confined to Latin America's relations with international bank creditors. Also foreign investment might be discouraged by persistent debtor-creditor confrontation.
- Under unfavorable economic policy conditions, resources retained through partial default may be used for consumption or fuel capital flight, rather than being invested productively.

Among the countries considered here, it was only Chile which attempted to avoid the drawbacks of non-cooperative debt policies from the beginning. This country followed a strategy based on the expectation that sustained internal adjustment efforts would be supported by voluntary and market-based debt concessions by the creditors. Chile implemented major reforms in the 1970s already. State enterprises were privatized, prices decontrolled, large fiscal deficits abolished, trade and financial markets liberalized. Nevertheless, the debt shock of the early 1980s hit Chile as well. In contrast to other Latin American countries, however, the Chilean government timely subscribed to IMF standby programs in order to remain current on external debt service. This "no-confrontation principle" [Meller, 1990, p. 69] went hand in hand with serious adjustment efforts, e.g., tight fiscal and monetary policies, export-enhancing devaluation, and wage de-indexation.

Sustained adjustment to the debt crisis was considered by the Chilean government to be an investment in the country's reputation in international capital markets. It helped the agreement with commercial creditors on a menu of market-based debt and debt-service reduction operations.¹³ In this way, Chile's total bank debt was reduced by

¹² Debt-service payments of Latin America were roughly the same in 1980 and 1985 (US\$ 30 billion). At the same time, credit disbursements dwindled from US\$ 33 billion to US\$ 8.7 billion, resulting in the reversal of net transfers (out of bank loans) from US\$ 2.8 billion to US\$ -21 billion [Funke, Nunnenkamp, Schweickert, 1992, p. 4]. The picture for 1985 did not change significantly until the late 1980s.

¹³ This menu included debt-equity conversions, direct cash buybacks, conversions of debt into collateralized discount bonds, reduced interest par bonds, etc.

more than half within four years, from US\$ 14.5 billion in 1985 to US\$ 6.7 billion in 1990 [El-Erian, 1991, p. 5].¹⁴

Nevertheless, it continued to be debated whether the perceptions of country risk could be lowered by a cooperative debt strategy. Especially commercial banks have been blamed to "have provided words of praise but no access to medium-run voluntary credit" [Meller, 1990, p. 84]. The question remains whether the timely adjustment in Chile, the later change from non-cooperative to cooperative debt policies in Mexico and the most recent reform efforts in Argentina were worth their costs. This question is addressed in two respects in the following. First, the effects of different debt strategies on the countries' competitive position in international capital markets are evaluated by referring to major elements of the "attractiveness portfolio" as revealed by the cross-country studies presented in Section II. Secondly, it is assessed whether adjustment efforts have resulted in a better access to foreign financing recently.

4. Consequences of Domestic Policies and Debt Strategies

4.1. The "Attractiveness Portfolio" of Major Latin American Debtors

According to the results reported in Section II, the attractiveness of a country for foreign capital critically depends on macroeconomic stability, overall economic performance, the level of government interference into goods and factor markets, and sovereign risk perceptions. For some of these areas, it is relatively straightforward to construct meaningful indicators. In other respects, this proves fairly difficult especially if cross-country information is required for the very recent past. Because of data limitations the subsequent discussion focuses on selected indicators of economic performance and stability, and some proxies reflecting the risk perceptions of foreign capital suppliers. The evidence on government encroachment on private economic activities is particularly deficient.¹⁵

¹⁴ Direct cash buybacks in 1988/89 extinguished US\$ 440 million of bank debt at a cost of US\$ 250 million, involving an average discount of 43.5 per cent.

¹⁵ On conceptual questions and data constraints in analyzing goods and factor market distortions, see Hiemenz, Nunnenkamp et al. [1991].

Notwithstanding these limitations, Table 1 presents fairly strong evidence supporting the proposition that internal adjustment efforts help to enhance and restore the country's attractiveness for foreign capital. In nearly all respects, Chile as the country with the longest reform history clearly outperforms its neighboring countries. Mexico which changed course relatively early ranks second. By contrast, the most unfavorable "attractiveness portfolio" is recorded for Brazil, i.e., the country most reluctant to abandon the traditional muddling-through approach.

