S. Hrg. 102-225

IMPACT OF CAPITAL FLIGHT ON LATIN AMERICAN DEBT

HEARING

BEFORE THE

SUBCOMMITTEE ON DEFICITS, DEBT MANAGEMENT AND INTERNATIONAL DEBT

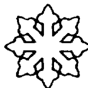
OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

JUNE 12, 1991



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
45-434 WASHINGTON : 1991

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-035713-6

5361-4

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IMPACT OF CAPITAL FLIGHT ON LATIN AMERICAN DEBT

WEDNESDAY, JUNE 12, 1991

U.S. SENATE,
SUBCOMMITTEE ON DEFICITS, DEBT MANAGEMENT
AND INTERNATIONAL DEBT,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:03 p.m., in room SD-215, Dirksen Senate Office Building, Hon. Bill Bradley (chairman of the subcommittee) presiding.

Also present: Senator Grassley.

[The press release announcing the hearing follows:]

[Press Release No. H-22, June 6, 1991]

SUBCOMMITTEE TO FOCUS ON CAPITAL FLIGHT, HEARING WILL EXPLORE EXTENT OF PROBLEM, POLICY OPTIONS

WASHINGTON, DC.—Senator Bill Bradley, Chairman, announced Thursday that the Finance Subcommittee on Deficits, Debt Management and International Debt will hold a hearing next week on the impact of capital flight on Latin American debt and development prospects.

The hearing will be at *2 p.m. Wednesday, June 12, 1991* in Room SD-215 of the Dirksen Senate Office Building.

"Capital flight severely limits Latin America's hopes of recovering from the debt crisis and resuming sustainable growth," Bradley said.

"We have to face the fact that while capital flight has seriously damaged the economies of several countries, it often represents a rational response to economic and investment conditions in those countries. The purpose of the hearing is to explore the extent of the capital flight problem in Latin America, its causes and effects, and policy options to reverse it in order to reduce the debt burden and stimulate investment and growth," Bradley said.

"Drawing upon the experience of countries where major episodes of capital flight have taken place, we aim to launch a comprehensive discussion and to begin looking for solutions to the causes of capital flight," Bradley said.

OPENING STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY, CHAIRMAN OF THE SUBCOMMITTEE

Senator BRADLEY. The subcommittee will come to order. Good afternoon, and thank you for joining us to examine the effects of capital flight in struggling economics of Latin America.

Capital flight can lay to waste all our best efforts to lift the burden of debt that holds these countries back from using their human and natural resources for productivity, growth, and a better life. At the same time, we have to understand that capital flight is a symptom, a symptom of lack of confidence in the future. It is a rational economic response.

We are not going to stop capital flight by telling investors that their money is trapped in an economy they don't trust. No economy has ever been able to create lasting growth by restricting investment.

To minimize capital flight, we have to ask why capital flight is so often a rational response, and we have to find a way to restore confidence that the economies we will be discussing can reach their extraordinary potential.

The debt crisis and capital flight have been a one-two punch to the economies of Latin America. The debt burden, eroded confidence that Argentina, Brazil, Mexico, Venezuela, Peru—just to name a few—would be able to get their economies up on their feet and moving again.

First, debt service ate up all the growth that the country's economy could reasonably produce; then, capital flight stole away what remained of the country's potential to finance new enterprises or invest in infrastructure of a productive nation.

Those of us who have focused our energies on solving the debt crisis in Latin America cannot afford to ignore capital flight because it can doom those efforts to failure. In the worst years of the debt crisis, the private foreign assets of Argentina, Mexico, and Venezuela may have exceeded their entire foreign debt.

At the same time, the countries that have restored some confidence in their economic futures have been able to repatriate capital at a rate in excess of the Brady Plan for debt relief, meaning that success in stemming capital flight can make a much bigger difference than anything our banks or the multilateral agencies can do to relieve debt.

Success in repatriating capital has also boosted the secondary market prices of Venezuela, Mexico, and Chile's debt, further restoring confidence in those economies.

If capital flight continues to shrink the resource base of Brazil, Argentina, and Colombia, all our efforts to end the debt crisis so that those economies can get moving will be in vain. On the other hand, if we can reverse capital flight, as in Mexico and Chile, our efforts to relieve the debt crisis will be reinforced by an influx of investment by those who know the country best.

The effect of the one-two punch of debt and capital flight on the countries of Latin America is visible in their deteriorating physical landscapes and in the faces of their workers and children. The frantic scramble to come up with cash to meet debt payments, while even more money flows out of the country, takes a heavy toll in human lives and on the physical environment.

The burden of capital flight is borne by those without capital. Reversing capital flight, therefore, can make the difference between an economy that is forced to exploit people, exploit the environment, or one that is able to see and use its human and natural resources to build confidence in a better future for all.

Knowing the effect of capital flight and solving the problem are two very different things. You can't force anyone to have confidence in a country's economy. Fortunately, we now have some success stories, some examples of countries that have attracted capital back, as well as some countries that are only now beginning to hemorrhage capital.

Every country is different, but I would hope that this hearing would help us extend the successes of other countries and to other countries and the ability to share this information with them. We will also ask what the United States might do to help Latin America build confidence in its economies.

We are very fortunate to have three panels today; and our first witness is Mr. David Mulford, who is the Under Secretary of International Affairs, U.S. Department of the Treasury, who has been an active participant throughout almost the last decade on issues related to capital flight and debt.

Mr. Mulford, we are very pleased that you would come today and look forward to your testimony; and we hope that you help the subcommittee think through the issue, which itself is very complex but central to resolving what still remains as a very serious international financial problem. Welcome to the subcommittee.

STATEMENT OF HON. DAVID C. MULFORD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF THE TREASURY

Secretary MULFORD. Thank you very much. First of all, Mr. Chairman, I would like to thank you for inviting me today; and I think you put your finger on the main issue when you said that capital flight, if not addressed successfully, could in fact undo the efforts of many of us and of the institutions and others over the past 8 or 10 years to promote investment in Latin America and the Caribbean. So, it is an absolutely key issue.

The future economic development of Latin America and the Caribbean largely depends on their ability to attract new capital investment. But competition for international capital has intensified recently, particularly from Eastern Europe and from the Middle East.

Commercial bank lending in the countries in Latin America has diminished, and budget limits constrain official bilateral flows. As a result, private capital, especially repatriated capital, is increasingly the engine for economic growth for the 1990's.

Private capital leaves one country for another to seek a higher return on investment or safety from risks. Investors anticipating sudden currency devaluations will move their money abroad to preserve their capital. Political uncertainty, the threat of nationalization, and populist hostility to capital may also discourage investors.

There are no reliable yardsticks of capital flight. Some estimates have placed the level of capital flight from Latin America at greater than the level of foreign borrowing, but these estimates probably have minimum credibility.

Whatever the precise magnitude of past capital flight, we believe that the pace of outflows may be easing for several developed countries; but it continues to be a major problem for others.

The negative consequences of massive capital outflows from less developed countries are clear. Capital invested abroad is capital unavailable for investment at home. Investment and growth decline in tandem and profits on capital held abroad are seldom fully repatriated. The national tax base and foreign exchange receipts are also victims of this process.

Reforms of macroeconomic and investment regimes are needed to make investment climates hospitable to both nationals and foreigners. Such reforms are at the heart of both the strengthened debt strategy and also of the Enterprise for the Americas Initiative (EAI).

The major objective of the Brady Plan has been to encourage market-oriented macroeconomic and structural policy reforms to achieve sustained growth and resolution of debt servicing problems. IMF or World Bank-supported adjustment programs are a prerequisite for commercial bank debt reduction under this strategy.

And as you know, agreements have been reached now with eight countries, including five in Latin America, those being Chile, Costa Rica, Mexico, Venezuela, and Uruguay. These eight agreements account for some $125 billion of commercial bank debt, or nearly half of all the commercial bank debt of the major debtor nations.

The benefits of this process have been substantial. Mexico's stock of medium and long-term commercial bank debt was reduced by 34 percent, Costa Rica's by 62 percent, and Uruguay's by 40 percent.

In concert with strong reform efforts, these agreements have also helped countries, such as Mexico, Chile, and Venezuela, gain access to capital markets and increased cash flows back into their economies.

These countries have liberalized their trade and investment regimes. Chile has now one of the most open investment regimes in Latin America and has moved to privatize key public enterprises. Venezuela is also beginning a privatization program.

Mexico has privatized its airline, copper, and trucking industries in the past 18 months and has announced some $20 to $25 billion of future privatizations of government-owned enterprises in the banking, steel, telecommunications, fertilizer, and insurance sectors.

To enhance growth and prosperity throughout the hemisphere, last June President Bush announced the Enterprise for the Americas Initiative, an ambitious agenda for strengthening our ties with Latin America and the Caribbean.

The initiative proposes specific action on three economic issues of great importance to the region, namely trade, investment, and debt. A key focus is to help countries in the region attract the capital essential for growth and development.

On trade, of course, our goal is to establish a system of hemispheric trade—free trade; and as a first step towards this aim, we are negotiating a free trade agreement with Mexico and Canada.

Since the announcement of the initiative, we have signed framework agreements with eight countries; and we are discussing such agreements with a number of other countries in the region. These are framework agreements for trade and investment, not as ambitious as a free trade agreements but a beginning down that road.

Under the investment segment of the initiative, to encourage countries to liberalize their investment regimes and help improve their ability to attract capital, the Inter-American Development Bank is establishing a new investment sector loan program.

The first loan under this program for Chile will be discussed by the IDB executive board on June 19, and we expect programs for Jamaica and Bolivia to follow within the next couple of months this summer.

We are also seeking contributions from other governments to a $1.5 billion Multilateral Investment Fund, to be administered by the Inter-American Development Bank, which would provide additional support for investment reforms.

The United States has proposed to contribute $100 million a year for 5 years. The Japanese have already announced their commitment to provide $100 million a year for 5 years in grant resources to this fund.

We anticipate firm commitments from other creditor countries in the near future.

We are confident that investment reforms negotiated with the IDB, together with the creation of this Multilateral Investment Fund, can make an immense difference in the climate for investment in the region and to its future growth. And by investment, I mean both foreign direct investment and also returning capital.

The debt reduction element of the Enterprise Initiative complements the strengthened debt strategy by addressing the debt problems of countries whose debt portfolios are primarily owed to official creditors, rather than just to commercial banks.

Several countries, including Jamaica, Chile, and Bolivia, are well positioned to qualify for Public Law 480 debt reduction within the next couple of months, authority for which—as you know—has been granted already by the Congress. Other countries could also move to qualify in the near future.

The potential for bilateral official debt reduction has been welcomed throughout the entire region. To provide the full extent of debt reduction proposed under the initiative, we must gain additional authority from Congress.

In particular, we are seeking authority to reduce AID debt, which represents $5.2 billion of the $7 billion in concessional debt owed by the region, and also authority to sell a portion of EXIM and CCC assets for debt-for-equity, debt-for-nature, and debt-for-development swaps.

I think you asked, Mr. Chairman, that I comment today on country experiences with capital fight and repatriation. Let me just take a moment to do that before I conclude.

I have explained the policy initiatives undertaken by the administration to encourage economic reform and to address the debt burden in countries in Latin America and the Caribbean.

Turning to Mexico, Mexican economic policy reforms since the mid-1980's have substantially increased confidence in the Mexican economy and have caused a dramatic reversal in the direction of private capital flows. Reform of exchange rate policies, tax reform, and measures to reduce the burden of the public sector provided a backdrop for economic recovery.

Capital repatriated into Mexico was some $1.5 to $2 billion in 1988 and may have been as high as $3.5 billion in 1989. All told, by our calculation, since the announcement of the commercial bank agreement in June of 1989, Mexico has experienced capital repatriation as well as new foreign direct investment totaling an estimated $10.5 to $11.5 billion.

Moreover, Mexican firms raised over $5.5 billion in debt and equity financing from abroad in 1990 alone and another $3.5 billion so far already in 1991.

And what is interesting about this situation is that it represents an absolutely fantastic reversal from outflows, which averaged an estimated $7 billion per year during the period of the early 1980's. So, the turnaround is absolutely dramatic now.

Since that commercial bank agreement was reached in 1989, investor confidence has significantly improved. Mexico reduced its inflation from nearly 160 percent in 1987 to under 30 percent in 1990 and well under 20 percent this year.

The announcement of plans to negotiate a free trade agreement with the United States was another positive factor, as was the introduction of a well-designed tax amnesty program which was aimed at attracting flight capital back into the country.

I might also add that domestic interest rates in Mexico during that same period, at the time of the bank agreement, were running at nearly 50 percent; they are now under 20 percent. So, you can imagine, in a country with heavy domestic borrowings, how substantial a budget saving that represents; it was a key element in reducing the deficit from 13 percent of GDP in 1988 to 3.5 percent of GDP in 1990.

So, the transformation is absolutely tremendous.

As for Chile, it has not had difficulty with capital flight since the severe world-wide recession of 1982; and Chile now has one of the most open investment regimes in Latin America. It is close to reaching an agreement with the IDB, as I have said, on an investment sector loan; and at that point, we will engage in reduction of official bilateral debt with Chile.

Argentina. Capital outflows have long been a problem for Argentina; but in the past 2 or 3 years, Argentina has taken a number of steps to make the country more attractive to investors. Trade and investment regimes have been opened, an ambitious privatization program has begun, and the administration has persisted in efforts to rein in public spending and cut inflation.

Besides addressing structural problems, Argentina is taking steps to directly address capital flight through tax incentives, much the way Mexico did. However, foreign and domestic investors remain cautious in Argentina, and major reflows of capital will require sustained reform over a period of time and sustained performance.

Brazil appears to have experienced relatively little capital flight in the earlier part of the 1980's, in part due to prevailing high domestic interest rates. Capital outflows last year appear to have been driven primarily by economic policy miscalculations and the failure of the freeze on domestic deposits in March 1990 to curb inflation.

There have been recently strong upturns in Brazil's two major stock markets, which are attributable to inflows from both domestic and global institutional investors. Substantial repatriation of capital probably will not occur, however, until Brazil has convinced investors that it can successfully implement adjustment and reform policies needed to stabilize the economy and foster noninflationary growth.

In conclusion, Mr. Chairman, repatriated capital and increased flows of foreign investment are critical motors of economic growth, as you yourself have pointed out. Both the Brady Plan and the Enterprise for the Americas Initiative encourage Latin American na-

tions to improve their macroeconomic and investment climates in order to attract investment.

And this, of course, is a critical lesson from the 1980's, that you cannot sustain growth living on a diet—a steady diet—of debt. You have got to attract more capital, and you can only do that by retaining savings and attracting savings back home, or attracting foreign direct investment from abroad.

So, it becomes critical for these countries to become, in a way, competitive in the global economy or in what I call the sort of "global capital sweepstakes" because, if you look at the trend in Latin America over the past 10 years, they have actually become less competitive in attracting capital up through 1988 or 1989, getting a smaller share overall of foreign direct investment flows.

Now, they have begun to reverse that, and they understand that they have got to get competitive out there in a world which is short of capital in general, with a lot of other countries competing to attract it.

That concludes my remarks, Mr. Chairman. I would be happy to take questions on these or any other topics related to this issue.

Senator BRADLEY. Thank you very much, Mr. Mulford.

Is there any reason why repatriation of capital to Latin American countries is not in our interest?

Secretary MULFORD. I think the answer to that is clearly no. If the thrust of the question was, do we need it to finance our deficits or are we, in a sense secretly happy to have their capital, I think the answer to that is that we are competitive ourselves; we have an open market. We are financed obviously from all over the world.

And we do not depend on capital flight from Latin America to finance our own needs.

Senator BRADLEY. In terms of the Enterprise for the Americas—the debt portion—it applies only to official debt; and about 80 to 85 percent of Latin America's debt is private debt. So, do you think that it will be sufficient to make a difference?

Secretary MULFORD. I think, Mr. Chairman, as you know, that the Enterprise Initiative comes on top of the Brady Plan, which is already addressing the commercial bank portion.

There was, I think, a strong need for us to reach beyond that and address the official bilateral debt burden, particularly of the medium and smaller size countries where they have relatively small exposures on the commercial bank side, and the bulk of their debt is multilateral institutions and bilateral official credit.

So, in a country like Jamaica, for example, they only have 10 percent of their debt with commercial banks. The balance is about equally divided between multilateral and official bilateral; and the United States has about half of that official bilateral debt.

So, we will make a major impact on their balance sheet when we come to act to reduce debt.

Senator BRADLEY. Is there anything that we could do to encourage repatriation of capital? What specific recommendations do you have?

Secretary MULFORD. Well, I think we need to stay the course on our various initiatives, the heart of which is to address the question of credible economic reform policies, and keep countries on that path.

Secondly, I think the debt reduction elements in the Brady Plan and in the Enterprise Initiative hold out a strong incentive for countries because there is a view around—and I would be interested in what the views of the committee are on this—but I think it is fair to say that where there is a big debt overhang, even though policies may be improving, there is a continued reluctance on the part of investors to restart their lending and investment because they fear that the debt overhang will sort of sabotage the recovery over time.

So, the idea of giving that debt a reduction or a "haircut" to bring it down is, I think, very important psychologically to investors; and we feel that this is an important rationale for both the Brady Plan and also the Enterprise Initiative.

Senator BRADLEY. Do any tax measures make any sense to you, any financial instrument measures? For example, should we prohibit bearer securities? Should we work for an international agreement to prohibit bearer securities?

Secretary MULFORD. We in the United States do not encourage bearer securities; but I do not personally believe that it would do a great deal of good to encourage that as a worldwide movement, particularly to stem the flow of capital.

And I don't think U.S. tax policies can really produce results; they would mainly be prohibitive in some way or punitive.

But I do think that the kind of tax measures that have been looked at by Mexico, where they have had a lenient one-time tax on repatriated money on a sort of forgive-and-forget basis, has been very effective in attracting back funds that were offshore and that were reluctant to come back because they feared stronger punishment.

Senator BRADLEY. What about multilateral tax information sharing on portfolio income of each of its citizens? Would that be helpful?

Secretary MULFORD. Well, I think that is helpful in general. I mean, I think there are other reasons we should do that, but I don't know whether potential capital flight would be much affected by that. I mean, I think capital is either attracted away by superior returns or driven out by bad policies and fear of devaluation.

I think those overriding incentives are not enormously affected by the reporting arrangements that exist.

Senator BRADLEY. You were unable to make the subcommittee's last hearing on debt and conversions in the environment. I wondered if you had any suggestions you would like to offer or what you expect to be doing in the area of debt for environment swaps?

Secretary MULFORD. Well, we are and have been now, for a number of years, very enthusiastic about the potential for debt for equity swaps, debt for nature swaps, and debt for development swaps.

And within the Enterprise Initiative, as you know, there is contained an arrangement whereby, when we do reduce debt, either by writing down concessional debt or selling at a discount nonconcessional debt, in both cases we have developed programs that will encourage swaps or other means of providing local currency for environmental programs.

So, we are very much interested in that. When we designed the Enterprise Initiative, that was an important feature of it. We have encouraged the IDB to follow up on that. We have talked with the countries. We have indicated to them the importance that we attach to this.

We have worked with other agencies here in town; and we are in the process, as you know, of creating an environmental committee that will be set up and will work with these countries to help promote the kinds of local grass-roots programs that can use these local currency results from swaps.

Senator BRADLEY. But this would occur only with official debt?

Secretary MULFORD. Well, this would occur with official debt. We have encouraged, even earlier, the commercial banks to pursue debt for environment and debt for equity swaps, and also private corporations.

Personally speaking, I found a number of the barriers there rather difficult and frustrating to deal with, as indeed there are barriers that act as a disincentive for the banks in some cases.

We have worked hard to try to address those; but even despite the barriers, it is a field that is catching on. And we are very positive about it.

Senator BRADLEY. We are in the middle of a vote now. I know that Senator Grassley would like to ask a question. Would you like to ask that now?

