

# New financing trends in Latin America<sup>1</sup>

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## 1. Introduction

The transformation of financing, the changing nature of financial risks and the resulting policy challenges were the main topics of a meeting on “New financing trends in Latin America: a bumpy ride towards stability” held in Mexico City on May 26–27, 2007 and jointly organised by the Bank for International Settlements and the Federal Reserve Bank of Atlanta. This introduction is an overview of selected issues discussed by central banks, finance ministries, multilateral institutions, academics and private sector participants.

Financial markets in Latin America have experienced a major transformation during the past 15 years. One of the most noticeable changes has been the shift from cross-border towards domestic financing. This has allowed domestic capital markets to expand, deepen and diversify and therefore become less dependent on bank financing. The first part of the meeting thus looked into the changes in financing and the factors driving them. The second and third parts discussed the development of domestic bond markets. Specifically, the second part of the meeting raised questions regarding the benefits for sovereigns of issuing in local currency, the pros and cons of doing so in domestic vis-à-vis international markets, the status of private markets, the role of structured finance and the extent to which developing these markets remains a policy objective for de-dollarising the economies in the region. The third part focused on policy challenges arising from developing domestic bond markets, such as those arising as a result of the emergence of new instruments or investors in the market, or the scope for a regional bond market.

The fourth part of the meeting discussed the implications of new financial markets for the transmission of monetary policy and the role that authorities play in developing these markets. Lastly, the financial stability implications of the new financing channels were discussed.

The remainder of this introductory article offers a brief account of the topics discussed at the meeting while highlighting their connexion with the papers published in this volume.

## 2. What has changed in financing in recent years?

In this volume, two papers analyse the recent transformation of financing in more detail. Quispe and Vilan (2008) describe the evolution of financial markets, portfolio flows, foreign direct investment (FDI), domestic banking sectors and workers’ remittances during the period 1990–2005. Jeanneau and Tovar (2008a) provide an overview of bond markets in local currency. Some of the key features highlighted in these studies are the following. First, domestic financing has expanded vis-à-vis external financing. Second, bond markets in local currency have become an alternative source of financing, relative to external dollar-denominated securities and bank financing. Third, FDI and workers’ remittances to the region

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have become the main source of financing. These developments should make the structure of capital flows less volatile than in the past and make local borrowers less exposed to exchange rate risk.

### **The role of foreign and domestic factors**

The changes recently observed in the structure of financing across the region reflect both external and domestic influences. In the first part of the current decade a benign **external environment** characterised by low real interest rates worldwide and decreased levels of risk aversion compressed the sovereign spreads on the region's external debt to historically low levels.<sup>2</sup> In addition, high commodity prices have led to very favourable terms of trade for the region and a significant expansion of exports.

**Domestic policies** have also improved, allowing a higher marginal propensity to save out of increased income than in the past. This is evident in the reduction of debt ratios, the unprecedented current account surpluses and the increased levels of international reserves. Some of the relevant changes in policies include: the shift toward moderately countercyclical fiscal positions (achieved by saving a large part of the increased revenues and generating significant primary surpluses); new government debt management policies aimed at improving sovereign debt profiles and reducing currency and maturity mismatches; more credible monetary and exchange rate frameworks; and better supervisory frameworks.

### ***The role of external factors: a sustainable external environment?***

How sustainable is this favourable external environment and what are the implications for the dynamics of capital flows? Clearly, the favourable terms of trade observed in the region during the past few years will not last forever and global imbalances will have to adjust at some point. The issue is the degree to which this will affect the economies in the region and whether it will induce a reversal in the development of capital markets. It seems unlikely that a reversal would have a significant impact in Latin American economies. In fact, the region has weathered recent large shocks in financial markets rather well (eg May–June 2006, February–March 2007 and most recently the one that began in July 2007). That said, four worries are often mentioned: (i) asset prices can become overvalued; (ii) an important share of flows seems speculative in nature, especially those associated with “carry trades”; (iii) financial markets in the region are still immature and investors are just discovering how these markets work; and, finally, (iv) in some countries the favourable external environment may have reduced the incentives to pursue deeper reforms, in particular at the microeconomic level (eg legal and regulatory regimes).

### ***The role of domestic factors: have policies improved the resilience of the economies?***

There was a consensus that better macroeconomic policies had improved the resilience of the region to adverse shocks. Indeed, sound fiscal positions are considered to be a key factor in such improvement. Several countries have implemented fiscal responsibility laws (eg Brazil, Chile and Peru) which should reduce the procyclicality of fiscal policies. This, together with new debt management practices aimed at improving debt profiles, has contributed towards reducing macroeconomic vulnerabilities. In addition, the new monetary frameworks adopted in most countries have led, not just to lower inflation, but also to lower and less volatile interest rates. This has helped in creating a more stable environment for

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<sup>2</sup> Financial innovation and the possibility of diversifying risk in financial markets were also cited as important factors behind lower risk premia and aversion.