Economic performance: The impressive growth and investment record of Chile has been mentioned in the introduction already. More interestingly, economic growth picked up in Mexico and Argentina after economic reforms had been introduced, whereas it proved unsustainable in Brazil where the 1980s were characterized by several short-lived consumption booms. Economic recovery of Mexico is also revealed by the rising private investment ratio. The favorable investment response provides a clear indication that the reform program of 1987 was considered credible and sustainable by economic agents.

Chile occupies the top position with regard to world market performance as well. All other sample countries lost export market shares during the 1980s. The decline was similarly strong for Brazil and Mexico when comparing 1991 with 1983–85. However, such a comparison conceals important differences. Brazil experienced a steady decline of market shares. By contrast, the sudden drop of Mexico's market share in 1986 was mainly due to depressed oil prices. Subsequently, market shares remained stable. A more favorable world market performance was prevented by the real appreciation of the Mexican peso since the late 1980s. This points to serious risks of applying fixed exchange rates as an anchor in stabilization programs [see also Corbo, 1992].

Macroeconomic stability: Chile has been characterized by sustained macroeconomic stability since the mid-1970s. Inflation rates and budget deficits have been exceptionally low by Latin American standards. Since the late 1980s, the same applies to Mexico. The reform program resulted in impressive fiscal consolidation which, in turn, helped to contain inflation. Although the more recent stabilization program in Argentina was initiated under extreme, i.e., hyper-inflationary conditions, success is looming in overcoming the tradition of pronounced macroeconomic instability. Again,

Table 1

**Major Elements of the "Attractiveness Portfolio"
of Latin American Debtor Countries, 1983-1991**

		Argentina	Brazil	Chile	Mexico
Real GDP growth (per cent)	1983-85 ^a	0.2	3.3	1.8	0.7
	1986-88 ^a	1.8	3.7	6.3	-0.2
	1989	-4.6	3.2	9.8	3.1
	1990	-0.2	-3.8	2.0	3.9
	1991	4.5	1.0	5.0	4.0
Private invest- ment ratio ^b (per cent of GDP)	1983-85 ^a	7.7	n.a.	6.3	11.6
	1986-88 ^a	5.8	n.a.	8.5	13.5
	1989	4.8	n.a.	13.7	14.4
	1990	4.5	n.a.	15.6	14.8
Inflation rate ^c (per cent)	1983-85 ^a	502	204	24	68
	1986-88 ^a	215	473	17	106
	1989	4924	1864	21	20
	1990	1344	1585	27	30
	1991	91	466	18	20
Budget deficit ^d (per cent of GDP)	1983-85 ^a	-8.4	-6.7	-2.7	-8.0
	1986-88 ^a	-3.0	-13.6	-0.2	-12.3
	1989	-0.8	-16.1	n.a.	-4.5
	1990	n.a.	n.a.	n.a.	0.8
Real interest rate ^e (per cent)	1983-85 ^a	(-102)	(36)	5.5	-13.7
	1986-88 ^a	(3)	(-16)	2.6	-23.7
	1989	(n.a.)	(4058)	6.3	16.6
	1990	(242)	(7803)	13.0	1.3
	1991	(-31)	(447)	4.5	-2.8
Financial deepening ^f	1983-85 ^a	28.7	2.5	44.4	28.0
	1986-88 ^a	28.0	20.0g	42.0	21.7
	1989	23.4	n.a.	44.1	19.0
	1990	n.a.	n.a.	43.6	25.8
	1991	n.a.	n.a.	43.3	n.a.
Real effective exchange rate ^h (1980-82 = 100)	1983-85 ^a	107	103	118	131
	1986-88 ^a	153	104	158	135
	1989	151	81	165	114
	1990	152	70	175	115
	1991	150	85	165	104

- to be continued -

Table 1 - continued -

		Argentina	Brazil	Chile	Mexico
Imports (per cent of GDP)	1983-85 ^a	9.2	8.0	24.3	9.8
	1986-88 ^a	9.8	6.1	28.8	13.2
	1989	9.5	5.1	34.2	15.5
	1990	n.a.	5.5	33.7	n.a.
	1991	n.a.	n.a.	31.0	n.a.
Export market share (per cent of world exports)	1983-85 ^a	0.46	1.40	0.21	1.28
	1986-88 ^a	0.32	1.16	0.23	0.82
	1989	0.33	1.18	0.28	0.79
	1990	0.37	0.94	0.25	0.81
Debt-service ratio (per cent)	1983-85 ^a	60.3	46.7	54.3	51.8
	1986-88 ^a	65.0	45.7	33.8	47.4
	1989	36.2	29.8	27.1	37.9
	1990	34.1	21.8	25.9	27.8
Interest arrears (US\$ billion)	1985	0.8	0.3	0	0
	1988	2.1	0.6	0	0
	1989	5.5	3.8	0	0
	1990	7.2	9.6	0	0
	1991	7.2	9.6	0	0
Secondary market notation ¹	1986	66	75	67	56
	1987	34	47	61	50
	1988	22	43	55	44
	1989	13	22	59	36
	1990	20	25	74	46
	1991	38	31	90	62
	1992	50	33	91	65