Senator GRASSLEY. Yes, I would like to do it now.

Secretary MULFORD. I would be happy to wait until you come back, if you want me to.

Senator BRADLEY. I will be right back. Let Senator Grassley proceed, and I will come right back.

Secretary MULFORD. All right.

Senator GRASSLEY. I wanted to follow up on a comment you made to the chairman when he asked you about whether repatriation was in our interest and you said it was in our best interest.

Does your response take into consideration the impact upon our economy or our institutions? Have you considered if that has any negative impact upon us?

Secretary MULFORD. I think it is a very hard calculation to make. When money leaves these countries, some of it may come to the United States, but other money may go to other centers—Switzerland and European countries and so on.

And obviously, some of it finds its way into our economy. And I suppose you could say it is useful that funds like that are here in use and so on.

On the other hand, I think one has to weigh that against the fact that, if repatriation occurs to Latin America, you are fueling the kind of recovery in Latin America which is extremely good news for the United States.

We have seen, for example, our trade relationship with Mexico more than doubled by a substantial margin in just a few short years, so that we have an enormous—I think it is our third largest bilateral trade relationship now.

As these countries recovery and the recovery of their capital is important to that process, they will once again become important markets to us. So, there is a very important offset; and on balance,

I think, we are probably better off with them recovering, both politically and economically.

Senator GRASSLEY. Let me change directions just a second. I don't suppose you will be able to give a very long answer to my question because I am going to have to go.

In Public Law 101.240, Congress required the Treasury Department to propose that the International Monetary Fund conduct a study on ways to reverse capital flight. Apparently, at least a working group put together a paper under the auspices of the IMF.

Was anything of value, obtained from this study, to help the IMF or the Treasury Department deal with the problem?

Secretary MULFORD. I will just give two quick answers to that. One is that there was a lot of valuable analytical work done; and two, the conclusions were, not surprisingly, that to stem capital flight, you need the right domestic policies in place to capture the confidence of the people and so on.

That, of course, was something that we already knew and were working on. So, there didn't seem to be new recommendations for policies that were different from what we were already doing.

Senator GRASSLEY. All right. The committee will stand in recess until the chairman returns.

Secretary MULFORD. Thank you.

[Whereupon, at 2:22 p.m., the hearing was recessed.]

AFTER RECESS

Senator BRADLEY. I want to thank you very much for waiting. I really have only one or two other questions.

Secretary MULFORD. All right.

Senator BRADLEY. In terms of the amount that would be available, in your opinion, for debt for environment swaps over the next several years, what is the amount that you would anticipate?

Secretary MULFORD. That is a very hard question. I would have to think about that and try to make that estimate for you and give it to you. I wouldn't want to just pull it out of the air.

There is an enormous market, in a sense, of bank paper floating around; and if you got the right programs, even with a fairly small share of that market, you could get quite big results. I think you would agree with that.

Also, resources can be generated through action on the official debt side. We are proposing to facilitate in swaps of a portion of the non-concessional Eximbank and CCC debt owed to the USG by qualifying countries. These swaps could take the form of debt-for-equity, debt-for-nature, or debt-for development.

But on the concessional side, we would write down the debt, restructure it and, on the reduced balance, we would have a local currency interest payment and pay it into a trust fund.

So, there is no swap; but there is generated over a period of maybe 10, 15, or 20 years, a flow of local currency resources dedicated to environmental programs. So, you would have to take all of that into consideration in trying to come up with some global number or assessment of resources.

Senator BRADLEY. Could you do that and provide it to the subcommittee, because this interest in the global environment and its interrelation with debt is very important?

And frequently, the idea of debt for nature swaps, as we heard from the previous hearing's witnesses, is very positive; but the amount of capital and, therefore, the total impact of such conversions hasn't even begun to be assessed.

It is a positive direction, but how much impact will it actually make? And I think that would be helpful if you would do that.

Secretary MULFORD. I will try to do that. Just as a cautionary note, I would say that it will be very, very difficult. On the other hand, I would like to refer back, Mr. Chairman, to 1985 when we were promoting the very beginning of debt-for-equity swaps.

And I heard from all kinds of people in the media and in the committees and so on how this was only going to ever be just a very marginal, rather unimportant area of activity. And today, you will find in Argentina, last year alone, they reduced their debt by $7 billion through debt-for-equity swaps in privatizing companies.

So, debt-for-equity swaps have really mushroomed; and it seems to me that, although environmental swaps probably won't be as big, I think it would be unwise to underestimate their potential.

Senator BRADLEY. But you would be willing to provide that for the subcommittee?

Secretary MULFORD. We will have a try at it.

Senator BRADLEY. The Enterprise for the Americas Initiative and the Brady Plan and the other initiatives are intended to try to get the economies of Latin America growing again with responsible economic policies, and I think that is very positive.

But I also see other things happening, such as the sale of subsidized grain—U.S. grain—to Brazil; and I see that working at cross-purposes with some of our other efforts. What is your view of the sale of that 700,000 tons of grain to Brazil?

Secretary MULFORD. Well, I think that, as you know, there are certain political and economic realities in the agricultural area, particularly with regard to grain sales, that produce these inconsistencies.

And that is why we have aimed our efforts at attempting to reform that problem in the GATT Round and conclude those discussions of agricultural trade, to try to reduce and eliminate these problems.

Obviously from a global standpoint, they are filled with inconsistencies; and I think that is best I can do really on that answer. It is not an easy position to defend in any kind of uniform fashion.

Senator BRADLEY. Right. It is inconsistent.

Secretary MULFORD. Yes, it is.

Senator BRADLEY. Let me ask one last question; and that is, you know, we have a changing relationship with the Soviet Union. Is there any point you want to make about capital flight to the Soviet Union?

Secretary MULFORD. Well, again, that is a very difficult field to make an assessment because they don't have a convertible currency.

Senator BRADLEY. But one of the suggestions is that we would put money into a stabilization fund so that they would have a

clearing house and convertible currency. You know, that is one of the elements of the so-called "grand bargain." I have not seen this; I have just read it in the newspapers.

Secretary MULFORD. Those reports—if they are true—of a stabilization fund for the purpose of supporting a convertible currency, I think, are entirely premature because a stabilization fund would just provide the resources for a conduit for capital flight if the basic economic policies for reform were not in place and the economy had not been stabilized.

So, I think you have to take those first steps before you have a stabilization fund.

Senator BRADLEY. So, you are saying that if a stabilization fund is created and we put in X billions—and the Germans and French or whoever put in billions—and the Soviet deficit continues to mushroom, internal deficit and other major problems of the internal economy are not addressed, then basically it ends up being a siphon for capital flight?

Secretary MULFORD. It could, if the conditions—the precedent that has to be set—the policy conditions are not in place and met. It could become that.

Senator BRADLEY. And the policy conditions that you think would be important would be what?

Secretary MULFORD. Well, there is a whole range of them.

Senator BRADLEY. Just the basic Macroeconomics 101?

Secretary MULFORD. That is correct. In reducing the deficit, a pricing system, a monetary system, and so on—all of these things have to be put in place. A stronger market-oriented economy and some gradual program designed as, for example, in the case of Poland after the very strong economic program was put into place, to allow convertibility and then a period of adjustment.

And that has come off quite successfully, but that was prepared over a period of a couple of years before the stabilization fund in January 1990—I guess it was—was put in place. A lot of preparatory work was done.

So, I think that the stabilization fund may have a role at some point, but we are not there yet in the Soviet Union, by any means.

Senator BRADLEY. And in terms of ticking off those aspects of economic change that have to take place—prices, reduced deficit, and so forth—those can be very easily measured? How will we know we are there in terms of a price mechanism?

Secretary MULFORD. I think you will know you are there when the policies introduced are market-based policies that aim at moving towards a transition towards a market-based reform program.

You will not, of course, be assured as to the results or to the degree of concerted dedication and consistent application over time. That is always a problem in these programs. The Soviet Union would be no exception there. There is an element of risk.

Senator BRADLEY. And until that happens, do you consider a stabilization fund a waste of money or unproductive?

Secretary MULFORD. I think it could be unproductive if it were done too soon and on the basis of the wrong policies.

Senator BRADLEY. All right. Just in terms of overall indebtedness, yesterday we announced another $1.5 billion in grain credits

to the Soviet Union. Would you say their creditworthiness has increased or decreased over the last year?

Secretary MULFORD. Over the last year, I would have to say that the creditworthiness of the Soviet Union has probably decreased.

Senator BRADLEY. So, they have about $45 billion in debt now.

Secretary MULFORD. At least.

Senator BRADLEY. At some point, don't some of the questions that we encountered in Latin America in the 1980's become relevant to the Soviet Union?

Secretary MULFORD. Well, they do; but the level of debt, whether it is $45, $50, or $55 billion—and the numbers are not clear—at those levels is still a very modest proportion of their GNP.

So, in terms of the potential productivity of the Soviet Union, the present burden of debt is not as compelling a problem as it was in Latin America when things turned there. But the present situation is a very serious one, and the Soviet Union is suffering some constraining problems with its debt.

Senator BRADLEY. So, even though the debt-to-GNP ratio might be smaller than in Latin America, there are major questions as to whether policies in place will unlock any of that potential and, therefore, unlock any ability to service that debt, in a kind of natural way?

Secretary MULFORD. Well, I think the Soviet Union has the capacity to service the debt that is being created by this action. I don't think there is any doubt about that.

But the overall situation, as you look out in the future, is something that has to be addressed by them if they are going to avoid getting into a seriously indebted situation.

They have got some—what you might call—cash flow problems, and their economy has been deteriorating. If they can introduce a reform program and make some progress over a period of time, it seems to me to be possible that that situation can be retrieved to some extent.

Senator BRADLEY. Just one last question. Over what period of time do you think is reasonable to expect them to have to make progress? I mean, how long do they have to have a reform program in place and functioning before we say, well, it looks like it is real?

Secretary MULFORD. I don't think that is a judgment you can make just offhand like that. I think it is something you have to make a judgment on as you go along. It is sort of an ad hoc, assess it as you go situation.

Senator BRADLEY. Great. Mr. Secretary, I thank you very much for coming today and sharing your views; and I hope you will get the subcommittee the debt-for-nature swap assessment.

Secretary MULFORD. We will try to do that as soon as we can.

Senator BRADLEY. We appreciate that very much.

Secretary MULFORD. Thank you very much, Mr. Chairman.

[The prepared statement of Secretary Mulford appears in the appendix.]

Senator BRADLEY. Our second panel consists of Dr. Nora Lustig, visiting fellow at the Brookings Institution; Mr. Daniel Marx, financial representative of Argentina; and Prof. Frank Gunter, professor of economics at Lehigh University.

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Welcome to the subcommittee, and the floor is yours. Let's begin with Dr. Lustig and then Mr. Marx and then Professor Gunter.

STATEMENT OF PROF. NORA LUSTIG, VISITING FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Professor LUSTIG. Thank you, Mr. Chairman, for inviting me to express my views on the evolution of capital flows in Mexico. I want to begin by saying that the views presented here are my own and should not be ascribed to the Brookings Institution.

The purpose of my testimony will be, first, to discuss the causes and consequences of capital flight in Mexico. Second, to discuss the factors which explain the recent wave of capital repatriation. And third, to suggest how the United States can continue to provide support to Mexico, as well as help the rest of Latin America in their efforts to implement sweeping reforms to achieve stability and growth.

Shortly before Mexico announced that it could not meet payments on its debt in mid-1982, a man carrying a suitcase containing $10 million (U.S.) in currency was stopped by the Mexican authorities at the airport. He was released a little while later because he had committed no crime. This gentleman was doing what hundreds of thousands of others were doing on a smaller scale and a few on a much larger scale: putting their savings abroad.

While Mexico was falling into its most protracted economic crisis of modern times, private citizens with liquid savings could divorce themselves from the painful process that affect their country.

How much capital flight was there in Mexico? Depending on the method chosen to estimate it, capital flight from Mexico over the period 1977 to 1987 ranged from a lower estimate of $22.1 billion (U.S.) to an upper estimate of $35.7 billion (U.S.), or 21 percent and 33 percent of the total external debt for 1987, respectively.

Note that these figures are well below the widely publicized Morgan Guaranty estimate of $45 billion (U.S.).

What were the causes of capital flight? There are three fundamental factors that explain capital flight in Mexico.

First, savers fled from an overvalued peso in search of higher expected returns or to protect themselves from the cost of devaluation.

Second, capital fled the country as a response to and/or in anticipation of government decisions that affect property rights, such as bank nationalization.

Third, capital left the country, and did not return, because savers and investors perceived that no matter how committed the government was to maintaining a coherent economic program, the pressures on the economy—especially those caused by the debt overhang—were insurmountable, and economic stability would not last.

What were the consequences of capital flight?

Capital flight made a balance of payments adjustment all the more difficult because the required trade surplus had to be large enough not only to cover the higher debt service, but also to finance capital flight.

Capital flight made it difficult to achieve economic stability because, first, it reduced government revenues by reducing the tax

base directly and indirectly through its impact on growth; and second, it exacerbated the volatility of the financial environment.

Third, capital flight generated a perverse redistribution of income. The large real devaluations of the Mexican peso and high domestic real interest rates, triggered in part by capital flight itself, enriched the holders of dollar assets, usually wealthy to begin with.

On the other hand, the burden of adjustment and fiscal austerity was borne by the less wealthy sectors of society, who did not have funds to place abroad beyond the reach of taxation and crisis. In Mexico, during the period 1983–1988 for example, real wages fell between 40 and 50 percent; and although capital can always find a haven country, this is not the case for labor.

Capital is flowing back into Mexico. A number of different sources consistently show that capital is flowing back. For example, a recently published report by the British Merchant Bank Charter, Ltd. estimated that capital repatriation into Mexico had been on the order of $5.2 to $5.5 billion (U.S.) in 1989 and 1990, respectively. This is one estimate.

Then, the latest report of the Bank of Mexico—the Central Bank in Mexico—indicates that in 1990, the amount of deposits held abroad by Mexicans declined by about $1.4 billion (U.S.), which is taken as an estimate of capital repatriation by them.

The Mexican Securities Commission estimated that, between June and December 1990, $2.9 billion (U.S.) were repatriated under the new fiscal amnesty scheme, known as the "Fiscal Stamp." Between January and May 1990, $1.0 billion (U.S.) was repatriated through the stock exchange.

The Secretariat of Finance and Public Credit, in its document "Mexico: A New Economic Profile," published in April 1991, estimates that capital repatriation during 1990 reached $4.3 billion (U.S.)

So, I would say that capital repatriation into Mexico in 1990 probably ranges from $3 to $5 billion (U.S.), depending on the method used to estimate them.

It is important to note that capital repatriation is not the only sign of a reversal in capital flows. Private sector access to the world capital markets, for example, is rising; and the Mexican stock exchange has been steadily growing for the last 3 years. Actually, it rose by six-fold since the end of 1988; and foreign investment in the securities market has increased substantially.

All available indicators show that the risk perceived by savers, investors, and lenders vis-a-vis Mexico has been substantially reduced. Perhaps the most unequivocal sign of this is the trend in domestic interest rates. The average yearly nominal interest rate for 1-month Treasury certificates was 45 percent in 1989; and it fell to 17.8 percent on May 30, 1991.

Why was Mexico able to reverse capital flight and increase its access to world capital markets?

What we are currently witnessing in Mexico is not the result of a single action or even the simple sum of a number of actions. It is the result of a comprehensive approach to tackle the nation's economic problems, which covers both the domestic and external com-

ponents and has an economic as well as political, institutional, and social dimensions.

The role played by haven countries—the United States in particular—has also been crucial to the process. This support has helped Mexico sign a Brady-type debt agreement with its commercial banks in early 1990 and obtain substantial loans from multilateral agencies—the World Bank in particular—to back their economic reforms.

More recently, political support has paved the way for the negotiation of a North American Free Trade Agreement, an initiative that will consolidate the new economic strategy and accelerate recovery.

Currently, I would say the most important contribution the United States can make to help Mexico's recovery is to sign an FTA with Mexico. To underscore the importance of the NAFTA, Mexico's interest rates fell by 2 percentage points immediately after the extension was granted for fast track authority.

All the recent actions taken by the United States have contributed to Mexico's enhanced credit worthiness and, perhaps more importantly, to the Mexican Government's credibility. The only complaint that should be raised is to question why this support was not forthcoming sooner.

By all accounts, Mexico's adjustment efforts were successful even going as far back as 1983. Similarly, the Mexican Government's commitment to sound economic policies and market-oriented reform were also evident since 1983.

Finally, Mexico's good conduct in the realm of the debt issue probably prevented the formation of a debtor's cartel, and this behavior paid high dividends to the financial sector in the creditor countries. If support had been forthcoming sooner, the years of instability and crisis could have been shortened, and the economic recovery could have been under way sooner.

Perhaps the most important lesson to be drawn from this experience for the United States and other developed countries is to provide adequate, and especially timely, support to those Latin American countries instituting economic reforms similar to Mexico's. The countries now implementing very courageous economic programs include Argentina, Bolivia, and Venezuela.

Some of these countries—Argentina, for example—will need support in reaching debt reduction agreements with their commercial banks. All need the support of multilateral agencies to finance their economic reform and policies.

Senator BRADLEY. Dr. Lustig, if you could wrap up?

Professor LUSTIG. I have one last sentence.

In addition, all countries in Latin America need to enjoy the benefits that could be derived from a free trade agreement with the United States. Thank you.

Senator BRADLEY. Thank you very much.

[The prepared statement of Professor Lustig appears in the appendix.]

Senator BRADLEY. Mr. Marx?

STATEMENT OF DANIEL MARX, FINANCIAL REPRESENTATIVE OF ARGENTINA, WASHINGTON, DC

Mr. MARX. Thank you, Mr. Chairman. Thank you for extending me the invitation to make this presentation before this distinguished group on the important issue of the repatriation of capital flight.

Although I am the Financial Representative of Argentina, the views I am going to express are personal and they do not necessarily represent the official government position.

I will maintain here that there is no substitute for sound economic policies and a stable political environment in order to attract capital back into Argentina; and it is the official goal of the Government of Argentina to repatriate capital. And, as a matter of fact, there are already early indications of a net influx of capital into Argentina.

Capital flight has been a systemic problem for Argentina. Although there are no official statistics, estimates indicate that the amount held by Argentines outside the country is over $30 billion (U.S.).

Let me first look at the causes of the problem; second, the policies addressed to correct these causes; then, the early results; and finally, what the United States could do in order to help these policies achieve their goals.

In relation to the causes of the problem, I would first refer to the chronic fiscal imbalances associated with inflation. Argentine residents try to hedge against that inflation through holding assets outside Argentina.

A second cause is the perceived threat of governmental actions, such as devaluations or even expropriations. A third cause is a domestic tax system that combined generally a weak enforcement of tax laws with emphasis placed on wealth taxes on domestic financial assets, like bank deposits, savings in the securities markets, et cetera.

The government is implementing five basic policies in order to correct those problems and to create an attractive domestic investment environment.

The first policy I would mention is the deregulation of private sector activities. The second is the privatization program. The third policy relates to the reform or the tax administration system. The fourth is the opening of the economy; and the fifth policy is to simplify the foreign exchange system, moving toward establishment of a single foreign exchange rate system and abolition of the multiple foreign exchange rates that were in place before.

The results from the privatization program are quite impressive. Through this program Argentina has been able to reduce its foreign debt by about $7 billion (U.S.). And in addition to reducing foreign indebtedness the privatization program shall help to increase productivity and investment.

Referring to the fiscal reform, I would like to point out that Argentina is in the process of introducing a tax system under which worldwide income would be included in the tax base. There is also a special program for capital repatriation under consideration in Congress.

The government is also eliminating the tax burden on certain financial assets, namely deposits, bank withdrawals, and the transfer of securities. And the government also allowed the domestic financial system to raise deposits that were nominated in foreign currency.

The early results of the government's efforts are quite impressive, I would say. First, there is a drastic reduction in the fiscal deficit and inflation.

