OVERVIEW OF INTERNATIONAL CAPITAL FLOWS IN THE 1990s

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1 Introduction

The currency and financial crisis that had been deepening in Asia from the second half of 1997 spread throughout the so-called emerging economies, including Russia and Latin America in 1998. Moreover, it appears to be spreading globally. Financial and foreign exchange markets of the advanced industrialized countries have become unsettled due to the destabilization of financial institutions and equity and bond markets in the United States and to the sharp fall in the value of the dollar following its dramatic rise. Some observers have suggested that the financial instability may lead to deterioration of the world economy as a whole.

It is not easy to compare the extent of international capital flows in the 1990s with flows in earlier periods. Obstfeld [1998] did so indirectly by examining the size of the disequilibrium in the current account balance (the amount of surplus or deficit) relative to GDP for 12 countries for the period between 1870 and 1996 (Table 1). His analysis is based on the theory that the current account disequilibrium indicates a country's savings-investment gap and that international capital flows take place to finance this gap.

Table 1: Ratio of Current Account Disequilibrium to GDP

	Argen-tina	Australia	Canada	Denmark	France	Germany	Italy	Japan	Norway	Sweden	U.K.	Sweden	Total
1870-89	18.7	8.2	7.0	1.9	2.4	1.7	1.2	0.6	1.6	3.2	4.6	0.7	3.7
1890-1913	6.2	4.1	7.0	2.9	1.3	1.5	1.8	2.4	4.2	2.3	4.6	1.0	3.3
1914-18	2.7	3.4	3.6	5.1	--	--	11.6	6.8	3.8	6.5	3.1	4.1	5.1*
1919-26	4.9	4.2	2.5	1.2	2.8	2.4	4.2	2.1	4.9	2.0	2.7	1.7	3.1
1927-31	3.7	5.9	2.7	0.7	1.4	2.0	1.5	0.6	2.0	1.8	1.9	0.7	2.1
1932-39	1.6	1.7	2.6	0.8	1.0	0.6	0.7	1.0	1.1	1.5	1.1	0.4	1.2
1940-46	4.8	3.5	3.3	2.3	--	--	3.4	1.0	4.9	2.0	7.2	1.1	3.2*
1947-59	3.1	3.4	2.3	1.4	1.5	2.0	1.4	1.3	3.1	1.1	1.2	0.6	1.9
1960-73	1.0	2.3	1.2	1.9	0.6	1.0	2.1	1.0	2.4	0.7	0.8	0.5	1.3
1974-89	1.9	3.6	1.7	3.2	0.8	2.1	1.3	1.8	5.2	1.5	1.5	1.4	2.2
1989-96	2.0	4.5	4.0	1.8	0.7	2.7	1.6	2.1	2.9	2.0	2.6	1.2	2.3

Note: *Excluding Germany and France.
Source: Obstfeld (1998).

The ratio of the disequilibrium (the scope for capital flows to finance the savings-investment gap) to output varies significantly from country to country. For all 12 countries together, the ratio exceeded 3 percent from the second half of the nineteenth century to the early twentieth century, during the time the gold standard was in force. This suggests that there were active international capital flows during the period when the world was under British hegemony (Table 1 □).

The level of international capital flows was depressed from the 1930s the first half of the 1970s (excluding the periods of the two world wars, when international capital flows expanded primarily due to active inter-governmental transactions), because most nations, including the advanced industrialized countries, regulated such flows. Then, capital flows expanded again from the second half of the 1970s to the 1990s, although they did not reach their levels just prior to World War I or during the two world wars (Table 1)

As capital flows increase, so does the tendency for problems that destabilize capital flows in one region to impact the economies of all countries via financial, equity, and foreign exchange markets. Consequently, on October 30, 1998 the G-7 financial ministers and central bank heads expressed the view that short-term capital flows should be monitored more closely. There are also moves in some quarters to introduce more direct measures to regulate capital flows. Debate on reform of the international currency system is gaining momentum, including discussion on reform of the International Monetary Fund and the possibility of creating a new international financial agency.

The present paper examines the expansion of international capital flows since the beginning of the 1990s and their erratic movements in recent years. Factors behind recent changes in capital flows include both the global macroeconomic environment, such as monetary policies of advanced industrialized nations, and microeconomic factors, such as structural reform and deregulation in the developing nations. Here, the analysis focuses on the impact of the macroeconomic environment in particular. Finally, the paper presents an outlook and views on future developments.