^a Period average.

^b Comparable data for Brazil not available.

^c Consumer prices.

^d Surplus indicated by positive figures.

^e Deposit rates deflated by consumer price indices; calculation results in extremely implausible results for Argentina and Brazil.

^f M2 in per cent of GDP.

^g 1986-87.

^h Index of national currency in terms of the basket of currencies of the country's main trading partners (weighted by the share of partner countries in national exports); deflated by wholesale price indices.

ⁱ In per cent of face value of loans; 1986: annual average; 1987-1991: fourth quarter; 1992: second quarter.

Source: IMF [a]; ECLAC [1991]; Pfeiffermann, Madarassy [1992]; World Bank [1991a; 1991b; 1992], Funke, Nunnenkamp, Schweickert [1992].

it is the country least prone to comprehensive and consistent policy adjustment which represents the tail-light in terms of attractiveness. Notwithstanding periodic price freezes and controls, Brazil continues to suffer from excessive and volatile inflation fuelled by extremely high fiscal deficits.¹⁶ Furthermore, high volatility of the real exchange rate creates considerable uncertainty with respect to both external trade and capital flows. Recent evidence suggests increased rather than reduced exchange rate fluctuation in Brazil [EIU, a].

Domestic financial markets: Extremely high and volatile inflation seriously impaired the functioning of financial markets in Argentina and Brazil. Real interest rates can not reasonably be calculated for these countries. Nevertheless, it can be safely concluded that erratic financial market conditions prevailed throughout the period under consideration. The inflationary environment contributed to the demonetization of these economies. Financial deepening, proxied by broad money supply relative to GDP, was found to be particularly poor in Brazil. Not surprisingly, Chile represented the antipole again. Financial deepening was significantly more advanced, and real interest rates were moderately positive. For Mexico, there is some evidence that economic reforms helped to overcome financial repression. Openness of domestic goods markets: Information on subsidies, discriminatory taxes, effective rates of protection, etc. would be required to correctly assess the degree of government interventions in goods markets. If at all, such data are not available on a current basis. Even the rather crude indicator of the degree of openness to import competition, presented in Table 1, is not free from limitations.¹⁷ Nevertheless, the typical ranking of the sample countries is revealed once again. Although Chile had opened up to world market competition in the 1970s already, import penetration continued to rise until recently. The Mexican reforms had a similar effect, though from a seriously depressed level of imports after the outbreak of the debt crisis. In sharp contrast, the

¹⁶ An astounding turnaround in public sector accounts was reported at the beginning of the 1990s [EIU, a]. However, the drastic reduction of deficits in Brazil was largely achieved through the accumulation of arrears on the external debt and the deferment of internal debt service [see also Ohana, Mussi, 1991]. Hence, fiscal consolidation is not sustainable and suffers from low credibility.

¹⁷ Large countries typically reveal a lower level of import penetration than smaller countries. Because of this large country bias, the subsequent interpretation is restricted to the change of the applied indicator.

isolation of Brazil from import competition became even more pronounced during the 1980s, which is reflected in the declining share of imports in GDP.¹⁸

Risk perceptions: In Section II, the debt-service ratio was used as a proxy for sovereign risk since default becomes more likely, the more resources could be saved in this way. According to this reasoning, sovereign risk has declined significantly for all four debtor countries. In 1990, the debt-service ratios were roughly half those registered in 1983–85. However, this picture conceals important differences. The improvement started much earlier in Chile than elsewhere. More importantly, the improvement was due to voluntary and market-based debt reduction operations. The same applies to Mexico, which recently agreed with its private creditors on an effective gross bank debt reduction of US\$ 15 billion.

