a good deal of the available capital and in some instances military expenditures ate up capital which might have been put to productive use.*

The problem of capital flight, experienced mainly but not exclusively by some big Latin American debtor countries, compounded an already critical situation. Large amounts of borrowed funds were re-exported by private citizens when their confidence in their own economies waned. Factors which generate the excessive outflow of capital include: an overvalued exchange rate, which makes foreign imports seem inexpensive and can make exports uncompetitive; a high rate of inflation, which erodes the value of money; negative real interest rates, which discourage domestic savings; and an economic environment that is generally not conducive to productive domestic investment. Of these, the overvalued exchange rate was particularly insidious at the time, as it fuelled anticipation of a devaluation in many middle-income countries and encouraged speculative capital outflows. Studies have estimated that as of 1983, flight capital amounted to two-thirds of Venezuela's external debt and approximately one-third of the external debt of Argentina and Mexico. The World Bank has estimated that for the period 1979 to 1982, the combined capital flight from Venezuela, Argentina and Mexico totalled about $70 billion, with capital inflows during the same period amounting to $100 billion. In Mexico's case, it has been estimated that the external debt of that country by the end of 1985 would have been only about $20 billion rather than $100 billion, had it not been for capital flight.

The Crisis Develops

Although Arab OPEC countries deposited large amounts of funds abroad in 1980, these funds had fallen almost to zero in 1981 and, in 1982, Arab countries actually withdrew $16.5 billion from their Eurocurrency deposits. However this dramatic turn-about appears to have been compensated for by new deposits flowing into commercial banks from two sources: domestic and intra-OECD lending stimulated by the historically high interest rates and the huge transfers of flight capital.

Accordingly, debtor countries' repayment problems resulting from rising real interest rates did not initially lead creditors to question the capacity of their borrowers to make payments. In fact in the period from December 1979 to December 1980 when the Argentinian currency was highly overvalued, U.S. banks increased their loans to that country by 42 per cent, and in the first six months of 1982, just prior to the Mexican debt crisis, U.S. banks increased their exposure in Mexico at an annual rate of 34 per cent.

By 1982 all the adverse factors, external and internal, converged. Externally, the international recession, high interest rates, the continuing impact of the second oil price rise and the price collapse for other commodities presented many developing countries with increased problems. Within the debtor countries themselves, inappropriate policies, including continued heavy borrowings even in

* At the same time, it must be added that a World Bank study has established that much of the borrowing done by developing countries in the 1970s was spent usefully, stimulating their economic growth. In fact, the growth rate in developing countries in the 1970s exceeded that of the OECD group.