2 Background and Impact of Changes in Capital Flows in the 1990s

2.1 Three periods

International capital flows have been erratic recently due to such factors as currency crises, after ballooning sharply at the beginning of the 1990s (Charts 1 and 2). This is true of flows among advanced industrialized nations and flows from the industrialized nations to developing nations (including emerging regions). The pattern of international capital flows suggests that the decade of the 1990s should be divided into three periods for the purpose of analysis.

Chart 1: Current Account Disequilibrium of Major Countries

The first period runs from 1990 to the middle of 1995. One reason that these years form a distinct period is the movement of the yen-dollar rate. After reaching a peak at around ¥160 in April 1990 the value of the dollar was quite volatile although its sustained trend was downward. It finally reached a trough of ¥79.75 in April 1995. Meanwhile, after flows of portfolio investment, primarily equity investment in Mexico and the rest of Latin America, rose dramatically, capital flows to developing nations came to an abrupt halt as Mexico plunged into a crisis.

Chart 2: Private Capital Flows to Emerging Regions

The second period covers the time from the middle of 1995 to the middle of 1997. During this period, capital flows from Japan and Europe to the United States increased, leading to a strong dollar vis-a-vis the yen and the D-mark. Also during this period, capital flows to the developing nations recovered, and movement of capital to both Latin America and Asia increased sharply.

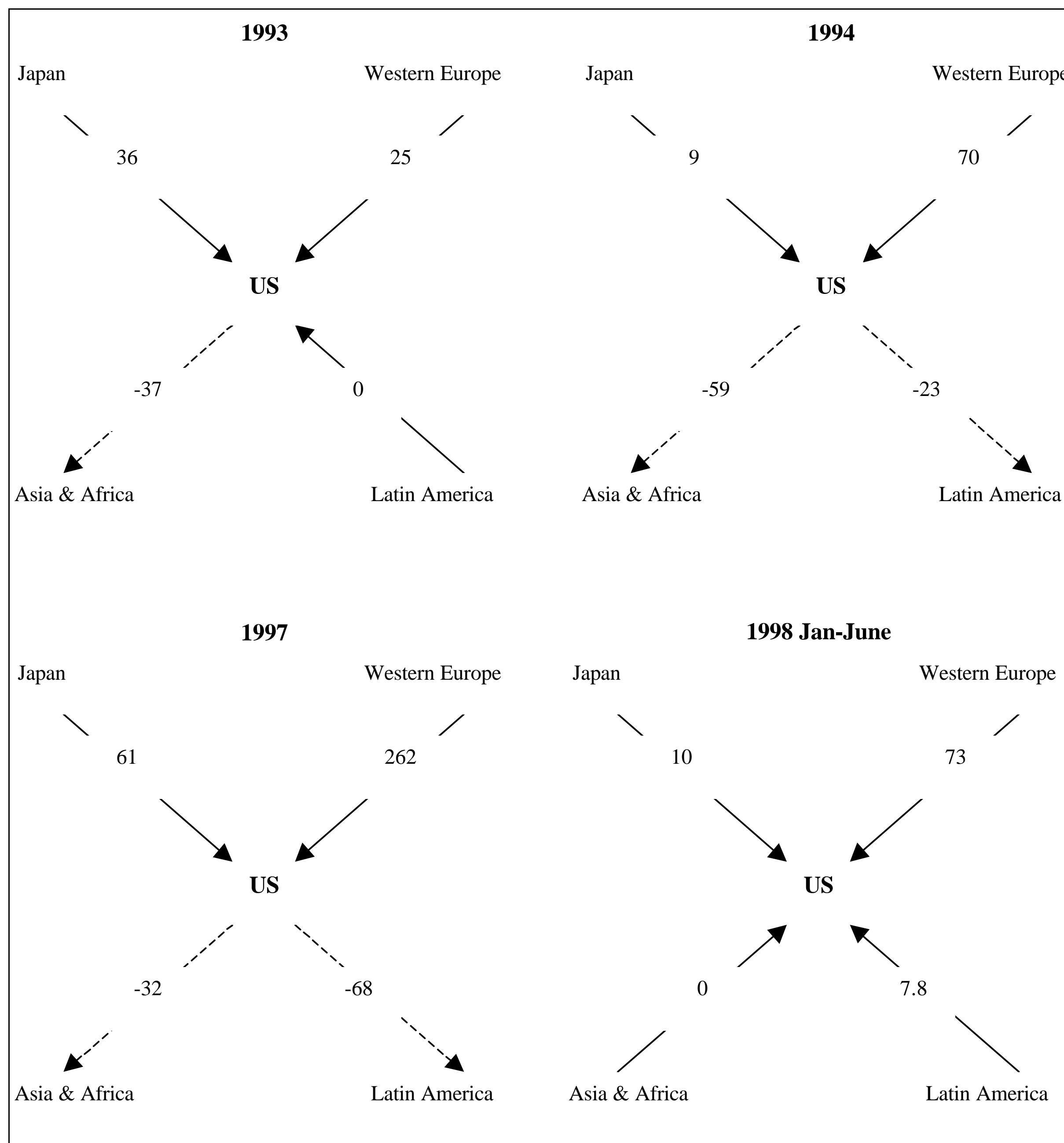
The third period is the years since mid 1997. The dollar remained strong until the summer of 1998, but with the outbreak of the Thai currency crisis, capital flows to the developing countries entered an adjustment phase and not a few emerging countries considerably eased the pegging of their currencies to the dollar. These countries began to adopt what may be called a 'near-floating rate' system.