Together with appropriate economic policies, mutually agreed debt relief operations have reduced debt overhang concerns in the case of Chile and Mexico [El-Erian, 1991]. This is clearly reflected by the secondary market notations for Chilean and Mexican debt paper. Chile outperformed all other sample countries by far. Secondary market discounts reached a maximum of 45 per cent in 1988, as compared to 80–90 per cent for Brazil and Argentina. Recently, the notation of Chilean debt paper approached its face value. The notation for Mexico, which was down to about 40 per cent of face value in the late 1980s, recovered quickly when the Mexican government regained credibility through sustaining economic reforms and the comprehensive restructuring of bank debt took place. Notwithstanding declining debt-service ratios, the risk perceptions of foreign capital suppliers continued to be rather unfavorable in the case of Argentina, and even more so in Brazil. This is not surprising since the improvement of debt indicators was largely due to non-cooperative debt policies, in particular the accumulation of huge interest arrears since 1988. Consequently, secondary market notations were dramatically below Chilean and Mexican standards in 1990. Subsequently, the notation of Argentine debt paper responded favorably to the sudden turnaround of economic policies in early 1991. Brazil's agreement on interest arrears with commercial banks in May 1991 resulted in slightly higher secondary market notations. But the country's rating fell considerably behind

¹⁸ Recently, the Brazilian government liberalized import regulations especially for industrial inputs [Funke, Nunnenkamp, Schweißert, 1992]. But the sustainability of trade liberalization is threatened as long as the domestic currency is overvalued in real terms (Table 1).

Argentina. This relative decline points to continued uncertainty of foreign capital suppliers with respect to Brazil's economic policy course in the future.

In summary, all major elements of the "attractiveness portfolio" considered above support the proposition that domestic policy reforms and cooperative debt strategies contributed significantly to better economic performance and helped to overcome unfavorable risk perceptions of foreign capital suppliers. What remains to be evaluated is whether these achievements translated into better access to international capital markets.

4.2. Access to International Capital Markets

After international capital markets had been a major source of external financing for Latin America until the early 1980s, the outbreak of the debt crisis resulted in a virtual drying up of all major sources of voluntary financing. It was only recently that several Latin American borrowers regained limited access to voluntary financing from international capital markets [Funke, Nunnenkamp, Schweickert, 1992]. Scattered evidence suggests that credit rationing has been relaxed for Chile, Mexico and Venezuela in the first place [El-Erian, 1991]:

- Chile used trade and project financing as a major source of external funding in 1989–90. The loan of US\$ 20 million raised by Chile in September 1990 was reported to be the first fully voluntary, unsecured general bank loan to a Latin American country since 1982.
- International bond markets became an important source of voluntary financing for Mexico (and Venezuela). In the period January 1990 – March 1992, Mexico raised US\$ 3.2 billion on these markets [World Bank, 1992]. The relaxation of rationing has been accompanied with significantly reduced risk premiums for Mexican bond issues [El-Erian, 1991]. The improved creditworthiness of selected borrowers is revealed by the drastic fall of spreads over US government bonds from 530–820 basic points in mid-1989 to 200–250 basic points two years later.
- A remarkable turnaround occurred with regard to capital flight. In the case of Mexico, it has been estimated that capital repatriation exceeded US\$ 10 billion in 1989–90, while outflows of US\$ 18 billion had been recorded during the period 1983–88. Repatriation continued in early 1991 [Lustig, 1991].

Comprehensive and consistent data on net resource flows to Latin American debtor countries are difficult to obtain on a current basis.¹⁹ However, the available evidence reveals significant differences between the four sample countries (Table 2). Total net resource flows in per cent of GNP were significantly higher in Chile than elsewhere immediately after the outbreak of the debt crisis. Resource flows to Chile declined slightly during the second half of the 1980s, but more than doubled in 1990. In relative terms, Chile outperformed its neighboring countries throughout the period under consideration. Though the recovery of total net resource flows started from a seriously depressed level in Mexico, the figures for this country clearly indicate a much more favorable development of international creditworthiness as compared to Argentina and Brazil. Also the comparison of the latter two countries reveals the by now well-known ranking. The contraction of net resource flows was most pronounced in Brazil, which remained the only country suffering from negative net resource flows in 1989–90.