Second, I would like to point out that foreign currency deposits are now over $3.5 billion (U.S.). Third, medium and long-term commercial debt has been issued by private firms in Argentina, although in amounts that are not very significant yet. As of last month it was about $130 million (U.S.), but it is a market that is growing. And fourth, in the privatization program, we see many Argentines buying those securities directly or indirectly.

There are certain difficulties to overcome yet. For example, the GNP has declined for 3 years in a row. The investment in essential public services reached a standstill in Argentina; and some people within Argentina are beginning to ask whether it is worthwhile to continue making sacrifices without tangible results in the very short run.

Addressing what the United States could do in order to help these efforts, I would like to point out first that, in light of payments to the multilaterals that, in the case of Argentina, are over $2.5 billion (U.S.) per year, the United States could encourage those multilateral organizations to continue extending credit to Argentina.

Second, when appropriate, the United States could urge the multilaterals to help create conditions that would allow Argentina to obtain debt and debt service reduction.

Third, the Unites States could modify the regulatory environment to help ensure that banks will not feel discriminated against if they participate in debt and debt service reduction deals and debt-for-equity swaps.

Fourth, the United States could encourage Eximbank to grant access to medium- and long-term export credits for private-sector companies in Argentina. And fifth, the United States could improve trade between the two countries in general through phasing out certain quotas, subsidies, and other trade barriers. Thank you.

Senator BRADLEY. Thank you very much, Mr. Marx.

[The prepared statement of Mr. Marx appears in the appendix.]

Senator BRADLEY. Mr. Gunter?

STATEMENT OF PROF. FRANK R. GUNTER, ECONOMICS DEPARTMENT, LEHIGH UNIVERSITY, BETHLEHEM, PA

Professor GUNTER. Thank you, Mr. Chairman. The Colombian situation is unusual for at least three reasons. Through a combination of good policy and good luck, they have experienced real growth through the 1980's. They have yet to reschedule any of their international debt; and finally, because of the perceived importance of the drug trade both to their international accounts and to the domestic economy.

The motivations for traditional capital flight—outward capital flight—have already been given by the other panel members; but Colombia also has to face the issue of the unreported repatriation or inward movement of illegal funds, most importantly the drug money.

The measures of capital flight used in my published remarks attempt to capture the net effect of these two flows: the outward traditional flight and the inward flow of drug money.

There are some theoretical and data problems. It is very difficult to measure, but my best guess is that in recent years we have been probably looking at a net outward flow in the range of $100 to $200 million a year.

This has changed. Recently, data has become available on the first 4 months of 1991. It appears there has been a sharp rise in capital repatriation to Colombia. The dollar value of Colombian exports is way up; the belief is that we are seeing misinvoicing as a way of facilitating the return of capital.

The earnings on services transactions are also up dramatically. In fact, the first 4 months of 1991 showed more earnings from services than the total of 1989 and 1990. April 1991 alone has numbers that are comparable to all of 1990.

It is too early for an accurate measure; but if current trends continue—which I realize as an economist I am not supposed to say—but if current trends continue, we are probably looking at repatriation on about a scale of maybe $2 billion (U.S.) in 1991.

This raises two questions. First of all, where is the money coming from? And secondly, why is it coming back to Colombia?

The "where" is an interesting one. Since the debt crisis began, there has been an increase in Colombian deposits, or deposits of Colombian nationals, in the world banking system and in United States banks. Some of this is government money or the funds of organizations associated with the Colombian Government, such as the coffee fund, which sterilized some of its funds from the 1986 boom. Some is traditional capital flight; some is working capital of legitimate Colombian firms; and some of it is probably laundered drug money.

The total—and I am referring to Table 3 on page 9—Colombian assets in banks worldwide came to almost $7.1 billion (U.S.) at the end of 1990. In U.S. banks alone, it was about $4.5 billion (U.S.).

To give you an idea of the scale here, the assets that Colombian nationals currently have on deposit in U.S. banks exceed the loans that U.S. banks currently have to Colombian individuals and entities. In fact, by the end of 1990, the gap was almost $1.9 billion (U.S.).

This might provide some insight into whether this recent repatriation is drug money sneaking back or whether it is capital flight that was otherwise legitimately returning. If we see when the data comes out that these legitimate holdings in the U.S. banks and other banks have declined, then it might be a sign that it is the traditional capital flight coming back.

The next issue is why the recent return? My best guess is that what we are seeing here is the result of some recent policy initiatives by the Colombian Government. Since 1985, they have followed a policy of a more rational exchange rate, of trying to prevent the

parallel rate and the legal rate from getting too far away from each other.

In 1984, for example, the parallel—the black market—rate for dollars was about 14 percent above the legal rate. For the last 5 years, it has been within 1 percent; and as of Monday, it was only 10 pesos different from 575. So, the government followed a fairly rational exchange rate policy.

I think most of the credit for this repatriation has to go to the recent anti-inflation policy adopted by the Colombian Government. Last year, 1990, was the worst year for inflation that Colombia has ever experienced—32 percent. The Monetary Board, in response to this, has clamped down on money creation, on credit creation, in the country.

In fact, the newest initiative is that they now have a marginal reserve requirement of 100 percent. This has driven real interest rates through the ceiling.

Recently, the real interest rate differential between Colombia and the United States was between 10 and 15 percentage points. Relatively safe institutions in Colombia are offering interest rates of 55 percent.

This aggressive policy to fight inflation, which has driven up real interest rates, has been combined with a temporary amnesty on capital flight funds. If funds are brought back within a certain period of time, there will be a small tax or fee.

The longer term causes have been the liberalization of the Colombian economy and the successful refinancing. Colombia was recently able to negotiate a $1.775 billion (U.S.) transaction with the world's banks, which should cover their financing needs through 1994.

As the first speaker mentioned, the debt crisis has passed for some countries; I think we can safely say it has definitely passed for Colombia.

There was a large amount of interest on behalf of U.S. banks in this refinancing, and I also have some answers to the questions of what the United States can do to facilitate this process. Thank you very much.

Senator BRADLEY. Thank you very much, Mr. Gunter.

[The prepared statement of Professor Gunter appears in the appendix.]

Senator BRADLEY. Let me thank the whole panel, and let me begin with Mr. Gunter. Why don't you tell us what we can do? [Laughter.]

Professor GUNTER. Thank you, Mr. Chairman. Basically, there are two steps that the United States can take. The first one is related to the illegal drug trade, and the second is the removal or the reduction of the trade barriers.

Despite some signs of initial progress, there was a story this morning in the Washington Post, there is still a severe problem with the drug trade. The inflow of drug money is supporting the violence in Colombia.

It is even more difficult to estimate the drug flows than it is to estimate the capital flight; I have provided two estimates in the published remarks, one sort of optimistic by a researcher associated

with the Central Bank, one more pessimistic by a professor in Colombia. Both of these were based on DEA statistics.

If you are looking for a best guess, we are probably looking at an inflow of drug money in the range of $500 to $1,500 million a year; let's say $1 billion.

To give that a sense of scale, this would put drug earnings third in Colombian exports; the largest export, of course, is petroleum and petroleum products, the second largest export being coffee; and the third would be earnings from illegal drugs. Coal and textiles would follow.

In my published remarks, I make the statement that it is a false view to look upon this drug money as being a benefit to Colombia. It fuels the violence; and in a narrow economic view, it encourages the traditional capital flight, which is, at least right now, fear flight.

To the extent that the drug flows can be reduced, there should be a reduction, after a lag, in violence, which hopefully will lead to an increased repatriation of some of this fear capital.

The second step the United States could take is to encourage economic growth in Colombia by reducing the trade and tariff and nontariff barriers to Colombian exports. Of the 10 largest Colombian exports, four of these—textiles and clothing, fresh flowers, sugar, and printing and publishing—face major restrictions, both nontariff barriers and tariff barriers in the United States.

The Colombian Government has supported the U.S. Government as far as the GATT Agreement goes, as far as opening up the agricultural trade in the United States. And as we recently heard, it is a participant in and supports the Andean Trade Preference Act.

So, consistent with the Administration's policy, if the United States should open up its markets to Colombian exports. Colombian exports to the United States are very important to Colombia, about 41 percent of their exports.

They are insignificant to the United States; we are talking about 1 percent of U.S. imports in 1990. But it would have a dramatic effect on the Colombian economy and expectations for the future.

Senator BRADLEY. If you take all of Colombia's exports and you facilitate access to markets, would the combined total increase in all of their nondrug exports come close to $500 to $1.5 billion?

Professor GUNTER. Immediately? No, sir.

Senator BRADLEY. For what period of time?

Mr. GUNTER. Oh, you are talking about dynamics. There are some markets, for example fresh flowers, that are being restrained by the size of the market. If the market opens up, then I think you will see an expansion of that kind of business.

Senator BRADLEY. But how long would you say it would take, assuming open markets, to displace the amount of capital that now flows as a result of illegal drug trade? Take your low number: $500 million.

Professor GUNTER. Yes, sir. $500 million, 2 years; if you take the larger number, we are talking 2 to 5 years, sir.

Senator BRADLEY. Two to 5 years?

Professor GUNTER. Yes, sir.

Senator BRADLEY. Let me ask Dr. Lustig a question, if I could. This perverse phenomenon where, as you take on more debt, cap-

ital flight occurs; could you kind of explore that a little bit? The phenomenon, I think, was relevant in Mexico.

Professor LUSTIG. Well, I don't think the causation is that as you increase indebtedness, more capital flight occurs.

Senator BRADLEY. I was referring to your statement in the testimony where you say that in 1981, more than 50 percent of the increase in Mexico's foreign debt was—more than $10 billion—was translated into capital flight. And here comes the money in, and there goes the money out.

Professor LUSTIG. Yes. The causation should go the other way around. At some point, the Mexican Government, instead of implementing the adequate policy reforms, decided to continue financing capital flight by increasing its external borrowing. That's what I meant.

Senator BRADLEY. So, this was just another example of wrong-headed policy—opportunistic and wrong-headed policy?

Professor LUSTIG. Well, or perhaps a policy based on the wrong assumption of future world oil prices. I would like to remind everybody that in 1981, for example, the World Development Report by the World Bank, estimated that world oil prices in 1990 would be around $70 or $80 per barrel. So, Mexico was not alone in misjudging the future.

Senator BRADLEY. Let me ask Mr. Marx a question. This Cavarillo plan is a rather bold plan. As I understand it, you are now setting a fixed dollar exchange rate, and you are hoping that you are going to have enough fiscal austerity that you will dramatically cut inflation.

And the reason this is possible is that half of the monetary base is dollars. So, if everybody came in and said we now want to have dollars, you would be able to do that without printing money.

Now, how long do you think this is going to take before you are able to say this is working, or it is not working?

Mr. MARX. Well, the timing is always difficult to assess. But, in any case, let me point out that this is not just a Cavarillo plan or just a fixed exchange rate plan.

What is underlying here is a major structural change within the Argentine economy. The whole thing I mentioned regarding liberalization, privatization, opening up of the economy, even no distinction between foreign and domestic investment.

We think that part of the structural change is that supports the plan. On top of that, we have the fixed exchange rate, within certain rules, that certainly requires a very tight fiscal balance; and the tighter fiscal balance is given by the fact that the government is not allowed to print money.

And the government felt that it was necessary this time to engage Congress, too, such as being known that the expenditure and revenue decisions are not only shared by the members of the executive power, but Congress representatives also have too much to say regarding that.

There is now the hope that this program will work, provided that fiscal accounts are being tightened up significantly; and the government is also relying upon the fact that some financing will be available, mainly from the Monte—in order just to net out the cash flow that the Republic of Argentina has with them.

Senator BRADLEY. So, what is the answer to the question? How long do you think we have to wait before we are able to say it is going to work or it isn't going to work? This year's budget?

Mr. MARX. No. As I said at the very beginning, it is not easy to point out any time constraints here. What I think is that you will see a slow pace of building up confidence or just the reverse. But it is not just from 1 day that you are going to say the program works or the program doesn't work.

All of these programs take time, and it is just one step after the other; and there is no possibility of making a distinction.

Senator BRADLEY. Mr. Gunter, you are aware of what President Gaviria did earlier this week in terms of dissolving the parliament?

Professor GUNTER. Yes, sir, for the October 1991 election.

Senator BRADLEY. Yes. Now, from your standpoint, from the economic standpoint, what is the implication of that?

Professor GUNTER. With the dissolving—and I understand it is being protested through the court system—but if the dissolving holds, most of the powers held by the legislature will pass into the president's hands, pending the February 1992 seating of the new representative body, sir.

Senator BRADLEY. So, he will be able to run a tighter economic ship?

Professor GUNTER. Well, some of the new policies that have been brought about have developed an element of unpopularity; and this should allow the president to resist this, at least until the election results are in.

Senator BRADLEY. And in terms of the export of drug trade, it also means that the parliament can't pass the law prohibiting extradition of drug traffickers. Is that not correct?

Professor GUNTER. As I understand it, that is correct, sir.

Senator BRADLEY. All right. If each of you had two things that you could suggest that the United States do in order to enhance prospects for capital repatriation in Argentina, Mexico, and Colombia, what would be your two suggestions? Mr. Marx? Only two apiece.

Mr. MARX. I know. I said the most urgent suggestions are two. One is the encouragement of the Monte—to provide financing. The program you referred to is showing some early signals of working, like the inflation rate coming down, etcetera; but it still requires some financing.

And the second is trade possibilities because that, of course, helps very much to create a very positive business environment.

Senator BRADLEY. I am adding a question. What is the most difficult thing that each country must do or continue to do?

Mr. MARX. The single most difficult task within the country is how to allocate the very scarce resources that are available in the budget.

Senator BRADLEY. All right. Dr. Lustig?

Professor LUSTIG. I would say that in the case of Mexico where economic stability is in place the most difficult what tasks are: (a) the recovery of growth, which entails the replacement of the infrastructure that has worn out, (b) the eradication of poverty and, (c) above all, the completion of a genuine modernization and democra-

tization of the political system. I see this last one as the major challenge facing Mexico and its government.

Senator BRADLEY. And what two things could the United States do?

Professor LUSTIG. I would say that, specifically in the case of Mexico, at this point there is perhaps one foremost important thing that the United States can do; and that is to sign a mutually productive free trade agreement with Mexico. In addition, the United States should support Mexico in all the initiatives designed to consolidate its open economic strategy. There are currently multiple ongoing negotiations where this support is necessary. For example, the pursuit of Mexico to become a member of OECD.

Senator BRADLEY. Dr. Gunter, what two things can the United States do, and what is the one thing that Colombia must continue to do or do differently?

Professor GUNTER. Mr. Chairman, as far as the two things the United States can do, in February 1990 Colombia started an aggressive liberalization trade package. They have eliminated the nontariff barriers; they have sharply reduced tariffs. It was announced yesterday that they are going to hit the 1992 tariff targets 2 years in advance.

This, to an extent, is a leap of faith. I think it was the right economic decision; but if Colombia liberalizes and opens up their markets to imports—in which the United States is going to be one of the great gainers—and yet the rest of the world refuses to accept their exported goods and services, then I think this will produce a crisis.

So, the first thing the United States could do, again, is to open up its markets for the legal Colombian exports.

The second thing the United States can do is tied together with the most difficult thing that Colombia can do, which is to eradicate the drug cartels. The level of violence—although recently it seems to have cooled off—in 1990 was incredible: 500 police officers were killed; three presidential candidates were assassinated.

The death rate in Medellin in 1990 was 10 times that of Washington, DC, approximately 20 murders a day. This is the major crisis; this the major battle that Colombia has to fight. And any assistance that the United States can provide in this I think would be much appreciated by the Colombian Government.

Senator BRADLEY. The murder rate was what?

Professor GUNTER. Sir, Medellin and Washington, DC, have different populations—but if you adjust for the population—the murder rate in Medellin was 10 times that in Washington, DC.

Senator BRADLEY. Since January, 3,000 persons have been murdered in Medellin.

Professor GUNTER. I don't have those figures.

Senator BRADLEY. That is the figure.

Professor GUNTER. Yes, sir.

Senator BRADLEY. Well, on that cheery note, let me thank the panel very much for your testimony; it has been extremely helpful.

This is an issue that the United States has always considered somebody else's problem; but I think understanding it, given the interrelatedness of our respective economies and the common aspi-

rations that we hold for our peoples and for the hemisphere, it becomes something that is very relevant to every American citizen.

Your perspectives are extremely helpful; thank you.

Professor LUSTIG. Thank you, Mr. Chairman.

Professor GUNTER. Thank you, sir.

Mr. MARX. Thank you.

Senator BRADLEY. Our next panel consists of Prof. Albert Fishlow, dean, international and area studies, University of California at Berkeley; and Dr. John Williamson, senior fellow at the Institute for International Economics, Washington, DC.

Welcome to the subcommittee, gentlemen. I appreciate your being here today to help us grapple with capital flight and its implications and what we can do. Why don't we begin with Professor Fishlow?

STATEMENT OF PROF. ALBERT FISHLOW, DEAN, INTERNATIONAL AND AREA STUDIES, UNIVERSITY OF CALIFORNIA, BERKELEY, CA

Professor FISHLOW. Thank you very much, Mr. Chairman. I am grateful for the invitation; and in the interest of brevity, I will try to summarize my statement.

It is clear that there is a broad consensus that macroeconomic stability is one of the central conditions to avert capital flight, as well as to secure repatriation. In the absence of such stability, one must depend upon very high real interest rates, which themselves become destabilizing by increasing public sector deficits, as well as reducing investment.

I would just like to make four points with regard to some of these questions of macroeconomic stability and its relationship to debt.

The first point is that it is clear that public policy in the guise of the Brady Plan has made a difference in the last 2 years; and second, in that regard, there is a continuing need for active official presence in negotiating such agreements.

The interests of individual banks, obviously, cannot be depended upon to reach acceptable debt reduction.

The second point that I would like to make is that, in spite of this progress, there has in fact been limited direct impact in terms of reduced cash flow in the context of most of these Brady settlements.

They are on the order of magnitude of around 10 percent in the case of Mexico, Venezuela, Uruguay, and potentially somewhat larger in the case of Costa Rica.

Here, I would emphasize that, while it is commonplace to put the debt problem behind us, we should note that the ratio of debt to exports in the region is, in fact, still higher than it was in 1980 and 1981; that in the second instance the gains that Mexico and Venezuela have gotten from the rise in petroleum prices have been more important than the benefits of debt reduction.

In addition, I would also point out that real interest rates are currently at very low levels, which obviously also gives rise to a favorable impression. Yet, despite all of these circumstances, arrears in the region now amount to something on the order of $30 billion

and have grown by an order of magnitude of something like $10 billion last year.

In other words, there is still a considerable fragility inherent in this debt problem.

The third point that I would like to make is that there is an opportunity for a more aggressive policy in implementing debt reduction, and that it should be sequenced more directly along with reform and stabilization.

We have followed a very conservative policy of waiting for the elements of reform to occur first and then for debt reduction to occur, rather than using debt reduction as one of the instruments in a coordinated fashion for policy as a whole.

This certainly helps to explain the lack of ability of Argentina, Brazil, and Peru to have much success either in macroeconomic stabilization or in debt reduction, while all of them have at least started out with efforts at trade liberalization, reform of the public sector, privatization, and other important steps.

The fourth point that I would make is that we should focus on future financial needs. Repatriation of past capital flight can be of some help, as it has been in particular in the case of Mexico; but it is unlikely to be a panacea.

The capital that fled is likely to be the last to return, rather than the first to return, as confidence is restored. And it will also be the case that some of that capital will remain outside the country as a result of a natural process of asset diversification.

Even with the return of Chile to the capital market—to some extent—and with the favorable response to Venezuela and Mexico, in part because of favorable petroleum prices, there will be a significant financing gap in the region over the course of the next several years if high rates of economic growth are restored.