There are many statistical limitations to grasping the overall picture of international capital flows and figures vary depending on the data source. To examine characteristics of capital flows in each of the three periods of the 1990s, this analysis relies primarily on U.S. data on international balance of payments, which is convenient for obtaining capital balances by region, along with international balance of payments statistics from the IMF and international financial statistics from the BIS.

2.2 1990 to mid-1995: Easy monetary policy in the U.S. expands capital flows

It is not possible to separate private capital flows from public flows. Nevertheless, it is safe to assume that a large part of the increase or decrease in investment in the United States by the public authorities of other countries is reflected in the increase or decrease in the foreign currency reserves of these countries. (For example, when the Bank of Japan makes a dollar-purchasing intervention in the market and increases Japan's foreign currency reserves, this would constitute investment in the United States by the Japanese government.) We assumed that dollar-related capital transactions by public authorities represent 80 percent of the change in foreign currency reserves. We then subtracted this amount from total capital flows by region to calculate the flow of private investment and loans for the United States for several years in the 1990s (Chart 3).

Chart 3: Capital Flows to and from the United States
US$ billion



Source: Nomura Research Institute, Ltd.

Reflecting chronic deficits in America's capital account, the balance ultimately shows a net inflow of capital. From the start of the 1990s to mid-1997, capital flowed into the United States from Japan and Europe, while the United States in turn used these funds to invest in Asia, Africa, and Latin America.

This pattern of capital flows can be attributed largely to higher growth and interest rates in the emerging economies as well as to the dollar's status as the world key currency. Before the Asian currency crises became really serious, most emerging economies had linked (or pegged) their currencies to the dollar.

As long as these currencies were linked to the U.S. dollar, the currency risk to investors who make portfolio investments or to U.S. businesses that make direct investments in these emerging countries

and regions was far smaller for American than for Japanese or European investors. This probably made it easier for Americans to invest in the emerging regions.

From 1990 to 1994, while capital flows from Japan and Europe to the United States were smaller than in 1997, the United States made substantial investment in emerging countries and regions. The relatively high level of capital outflows from the deficit-ridden United States intensified the downward pressure on the dollar.

The backdrop for this pattern of capital flows includes such important factors as the end of the Cold War, resolution of the debt crises that had erupted in the developing countries in the 1980s, and structural reform of the economies of Asia and Latin America. Another equally important macroeconomic factor was the low-interest rate policy in the United States. Between 1990 and 1993, the U.S. official discount rate was kept at 3 percent. (It was zero percent in real terms, since the U.S. inflation rate remained at around 3 percent during the first half of the 1990s.) Policy makers apparently were keen to solve the bad debt problem of the savings and loan associations that had surfaced toward the end of the 1980s.