For all four countries, total net resource flows mainly consisted of debt flows in the early 1980s. Hence, it is not surprising that the development of net debt flows largely resembles the picture on total flows. The only noteworthy difference is that Argentina's position was not better than Brazil's position. As shown before, both countries had accumulated huge interest arrears. The drastic change of economic policy in Argentina occurred only in early 1991 and was not anticipated by external creditors. The figures on private non-guaranteed debt indicate that the reversal of capital flows after the outbreak of the crisis was mainly due to the drastically changed lending behavior of international commercial banks. Furthermore, the banks were more reluctant to resume lending on a non-guaranteed basis immediately after economic reforms had been implemented. This applies to Mexico in particular. Though their favorable response was sometimes delayed, the banks honored internal adjustment efforts of debtor countries by relaxing the rationing of private non-guaranteed debt. In 1990, access to this type of external finance appeared no longer to be a problem for Chile, and Mexico's creditworthiness was considerably improved. Negative flows of non-guaranteed debt were again restricted to Brazil.

¹⁹ Subsequently, the focus is on net resource flows rather than net transfers, i.e., interest payments are not subtracted from (gross) disbursements. In contrast to Section II, it would be strongly misleading to concentrate on net transfers as an indicator for the access to voluntary external financing in recent years. This is because net transfers are heavily influenced by the accumulation of interest arrears in the case of Argentina and Brazil.

Table 2

**Net Resource Flows to Major Latin American Debtor Countries,
1983 – 1991 (US\$ billion)**

		Argentina	Brazil	Chile	Mexico	
Total	1983-85 ^{a,b}	1.81 (2.9)	5.04 (2.5)	1.24 (7.5)	1.82 (1.1)	
	1986-88 ^a	1.50	2.05	1.00	3.48	
	1989	0.65	-0.68	0.98	2.84	
	1990 ^b	1.33 (1.3)	-0.09 (-0.0)	2.17 (8.4)	8.42 (3.7)	
	1983-85 ^{a,b}	1.34 (2.1)	3.51 (1.7)	1.13 (6.8)	1.32 (0.8)	
Long-term debt	1986-88 ^a	0.93	0.51	0.88	0.95	
	1989	-0.43	-1.99	0.67	-0.24	
	1990 ^b	-0.75 (-0.8)	-0.17 (-0.0)	1.51 (5.8)	5.72 (2.5)	
	1983-85 ^{a,b}	-0.04 (-0.1)	-1.39 (-0.7)	-0.15 (-0.9)	-0.17 (-0.1)	
	1986-88 ^a	-0.07	-0.65	0.21	-1.28	
Private non-guaranteed (long-term) debt	1989	0	-0.91	0.58	-0.73	
	1990 ^b	0 (0.0)	-0.13 (-0.0)	1.27 (4.9)	0.44 (0.2)	
	1983-85 ^{a,b}	0.46 (0.7)	1.50 (0.7)	0.09 (0.5)	0.45 (0.3)	
	1986-88 ^a	0.57	1.50	0.10	2.45	
	1989	1.03	1.27	0.27	3.04	
Foreign direct investment	1990 ^b	2.04 (2.1)	1.34 (0.3)	0.60 (2.3)	2.63 (1.1)	
	1991	2.35	1.60	0.32	4.24	
	<u>memo item:</u>					
	Net movement of capital ^c	1989	-0.04	0.69	1.49	4.29
		1990	1.59	3.45	3.30	8.82
	1991	5.10	-0.40	1.39	19.59	

^a Period averages.

^b In parentheses: in per cent of GNP.

^c Not comparable to other figures in the table; includes short- and long-term capital flows, unrequited official transfers, and errors and omissions; 1991: preliminary estimates.

Source: World Bank [1991a; 1992]; ECLAC [1991].

The favorable consequences of internal policy reforms on the access to external financing were most pronounced with regard to foreign direct investment flows. FDI stagnated in Brazil, which had traditionally been the favorite location of foreign investors in Latin America. In per cent of GNP, Brazil suffered from a serious decline of FDI. This was in sharp contrast to the other three countries:

- Though the absolute figures continued to be relatively small, FDI increased steadily in Chile throughout the 1980s.
- Economic reforms in Mexico triggered a quick response by foreign investors. Recently, the NAFTA agreement provided a further stimulus to FDI flows to this country. In 1991, Mexico attracted net FDI flows of an amount that matched the aggregate figure for the three other countries and was about ten-times the annual flows to Mexico in 1983–85.
- Foreign investors responded favorably to the more recent reforms in Argentina as well. In the early 1990s, net FDI flows more than doubled the amount reported for 1989.