Ironically enough, because of the Brady Plan, what we have done is to foreclose future renegotiations, which means one is going to have to go to Baker Plan solutions in the future in terms of increased cash flow to deal with the problem of financing economic growth in these countries. Thank you.

Senator BRADLEY. Thank you very much, Professor Fishlow.

[The prepared statement of Professor Fishlow appears in the appendix.]

Senator BRADLEY. Dr. Williamson?

STATEMENT OF DR. JOHN WILLIAMSON, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Dr. WILLIAMSON. Thank you, Mr. Chairman. It is sometimes rather unrewarding to be the final speaker in the final panel of a three-panel session; but I think it has been such a constructive afternoon, and I agree with so much of what has gone before, that all I have to do is dot some "i's" and cross some "t's."

For example, at the beginning of my paper, I tried to give some estimates of the repatriation of flight capital. I agree very much with what Mr. Mulford said earlier, that there are no reliable figures. I don't think these figures are terribly reliable; I make the point by showing a contrast with some figures that came out of a conference I edited several years ago.

Nevertheless, I think they are sufficiently robust, and what has been said by other speakers confirms that, to indicate that there has been a major change in the last 2 years and that overall we are now getting capital repatriation, although that is still very much differentiated by country. Capital is going back to some countries; it is still unfortunately fleeing from others.

I also agree with the theme that has been made by several witnesses that primarily capital flight occurs because it is driven out by bad policy; and in the case of Latin America, that is primarily macroeconomic mismanagement.

But also, I agree with what Mr. Mulford said, when he said that there was a second cause of capital flight; and that was that capital could be attracted by superior returns abroad. And I think that was a background part of the problem in the 1980's. Despite the fact that the big surges were caused by bad macroeconomic policies, the fact that there was a continuing attraction from the rest of the world made the problem more difficult. That attraction arose because of the high real interest rates in the rest of the world, and also because of the tax factor. Some Latin American governments didn't even attempt to tax interest on money that had been placed abroad. But even if they attempted to, they didn't succeed because there were no adequate tax reporting facilities. And consequently, the choice for the Latin American investor is all too often between paying tax if he leaves his money at home, and not paying tax to anyone if he places this money abroad.

I also discuss the effects of capital flight; and again, I endorse what has been said by other speakers. We haven't heard anybody trying to say that this is a great benefit; on the contrary, everyone has identified it as something which has pernicious effects and whose primary burden is borne by the poor, as you indeed said in your introductory remarks.

In terms of the policy responses, it is very clear that one has to look primarily to better macroeconomic management in the countries of the region. And we now do have some countries that have made those policy changes; and in at least two of them, we very clearly see the benefits in terms of a reflow of capital. I am thinking here, of course, of Chile and Mexico.

But I think it is important to recognize that, while better macroeconomic policies are an essential precondition, they won't necessarily by themselves suffice to reverse capital flight. You also have to convince wealth owners that the country is capable of managing its debt burden according to the contractual terms because, if it is not capable of doing that, then it follows that at some stage down the road it is going to have to go back on some contracts. And the wealth owners naturally fear that they may be the ones who bear the burden of that arbitrary change in policy.

Now, I think that the Brady Plan has been a considerable success. Certainly in Mexico, it was critical in changing the perceptions as to whether Mexico could manage its debt burden according to the contractual terms; and once wealth owners were convinced of that, the benefits were altogether more important than those that came directly from the reduction in debt service payments. The benefits came partly in terms of money coming back and partly in the form of lower interest rates; and even though I think

Mr. Mulford exaggerated when he quantified those as 8 to 10 percent of GNP, even if my figure of 5 percent of GNP is right, that is still massive. That is a benefit even greater than the U.S. Congress wrestled with in trying to reduce the budget deficit, so, it is extremely important.

Finally, I then turn to what the United States could and should be doing; and I focus here on the possibility of reducing real interest rates, which means following up on the commitment to reduce the budget deficit over time, and facilitating further debt reduction programs. And there, I think the missing bit still is the public sector.

And finally, this question of taxation in which I make a series of suggestions; and I was delighted to hear in your questioning to Mr. Mulford earlier that our minds appear to be moving in parallel on these issues.

I think we need internationally consistent tax legislation in which all countries, and certainly including Latin American countries, aim to tax the world-wide income of their residents. Argentina, as we heard from Mr. Marx, is moving to that; that is good news.

We need international action to prohibit bearer securities, multilateral tax information sharing, and as a backup, a common rate of withholding tax imposed by a country in which portfolio income is earned, which is only reimbursed on presentation of evidence that the income has been reported to the authorities of the country in which the taxpayer is a resident. Thank you.

Senator BRADLEY. Thank you both very much.

[The prepared statement of Dr. Williamson appears in the appendix.]

Senator BRADLEY. Professor Fishlow, in your written testimony, when you are talking about Mexico, you say they have had some success, but that doesn't mean this is sort of the best way to go.

I wasn't quite sure what you meant by that. Could you elaborate? I mean, should they have done something different than they have done?

Professor FISHLOW. I think the point was a little bit more straight-forward. What I was trying to underline is how late we have come to using debt reduction as part of the arsenal that would assist in achieving macroeconomic stability in Mexico and thereby accelerate the process of capital repatriation.

Senator BRADLEY. So, basically, you are saying that we should have done more sooner?

Professor FISHLOW. Exactly. And there is an important lesson in thinking about the critical cases at the moment of Argentina and Brazil. We are faced in these countries with trying to make a decision about when one should undertake these kinds of debt reduction negotiations.

We know how long they take; and one of the arguments that can be advanced is that if we wait until after stabilization success is achieved, then what we fail to do is to help achieve it.

Senator BRADLEY. Yes. So, with Argentina and Brazil, you would move with a sense of urgency on debt reduction?

Professor FISHLOW. Yes.

Senator BRADLEY. Do you agree, Dr. Williamson?

Dr. WILLIAMSON. I am not sure. I think perhaps Argentina has now got to the stage where it would be appropriate. It is not equally clear to me that in Brazil, at the moment, it has already got a program in place that justifies making that step.

I think it is important to retain the debt reduction agreement as some sort of certification that now the country has taken the necessary steps and got things tied up. Once upon a time, an IMF agreement served that function; but unfortunately, an IMF agreement no longer does serve that function. It has become too routine; and consequently, one can't get this reflux of confidence simply by an IMF agreement. Now, we must not risk losing the potential of Brady agreements to serve that function.

Senator BRADLEY. So, do both of you believe that Argentina has a program in place that will indeed lead to capital repatriation? I mean, what are your estimates of success?

Dr. WILLIAMSON. What I am still not sure about is whether the budget deficit, which has been the perennial problem in Argentina, really is being dealt with at this time. The initial results look more encouraging than in the past; there does appear to be an increase in tax revenue, and that is something Argentina simply had to have in order to make a program stick.

And if this time around the improvement in the budget outcome is not the result of temporary factors, which it has been so often in the past, but really is due to something that can be perpetuated in the long run, then, yes, I think perhaps Argentina is getting there.

I mean, it has done quite an impressive number of things, as indeed Mr. Marx was saying earlier.

Senator BRADLEY. Are you troubled at all by the fixed exchange rate?

Dr. WILLIAMSON. I think that Argentina has now got to the stage where the ability to change the exchange rate was of very small value for anything other than to compensate for having run a past budget deficit, which then had to be inflated away—the consequences had to be inflated away.

That was really the only function it served. When the price system has lost all of its domestic contracts for any length of time—we were hearing earlier how there were now some new debt contracts in Argentina, but they are all denominated in dollars. So, you can't get those adjusted by changing the exchange rate, anyway.

Hence I think there is really very little there—essentially, nothing there—that is worth preserving.

So, no, I don't advise a country to be that rigid in fixing its exchange rate when it still has something to gain out of a flexible exchange rate. But I don't think, at this stage, that Argentina does.

Senator BRADLEY. It doesn't have anything to gain out of a——

Dr. WILLIAMSON. I am sorry; out of a flexible exchange rate.

Senator BRADLEY. A flexible exchange rate? So, your view is that it is a good risk to restore confidence to have a fixed exchange rate?

Dr. WILLIAMSON. Yes, as long as they can make the budget continue to balance, be in surplus; in the long term, then I think it makes sense for them to have a fixed exchange rate, and that that is making the best of a bad situation.

Senator BRADLEY. Professor Fishlow?

Professor FISHLOW. I would just say that the exchange rate is not the key part of the plan. They have had fixed exchange rates in the past. This has been a disease of the southern cone, in which the mechanism by which Argentina very frequently has tried to stabilize has been by holding the exchange rate constant. And as we know, it has not been very successful.

I think the key element in the plan is really the argument that no domestic currency will be printed without having dollar reserves; and that, in turn, implies that one will get a long-run budgetary equilibrium.

I think it is very important, as John Williamson has just suggested, to use as our concept of budgetary equilibrium a permanent, rather than temporary, equilibrium.

In the case of Brazil, for example, the results last year appeared to be approximate budget balance; but that was based on the once-and-for-all financial tax associated with the expropriation of domestic assets that occurred with the first plan. That is something which cannot be repeated.

So, what we have do to is get the concept of fiscal stability right before we are in a position to be able to judge the likely future outcome.

I think the key difference between us on debt reduction, when John Williamson suggested that he would like to wait and have the Good Housekeeping Seal of Approval, is whether you wait for 7 years—as one did in the Mexican case of reform—or whether one waits for something on the order of 6 months, and then tries to be more aggressive in assisting countries in the formulation of adjustment policy.

Senator BRADLEY. Yes. Let me ask both of you a question. Given that there is a limited pool of capital in the world and that there could be a sizable new borrower budging into the scene in the East and the Soviet Union, how will that affect the capital needs of Latin America?

Dr. WILLIAMSON. I think you are quite right in suggesting that there is some competition there. The question is how severe it is going to be; and there is also a question, of course, as to how much competition is going to come from other parties.

And in particular, if the U.S. budget deficit is run down in the future years, then that could provide the resources for East Europe and the Soviet Union without any additional pressure on Latin America.

Senator BRADLEY. But that presumes Latin America is now attracting sufficient capital. See, my point is that if the pool of capital is limited, every dollar that goes to the Soviet Union is a dollar that doesn't go to Brazil, Mexico, or Argentina. Is that wrong?

Dr. WILLIAMSON. Oh, I think that is wrong. Yes.

Senator BRADLEY. Pardon?

Dr. WILLIAMSON. I think that is wrong. I think every dollar that goes to the Soviet Union is going to come from somewhere else, but it may come out of consumption in Japan or investment in the Philippines, or who knows? There are lots of other places that it can come from.

We certainly can't think in terms of a world in which there is a fixed pool of money from the OECD area, which then goes either to the Soviet Union and East Europe or to Latin America. I think that would be seriously misleading.

Senator BRADLEY. Why?

Dr. WILLIAMSON. Because, first of all, it is not a fixed pool; and secondly, there are other places to which it can go: Asia, Africa, the Middle East.

Senator BRADLEY. Right. Professor Fishlow?

Professor FISHLOW. While there may not be a fixed pool, I do think that many are concerned about what will happen in the 1990's as there are more demands that are placed upon the global savings that are being generated.

While one clearly cannot take the total pool as given in the absence of other circumstances—the U.S. deficit may come down, interest rates going up may attract more resources—all of the indications are that there may be increases in interest rates in the 1990's.

That will have an adverse impact upon Latin America as a region because it will remain relatively highly indebted and, therefore, will have to continue to service its past debt.

I would also observe that this circumstance in the 1990's is likely to have a very important differential impact within Latin America. At the moment, it is clear that Mexico is in a very much more favored position to attract U.S. investment than most of the other countries in the region.

It is in a favored position in part because of proximity; it is in a favored position because of the reforms that have been undertaken. It is in a favored position because the free trade agreement promises privileged access to the U.S. market.

So, the competition is not only between Latin America and other areas of the world, but also within the region itself.

Senator BRADLEY. Let me try to reformulate this for Dr. Williamson. Would it be proper to say, as I think Professor Fishlow said, that there is a fixed amount of savings in the world that is used in a certain number of ways? To the extent that it is used in one way, it is not used in other ways. I mean, given normal, assuming no gigantic increase in savings?

Dr. WILLIAMSON. Clearly, one of the key questions here is just how fixed the amount of world saving is. Now, I don't believe there is much evidence that the level of world savings responds with respect to the level of interest rates; but I think that there are other things that it responds to, fiscal policy being one—perhaps the main one.

There are also longer term factors; there are things that are less amenable to policy. There may be some longer term things that policy can do to increase savings, although we don't, I think, have a very clear fix on that.

But I think I would be reluctant to go along with any analysis which said that there is a fixed pool of savings. I think it is largely fixed with respect to the interest rates, but there are other things that influence it.

Senator BRADLEY. Professor Fishlow?

Professor FISHLOW. I think the major potential positive influence is a reduction of the United States deficit. The forces that operate on the other side are the substantial absorption of German savings in the reconstruction of East Germany, where it will have a priority application, and demographic changes in Japan, which may have an impact in reducing the high savings rate in that country.

Looking at all of these elements taken together, while it is clear that one could get very significant increases in total savings, savings is already somewhat reduced as a percentage of total world income relative to what it had been earlier in the 1970's and the late 1960's.

Senator BRADLEY. I don't want to belabor this point, but maybe I am just not understanding it. This is a hearing on capital flight; and every one of the witnesses has said the debtor countries have to get their own economies in order, in order to attract back capital that has been deployed elsewhere for some other reason.

Now, as they are attempting to get the capital back, the national that has the capital abroad looks at a menu of possible other places that they could put that capital. They have to decide that they would rather put it back in Mexico or in Argentina than they would put it in the Soviet Union. Is that not correct?

Dr. WILLIAMSON. When we are talking about capital repatriation, I think that is not much of a choice. Few Argentinean investors are going to think of putting their money in the Soviet Union.

Senator BRADLEY. Why?

Dr. WILLIAMSON. Because if they don't want to put it at home, they want to put it somewhere safe. I mean, the reason an Argentinean puts his money abroad is because he is afraid; and if he is risk averse—if he is afraid—he is not going to put it in the Soviet Union.

Senator BRADLEY. Unless he feels that the new Soviet leadership restores greater confidence for him than does his own Argentinean leadership.

Dr. WILLIAMSON. Even then, I don't think that that is where you will find the bulk of the money going to the Soviet Union from. The natural place for that is from Western investors who are prepared to take a risk of losing in return for the possibility of exceptionally high returns.

And of course, for the Soviet Union to create such a possibility, if they do that, that will be a revolution in itself. And at the moment, they are not there; but who knows? Things change week by week.

Senator BRADLEY. Professor Fishlow?

Professor FISHLOW. Yes. Capital repatriation refers to the stock of past savings, whereas, of course, each year we would be generating new capital through additional savings.

I don't think the bulk of the total pool of Latin American capital flight which has been estimated as something on the order of around $100 billion, is likely to do much else than stay in banks or in real estate in the United States or elsewhere, and is unlikely to be invested in the Soviet Union or Eastern Europe.

Senator BRADLEY. Let me thank both of you for your testimony. I appreciate your taking the time to help us try to think this through.

If I could ask you as a final question the same thing I asked the previous panel, in terms of what two things do you think the United States could do to hasten repatriation of capital, and what one thing must these countries continue to do or do differently, what would you say?

Professor FISHLOW. In terms of the one thing that the countries have to do differently, it seems to me that you put your finger on it much earlier. It is fiscal policy. There can be no stability in these countries until you get equitable taxation and reduction of government expenditures. So, I think that is relatively clear.

With regard to U.S. policy, I would still like us to be more aggressive in trying to fold in debt reduction more actively as part of an effort to influence stabilization and reform, as it is ongoing, rather than wait a long time to assure it has already been successful.

And secondly, I would like to begin trying to anticipate Latin American capital needs for a more rapidly growing region over the course of the next 5 years, rather than waiting to react when there may be a shortfall.

Senator BRADLEY. Dr. Williamson?

Dr. WILLIAMSON. On what countries should do for themselves, there is a difficulty because the country situations differ very much. The ones that really need to do things differently are the ones for which fiscal action is still needed; and I think, if those are the ones we are addressing ourselves to, then I agree very much with what Al Fishlow has just said.

Now, on what the United States should do, I was impressed by the remarks of earlier speakers about trade; but nevertheless, I will stick with the two things that I have in my original prepared testimony, one of which was to at least match the timetable for reducing the U.S. budget deficit—and preferably do better—so as to reduce real interest rates and make more funds available to flow to Latin America and to Eastern Europe and the Soviet Union, among other areas.

And the other one is to start extending to the countries outside of the OECD the sort of arrangements on tax information sharing that the OECD negotiated among themselves and which hopefully is going to start coming into operation very rapidly, as there is only one more ratification needed for that treaty to become operative.

Senator BRADLEY. Let me thank both of you for taking the time to come in and share your thoughts. Let me thank all of the panelists. It has been extremely helpful.

As I said earlier, this hasn't really been on the screen of American politics; but I think increasingly it must get to the screen before it becomes a relevant domestic issue.

So, I want to thank everyone for their testimony. This hearing is now concluded. Thank you very much.

[Whereupon, at 4:10 p.m., the hearing was adjourned.]

APPENDIX

Additional Material Submitted

Prepared Statement of Albert Fishlow

It is now almost a decade since the Latin American debt crisis first became manifest. The subsequent adjustment has taken a significant toll in foregone economic growth for the people of the region: per capita production now stands 10 per cent below 1980 levels; and per capita income, factoring in the 20 percent decline in the regional terms of trade, lower still. And there is evidence to suggest in many countries that the principal burden of the lost decade of the 1980s has fallen upon the poor.

Gradually, public policy of the industrialized countries and multilateral financial institutions has shifted from an immediate concern with the fragility of the international financial system and the exposure of bank lenders to a recognition of the need to focus upon renewing economic development. The Baker Plan in 1985 envisaged larger financial flows, both from official sources and commercial banks, to ease the large financial transfers required by debt service. This policy failed for two reasons. First, the required private flows were not forthcoming; second, medium term uncertainties created by the sheer size of the debt overhang made the Baker policy of growing into an expanded debt progressively more difficult.

More than two years ago, partially in recognition of the more precarious position of official lenders who were being placed in the position of underwriting interest repayments to commercial creditors, the Brady Plan was launched. It recognized the need for debt reduction, both as a means of improving cash flow as well as avoiding disincentive consequences of the debt overhang. Such new style agreements have now been negotiated with Costa Rica, Mexico, Uruguay and Venezuela, while Chile has opted in favor of rescheduling with new money, including a return to the voluntary capital market.

But while it is now fashionable to put the debt problem behind, it is well to remember that many countries of the region remain in arrears to an estimated total of some $30 billion; that several are delinquent in payments to the multilateral institutions; and that the Latin American debt of well over $400 billion remains much higher relative to exports than it did in 1981 and 1982.

What are the lessons to be learned from this experience?

First, public policy of the United States and other industrialized countries, and of the multilateral institutions, makes a difference. Brady style agreements, without simply diverting benefits from debtors to creditors, were possible only in the context of significant pressure in behalf of debtor countries. Otherwise, the free rider problem would have encouraged individual banks to hold out in favor of more beneficial terms. Private profit maximization in isolation does not correspond to the best social outcome. Conversely, countries that have tried to go it alone and impose unilateral debt relief, were largely unsuccessful, including at various times, Argentina, Brazil and Peru. Even where countries were able to avoid immediate payment, the extra cash flow was reduced in its favorable effects both by poor domestic policy and the attendant uncertainty of its sustainability. Bank negotiating positions thus remain relatively strong; there can be no solution without active private participation.

Second, debt relief has generally been limited in its magnitude. In the cases of Mexico, Uruguay and Venezuela the improvement in cash flow has been of an order of about 10 per cent of cash flow, but higher for Costa Rica. The reason is that typically only a portion of total debt is reduced, and not at deep discounts. That does not mean that such arrangements were not desirable—their calculated rates of return are favorable—but rather that debt relief cannot be counted on in isolation

to make a big difference. The overall content of domestic policy, and external variability in import and export prices and interest rates, count for much more. Note that Mexico and Venezuela gained more incremental foreign exchange from the rise in oil prices than from debt relief. All countries in the region are still in fragile circumstances, and will need years of sustained growth to emerge strengthened.