Chart 4 shows growth of the money supply in the United States. Before the mid-1990s, the broad money supply, M3, stagnated due to a decline in the credit multiplier while the narrow money supply, M1, which includes cash and highly liquid deposits, showed strong growth. (A credit crunch was brought on by the reluctance of financial institutions to lend as they faced the bad debt problem.) This indicates that the Federal Reserve Board pursued rather easy monetary policy to increase the supply of liquidity in the face of sluggish credit growth.

Chart 4: U.S. Money Supply and Credit Multiplier

By 1993, it was recognized that corporate restructuring efforts were worsening the employment situation in the United States while the cut in defense expenditures that followed the end of the Cold War and other factors were exerting downward pressure on the economy on the fiscal front. These factors probably caused the Fed to increasingly relax monetary policy.

Low-interest money supplied to the market under the Federal Reserve policy flowed out of the United States in two ways. One was through direct business investments in emerging countries and regions and the other was through investments in overseas securities by U.S. mutual and pension funds. Mutual funds had begun to expand dramatically from the beginning of the 1990s.

Capital flows to both Asia and Latin America increased during the first half of the 1990s (Table 2). The flows to Asia were primarily in the form of direct investment, while portfolio investment increased sharply in Latin America (which appears as the Western hemisphere in the table).

Since the currencies of the developing countries were pegged to the U.S. dollar, part of the inflow of funds is thought to have flowed back to the United States, as governments used the capital inflows to maintain dollar reserves (through investment in dollar bonds).

From about 1994, the monetary situation in the United States headed toward normalcy (Chart 4). In February 1994, the Fed began to increase short-term interest rates. As a result, the flow of money from the United States to the developing nations slowed temporarily, particularly to Latin America, where previous flows had been concentrated in portfolio investment in local securities.

Reflecting the Mexican crisis, capital flows to Latin America in the form of securities investment plummeted from $66.0 billion in 1994 to $4.8 billion in 1995 (Table 2). In contrast, capital flows to Asia, which were mostly direct investment, increased rather than decreased. This is a marked difference between this period and the period after the middle of 1995.

In sum, during the first half of the 1990s, there was a relatively small net inflow of private capital from Japan and Europe to the United States, while the Federal Reserve's low interest rate policy encouraged heavy investment from the United States to Asia and Latin America. This policy depressed the value of the dollar against the yen and the D-mark, while it increased the supply of low-interest funds to emerging countries and regions. This period was characterized by expanding capital flows brought on by America's monetary easing.

Table 2: Net Investment Balance by Region

US$100 millions

	1990	1991	1992	1993	1994	1995	1996
	Net Investment Balance						
Total	1,922	2,157	2,085	1,986	1,758	2,984	3,455
Industrialized economies	1,574	583	605	96	521	899	1,270
Developing economies	413	1,648	1,410	1,988	1,348	2,253	2,326
Africa	50	81	59	98	127	188	150
Asia	201	501	386	630	677	984	1,275
Europe	153	-29	137	277	-107	440	214
Middle East	-163	749	271	306	182	53	-49
Western Hemisphere	173	346	557	677	470	589	735
	Direct Investment						
Total	-375	-393	-225	-61	-154	110	126
Industrialized economies	-582	-736	-608	-645	-965	-850	-1,005
Developing economies	206	343	384	585	812	960	1,131
Africa	11	21	15	25	39	37	46
Asia	91	159	174	343	442	505	565
Europe	4	34	55	79	76	165	155
Middle East	27	15	3	25	10	-7	3
Western Hemisphere	73	115	137	113	246	260	363
	Portfolio Investment						
Total	783	1,235	921	1,916	972	2,002	2,989
Industrialized economies	585	906	550	740	75	1,631	2,095
Developing economies	52	200	421	1,080	848	303	835
Africa	-2	-3	18	11	24	24	28
Asia	-23	26	90	179	125	141	187
Europe	5	5	22	81	41	32	97
Middle East	-41	3	-71	101	-2	58	-78
Western Hemisphere	113	169	362	708	660	48	601
	Other Investment						
Total	1,514	1,315	1,390	131	939	872	340
Industrialized economies	1,571	413	663	2	1,412	118	179
Developing economies	155	1,105	606	323	-312	990	360
Africa	41	63	26	62	64	127	77
Asia	133	316	122	108	110	337	524
Europe	143	-68	60	117	-224	243	-38
Middle East	-149	731	340	181	173	3	26
Western Hemisphere	-12	63	59	-145	-435	280	229

Note: IMF-basis, excluding increases in reserve assets
Source: Nomura Research Institute, Ltd.