All in all, the available evidence strongly supports the earlier proposition that policy reforms and cooperative debt strategies not only result in better economic performance, but also help considerably to regain access to voluntary external financing.

V. Summary and Conclusions

Inflows of foreign capital continue to be required to fully exploit the growth potential of major Latin American debtor countries. The basic hypothesis of this paper was that domestic policy reforms and cooperative debt strategies are best suited to break out of the vicious circle of economic decline or stagnation and impaired attractiveness for foreign capital. This proposition remained heavily disputed even after the crucial role of domestic economic policies in determining whether foreign debt became unmanageable had been firmly established in empirical analyses.

Cross-country estimates on the determinants of foreign capital inflows in the aftermath of the debt crisis clarified the ongoing discussion in several respects:

- Private creditors honored favorable policies by easing the access to international credit markets. However, narrowly defined adjustment measures were an insufficient condition for a resumption of bank lending when private lenders perceived serious sovereign risks to persist.
- Foreign investors responded to policy induced distortions and transfer risks in a similar way as private lenders. Consequently, the chances of debt-ridden countries to restructure their external financing remained limited at best unless the attractiveness for debt and FDI inflows was restored.

The requirements to regain access to international capital markets were particularly difficult to be fulfilled by Latin American countries, the creditworthiness and credibility of which had been seriously eroded. In view of these difficulties, major debtors were fairly reluctant to revise their economic policies in a comprehensive and consistent manner. Sustained internal adjustment efforts combined with cooperative debt policies were largely restricted to Chile over much of the period under consideration. Brazil represented the best example of a persistent muddling-through approach and protracted confrontation with its creditors. Mexico, and most recently also Argentina, changed policy course and initiated comprehensive reform packages after their earlier reaction to the debt crisis had largely resembled the Brazilian strategy.

Arguably, the change in domestic policies and debt strategies in Mexico and Argentina was encouraged by Chile's relative success in terms of economic performance and access to external financing. Throughout the 1980s, Chile outperformed the less reform-minded neighboring countries with respect to GDP growth, the recovery of private investment, and world market performance. Macroeconomic stability was maintained. The risk perceptions of foreign capital suppliers were alleviated tremendously so that the secondary market notations of Chilean debt paper approached its face value. These achievements had as a consequence that credit rationing was significantly less severe in Chile than elsewhere. Furthermore, FDI inflows increased steadily during the 1980s.

When economic policy reforms followed suit in Mexico in 1987, similarly favorable consequences could be observed. Economic growth and private investment picked up, macroeconomic stabilization was impressive, and mutually agreed debt relief operations resulted in improved risk perceptions. Due to the restoration of the government's credibility, Mexico regained access to international capital markets at a

significant scale. Bond issues became an important source of voluntary external financing, and the country benefited from a boom in FDI.

It is still too early to reach a definite conclusion on the outcome of the more recent reforms in Argentina. However, preliminary evidence on the country's "attractiveness portfolio" and the reaction of foreign capital suppliers suggest that Argentina might become another telling example for the usefulness of internal policy reforms. Shortly after the policy change, Argentina surpassed Brazil in terms of economic performance, risk perceptions, and access to foreign capital markets. Brazil represented the tail-light of the four major Latin American debtor countries in nearly all respects. Economic growth proved to be unsustainable, export market shares declined steadily, and macroeconomic instability remained unchecked. Hence, it is not surprising that foreign capital suppliers remained concerned about sovereign risk and were reluctant to relax credit constraints and channel more investment funds to Brazil.

In summary, the analysis reveals a nearly perfect correspondence between the degree of reform-mindedness and the attractiveness of major debtor countries for foreign capital. Furthermore, economic performance indicators and capital inflows responded fairly quickly to domestic policy reforms and cooperative solutions to persistent payment problems. These results should encourage countries such as Argentina, which initiated comprehensive reforms recently, to stay on course. Countries such as Brazil, which are still lagging behind with regard to economic adjustment, are well advised to follow suit. Otherwise, these countries will be the first candidates which cannot stand the fiercer worldwide competition for foreign capital in the 1990s. Adjustment pessimism is not justified on the ground that the benefits of domestic policy reforms will be reaped by the country's foreign creditors exclusively. To the contrary, it is mainly the debtor country that benefits in terms of improved economic performance and easier access to international capital markets.

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