Third, debt policy thus far has failed to contribute to successful stabilization and adjustment in Argentina and Brazil. It is argued, and persuasively, in view of massive inflation, a succession of failed domestic macroeconomic plans and diminished confidence in domestic policies, that debt relief must await more durable evidence of these governments' commitment to reform. Otherwise any increase of external resources will be diluted in wasteful public deficits and capital flight. But this sequencing is too simplistic and also potentially too costly: the objective is not to maximize austerity but to induce durable structural change within the context of democratic politics.

There is an opportunity, and a need, for integrating structural reform—including privatization and trade liberalization, most prominently—macroeconomic stabilization and debt relief to achieve favorable results in Argentina and Brazil, and in other lagging Latin American countries. In both these larger countries there is an ample effort underway. Inadequate implementation can be given a boost by external support rather than a more cautious policy of wait and see that can contribute to erosion of private sector support.

Mexico and Chile provide lessons, but perhaps others than are conventially drawn in favor of domestic reform first, and eventual external accommodation second. Earlier endorsement of the de la Madrid reform policies might have been helpful rather than deleterious; there could be no doubt of his commitment, as continued and amplified by President Salinas. Yet Mexican economic growth was hampered by excessively high real domestic interest rates and handicapped by potential foreign exchange limitations. Because there are now much more favorable Mexican economic prospects does not mean that the way chosen was the best. In parallel fashion, Chile's current democratic politics and growing economy should not simply rationalize Pinochet's dictatorship and underline how essential the earlier reforms were. Rather, optimistic Chilean forecasts demonstrate how, given an advantageous economic starting point, democracy can work.

Helping to create these economic conditions where the inheritance has been less favorable is what external policy should be about. It is encouraging to see United States leadership in helping Honduras and most recently Peru make up their arrears to the multilateral financial institutions as a prelude to renewed eligibility for official finance. But a more aggressive stance on private debt relief could also prove productive and help to provide immediate assistance to reform efforts elsewhere. For smaller countries, like those of Central America and the Caribbean, moreover, official debt owed to the United States represents a significant sum. Active implementation of the promise of relief inherent in the Enterprise for the Americas can afford assistance.

Fourth, financing needed economic growth in the region in the 1990s must remain a concern. Inevitably the vast bulk of the resources must be supplied domestically. But rebuilding obsolescent public infra-structure and private capital will require an external contribution. There is wide recognition in Latin America that private investment must play a significant part in transferring not only savings but also technology. Attitudes about foreign investment, and earlier restrictions, have shown important modification.

Renewed economic growth will attract back to some countries, most notably Mexico, capital that earlier left. The estimated $100 billion held outside countries of the region constitutes a major pool. But one must also not exaggerate expectations: some will stay abroad as part of a desired diversification of asset holdings just as we see with other countries, and cautious owners of deposits may be the last to commit. Accumulated flight capital cannot be held up as a rationale for doing nothing on the grounds that the resources exist. But, equally, evidence of persistent renewed capital flight is a signal that domestic policy is not working.

The 1990s promise to be a decade of increased pressure on available savings as industrialized countries progressively recover, the needs of Eastern Europe and the Soviet Union are taken into account and one factors in restored economic growth in Latin America. In such circumstances, interest rates will remain relatively high, penalizing countries of the region for their past indebtedness and making external resources the more necessary. Paradoxically, since debt reduction has been only modest, and further renegotiation is now rendered more difficult, the "success" of the Brady Plan will quite possibly require a new Baker Plan, but one dimensioned over a medium term.

In order to sustain growth rates of the order of 5 per cent, Latin America will need to increase both its rate of investment as well as its imports of capital goods. While both domestic savings and exports can be expected to play the largest role in financing these increments, a residual requirement of external finance will be needed. Even under present circumstances, arrearages are being accumulated. Rough calculations would suggest a shortfall of the order of $25 billion annually as growth accelerated.

The successful placement of the Chilean issue and return to the market in modest scale of Mexico and Venezuela, enhanced by the higher oil price, while encouraging, and the recovery of private investment, do not suggest that a totally private response will be adequate to meet it. Covering the gap would fall to longer term official flows that should be programmed now; in their absence, growth potential will be diminished.

Private equity and official debt should again become the principal vehicles for external finance for countries of the region in the 1990's, as they were earlier. The Enterprise for the Americas emphasizes trade and not aid. It should also emphasize finance and not aid if the promise of rapid economic development in the 1990s is to become a reality.

This hearing occurs at a time when much attention is upon industrial country response to the request of the Soviet Union for large economic assistance to undergird its transformation into a market economy and its conversion to democratic politics. It would be more than ironic, after a decade of costly sacrifice for the Latin American countries, if the needs of our hemispheric neighbors were given short shrift by these other priorities. Almost all countries in the region have already moved far along in economic and political transformation. And what they require is not massive assistance but fuller extension of debt reduction and assured access to finance. The claims of eastern Europe and the Soviet Union are important for our vital interests, but they need not be exclusive of also vital concerns for economic development and political democracy in Latin America.

Prepared Statement of Frank R. Gunter

ABSTRACT

Recent Colombian economic development has differed in several fundamental ways from that of the rest of Latin America. Colombia has experienced continuous real growth and, despite the debt crisis, has yet to reschedule any of its foreign debt. Colombia has also experienced more moderate capital flight then neighboring countries. However, these low estimates of capital flight may be deceptive since Colombia is the recipient of unreported earnings from the illegal drug trade. Thus the observed moderate level of capital flight results from the inward flow of drug related funds offsetting an almost equally large outflow of traditional capital flight. These offsetting flows are not independent since, at least recently, violence fueled by illegal drugs has apparently been the primary motivation behind outward flight of unreported funds from Colombia. If this analysis is correct then the eradication of the drug trade may lead to a reduction in tradtional capital flight from Colombia and an improvement in the country's external economic situation.

> "Why is it that when an American puts money abroad it is called 'Foreign Investment' and when an Argentinian does the same it is called 'Capital Flight'? Why is it when an American company puts 30 percent of its equity abroad it is called 'Strategic diversification' and when a Bolivian businessman puts only 4 percent abroad it is called 'Lack of Confidence'?"
> [Stephen C. Kanitz, *Wall Street Journal*, September 21, 1984.]

I. INTRODUCTION

Despite the great difficulty in separating "good" international diversification from "bad" capital flight, the size and variance of these capital exports from developing countries have become a matter of increasing concern. According to some analysts, this capital flight has contributed to the sharp increase in foreign debt of developing countries, undermined the tax base and in extreme cases even resulted in a net real capital transfer out of the country.

The Colombian situation is unusual for two reasons. First, through a combination of good management and good luck, Colombia has avoided the worst effects of the debt crisis. It has experienced continuous real growth since the debt crisis began and has yet to reschedule any of its foreign debt. The second issue is more contro-

versial. In the popular view, the Colombian trade economy is tied to exports of illegal drugs. Despite the volume of information (and possibly mis-information) published concerning this trade, it is difficult to estimate its real effect on Colombia's international and domestic economy. If plausible estimates of the direction and volume of capital flight with respect to Colombia can be produced then insights into both of these issues should be possible.

In most studies of capital flight, it can be assumed the usual direction of flight is "out." Although improvements in regulatory or taxation policies or simply an improvement in the country's economic outlook may bring about a temporary repatriation of flight capital, the desire of wealth holders to diversify their portfolios will eventually lead to a restoration of outward flows. But the incentives for either an outward or inward movement are the same in the sense that a policy that would increase outward flight would tend to reduce inward repatriation.

However, in the case of Colombia, one can't be sure that the usual direction of Colombian capital flight is "out" since the motives for movements in different directions appear to be different. The repatriation of the profits of illegal drug sales to Colombia provides incentives for unreported international capital flows into Colombia. This repatriation of capital may take the form of working capital for further drug transactions or to provide funds for consumption by the successful dealer. These motives are distinct from those of a Colombian wealth holder seeking international diversification. Most measures of capital flight will only capture the net effect of these opposing flows.

II ALTERNATIVE MEASURES OF COLOMBIAN CAPITAL FLIGHT

There are a variety of means of moving funds across borders without leaving a trail including: via the international payments mechanism, via cash movements, via precious metals and collectibles, via false invoicing of trade transactions as well as via the cross border movement of contraband and human capital. These methods can be viewed as a three way tradeoff among secrecy, expected returns and risk. Attempts to increase the secrecy involved in an international capital transaction will result in lower, possibly negative, returns and increased risk of lose of principal.

Therefore, while perfectly hidden transactions are possible, their cost in foregone return and increased risk is substantial. Most unreported international capital transfers are a compromise and leave indirect, if not direct, evidence of their occurrence. The two means of estimating capital flight for Colombia that are used below are intended to capture in different ways, this indirect evidence. However, these measures must be adjusted to correct some discrepancies in the existing data.

The balance of payments approach for estimating capital flight was developed by Cuddington in 1986. He believed that the most important characteristic of flight capital was that it was "hot" money. Small changes in perceived returns or risks could result in a rapid transfer of these funds out of the country. Based on this characteristic, Cuddington's estimates of capital flight are equal to the sum of reported short-term capital exports by the private non-bank sector and, the balance of payments residual, errors and omissions. The latter inclusion is based on his belief that errors and omissions largely reflect unrecorded short-term capital flows.

One weakness of the Cuddington method is that it relies on the completeness and accuracy of the country's balance of payments statistics. The figures for short-term non-bank capital flows are notoriously unreliable and would be distorted by smuggling and mis-invoicing. This mis-invoicing may be motivated by a desire to facilitate capital flight or as a means of reducing tariffs or avoiding quotas. For example, a Colombian resident may under-invoice his exports and then direct the unreported difference between the invoice amount and his actual receipts to some financial haven. Such under-invoicing of exports would widen (narrow) the reported trade deficit (surplus). An attempt has been made to adjust the net Colombian capital flight estimates in the Table for mis-invoicing.

The most widely used measure of capital flight is based on the reported foreign debt of the country. If this reported foreign debt exceeds the amount of foreign debt that is explained by the country's "legitimate" international transactions then the excess is considered as capital flight. Commonly changes in gross foreign debt are compared to the sum of the current account balance, changes in reserves and net direct investment. The difference between these two aggregates was considered to be capital flight. This measure would seem to be exaggerate capital flight since it ignores the necessary foreign transactions of the banking system. To facilitate trade and investment it is necessary for the banking system of a developing country to create foreign assets. This outflow of funds would increase the country's need for borrowing and this increase would show up as an apparent increase in capital flight.

The residual estimate of net Colombian capital flight in the Table has been adjusted for mis-invoicing of trade statistics, under statement of legitimate resident foreign capital and currency valuation. Rather than concentrate on a single measure of capital flight from Colombia, both the balance of payments and the residual methods are listed in the Table. These two estimates, which rely on fundamentally different methods, should provide a rough guide to direction and volume and yet avoid the danger of implying an accuracy to the results that is not deserved.

III PATTERN OF COLOMBIAN CAPITAL FLIGHT

Based on the data in the Table, net Colombian capital flight has gone through three phases since the beginning of the debt crisis. From 1983 through 1985, it was roughly $500 million a year. As a matter of scale this was equal to about 15% of average Colombian exports during this period. In the following two years, 1986 and 1987, the evidence points to net capital *inflow* while the most recent data points to a situation of mild net capital flight. Net capital flight has been a less serious problem for Colombia compared to the rest of the countries of Latin America.

However, returning to the issue raised in the introduction, net Colombian capital flight can be viewed as the difference between two types of flows. The first would be the "traditional" capital flight observed in the most of the countries of Latin America during this period. This is unreported, usually illegal, movements of capital out of the country to avoid taxation, expected devaluation or possibly as a result of fears of nationalization or accelerating inflation. The second type of flow would be the unreported movement of funds earned by smuggling or other illegal activity into the country. This inward flow is usually associated with the drug trade.

A. The Drug Trade

For Colombia, this second flow was traditionally dominated by emeralds and later by illegal coffee and beef exports. The unreported beef exports were to Venezuela across its long, almost open, border with Colombia. The illegal emerald, coffee and, later, marijuana and cocaine smuggling was generally either directly or indirectly to the industrialized countries and especially the United States. Estimates of the value of this trade is subject not only to all the usual problems with estimating illegal activity but also ambiguities about whether the estimates are gross or net and whether they reflect earnings actually smuggled into Colombia or possibly stored away in some safe haven.

Colombian gangs generally fill a middleman role in the cocaine trade. The Coca paste is flown in from Bolivia and Peru. Using chemicals often imported from the United States, the paste is converted into cocaine base and then cocaine hydrochloride. It is the hydrochloride form that is generally smuggled into the U.S. or Europe. Wholesalers and retailers dilute the cocaine hydrochloride dramatically before sale. Thus 1 kg of cocaine in 1988 required about $750 of coca paste and sold for an estimated $4000 a kilo as cocaine hydrochloride. This kilo, if 85% to 95% pure, might have wholesaled for $18,000 in the U.S. and, after being cut, retailed for $200,000 a kilo in the street. To the extent that Colombians vertically integrate by moving into wholesale and retail operations, their revenues could rise dramatically. However, the costs of being a wholesaler or retailer are also much higher as well and it is very difficult to determine the net effect of such a strategy on Colombian earnings.

Estimating the balance of payments effect of the drug trade for Colombia requires three inter-related estimates (see Thoumi F. (1990) "Estimates of the Economic Impact of the Narcotics Industry on Colombia: An Evaluation," mimeo, June for a discussion of this issue.) First, the revenues to Colombians from illegal drugs must be estimated. Second the foreign costs of production should be subtracted from these revenues. these expenses, paid to nationals of other countries, would include payments to Bolivian and Peruvian producers of coca paste, U.S. chemical companies and U.S. lawyers. Finally, the proportion of net earnings that are smuggled back into Colombia must be estimated.

Detailed studies of drug earnings by Gomez H. (1990, "El Tamano del Narcotrafico y Su Impacto Economico," Economia Colombiana Vol. 226, No. 2, pp. 8–17) and Kalmanovitz S. (1990 "La Economia del Narcotrafico en Colombia," Economia Colombiana, Vol. 226, No. 2, pp. 18–28.) are presented on lines C and D in the Table. These estimates have been adjusted for payments to non-Colombians. Also it has been assumed that only 50% of the earnings returned to Colombia.

As can be seen from the Table, in recent years there has been an almost $2 billion difference between the estimates of drug related earnings of these studies. Gomez estimates are based on a 72% decline in the U.S. price of cocaine combined with a 17% decrease in volume. Kalmanovitz is more pessimistic on both the price and

volume issues. One might feel fairly comfortable that these estimates are upper and lower limits. Thus recent net repatriated Colombian earnings from the illegal drug trade are probably in the range of $500 million to $1.5 billion.

B. Traditional Capital Flight

If we assume independence between traditional capital flight and the inward flows related to the drug trade, then the volume of inward flows may be added to the net Colombian capital flight estimates in Lines A and B in order to provide estimates of the offsetting traditional capital flight. The most pessimistic estimate for traditional capital flight is given on Line E while the most optimistic is given on Line G. The middle estimate is simply the average of these two estimates. This pattern of traditional capital flight mirrors that of net capital flight, a high level of flight is followed in 1986 and 1987 by an improvement before a more recent deterioration.

Traditional capital flight is driven by fears that future events or policies will reduce the value of domestic assets. If there is no government exchange control then domestic asset holders will respond to these fears by international diversification. However, in the presence of exchange controls, the only option are the unreported international movement of funds referred to as capital flight.

Colombia has had a strict exchange control policy since 1967 and, as a result, has forced international diversification underground. The pattern of traditional capital flight shown from 1983 through 1987 is susceptible to a economic explanation. Beginning in 1982, Colombia's exchange rate became increasingly overvalued. Fearing the loss of the value of their asset holdings when the eventual devaluation occurred, many Colombians sought to convert their holdings into other currencies.

Aside from the capital flight measures in the Table, evidence for this explanation can be found in other data. First, there was a sharp drop in Colombian international reserves. From $4.7 billion in 1981, these reserves fell to $1.4 billion in 1984. Second, the parallel market in U.S. dollars went from a discount of 4% in 1981 compared to the legal exchange rate to a surplus of 17% in 1984. Following the devaluations of December 1984 and 1985, this particular incentive for capital flight declined. By 1986, Colombian international reserves had climbed back to $2.7 billion while the parallel market value of U.S. dollars had returned to approximately par with the official rate.

The more recent data are somewhat suspect because of the radical revisions that occur in the capital side of the balance of payments statistics. However, both measures reveal an increase in traditional capital flight while the economic incentives for capital flight were apparently decreasing. Devaluation fears appear to have receded, reserves grew to almost $4 billion by the end of 1989 while the parallel market value of the dollar was within 1% of par in that year. However, if the purely economic incentives for traditional capital flight have receded then what caused the substantial rise in estimated traditional capital flight in 1988 and 1989.

During the decade of the '80s the prevalence of political and personal violence increased. Crimes against property, murder rates and kidnapping all increased. An attorney-general, a justice minister and more than 50 judges have been killed by drug-traffickers and guerrillas, while during the last year, even greater depths of violence were plumbed by the assassinations of several presidential candidates. A natural reaction to this climate of increased uncertainty and fear has been to seek international havens for funds and often for families as well. Thus although the purely economic motivations for traditional capital flight may have at least temporarily disappeared, fear of violence may be sufficient to lead to continued net capital flight. Thus traditional capital flight appears to have offset the inward flows from illegal activities during 1988 and 1989.

C. Interdependence of Capital Flight and the Drug Trade

The scale of the net capital flight flows compared to those associated with the drug trade (inward) and traditional capital flight (outward) appears to shed light on a major issue concerning the importance of the illegal drug trade to the Colombian economy. A variety of sources have commented on the perceived importance of drug earnings to the Colombian economy. Some articles in the press have credited these earnings with allowing Colombia to continue to service its foreign bank debt while the rest of Latin America has sought rescheduling. According to this view, eradication of the drug trade will end the inward flow that has substantially offset traditional capital flight. Thus the end of the drug trade will also end Colombia's ability to avoid the worst effects of the debt crisis. However, this view assumes that the two offsetting flows are independent.

As was argued above, the major cause of the recent increase in traditional capital flight is the perception of a rising level of violence and lawlessness in Colombia. To

a great extent the daily murders, kidnappings and random violence towards officials and ordinary citizens are drug related. Thus the two flows are not independent. The growth of the drug trade has increased the inward flow of drug money but, by reducing confidence in the country's future, has led to a sharp rise in traditional capital flight. Viewed narrowly as purely an economic issue, the drug trade appears to have caused a net deterioration of Colombia's international situation in recent years. And the eradication of the drug trade, by reducing the fears that are fueling traditional capital flight, may lead to a net improvement.

Stated in another way, since net Colombian unreported capital flows have, with few exceptions, been outward over the last decade, the drug trade, viewed purely as an economic issue, appears to have caused a net deterioration of Colombia's international situation. Consequently, eradication of the drug trade, by reducing the fears that are fueling traditional capital flight, may lead to an improvement.

COLOMBIAN CAPITAL FLIGHT
($ millions, positive number represents capital outflow)

	1983	1984	1985	1986	1987	1988	1989
Net Capital Flight Estimates							
A Balance of Payments	$700	$400	$150	$100	($650)	$500	$100
B Debt Residual	$500	$200	$800	($600)	($300)	($50)	$50
Drug Related Inflows							
C Gomez '90	($1,100)	($700)	($700)	($700)	($400)	($350)	($300)
D Kalmanovitz '90	($1,750)	($1,900)	($1,800)	($1,650)	($2,250)	($2,150)	($2,400)
Traditional Capital Flight							
E High Estimate	$2,450	$2,300	$2,600	$1,750	$1,950	$2,650	$2,500
F Middle Estimate	$2,025	$1,600	$1,725	$925	$850	$1,475	$1,425
G Low Estimate	$1,600	$900	$950	$100	($250)	$300	$350

A Cuddington method adjusted for mis-invoicing.
B Morgan method adjusted for mis-invoicing and currency valuation.
C Gomez 1990, Cuadro 5, p. 14 minus 50% except 1989 data which is estimated by author.
D Kalmanovitz 1990, Cuadro 1, p. 19 reduced by 57.5%.
E Greater of A or B minus lesser of C or D.
F Average of E and G.
G Lesser of A or B minus greater of C or D.