2.3 Mid-1995 to mid-1997: Monetary easing in Japan and Europe expands capital flows

According to Chart 3 capital flows from Japan and Europe into the United States increased dramatically in 1997, while outflows of money from the United States to the emerging countries and regions also expanded. As monetary policies in Japan and Europe became increasingly easier from the second half of 1995 to 1997, capital from these areas flowed to the emerging markets via the United States.

Chart 5 indicates how the financial situation in Japan after 1995 became similar to the situation in the United States in the first half of the 1990s. Amid growing uncertainties over the financial system, in July 1995 Japan adopted an ultra low-interest rate policy, which boosted investment in U.S. bonds from Japan. In addition, Japanese financial institutions had to send more and more capital abroad because their lower credit rating had made it more difficult to raise funds in international financial markets and had given birth to the "Japan premium."

Chart 5: Japan's Money Supply and Money Multiplier

According to data from the Bank of Japan, the outstanding balance of funds remitted by Japanese banks to their overseas branches has surged since 1995 as Japan's financial crisis deepened (Chart 6). It is said that in international financial markets, Japanese banks borrowed dollars and other foreign currencies in short-term inter-bank markets, and rolled over these debts to lend long-term via syndicated loans and other instruments to the emerging countries and regions. However, as it became more difficult for Japanese banks to raise funds, they were forced to reduce (repay) their

short-term borrowing (debts). They resorted to offsetting the shortfall by remitting yen from Japan and exchanging it into dollars for a fixed period through swap deals (selling yen in the spot market and buying it back in the futures market).

Chart 6: Outstanding Remittances from Japanese Banks to Overseas Branches

In this picture, hedge funds and other investors borrowed yen at low interest rates and invested in the dollar and high-yield currencies of emerging economies that were linked to the U.S. dollar, thus expanding global carry trade. (According to the 1996 BIS *Annual Report* hedge funds actually borrowed dollars and sold yen forward.) This behavior by hedge funds is thought to have been partly responsible for the weakening of the yen.

IMF data show that the outstanding balance of hedge fund assets at the end of 1997 stood at the high level of US$109.6 billion (Table 3). (Actually hedge funds are believed to have leveraged these assets and taken positions five to 10 times greater than their assets). The bulk of hedge fund assets is registered in the so-called tax havens. According to the Fed's *International Financial Statistics*, lending by U.S. banks to companies registered in tax havens ballooned from approximately $42.0 billion at the end of 1994 to more than $100 billion at the end of 1997 (Table 4).

Table 3: Hedge Fund Assets under Management by Domicile as of 31 December 1997

	Hedge Fund Assets US$ millions		Hedge Fund Assets US$ millions
Austria	1	Hong Kong	2
Bahamas	2,649	Ireland	223
Bermuda	6,602	Mann Island	110
British Virgin Islands	15,801	Luxembourg	1,597
British West Indies	308	Netherlands	54
Canada	255	Dutch Antilles	26,576
Cayman Islands	17,440	Turks and Caicos	033
Channel Islands	372	U.K.	042
Curacao	4,000	U.S.	31,792
Guernsey	1,723	*Total*	*109,575*

Source: IMF *Occasional Paper* No. 166.

On the other hand, European investors increasingly chose to invest in U.S. bonds and equity. This is attributable to two factors. First, austere fiscal policies adopted by European governments between 1996 and 1997 in preparation for the January 1999 inauguration of the single European currency resulted in deceleration of their economies, which in turn led to monetary easing. Second, the future of the currency integration itself was uncertain.

Under these circumstances, funds in excess of the U.S. current account deficit flowed into the United States from Japan and Europe, where the governments continued easy monetary policy. These inflows strengthened the dollar and were also partly responsible for stabilizing U.S. bond yields at low levels and causing a surge in U.S. equity prices. The United States in turn recycled these funds to emerging economies in Asia and Latin America, where currencies were linked to the U.S. dollar.

As long as there were capital inflows, Asian and other emerging countries were able to finance their current account deficits without tightening monetary policy, to increase their foreign currency reserves, and to maintain economic growth while keeping their exchange rates steady. The pattern that emerged from mid-1995 was that the United States and the entire zone of countries with currencies linked to the U.S. dollar enjoyed sustained economic expansion leveraged by monetary easing in Japan and Europe.