Methods and analysis from Gunter, Frank R. (1991) "Colombian Capital Flight," Journal Of Interamerican Studies and World Affairs, Vol. 33, No. 1, pp. 123-147.

Table 2

U.S. Bank Exposure in Latin America
(Adjusted for guarantees)

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Adjusted Debt ($ mn)									
MCB - Colombia	$2,584	$2,381	$2,207	$1,843	$1,534	$1,398	$1,426	$1,370	$1,341
All - Colombia	$3,664	$3,579	$3,021	$2,535	$2,155	$2,073	$2,095	$1,853	$1,740
MCB - Latin America	$51,186	$51,311	$53,720	$52,516	$51,451	$49,972	$46,661	$40,353	$32,619
All - Latin America	$83,695	$84,079	$86,184	$81,425	$78,993	$74,741	$64,081	$51,793	$39,916
% of U.S. Bank Capital									
MCB - Colombia	8.91%	7.56%	6.01%	4.36%	3.28%	2.71%	2.56%	2.40%	2.26%
All - Colombia	5.19%	4.51%	3.28%	2.41%	1.86%	1.60%	1.54%	1.28%	1.14%
MCB - Latin America	176.50%	162.89%	146.38%	124.15%	110.17%	97.03%	83.62%	70.79%	55.01%
All - Latin America	118.83%	105.89%	93.48%	77.25%	68.04%	57.85%	47.26%	35.67%	26.11%

MCB - 9 Money Center Banks
Data: FFIEC Statistical Release, E.16 (126), various issues

Table 3

External Position of Colombians vis-a-vis Banks
(All sectors)

	1982	1983	1984	1985	1986	1987	1988	1989	1990
BIS Reporting Banks ($ mn)									
Colombian Assets			$3,839	$3,708	$4,337	$4,853	$5,969	$6,740	$7,107
Colombian Liabilities			$7,098	$6,462	$6,543	$6,649	$7,087	$6,629	$6,635
Net Position			($3,259)	($2,754)	($2,206)	($1,796)	($1,118)	$111	$472

Data: Bank for International Settlements, International Banking, various issues

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Banks in the U.S. ($ mn)									
Colombian Assets			$2,514	$3,104	$4,285	$4,204	$4,374	$4,653	$4,492
Colombian Liabilities			$3,499	$3,249	$2,826	$2,740	$2,944	$2,784	$2,585
Net Position			($985)	($145)	$1,459	$1,464	$1,430	$1,869	$1,907

Data: Federal Reserve bulletin, Tables 3.17 and 3.18, various issues

PREPARED STATEMENT OF NORA LUSTIG *

Thank you Mr. Chairman for inviting me to express my views on the evolution of capital flows in Mexico.

Shortly before Mexico announced that it could not meet payments on its debt in mid-1982, a man carrying a suitcase containing U.S. $10 million in currency was stopped by Mexican authorities at the airport. He was released a little while later because he had committed no crime. At the time there were no controls on capital outflows in Mexico. This gentleman was doing what hundreds of thousands of others were doing on a smaller scale, and a few on a much larger scale: putting their savings abroad. While Mexico was falling into its most protracted economic crisis of modern times, private citizens with liquid savings could divorce themselves from the painful process that affected their country. The siphoning of savings abroad made the adjustment process ever more difficult, as this process reduced foreign reserves, putting more pressure on the already strained external accounts.

Capital flight was not a new phenomenon in Mexico. Capital fled Mexico during the controversial years of President Echeverria's government, peaking in 1976 when the country faced a very severe balance of payments crisis. A combination of anti-capitalist rhetoric and actions, an over-expansive fiscal policy, and an unsustainable exchange rate policy caused this wave of capital flight. After a three-year lull, capital flight from Mexico resumed with a vengeance in the early 1980's. The flow only began to reverse itself sometime in 1989 when a stabilization program—the third attempted since 1983—finally succeeded in bringing down inflation. In addition, a number of other measures were implemented to attract domestic and foreign capital. Beyond capital repatriation, new sources began to flow as investors saw Mexico as a promising country. But, indeed, the distinction is not so relevant. The fact is that Mexico's credit-worthiness has been growing steadily since 1990, and Mexicans and foreigners alike are ready to bring in their capital and invest.

The purpose of my testimony will be, first, to discuss the causes and consequences of capital flight in Mexico. Second, to discuss the factors which explain the recent wave of capital repatriation. And third, to suggest how the United States can continue to provide support to Mexico, as well as help the rest of Latin America in their efforts to implement sweeping reforms to achieve stability and growth.

I argue that capital flight was not a primary cause of the crisis, but the result of an unfortunate combination of internal mismanagement and external shocks. Capital flight, however, continued beyond the period of policy mismanagement. Because of the debt overhang, savers did not believe stability was achievable for even the most committed and iron-fisted government. Capital flight made adjustment very difficult because it reduced foreign reserves, added to the pressures on the external accounts, and made the economic environment even more unstable. Capital flight also produced very regressive income distribution effects because owners of flight capital are often wealthy, and adjustment falls on wage earners and the poor.

Now, capital flight in Mexico has stopped and capital repatriation has begun. Capital has come back because of a successful stabilization program, in addition to a number of policies and initiatives that have increased the country's credit-worthiness. Market-oriented reforms, the debt agreement with commercial banks, and—more recently—the prospects of a North American Free Trade Agreement (NAFTA), have all contributed to enhance Mexico's credit-worthiness. Today, the most important contribution that the United States can make to aid Mexico's recovery is to make the Free Trade Agreement come true, and to do it as soon as possible. At this point it will not help Mexico to attempt further reductions in its foreign debt, as some FTA opponents have suggested in place of a Free Trade Agreement. This action would immediately curtail its renewed ability to borrow in international capital markets. The savings obtained from further debt reduction could be easily countered by the fall in new credit, and the uncertainty produced by an off-schedule debt-reduction scheme could dampen the hard-won climate of confidence.

I shall begin my exposition by giving the order of magnitude of capital flight.

1. How much capital flight was there in Mexico?

For the purposes of this exposition capital flight is defined as capital that flees from perceived abnormal risks at home, such as currency devaluations, political instability, or confiscatory measures. Depending on the method chosen to estimate it,

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capital flight from Mexico over the period 1977-1987 ranged from a lower estimate of U.S.$ 22.1 billion to an upper estimate of U.S.$ 35.7 billion; or 21% and 33% of the total external debt for 1987, respectively. [1] Note that these figures are well below the widely publicized Morgan Guaranty estimate of U.S.$ 45 billion. [2]

2. What was the time profile of capital flight?

After a three-year respite, capital flight accelerated in the second half of 1981 resulting in a total of U.S.$ 11.6 billion for the year. In 1982 the rate of capital flight continued to be high, but the total was lower than in the previous year. The figures declined substantially for the 1983-85 period, and there was a sizable inflow of capital in 1986 and early-1987. In 1988 there was a resumption of capital outflows, followed by the current wave of capital inflows, especially from mid-1990 onward. However, yearly figures can be misleading with respect to the extent of capital flight and its impact in some periods within the year. For example, 1985 and 1987 appear as years when capital flight was relatively small. The rapid acceleration of capital outflows in mid-1985 and October 1987, however, triggered fundamental changes in the domestic policy arena.

3. What were the causes of capital flight?

There are three fundamental factors that explain capital flight in Mexico. The first is the overvaluation of the Mexican peso, i.e., that the dollar is "too" cheap to be sustainable. In this case savers fled from the peso in search of higher expected returns, which a devaluation will instantaneously produce, or to protect themselves from the costs of devaluation, such as higher inflation rates. Second, capital fled the country as a response to and/or in anticipation of government decisions that affect property rights. Third, capital left the country, and subsequently stayed out of the country, in a rush to safety action. Savers and investors perceived that no matter how committed the government was to maintaining a coherent economic program, the pressures on the economy—especially those caused by the debt overhang—were insurmountable, and economic stability would not last.

All three factors, either in isolation or jointly, have induced capital flight. Upsurges in capital flight during the second half of 1981, the first part of 1982, and in mid-1985 were based on the perception that the peso was overvalued, and that the economic policies pursued were inconsistent and unsustainable. Capital flight in the second half of 1982, and to some extent in 1983 and afterward was a reaction to the freeze on dollar denominated accounts, and to the nationalization of the banking system. The middle class and big business lost confidence in the government as a result of these two measures, which affected property rights. Despite efforts made by the new administration in December 1982 to change this attitude, it would take many years before savers began to trust in their government again. This attitude was prevalent throughout the period, and it was reinforced by other factors inducing savers to put and keep their money abroad. Finally, the perception that economic stability was very hard to achieve by even the most committed and trustworthy government explains the bout of capital flight in October 1987, when foreign reserves were at a historic peak. This perception was also prevalent in 1988, when savers were not sure that the new stabilization package would succeed, and when they were weary of an exchange rate policy that was based on keeping the exchange rate fixed.

4. What were the consequences of capital flight?

In the years prior to the crisis the Mexican government ran rather sizeable fiscal deficits. A portion of these deficits were a result of generous subsidies given to the private sector, including cheap energy and other public sector goods. [3] These deficits were partly financed through external borrowing. In the meantime, private investors were able to acquire foreign assets cheaply, given the overvaluation of the peso. The end result was a public sector that *owed* a dollar denominated debt, and a private sector that *owned* dollar assets. This public/private dichotomy made things very difficult for stabilization and adjustment policies in Mexico. The foreign assets held by the Mexican private sector did not generate any dollar income for Mexico,

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[1] Gurría, José Angel and Fadl, Sergio (1990), "Efectos de la politica economica en la fuga de capitales. La experencia de Mexico, 1970-1989," mimeo, Secretariat of Finance and Public Credit (Mexico).

[2] Part of the difference is explained because Morgan Guaranty's estimates do not correct the total debt figure (which when done reduces the sources), and excludes the changes in foreign assets by the banking sector and public enterprises (which increases the uses of foreign exchange).

[3] During the oil boom domestic gasoline prices at times were a third of their U.S. price.

while the foreign debt had to be serviced in dollars. Most of the debt service had to be financed through a purely internal effort.

Capital flight was not a primary cause of the economic crisis in Mexico, but a consequence of the unhappy coexistence of internal mismanagement and external shocks. Capital flight, however, contributed to the severity of the crisis, and to the great difficulties in restoring macroeconomic stability and economic growth. First, in the wake of the crisis, capital flight was financed through foreign reserves and/or foreign borrowing. In 1981, more than 50% of the increase in total foreign debt—or close to U.S.$ 10 billion—translated into capital flight. [4] Second, when borrowing was no longer possible and reserves were exhausted, the country had to face a balance of payments adjustment. Capital flight made that adjustment all the more difficult. The required trade surplus had to be large enough to not only cover the higher debt service, but to also finance capital flight. This was in an environment of falling oil prices, rising external interest rates, as well as a sudden contraction in commercial foreign lending. In the case of Mexico the required trade surplus implied lower levels of consumption and, in particular, investment, resulting in lower current output and future growth.

In addition, capital flight made it difficult to achieve economic stability. The fiscal deficit had to be reduced to restore stability, which meant a reduction (in the non-interest component) of government expenditures, and an increase of government revenues. Capital flight reduced government revenues because it reduced the tax base directly, and indirectly through its impact on growth. Moreover, the pressure generated by external debt service on the fiscal and external accounts created a very vulnerable economy, as well as a volatile financial environment. Under these circumstances preventing capital flight required an extremely conservative macroeconomic policy, in addition to a high degree of undervaluation of the peso, or very high real interest rates. Such policy combinations resulted in somewhat lower inflation rates, but at the cost of a profound recession. Moreover, high real interest rates could put the fiscal targets at risk.

The whole process of capital flight, and the policies that have to be pursued to reverse it, generated a perverse redistribution of income. First of all, savers in Mexico are concentrated almost solely at the top ten percent of the population. Big savers, moreover, are at the very top of this ten percent. The large real devaluations of the Mexican peso, triggered in part by capital flight itself, enriched the holders of dollar assets. On the other hand, the burden of adjustment and fiscal austerity was borne by the less wealthy sectors of society, who did not have funds to place abroad beyond the reach of taxation and crisis. Though capital can always find a "haven-country," this is not the case for labor. Hence the burden of adjustment is soon translated into falling real incomes of the unlucky "capital-short." In Mexico during the period 1983 to 1988, real wages fell between 40% and 50%.

5. Capital is flowing back into Mexico.

Unfortunately there are no available updated calculations analogous in method to those presented in section 2 on the magnitude of capital repatriation. A number of different sources, however, consistently show that capital is flowing back into Mexico. For example:

(a) A recently published report by the British merchant bank Chartered West LB Ltd. estimated that capital repatriation into Mexico had been of the order of U.S.$ 5.2 and U.S.$ 5.5 billion in 1989 and 1990, respectively. This is in comparison to their estimated cumulative flight capital of U.S.$ 18 billion during the period 1983-1988. [5]

(b) The latest report of the Bank of Mexico, the central bank in Mexico, indicates that in 1990 the amount of deposits held abroad by Mexicans declined by about U.S.$ 1.4 billion, which is taken as an estimate of capital repatriation. However, changes in deposits held abroad by Mexican citizens may be a conservative estimate of capital repatriation, in the same way that they are a conservative estimate of capital flight.

(c) The *Mexican Securities Commission* estimated that between June and December 1990 U.S.$ 2.9 billion were repatriated under the new fiscal amnesty

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[4] For a longer time period it has been found that the "propensity to flee," with respect to additional foreign lending, is close to a third. Thus, a considerable portion of Mexico's foreign debt can be "explained" by capital flight.

[5] The latter estimate is far larger than the estimate given by Gurria and Fadl (1990), op cit., which for the same period equals U.S.$ 4.1 billion, and the difference cannot be ascribed simply to the exclusion of interest revenues from Gurria and Fadl's estimate. Hence, the Chartered's estimate may be an exaggeration of actual inflows.

scheme known as the *Fiscal Stamp*. Between January and May 1991 U.S.$ 1.0 billion was repatriated through the Stock Exchange, and between January and March 1990 U.S.$ 250 million through the banking system.

(d) The Secretariat of Finance and Public Credit in its document "Mexico: a New Economic Profile" (April 1991), estimates that capital repatriation during 1990 reached U.S.$ 6 billion, which include the U.S. $2.9 billion that were registered through the *Fiscal Stamp*.

(e) It is important to note that capital repatriation is not the only sign of a reversal in capital flows. Private sector access to the world capital markets, for example, is rising. The Mexican Stock Exchange has been steadily growing for the last three years or so, and foreign investment in the securities market has increased substantially.

All available indicators show that the risk perceived by savers, investors and lenders vis-a-vis Mexico has been substantially reduced. Perhaps the most unequivocal sign of this is the trend in domestic interest rates. The average yearly nominal interest rate for one-month Treasury Certificates was 45% in 1989; 26% in December 1990; and 17.8% on May 30, 1991. This is not only a welcome sign of economic confidence, but it also represents an important relief for the fiscal accounts in that it reduces the burden of servicing the domestic debt.

6. Why was Mexico able to reverse capital flight, and increase its access to world capital markets?

What we are currently witnessing in Mexico is not the result of a single action, or even the simple sum of a number of actions. It is the result of a comprehensive approach to tackle the nation's economic problems. The comprehensive approach has both a domestic and external component; and it has an economic, as well as political, institutional and social dimension. In the domestic arena the components that have been of crucial importance include the *restoration of price stability, the opening-up of new investment opportunities particularly through changes in trade and foreign investment regimes, the achievement of an agreement with commercial banks on external debt, and the introduction of a number of reforms and initiatives that prove the government's commitment to a market/outward oriented economy.* The most important of these reforms and initiatives are the sweeping trade liberalization, the privatization of the banking system, and the pursuit of a Free Trade Agreement with the United States and Canada.

The role played by "haven-countries," the United States in particular, has also been crucial to the process. This support has helped Mexico sign a Brady-type debt agreement with its commercial banks in early 1990, and obtain substantial loans from multilateral agencies—the World Bank, in particular—to back their economic reforms. More recently, political support has paved the way for the negotiation of a North American Free Trade Agreement (NAFTA), an initiative that will consolidate the new economic strategy and accelerate recovery. Currently, the most important contribution that the U.S. can make to help Mexico's recovery is to sign an FTA with Mexico. To underscore the importance of the NAFTA, Mexico's interest rates fell by 2 percentage points immediately after the extension was granted for "fast track" authority. Although the external debt is still sizable, initiatives geared to reduce it further will at this point be counter-productive because they will reduce Mexico's access to credit and discourage foreign investment.

All the recent actions taken by the United States have contributed to Mexico's enhanced credit-worthiness and, perhaps more importantly, to the Mexican government's credibility. The only complaint that should be raised is to question why this support was not forthcoming sooner. By all accounts, Mexico's adjustment efforts since 1983 have been quite substantial. Similarly, the Mexican government's commitment to sound economic policies and market-oriented reform were also evident since 1983. Finally, Mexico's "good conduct" in the realm of the debt issue probably prevented the formation of a debtor's cartel, and this behavior paid high dividends to the financial sector in the creditor countries. If support had been forthcoming sooner, the years of instability and crisis could have been shortened, and the economic recovery could have been under way sooner. More importantly, it could have made economic recovery occur at a quicker pace. After so many years of economic instability and of reduced investment rates, it is certainly more difficult to generate a growth rate high enough to absorb Mexico's growing labor force, as well as to steadily improve the living standards of its population.

Perhaps the most important lesson to be drawn from this experience for the U.S. and other developed countries is to provide adequate, and —especially—timely support to those Latin American countries instituting economic reforms similar to Mexico's. The countries now implementing very courageous economic programs in-

clude Argentina, Bolivia, and Venezuela; and Brazil is in the process of joining these ranks. Some of these countries, Argentina and Brazil for example, will need support in reaching debt reduction agreements with their commercial banks. All need the support of multilateral agencies to finance their policies. In addition, all countries in Latin America need to enjoy the benefits that could be derived from a free trade agreement with the United States.

APPENDIX—CAPITAL FLIGHT: A MATTER OF DEFINITION

What is capital flight? Whenever economists tried to seriously analyze the subject, it immediately became clear that the distinction between "normal" outflows and "capital flight" is not an obvious one. In the past, some analysts used the term "capital flight" for only illegal outflows. However, this is not a useful definition. Mexico is a country that, by any of the available measures, experienced the largest capital outflows in absolute terms during the first half of the 1980's. There were no legal restraints on that outflow, yet everybody talks about the massive capital flight experienced by Mexico.

Currently, there is consensus in defining "capital flight" as capital that flees from perceived abnormal risks at home. These risks could include large devaluations of the exchange rate, the imposition of capital controls, and/or tax increases on capital income, or confiscatory measures. In contrast, "normal" capital outflows are those that occur in response to what is perceived as better opportunities abroad. Making this definition operational has its own problems, and they are not merely of academic interest. The *magnitude* of capital flight will, of course, depend on how it is defined.

The most widely used method to measure capital flight is based on the "residual approach." [6] This method measures resident capital outflows as the difference between *sources* and *uses* of foreign exchange. The *sources* include the increase in a country's recorded net external debt plus direct (new) foreign investment. The *uses* basically comprehend the current account deficit plus the increase in official reserves. Calculations in search of accuracy subtract from the capital flight figure the net foreign assets held by public enterprises that support normal operational needs, as well as net lending by banks. Also, pertinent corrections are made on the calculation of the increase in net external debt, such as eliminating the impact of exchange rate changes among creditor countries to obtain the level of *actual* additional credit.

Several Mexican authorities writing on the subject have preferred to exclude from the current account the interest income earned on foreign assets. This increases the *uses* component, and reduces the estimated magnitude of capital flight. It is argued that since interest income was never in the country to begin with, it cannot be counted as capital flight. However, it certainly qualifies as resident capital outflow. Nonetheless, since both methods, i.e., including or excluding interest income, are the two most common forms in which capital flight has been calculated for Mexico, both will be presented below. Conceivably, they give an "upper" and "lower" bound estimate of the magnitude of capital flight in Mexico.

PREPARED STATEMENT OF DANIEL MARX [*]

Mr. Chairman and members of the Subcommittee. Thank you for extending to me an invitation to make this presentation before this distinguished group on the important issue of the repatriation of flight capital. As I will point out in my further remarks, the repatriation of flight capital is dependent on sound economics and a stable political environment. While appropriately tailored Argentine policies are essential to such stability, the United States has an important role to play in Argentina's efforts in this area, particularly in the realm of debt and debt service reduction and trade matters.

Over the past two decades capital flight has proved a systemic problem in Argentina. Although there are no official statistics, estimates of Argentina's capital flight abroad suggest that it exceeds US $30 billion. The Government of Argentina has worked hard to promote the repatriation of capital. There are indications that these efforts have begun to succeed and capital repatriation has begun to overtake capital

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[6] As opposed to the "Errors and Omissions" item of the balance of payments, or changes in recorded deposits in foreign banks.

[*] Daniel Marx is the Financial Representative of the Republic of Argentina in Washington, D.C. The views expressed herein are those of Mr. Marx and should not be taken to represent the views of the Government of the Republic of Argentina.

flight in Argentina. Argentine investors are beginning to have confidence in the domestic investment environment.

As it has dealt with the problem of capital flight, the Argentine Government has become acutely aware of its fundamental causes. Simply put, domestic capital leaves a country for two basic reasons: uncertainty about the economic climate and a lack of opportunity to invest that capital at home. And just as simply, capital returns when there is stability and there exist investment opportunities for domestic capital. Neither punitive measures nor special repatriation incentives work where the prerequisites of stability and opportunity have not been achieved.

The history of capital flight and recent repatriation in Argentina illustrates these fundamental points. Why has capital flight been one of the most serious problems faced by Argentina? First, Argentina has suffered from fiscal imbalances and chronic inflation. Against the background of negative real interest rates, taking capital outside of the country and investing abroad was seen as the best protection from domestic inflation. Second, investor concern was raised by the perceived threat of governmental actions such as sudden devaluations of the currency and state intervention in the private sector, and by the general uncertainty provoked by domestic political instability. Finally, given the relatively weak enforcement capabilities of the Argentine tax authorities and, the resulting tax evasion, emphasis was placed on taxing visible evidences of wealth. The burdensome taxes thus imposed upon the ownership and transfer of financial assets, including bank deposits, encouraged Argentine investors to transfer their capital outside the country. In this uncertain and unfavorable domestic climate, and in the context of high interest rates prevailing in the international markets, many Argentines took the easy course of investing their capital abroad.

The Government of Argentina has implemented a number of policies designed to reverse the flight of capital by creating an attractive investment environment in Argentina. The Government has sought to create domestic business opportunities through deregulation of private sector activities, through the expansion of that sector by privatizing public sector companies, and through the opening up of domestic markets to international trade and competition. The Government has also initiated a reform of the Argentine tax system in order to eliminate those features that discourage the retention and investment of capital within the country. Finally, the Government has reformed foreign exchange regulations to eliminate the distortions produced by the multiple exchange rates previously in effect.

In order to make the country attractive to foreign and domestic investors, the Government has sought to deregulate the private sector. For example, all price controls, including those related to the sensitive oil sector, have been eliminated. In addition, the requirement of prior government approval of foreign investment has been eliminated (as you are probably well aware, flight capital most often returns in the guise of foreign investment). Now, from a legal perspective there is no distinction between domestic and foreign investment.

Perhaps the most visible example of the Government's efforts to create a hospitable environment for the return of capital is the privatization program currently being carried out. Through privatizations, the Government can improve the economy's productivity, increase domestic investment and reduce governmental indebtedness. The two largest privatizations thus far have involved the telephone company, ENTel, and the national airline, Aerolíneas Argentinas, both of which were sold for a combination of cash and external debt conversion. The sale of the telephone company alone generated more than US $200 million in cash and US $5 billion in debt cancellation through debt to equity conversions. The sale of the national airline produced US $260 million in cash and other consideration and US $2 billion in debt cancellation. A portion of the cash and debt paid in these privatizations was provided by domestic companies and is a tangible demonstration of renewed confidence among domestic investors.

The Government is engaged in a drastic reduction of the fiscal deficit. At the same time it has announced a number of tax reforms that would diminish incentives for transferring capital abroad. Under recently proposed tax legislation, Argentine residents will be required to pay taxes on income earned outside of Argentina. The Government is also seeking to improve the tax administration's enforcement capabilities with respect to income generated outside of the normal channels of the domestic economy so as to reduce the incentive for removing capital from these markets for investment abroad.

Recently, the Government announced a special tax program for repatriated capital. Under this program, taxes on repatriated funds would be limited to a one to three percent flat tax on such funds as they are brought back to the country. Another reform aimed at encouraging investors to put their savings to work in the do-

mestic capital and financial markets is the reduction of the over-all Argentine income tax burden and the elimination of special emergency taxes on bank deposits and withdrawals and on the net transfer of securities. As a further boost for domestic savings, domestic savings accounts may be held in foreign currencies.

The Government of Argentina is acutely aware of the need for freer trade and more open markets as a means to promote efficiency and stability. The country has reduced import duties; the average duty now stands at nine percent. Also non-tariff barriers like import quotas have virtually been eliminated.

As a final stimulus to trade and investment, in December 1989 the Government implemented a new foreign exchange program. A single uniform foreign exchange rate system of multiple exchange rates, which invited manipulation and often induced capital outflows. It should be noted that for some years there have been no restrictions on access to foreign exchange for making private sector payments.

The varioius programs described above have created a more stable, attractive economic climate for investment in Argentina. Inflation is being brought down significantly. Although it is still beyond the level where the Government would like it to be, the rate of inflation has steadily decreased for the past twelve months. This reduction in inflation, combined with the business community's perception that Argentina is a friendlier environment in which to do business, appears to have resulted in increased capital flows into Argentina.

There are strong indications that such is the case. For example, the newly created foreign currency savings accounts already have attracted over US $3.5 billion of capital. And whereas in prior years there was virtually no way to issue debt domestically, there is now US $130 million worth of medium and long-term private domestic debt outstanding, most of which is denominated in dollars. Further evidence of repatriation of capital would appear to be provided by the country's privatization program where the cash purchase price (as well as the capital needed to purchase external debt for conversion) appears to be coming in part from Argentine investors. Indeed, the Government has conducted a number of smaller privatizations designed to appeal to domestic investors. For example, just three weeks ago, the Government completed the sale of an Argentine resort for US 3.9 million and cancellation of US $12.7 million of Argentine debt.

To the skeptical, the results in Argentina might seem too short-lived, too recent, to prove anything. May I suggest, however, that we look to the experiences of Mexico and Chile, the two countries that have recently out-performed the rest of Latin America economically. Mexico and Chile have achieved impressive economic results by providing strong and stable domestic business environments. Both nations are reaping the benefits of difficult and long-term policies designed to deregulate the economy, privatize inefficient public sector companies and liberalize the market—the same types of measures that Argentina has recently undertaken.

The Argentine Government is committed to adhere to its economic program because experience shows that, over the long term, these policies work. But the Argentine program must take into consideration a number of difficult circumstances. GNP in Argentina has fallen for three years in a row, and public investment in essential services has come to a standstill. Some people may perceive that it is worthless to continue making sacrifices without seeing tangible results. Thus, the Government must do everything in its power to create an environment that will allow it to continue with its program.

Although only Argentina can solve the structural problems that have led to capital flight and other economic difficulties, the United States has a significant role to play in the process. First, the United States can encourage the multilateral financial organizations of which it and Argentina are members to provide the timely and effective support necessary to give the current economic program a chance to succeed by extending credits to both the public and private sectors. In light of public sector payment obligations to multilaterals that total more than US $2.5 billion per year, any interruption in new loans from these institutions would significantly increase the net outflow of capital and, consequently, would restrict the Government's ability to maintain continued political support for non-coercive economic policies. At this crucial time, the multilaterals must be urged to show confidence in the Government's economic program and not take advantage of that program by insisting upon a significant external transfer of funds.

Second, the United States can help to create conditions that would allow Argentina at the appropriate time to obtain debt and debt service reduction. The recovery of other Latin American economies, including the economy of Mexico and Chile, can in part be traced to the improved environment resulting from the negotiation of successful debt and debt service reduction packages. It is no accident that the economies of these countries began to recover as the perception grew that they were on

their way to resolving their external debt problems. Overcoming the debt crisis has led to greater investor confidence, greater investment and return of capital and finally, it is to be hoped, sustained growth through an open economy.

The pressures of Argentina's debt burden are tremendous and endanger the economic progress that has been made thus far. Debt reduction and reduced debt service would enable Argentina's economy to continue to grow and ultimately assure the continued servicing of its remaining debt.

As the recent experiences of other Latin American countries show, substantial debt and debt service reduction cannot be accomplished in the absence of access to resources that can be used to buy-back debt or collateralize substitute obligations. The United States can assist Argentina in this respect by encouraging official financial institutions to make available funds to be used for debt and debt service reduction operations.

The United States can also help to create a regulatory environment that does not penalize U.S. banks for participating in debt reduction operations. The tax consequences of debt and debt service reduction transactions is an area of particular concern. So is bank regulatory treatment of LDC assets. For example, there is presently some uncertainty among commercial banks that if they participate in privatizations in which Argentine debt is converted into equity, Federal bank regulators will require them to write down that equity based on reserve requirements imposed with respect to outstanding sovereign debt, even though the value of such equity may be totally unaffected by the risks that prompted the debt reserve requirements.

Third, the United States can join Argentina in its efforts to promote increased trade between the two countries. One way this might be achieved is through expanding the availability of export credit financing from the Export-Import Bank of the United States. Currently, Eximbank provides only short-term credit. Trade between our two countries would be given a substantial boost if Eximbank were to give credit-worthy private sector companies in Argentina access to medium and long term loans to finance the purchase of U.S. goods.

Finally, the United States can work with Argentina to improve the environment in which trade develops through phasing out certain quotas, subsidies and other trade barriers. In addition, the principles of the North American free trade pact could be extended to Argentina and other interested South American countries within the framework of the Enterprise for the Americas Initiative. Freer trade between the United States and Argentina would provide further business opportunities in both countries. It would also help to maintain a hospitable environment for the further return of flight capital.

Capital flight from Argentina is not an isolated problem, but part of a greater problem. Capital flight stems from a lack of confidence in the domestic economic environment. No amount of penalties, incentives or other gimmickry will lure money back to a country; only an economy with attractive investment opportunities will succeed in doing so. If world international rates remain at reasonable levels, Argentina's efforts will foster the return of flight capital. By assisting in the debt reduction process and promoting increased trade with Argentina, the United States can play an important role in helping Argentina achieve its goal of a stable, healthy economy, attractive to local and foreign investors alike.

Prepared Statement of David C. Mulford

I welcome this opportunity to discuss today two financial issues which are of continuing concern in this Hemisphere: capital flight and debt. The Administration is addressing these problems through both the Strengthened Debt Strategy and the Enterprise for the Americas Initiative (EAI).

The prospects for future economic development in Latin America and the Caribbean will be largely dependent on policies which attract new capital investment. In many instances these policies are now being implemented and represent a significant reversal of past, failed policies of statism and protectionism that have contributed to capital flight and to a dependence on debt financing from abroad. We have been impressed by policies implemented by a number of new Latin leaders, but more must be done. The EAI can make a significant contribution in realizing these objectives.

While Latin America requires capital for growth, competition for international capital has intensified with the opening of Eastern European economies and demands in the Middle East. At the same time, commercial bank lending to developing countries has diminished and budget limitations constrain flows from official bi-

lateral sources. As a result, private capital, including repatriated capital, is increasingly the engine for economic growth for the 1990s.

There are no reliable measurements of capital flight, and economists' estimation procedures produce both variable and dubious results. Some estimates have placed the level of capital flight from Latin America at greater than the level of foreign borrowing, but these estimates probably have minimum credibility. Whatever the magnitude of capital flight in the past, we believe that the pace of outflows may be easing for several countries, and that some are experiencing inflows, but outflows continue to be a major problem for other less developed countries.

CAUSES AND CONSEQUENCES OF CAPITAL FLIGHT

What are the causes of capital outflows? Private capital leaves one country for another to seek a higher return on investment or a safer haven with reduced risks. Important factors therefore include the direction of macro-economic policies and the relative stability of the political climate. High inflation rates erode purchasing power, increase uncertainty and exacerbate risks. Investors anticipating sudden currency devaluations as a result of inflationary policies will move their money abroad to preserve their capital.

Political uncertainty, and the threat of nationalization and populist hostility capital may also discourage both foreign and domestic investors. Drug production, trafficking and money laundering threaten political stability in some countries, and also contribute to instability in domestic financial markets. The Administration is vigorously pursuing policies to combat drug-trafficking in Latin America.

Many countries pursue unfavorable and short-sighted investment policies, which stimulate capital outflow. Investment opportunities can be limited by restrictions or prohibitions on investment in "sensitive" sectors. These often include areas such as telecommunications or transportation, which are reserved for the state or for a state-sanctioned monopoly. Onerous regulatory regimes, together with a reliance on price controls and subsidies, further erode the profitability of investment.

These problems are often compounded by market-distorting credit policies. Interest rate policies, including ceilings on interest paid to depositors, and credit allocation policies, undermine capital markets. Tax avoidance may be another stimulus to capital outflows, reflecting discriminatory tax policies that erode the return to investors. Restrictions on transfering funds out of a country also encourage investors, where possible, to keep and invest their capital abroad.

The negative consequences of massive capital outflows from less developed countries are clear. Capital which is invested abroad is capital that is not available for investment in the developing country. Investment and economic growth will tend to be lower. Moreover, profits on capital held abroad are seldom fully repatriated. Capital outflows also erode the national tax base, due to unreported and unrecorded income which escapes the tax authorities. Foreign exchange receipts may also be under-reported and held abroad.

The political leaders in less developed countries must address the need to reform the investment regimes, to make them more hospitable to investment by both nationals and foreigners. In the past few years we have witnessed a growing awareness of the importance of an attractive investment regime that offers competitive returns and a wide range of investment opportunities.

Such reform is at the heart of both the Strengthened Debt Strategy, known as the Brady Plan, and the EAI.

THE STRENGTHENED DEBT STRATEGY

The major objective of the Brady Plan has been to encourage highly indebted countries to successfully implement market-oriented macroeconomic and structural policy reforms in order to achieve sustained growth and ultimately resolve their debt servicing problems. IMF or World Bank supported adjustment programs are prerequisites for debt reduction under the new strategy.

In advancing this strategy, we have encouraged commercial banks to consider debt and debt service reduction as well as to mobilize additional financial resources in support of debtor reforms. We have also redirected IMF and World Bank resources to back debt and debt service reduction for commercial banks while creditor governments continue to provide needed support.

As we begin our third year under the strengthened debt strategy, we can survey some key successes and progress made to date. In assessing progress within the strategy, we should consider first the magnitude of debt covered through debt reduction agreements and the number of countries involved.

Agreements have now been reached with eight countries, including five in Latin America—Chile, Costa Rica, Mexico, Venezuela, and Uruguay. The eight agreements account for some $125 billion in commercial bank debt, or nearly half of the commercial bank debt of all of the major debtor nations.

The benefits to these debtor nations have been substantial: Mexico's stock of medium and long term commercial bank debt was reduced by 34%, Costa Rica's by 62% and Uruguay's by 40%, in addition to significant annual debt service savings and innovative collateralization have reduced the burden of principal payments. The IMF and World Bank have provided some $5 billion in resources to support debt and debt service reduction by commercial banks.

The strong reform efforts by such countries as Mexico, Chile and Venezuela have been rewarded by their successful reentry into the capital markets and increased cash flows into their economies. All have liberalized their trade and investment regimes. Chile has one of the most open investment regimes in Latin America and has moved to privatize key public enterprises. Venezuela is also beginning a privatization program. Mexico has privatized its airline, copper, and trucking industries in the past 18 months, and has announced some $20-25 billion of future privatizations of government-owned enterprises in the banking, steel, telecommunications, fertilizer, and insurance sectors.

Investor confidence is increased when a country maintains sound relations with its international creditors, including commercial banks and the international financial institutions. Both Mexico and Chile experienced inflows of repatriated funds and foreign capital following reduction of their debt with commercial bank creditors under the Brady Plan. We also believe that Venezuela, which reached agreement with commercial bank creditors in March, 1990, has begun to see a reversal of capital outflows.

EAI—CONTINUING SUPPORT FOR REFORM

To enhance growth and prosperity throughout the hemisphere, last June President Bush announced the Enterprise for the Americas Initiative—an ambitious agenda for strengthening our ties with Latin America and the Caribbean. The Initiative proposes specific action on three economic issues of greatest importance to the region—trade, investment, and debt. A key focus is to help countries in the region attract the capital essential for growth and development.

Trade

Our long-term goal is to establish a system of hemispheric free trade. As our first step toward our objective, the President has announced our intention to negotiate a North American Free Trade Agreement. We have recently gained from Congress an extension of fast-track negotiating authority, which will allow us to enter into negotiations with Mexico and Canada to eliminate barriers to trade and investment.

The Administration is also proceeding to conclude EAI Trade and Investment framework agreements with eight countries—Colombia, Ecuador, Chile, Honduras, Costa Rica, Venezuela, El Salvador and Peru. We are also discussing such agreements with Panama, Nicaragua, the CARICOM group of countries, and a group of countries composed of Argentina, Brazil, Uruguay and Paraguay. Framework agreements constitute a declaration of trade and investment principles and set up Councils to consult on these issues and to work towards liberalization.

Investment

To encourage countries to liberalize their investment regimes and help improve their ability to attract capital, the Initiative proposed creation of a new investment sector loan program in the Inter-American Development Bank (IDB), and the creation of a Multilateral Investment Fund. The IDB has sent diagnostic teams to several countries to negotiate investment sector loans. The first loan, for Chile, will be discussed by the IDB Executive Board on June 19th, and we expect programs for Jamaica and Bolivia to follow this summer.

We are also seeking contributions from other governments to a $1.5 billion Multilateral Investment Fund to be administered by the IDB, which would provide additional support for investment reforms. The US has proposed to contribute $100 million a year, for 5 years. The Japanese have already announced their commitment to provide $100 million a year, for five years, in grant resources to the Fund. Last week, several other governments indicated support for the MIF, and we hope to be able to achieve firm commitments in the near future.

We are confident that investment reforms negotiated with the IDB, together with the creation of a new Multilateral Investment Fund, can make an immense difference in the climate for investment in the region, and to its future growth.

Debt

The debt reduction element of the EAI establishes a coherent approach to bilateral debt reduction which reinforces ongoing economic reforms in Latin American and Caribbean countries. It complements the strengthened debt strategy by addressing the debt problems of countries whose debt portfolio is primarily owed to official creditors rather than to commercial banks.

We propose to reduce existing debts to the USG of countries which are undertaking macroeconomic and structural reforms, are liberalizing their investment regimes, and have negotiated agreements with their commercial banks, as appropriate. We have gained authority from Congress to take such action on PL-480 debt.

Several countries—including Chile, Jamaica, and Bolivia—are well positioned to qualify for PL-480 debt reduction in the next few months. Other countries could also move to qualify in the near future.