In 1996, capital flows to the developing countries increased dramatically (Table 2). What was noteworthy was that as portfolio investment began to increase again in Latin America, capital inflows to Asia diversified from mainly direct investment, which had been the prevailing form in the first half of the 1990s, to include more portfolio and other types of investment (primarily bank lending). These types of investment are said to be more volatile than direct investment, and their increase in Asia has important implications for the study of the currency crises that occurred since mid-1997 and for changes in international capital flows.

Table 4: Balance of U.S. Banks' Claims by Region

	Dec. 1994	Dec. 1995	Dec. 1996	Dec. 1997	March 1998	
	$ billion	$ billion	$ billion	$ billion	$ billion	%
Americas	64.1	70.9	84.7	100.1	105.9	14.6
North America	28.4	27.6	30.2	31.1	31.2	4.3
Latin America	35.7	43.3	54.5	69.0	74.7	10.3
Asia	99.3	124.5	134.2	134.1	135.5	18.7
Japan	21.1	28.5	23.7	28.6	25.8	3.6
NIEs	55.5	66.6	76.4	69.5	75.1	10.3
ASEAN4	12.3	18.2	22.7	22.9	20.5	2.8
China	1.1	1.8	2.5	3.2	4.2	0.6
Other	9.3	9.4	8.9	9.9	9.9	1.4
Australia	15.4	16.4	24.0	23.1	23.2	3.2
Oil-producing Middle East	15.3	13.3	10.7	14.4	14.3	2.0
Europe	192.0	204.1	237.3	278.9	262.3	36.1
Western Europe	189.3	199.9	230.4	239.8	252.4	34.8
Eastern Europe	2.7	4.2	6.9	9.1	9.9	1.4
Africa	3.6	3.8	4.8	5.7	7.8	1.1
Tax havens, etc.	42.8	61.1	90.1	100.8	80.5	11.1
Other	67.0	57.8	59.5	98.8	96.6	13.3
Total	499.5	551.9	645.3	725.9	726.1	100.0

Source: United States *Federal Reserve Bulletin.*

2.4 Since mid-1997: Accumulation and surfacing of adjustment pressure

In mid-1997, as the Asian currency crises began to grow in severity, capital flows reversed and

money began to flow back to the United States from Asia. From the beginning of 1998, some of the funds that had flowed into Latin America also began to move back to the United States (Chart 3).

The capital flows from the United States, which had been stimulated by monetary easing in Japan and Europe, led to deterioration of current account balances in the emerging countries and regions. Pressure for adjustment began to be felt after the onset of the Asian currency crises in the middle of 1997. As a result, erratic capital flows became a risk factor to the real economy. The situation not only forced the United States to shift to monetary easing, joining Japan and Europe, but also plunged the international financial system into a period of turmoil, during which the nature of the system itself underwent change.

With the reversal in the direction of capital flows, the developing countries faced downward pressure on their currencies, which resulted in market interventions that reduced their foreign currency reserves. Stock prices plunged and business conditions deteriorated due to austere policies, which included increases in interest rates and the reduction of budget deficits. The developing countries, thus, were forced to seek a lower equilibrium by improving their current account balances through a reduction in imports.

The change in the level of foreign currency reserves held by public authorities (excluding the United States) provides a barometer of the pressure for tighter monetary policy brought about by outflows of capital from the developing economies. As stated earlier, in a period of smooth capital inflows and increasing foreign currency reserves, monetary condition can be eased with a resultant expansionary effect on the economy. Conversely, outflows of capital generate pressure to tighten monetary policy.

U.S. Treasury securities are believed to account for the bulk of the foreign currency reserves of most countries. After increasing by more than $110 billion in the peak year of 1996 over the end of the previous year, the balance of U.S. Treasury securities held by public authorities (excluding the United States) declined by $8.1 billion in 1997. The balance declined another $40.2 billion during the first nine months of 1998. This implies that the change in the direction of capital flows was generating strong pressure to tighten monetary policy.