The potential for bilateral official debt reduction has been welcomed throughout the region. To provide the full extent of debt reduction proposed under the Initiative, we must gain additional authority from Congress. In particular, we are seeking authority to reduce AID debt—which represents $5.2 of $7 billion in concessional debt owed by the regional countries to the US—and to sell, cancel or reduce a portion of Eximbank loans and Commodity Credit Corporation (CCC) assets acquired through its export credit guarantee program for debt-for-equity, debt-for-nature, and debt-for-development swaps.

By reducing bilateral official debt, we hope not only to ease countries' financial burdens but also to provide significant support for the environment. If the debtor country has entered into an environmental framework agreement, interest payments on reduced concessional debt obligations will be made in local currency into an Environmental Fund in the debtor country.

The burden of external debt has constrained the resources available for growth and tested the resolve of nearly every government in Latin America and the Caribbean. By easing the burden of official debt for countries committed to necessary economic reforms, we can reinforce the rewards of sound economic policies—helping them to restore confidence in their economy and attract both domestic and foreign investment.

COUNTRY CASES

I have explained the policy initiatives undertaken by the Administration to encourage economic reform and to address the debt burden in countries in Latin America and the Caribbean. Let me now turn to developments in several countries.

Mexico

Mexican economic policy reforms since the mid-1980s have substantially increased confidence in the Mexican economy, bringing a dramatic reversal in the direction of private capital flows. Trade and investment liberalization, tax reform, and measures to reduce the burden of the public sector have provided a backdrop for economic recovery and for repatriation of flight capital.

We estimate that capital repatriated into Mexico ranged from $1.5-2.0 billion in 1988 and from $2.0-3.5 billion in 1989. All told, since the announcement of the commercial bank deal in June, 1989, Mexico has received an estimated $5.5-6.0 billion in capital repatriation and an additional $5.0-5.5 billion in foreign direct investment. This represents a dramatic turnaround from the early 1980s, when capital flight averaged an estimated $7 billion per annum.

Increased confidence in the Mexican economy is also reflected in Mexico's return to the international capital markets. Mexican firms raised over $5.5 billion in debt and equity financing during 1990, and nearly $3.5 billion so far in 1991.

Mexico's success is due to several factors, in addition to the reforms already mentioned. Investor confidence has improved significantly since the announcement of the commercial bank debt and debt service reduction agreement. This renewed confidence was reflected in a dramatic decline in Mexican interest rates from nearly 50% per annum before the announcement of the commercial bank agreement, to under 20% today. Lower interest costs have been a key element in the fall in Mexico's fiscal deficit, from 13% of GDP in 1988 to 3.5% in 1990. This improved fiscal position has enabled Mexico to reduce inflation from 160% in 1987 to under 30% in 1990, while at the same time achieving GDP growth of 3.9% last year.

Recent measures have further enhanced Mexico's attractiveness to investors. These include a constitutional amendment in June, 1990, that allows privatization of nationalized commercial banks. The announcement of plans to negotiate a Free Trade Agreement with the US was another positive factor, as was the introduction

of a well-designed tax amnesty program for repatriation of flight capital. Under this program, Mexican nationals pay a flat 1% tax on all repatriated funds.

Venezuela

Venezuela appears to have reversed capital flight beginning in 1988, when over $1.5 billion in capital was repatriated. Poor economic performance caused capital outflows to resume briefly in 1989, but at modest levels. Falling real GDP (−8.3%) and rising inflation (81%) were the principal causes that year.

In 1989, Venezuela successfully adopted a series of strong adjustment measures which spurred renewed growth and cut inflation. The Government of Venezuela continues to implement an ambitious program of economic reform in a number of sectors and has undertaken trade and fiscal reforms, financial sector reforms, and privatization. These initiatives have been reinforced by the 1990 debt package with commercial bank creditors under the Brady Plan, and together have contributed to attracting capital back into the country. Investor confidence is growing, a fact reflected in the decision of one-third of commercial bank creditors to participate in the new money option in the 1990 debt package.

Chile

Chile has not had difficulty with capital flight since the severe, world-wide recession of 1982 that produced significant economic uncertainty. Chile's successful debt-conversion program has reduced Chile's stock of debt by about $10 billion since 1985, equivalent to about 70% of medium and long-term debt to commercial banks outstanding at end- 1985, and has provided a vehicle for investment including repatriated capital. In 1985 the Government put in place a structural adjustment program which has been very successful in fostering both domestic and foreign confidence in the Chilean economy.

A key result of the program is that Chile has one of the more open investment regimes in Latin America. Increased investor confidence in Chile is apparent from Chile's return to voluntary commercial bank lending in 1990 and from the $320 million international bond issue in early 1991. Private foreign investment inflows of direct investment and loan disbursements have increased dramatically from about $400 million in 1986 to $1.6 billion in 1990. In addition, foreign portfolio investment has increased substantially in the past two years. Chile continues to work to improve its investment climate and is very close to reaching an agreement with the Inter-American Development Bank on an investment sector loan.

Argentina

Capital outflows have long been a problem in Argentina. Recognizing that the only way to bring capital back to Argentina is through sound and sustained economic policy, Argentine policy makers have sought to stabilize the economy and rebuild confidence.

In the past 2-3 years, Argentina has undertaken a number of steps to make the country more attractive for investment and to promote economic growth. The trade and investment regimes have been opened, an ambitious privatization program has begun, and the Administration has persisted in its efforts to rein in public spending and cut inflation. In April of this year, the Government of Argentina established a new exchange rate regime and continued a tight monetary policy in order to control inflation and further stabilize the economy.

In 1990, under its privatization program, the Government sold two parastatals, the telephone company ENTEL and the airline Aerolineas Argentinas. Although these transactions were difficult to arrange, Argentina ultimately attracted both foreign and domestic capital: Morgan Guaranty and Citibank participated as agents; the European firms STET, Radio France and Iberia Air participated as buyers. Today, Argentina is pursuing privatizations, through sale or concession, of other state entities including oil fields, steel, electricity, gas, shipping and railroads.

Besides addressing its structural problems, Argentina is also taking specific tax measures to address the problem of capital flight. Legislation proposed last month would tax capital held abroad this year at 2%, but would tax it at 1% if it is repatriated. Capital returning through the end of this month (June 1991) would be exempt from any legal or administrative penalty and from any past tax obligations. This legislation awaits passage by Argentina's Congress. Argentina is seeking an IMF program as a precursor to discussions with commercial bank creditors.

Despite the many positive developments, investors—both foreign and domestic—continue to be cautious with respect to Argentina. Major reflows of capital will depend on a sustained period of economic performance and completion of additional elements of the structural reform process.

Brazil

Brazil appears to have experienced relatively little capital flight in the 1980s, in part due to prevailing high domestic interest rates. Rough estimates place capital flight at about $15 billion cumulatively from 1980 to 1987.

In testimony to the Brazilian Senate's Commission for Economic Affairs in early June 1991, a Central Bank official estimated that, since 1980, Brazil had incurred a cumulative $35 billion in capital flight, equivalent to 10% of GDP. A large part of the recent capital flight, he claimed, was attributable to the Government's move to block deposits in March, 1990.

Capital flight in Brazil since March, 1990 appears to be driven primarily by economic policy miscalculations and the accompanying plunge in investors' confidence. A key event propelling capital flight has been the failure of the massive freeze on domestic deposits in March 1990 to curb the high inflation rate. This event has not only intensified capital flight, but investors appear to have fled depository accounts in the domestic banking system in fear of another confiscation of their deposits. Numerous investors have thus transferred their funds into other assets such as real estate and the domestic stock markets. In fact, there have recently been strong upturns in Brazil's two major stock markets, attributable to inflows from both domestic and global institutional investors. The inflows from international investors have been spurred by new regulations permitting foreign investors to directly buy and sell shares on Brazil's stock exchange.

Substantial repatriation of capital probably will not occur until Brazil has convinced investors that it can successfully implement adjustment and reform policies needed to stabilize the economy and foster non-inflationary growth.

Colombia

In the past few years, increased drug trafficking and violence has promoted capital flight from Colombia. This has been partially offset by repatriation of some of the drug profits. Colombia has recently implemented a number of market-oriented reforms and has liberalized trade and investment regimes. In February, 1990, Colombia launched its "Apertura" policy of gradual trade liberalization. Colombia has also taken steps to improve the investment climate, including launching a privatization program and announcing a policy of granting equal treatment to foreign and domestic investors.

CONCLUSION

Private investment plays an increasingly important role in growth and development. Repatriated capital and increased flows of foreign investment are critical motors of economic growth. For this reason, it is important for developing nations work to improve their macro-economic and investment climates in order to attract investment. We are supporting these efforts by Latin American countries with initiatives which are aimed at supporting reform: the Brady Plan, and the EAI.

As the examples of Mexico, Chile and Venezuela demonstrate, strong reform efforts generate a pay-off in terms of inflows of foreign investment. These examples have confirmed the potential for economies in the region to make the transition from crisis to performance.

Prepared Statement of John Williamson

The only recent estimates of capital flight of which I am aware, compiled by Chartered WestLB Bank and shown in Table 1, indicate that for the past two years there has been a significant net repatriation of flight capital to Latin America. These figures should be treated with considerable caution: as the first four rows of the table demonstrate, there are substantial discrepancies between the recent estimates of Chartered WestLB and estimates presented to the conference on capital flight that the Institute for International Economics organized in 1986.[1] Nonetheless, the major turnaround shown for Mexico, which dominates the aggregate result, is certainly a historical fact rather than a statistical error.

CAUSES OF CAPITAL FLIGHT

The principal cause of capital flight in Latin America was macroeconomic mismanagement. This generated fears of major losses if capital were left at home. Over-

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[1] That conference was reported in D.R. Lessard and J. Williamson, eds., *Capital Fight and Third World Debt* (Institute for International Economics), 1987.

valued exchange rates made it obvious that a big devaluation would have to occur before long, which gave an incentive to wealth-owners to place their funds abroad before the devaluation actually happened. Fiscal deficits led to a buildup of foreign debt that created expectations that the government would have to raise taxes to service the debt. Real interest rates were sometimes strongly negative, and at other times they were so high as to nurture fears that the government was heading for insolvency and would be unable to continue respecting its obligations. Inflation provided an arbitrary way of raising revenue when explicit taxes failed. The slowdown in real growth made domestic investment opportunities less attractive. Fears that the economic order was collapsing led to great uncertainty as to whether property rights would be respected.

There is also some evidence that conditions in the developed countries acted as a magnet to attract flight capital. In particular, high real interest rates prevailed during the 1980s. In addition, an increasing number of developed countries—starting with the United States in 1984—exempted interest income earned by non-residents from taxation. Since the Latin American tax authorities had no way of learning of the interest income earned abroad by their residents (and in some cases did not even attempt to subject such income to taxation), Latin wealth-owners were confronted with a very unlevel playing field when it came to deciding where to place their funds. At home they were taxed; abroad they escaped taxation by both their country of residence and the country where the funds were placed.

It is important to recognize the role of foreign debt in stimulating capital flight. A high level of foreign debt surely raises threats of high taxation, high inflation, and conceivably expropriation of domestically-held assets, and thus tends to promote capital flight. But easy access to additional foreign credit has also been blamed for promoting capital flight, since it permitted the maintenance of sloppy macroeconomic policies and provided the foreign exchange that financed capital flight.

Most major episodes of capital flight have taken place from currencies that were not subject to exchange controls. For example, of the five countries shown in Table 1, only Brazil had capital controls when major outflows occurred. The fact that Brazil lost so much capital even though it was illegal shows that there is no easy administrative solution to the problem of capital flight: it cannot simply be banned. At the same time, it is just not true that capital controls are totally ineffective, as is sometimes asserted. At the very least, capital controls can slow down the process of capital flight, and thus give the authorities time to adjust the policies causing the trouble before the country has been bled dry.

EFFECTS OF CAPITAL FLIGHT

The principal effect of capital flight is to reduce the funds available for investment at home, thus depressing both the level of income in the short run and its rate of growth in the longer run. This effect may be intensified by the shortage of foreign exchange, which may compel the government to deflate demand and/or to devalue more than is appropriate from a longer-run standpoint (which also tends to be deflationary in the short run). In addition, the fact that interest income avoids taxation increases the budget deficit. Alternative forms of taxation, including the inflation tax, are almost invariably more regressive, so that the poor end up paying the bill for the ability of the rich to place their funds abroad.

Those of us who have never confronted the ugly choice between risking the future wellbeing of our family by keeping money at home and jeopardizing the prosperity of our society by sending it abroad should not be too self-righteous in condemning the decisions that were made by Latin wealth-owners. But that does not mean that the effects of capital flight were anything other than pernicious for the countries involved.

POLICY RESPONSES

Just as the principal cause of capital flight was macroeconomic mismanagement, so the indispensable precondition to capital repatriation is the restoration of prudent macroeconomic policies. This has already been accomplished in several Latin countries: both Chile and Mexico, as well as Colombia (the one Latin American country that never rescheduled its debt during the 1980s, as a consequence of the responsible macroeconomic policies that it had followed during the preceding years), have now placed their policies securely on a sound basis. As Table 1 shows, both Chile and Mexico have enjoyed substantial capital repatriation in recent years.

While enlightened macroeconomic policies are an essential precondition, they will not necessarily suffice by themselves to reverse capital flight. Wealth-owners need also to be convinced that the country will be capable of managing its debt burden

according to the agreed contractual terms before they will be confident that the threat to their wellbeing posed by holding capital locally has vanished. The Brady Plan restructuring of Mexico's debt was critical in persuading Mexican wealth-owners that it was safe to bring their money home. The reduction in debt-service payments engineered by the debt restructuring itself was modest compared to the spin-off benefits of transforming the attitudes of Mexican citizens regarding the advisability of holding wealth at home: not only did this bring a turnround of approaching $10 billion per year in the flow of resident-owned capital, but it permitted a reduction of something like 20 percentage points in the real peso interest rate, which improved the Mexican fiscal position by around 5 percent of GNP.

While I could have wished that the Brady Plan had been better funded and thus able to offer somewhat more relief on commercial bank debt, it seems to have proved just about adequate to the task of dealing with the commercial bank portion of the debt. What remains to be done is to arrange for comparable relief on public-sector debt (a topic of interest primarily to the smaller countries, notably in Central America). The Enterprise for the Americas Initiative provided a framework for such relief, but apparently on a scale much less generous than that accorded to Poland in its recent restructuring. It is time for the administration to stop playing at King Canute, and admit that the Polish settlement created a precedent.

Not only must macroeconomic policy be placed on a sound footing and debt service obligations be reduced to a level that the country can handle, but wealth-owners must feel confident that this situation will not be jeopardized by political change. The importance of this factor is indicated by the large capital repatriation to Chile in 1990 (Table 1), following inauguration of the first democratic government and its commitment to the maintenance of prudent macroeconomic policies.

While present and future macreconomic policies and their consistency with debt-Service obligations are unquestionably the key factors that drive large short-run swings in capital flight, there are also several important background factors that influence how large a part of their portfolio Latin investors want to hold abroad even when circumstances at home are normal. One of these is the level of real interest rates in the rest of the world; this provides yet another reason for hoping that the US budget deficit will be brought down on schedule (or, better still, ahead of schedule) in the coming years. Another is financial sector reform in Latin America; liberalization should provide investors with a more attractive menu of assets at home, as well as raise domestic currency real interest rates by compressing interest spreads.

But the most important such factor relates to taxation. As noted above, present tax arrangements have in many cases resulted in a distinct bias encouraging Latin portfolio investors to place their funds abroad, where they can expect to avoid taxation. Eliminating this distortion is bound to be a long-term process requiring comprehensive international agreement, but the process is one in which the average taxpayer in the United States and other industrial countries also has a strong interest, since in the absence of adequate international arrangements it seems certain that the rich would increasingly hold their money abroad with the object of evading taxation. An end to tax evasion will require four mutually reinforcing measures: [2]

—internationally consistent tax legislation, in which all countries aim to tax the world-wide income of their residents
—international action to prohibit bearer securities
—a multilateral tax-information sharing agreement, in which tax authorities will inform each other of the portfolio income of each other's residents
—a common rate of withholding tax imposed by the country in which portfolio income is earned, which is reimbursed on presentation of evidence that the income has been reported to the authorities of the country in which the taxpayer is a resident.

The United States already has an appropriate system of taxation based on the residence principle and encompassing world-wide income. It has also recently ratified the multilateral tax-information sharing agreement negotiated in the OECD in 1988–89; since Finland, Norway, and Sweden have also ratified and the agreement becomes operational after five ratifications, it requires only one further ratification to come into force. The United States has also concluded (rather limited) bilateral tax-information sharing arrangements with several Latin American countries, notably Mexico.

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[2] A study under way at the Institute for International Economics will develop proposals along these lines: see G.C. Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (Washington: Institute for International Economics), forthcoming.

Unfortunately, however, it is only the latter step that is of any direct assistance to Latin countries in eliminating the tax distortion to invest abroad. The OECD agreement is open only to member countries of the OECD and the Council of Europe. A serious attack on the tax distortion in Latin America would require that this agreement be opened to all countries (or at least to those of Latin America), as well as extensive revision of the tax legislation in many Latin countries and an international agreement to outlaw bearer securities. Finally, and perhaps most difficult of all, it would need a reversal of the tendency of the last ten years to abolish withholding requirements against foreigners. Such a reversal is doubtless conceivable only in the context of a parallel move on a multilateral basis, so as to avoid the loss of competitive ability to attract foreign investors that motivated the dismantling of withholding taxes in the mid-19805.

CONCLUDING REMARKS

Three of the seven major countries of Latin America—Chile, Colombia, and Mexico—have at last clearly put the debt crisis behind them. Another one, namely Venezuela, is showing hopeful signs, though doubts remain. The other three, namely Argentina, Brazil and Peru, are still struggling, but at least they are struggling to do the right things.

Reversal of capital flight is a crucial element in recovery from the debt crisis. Achieving the repatriation of resident capital is primarily a matter for the Latin countries themselves, through implementing responsible macroeconomic policies and achieving a social consensus that such policies should be invariant to political change. But the industrial countries have an important supporting role, notably in ensuring that countries that have adopted the necessary policy reforms receive help in cutting back their contractual debt service obligations to a level that the debtor country can afford to pay. Particular policy initiatives that would be helpful include recognition that Poland does indeed constitute a precedent for relief of public-sector debt and, in the longer term, a major overhaul of world-wide arrangements for the taxation of portfolio income earned outside the taxpayer's country of residence.

Table 1.—ESTIMATES OF CAPITAL FLIGHT (−) AND REPATRIATION (+)

[Million dollars]

	Argentina	Brazil	Chile	Mexico	Venezuela	Total
1983	−1,729	−4,302	+237	−1,818	−4,509	−12,121
1983a	−1,955	−617	−344	−4,314	−715	−7,945
1984	+924	−6,366	+1,202	−3,092	−1,626	−8,958
1984a	+1,635	+406	+439	−2,585	−1,210	−1,315
1985	+390	−1,313	+1,004	−4,130	+444	−3,605
1986	+1,639	−413	+583	−2,608	+1,223	+964
1987	−1,766	−1,015	+190	−1,610	+975	−3,226
1988	+833	−1,494	−566	−5,265	+1,791	−4,701
1989	−1,297	−1,704	+28	+5,203	+1,181	+3,411
1990	+333	−1,023	+1,401	+5,507	+747	+6,965
Total	+673	−17,633	+4,079	−7,273	+226	−21,279

Sources: Chartered WestLB Bank, reproduced in *Latin Finance*, May 1991, p. 7.
Alternative figures (labelled 1983a and 1984a) from J. Cuddington, "Macroeconomic Determinants of Capital Flight: An Econometric Investigation," table 4.1, in D.R. Lessard and John Williamson, eds, *Capital Flight and Third World Debt* (Washington: Institute for International Economics), 1987.

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