The reversal of capital flows and the resulting mounting pressure to tighten monetary policy in the developing countries are also affecting the economy and financial situation in the United States. At the outset of the Asian crises, the deceleration of the Asian economies resulting from erratic capital flows was expected to affect the U.S. economy adversely, because it would depress U.S. exports. However, it was also expected that as money returned to U.S. equity and bond markets and to the banking sector, interest rates would stabilize at low levels and stock prices would rise, providing a strong stimulus to domestic demand. The prevailing view was that the United States would see sustained growth without inflation as it struck a balance between deteriorating external demand and firming domestic demand.

As a result of this optimism, investment in U.S. bonds continued and foreign investment in U.S. equities, particularly from Europe, rose dramatically from the second half of 1997 through the first half of 1998.

U.S. Treasury Department statistics on European investment in U.S. securities show that net equity investment (purchases minus sales) increased more than 10 times, from only $5.4 billion in 1996 to $59.2 billion in 1997. During the first six months of 1998 investment from Europe increased at an annual rate of $99.5 billion (obtained by doubling the January-June figure of $49.8). This investment is thought to be a major factor behind the appreciation of the dollar and the accelerated increase in U.S. equity prices from 1997 through the first half of 1998.

Later 1998, however, Russia, which had been attracting funds by offering high interest rates and linking the ruble to the U.S. dollar, was forced to devalue its currency because of the deterioration of its economy and a drastic fall in its stock market. The downward pressure on currencies, which

spread to Latin America and to America's NAFTA partners Canada and Mexico, had a large economic and financial impact on the United States. It led to deterioration of external demand, a drop in prices, and a worsening of financial institution earnings in the United States. The subsequent sharp drop in European investment in U.S. equities, following its dramatic increase during the first half of 1998, is thought to be a factor in the recent sharp fall in the value of the dollar and the U.S. stock market.

Rather than being simply a temporary decline and reversal of capital flows, this development is leading to a number of changes in the framework of the international financial system. First, many countries, primarily in Asia, are relaxing the link between their currencies and the U.S. dollar. As a result, American investors and businesses are facing greater foreign exchange risk in their investment in these countries. Second, some countries, Malaysia among them, have strengthened regulations on capital flows. Third, the international financial markets have been destabilized. Also, investors began to pull money out of the U.S. bond and mortgage bond markets causing major losses to hedge funds and other financial institutions. These losses, in turn, are leading to a contraction of high-risk capital transactions, such as global carry trade.

The recent plunge in the value of the dollar against the yen, the largest since the floating exchange rate system was adopted, is symbolic of the change in the international financial system. The increase in the value of the yen occurred despite severe pressure on Japanese banks to move funds abroad to escape the financial system uncertainty and very low interest rates at home.

3 Outlook and Summary

3.1 Global risks

Continuation of the present erratic flows of capital threatens to lower the growth rate of the global economy.

It is clear that changes in international capital flows have completely altered the picture of economic growth in the developing countries in the 1990s from that in the 1980s. As is widely known, the debt crises in the developing countries, particularly those in Latin America, that erupted in the early 1980s, dramatically limited capital flows to these countries for the ensuing approximately 10 years.

During the 1980s, aggregate capital inflow to the developing countries ranged from zero to a deficit (net outflow) of $30 billion. Even in Asia, inflows amounted to no more than $10-20 billion. In an environment of limited capital inflows and current account deficits, governments are forced to adopt austerity measures, because selling pressure on their currencies reduces their foreign currency reserves. This is what actually happened, and the growth rates of the developing countries were depressed. This is why the 1980s are dubbed "the Lost Decade" for the developing countries. In order for them to continue growth while maintaining foreign exchange reserves, they needed to increase exports so that external demand would play the role of the "engine" for growth.

The picture changed completely in the 1990s. In 1996 alone, capital flows to the developing countries amounted to $232.6 billion. Asia saw inflows of $127.5 billion during the year (Table 2). The total capital inflow to developing countries in 1996 was far in excess of the $69.9 billion aggregate current account deficit of the developing countries ($28.0 billion of which was in Asia). Thus, inflows of capital were large enough to offset the current account deficits and still allow the developing countries to substantially increase their foreign currency reserves. This situation caused domestic demand to expand faster than supply capacity. But because their foreign currency reserves were growing, these countries were able to maintain exchange rate stability, pursue relaxed monetary conditions, and continue economic growth despite their current account deficits.

As discussed above, the economies of the developing countries are sometimes vulnerable to the flow of capital from the industrialized countries. Although large capital inflows allow the developing countries to continue high growth despite current account deficits, once such inflows decelerate their

rates of economic growth must slow. Contraction of capital flows could plunge these countries into a period of sluggish growth, which could have not only economic but also political consequences.

The other side of the coin is that the United States is generating current account deficits at the rate of more than $200 billion a year. The American deficits are supporting the economies of Japan, Europe, and other regions by creating effective demand. If inflows of capital to the United States contract dramatically and the United States is forced to move to a lower economic equilibrium, that would put further deflationary pressure on other economies. The impact would be particularly devastating for Japan, which is presently in the midst of a structural adjustment both in the real economy and in the financial system.

The situation would look similar to that in the 1930s, if the problem spreads to the United States. During the Great Depression, the reversal of international capital inflows made it difficult for Germany and other countries to finance their deficits, forcing them to devalue their currencies and resort to protectionism. It heightened political unrest. Thus, it is essential to stabilize international capital flows in order to limit their impact on the real economy.

3.2 Policy responses and the direction of capital flows

International policy cooperation and coordination are necessary as short-term responses at the following three levels:

1) The IMF must restructure its financial relief strategy by setting more realistic conditions for economic reform and it must expand the emergency supply of liquidity to stem the tide of capital outflows from the emerging economies.
2) The industrialized countries, including the United States and European countries, must coordinate their monetary policies toward easing in order to counter the contractionary pressure on global capital flows, and if it becomes necessary they must consider fiscal stimulus as well.
3) Japan must resolve its financial problems, which are a destabilizing force for Asia.

The G-7 emergency statements issued on September 14 and October 30, 1998 are steps in the right direction. Japan has committed $30.0 billion in financial relief for Asia through the "New Miyazawa Plan," while on November 16, the governments of the United States and Japan announced the "Asian Growth and Economic Recovery Initiatives," which are worth $5.0 billion in total. Nevertheless, there are many hurdles to overcome between late 1998 and early 1999. They include 1) discord between the governments of major European countries and their central banks; 2) leadership of the Japanese government in restoring the health of the Japanese financial system; 3) ability of Brazil and Russia to implement measures demanded by the IMF; and 4) the extent to which monetary easing by the U.S. Federal Reserve can restore normalcy to U.S. financial markets.

With respect to medium-term reform of the present system and the desirable picture of capital flows in the future, there have been suggestions to tighten regulations on capital flows or to create a new international body. Opinions are sharply divided not only among the developing countries but also among the industrialized countries. Judging from the G-7 statement of October 30, 1998, whatever changes are implemented are likely to be only partial reforms. They likely include 1) strengthening disclosure requirements for hedge funds and other investors as well as for financial institutions; 2) partial regulation of inflows of short-term funds by the developing countries; and 3) strengthening the IMF's capacity to respond to crises, including the creation of new quotas for emergency financial relief.

Themes for future study include 1) whether or not it is possible to distinguish stable capital from unstable capital; 2) whether it is possible to distinguish the types of capital that contribute to economic growth from those which do not; and 3) whether restrictions on flows of short-term capital

affect flows of long-term capital.

Several structural changes have taken place since mid-1997 that are likely to affect the future of international capital flows. First, the developing countries have adopted the floating rate system for their currencies. Second, monitoring and regulation of short-term capital flows have been strengthened and high-risk capital transactions have been reduced. In addition, it is expected that in the long term, countries will shift part of their foreign currency reserves from the dollar to the euro following the European currency integration.

Under these circumstances, the following characteristics will emerge:

- It will take some time for international flows of private capital to return to the high levels of 1995-97 as investors become more aware of risk;
- With tighter monitoring of short-term capital flows, long-term capital, such as direct investment, will begin to account for a greater share of private capital flows.
- Given the greater volatility of the developing countries' currencies vis-a-vis the U.S. dollar and the shift of some foreign currency reserves to the euro, international capital flows will become more diversified. Capital should flow directly from Japan and Europe to the developing countries and from the developing countries to Japan and Europe rather than indirectly through the United States. Such new patterns of capital flows are expected to account for an increasing share of total capital movement.

In order to cope with the instability inherent to the transition in capital flows, the weight of public funds, such as those of the IMF, should increase, while monetary policies of the industrialized countries should generally remain easy.

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