Enrique V Iglesias: Economic Trends in Latin America – The Context of a Globalized Economy

Statement of Mr Enrique V Iglesias, President of the Inter-American Development Bank, at the meeting of the Bank for International Settlements, in Mexico City, Mexico, on 13 November 2000.

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Dear Governors and friends:

I am honored that BIS invited me to speak to this distinguished audience of Central Bank Governors from so many countries. That our host, the Bank of Mexico, is celebrating its 75th anniversary makes this a particularly special occasion.

As you may expect, my topic today is Latin America. I would like to use this opportunity to convey the views of the Inter-American Development Bank on the state of economic affairs in the region and also to share with you some of our concerns about the future. I hope that some of these concerns may be of interest to the BIS as they relate to its important work of strengthening financial systems.

I shall divide my remarks in three parts. FIRST, I shall briefly talk about the deep reforms that our region undertook in the past decade, which have radically transformed for the better the economic landscape of Latin America. However, despite the strong policies and institutions that were put in place, as you know, our economies were overwhelmed by the external shocks suffered in recent years. SECOND, I shall tell you how our region has experienced recent international financial turmoil and how it is currently recovering from a growth slowdown. The key question now is whether changes have been made to prevent the same experience from happening again and, after this painful episode comes to an end, whether growth and stability will prevail. I certainly hope so, but, FINALLY, I shall close with some of my concerns about our continuing vulnerability to a sometimes hostile external environment, which I think are of interest to the BIS and others involved in reforming the international financial architecture.

1. The reforms undertaken by the region in the last decade

The reforms were deep: In the last decade, Latin America embarked on a broad range of macroeconomic stabilization efforts and structural reforms that radically changed the economic environment.

Macroeconomic stabilization has been the result of a very important effort to correct our traditional fiscal imbalances throughout the region. Fiscal deficits larger than 3% of GDP were common in the eighties and are now exceptional: The average fiscal deficit in the last ten years has been just 1.4% of GDP. Fiscal consolidation has been supplemented with sound monetary policies, which has resulted in much lower levels of inflation in most countries of the region. The typical rate of inflation in our countries is now 6%.

The progress of structural reform has been equally impressive. In the eighties, the typical Latin American economy was isolated from the rest of the world, financially repressed, and seriously distorted by all sorts of government interventions. That has changed. Trade restrictions have been virtually eliminated and tariffs have been drastically cut to less than 10% at present. Privatization has been the most visible component of the strategy of modernization and consolidation of the state in Latin America. In the area of finance, liberalization measures have led to lifting controls on capital and interest rates, as well as dismantling bankrupt systems of targeted credit.

Improvements in prudential regulation and supervision of banking systems, in large part based on well learned lessons from past banking crises, merit special mention. Banking crises of the past led to important lessons. The shift towards accepting and acting on these lessons began in the late 1980s, but gained its full impetus only after the Mexican financial crisis in 1994-95. The policy lessons extracted

include the need for accounting standards, especially concerning the valuation of loan portfolios, standards on information disclosure and auditing, the importance of regulating loan concentration and connected lending, and the weakness of the supporting legal system, especially bankruptcy law. There is growing recognition in the region that international Basle capital requirements may be insufficient on average due to the larger shock volatility in Latin America, but in any event, requirements ought to reflect overall portfolio risk, not only credit but also exchange and interest rate risks. Many of these areas of regulation, such as most of the standards, are universal and the corresponding international standards ought to be promptly adopted. Others are dependent on country diversity and international convergence will be more difficult. Supervision needs to be independent. Bank restructuring needs to be done promptly, making sure that owners are not unduly saved and face potential losses.

Not everything is fine, unfortunately. For all their promise, a decade of reforms have not made a visible reduction in poverty or a dent in income inequality, which as you know is a very big social problem in Latin America. Many economists think that inequality would have actually worsened in the period in the absence of these reforms, and they may very well be right, but we will not be satisfied until we see a significant drop in inequality.

Nevertheless, reforms have improved efficiency as expected and led to higher growth and resiliency. Our research shows that macroeconomic stabilization and structural reforms have led to significant gains in growth. As a result, 1997 was the year of fastest growth in 25 years. This same process led to unprecedented resiliency in the face of serious challenges during 1998-99. In fact, with the exception of Ecuador, fiscal discipline was maintained, inflation was tamed, and there was no uncontrolled currency crisis, widespread banking crisis, or external payments crisis.

The reforms are solid: they were not rolled back, but withstood the 1998-99 recession. Much has been said about an alleged reversal of reforms. Such a reversal has not taken place. In spite of the serious difficulties caused by the international financial crisis of 1998-99, virtually all countries of the region continued to deepen the structural reforms instituted in earlier years. Of 14 countries evaluated by the Bank, 10 promoted major fiscal or tax reforms in 1999, 7 were discussing significant reforms in their social security systems, 4 had made major progress in their privatization programs and 4 were discussing deep labor reforms. The review noted an additional 25 cases of reforms in financial systems, in legislation to promote competition and in other areas of economic and social policy in those countries.

2. Recent experience with financial turmoil

If reforms were so effective and fundamentals so strong, why did Latin America have a serious growth slowdown and recession during 1998-99? The answer is the combination of negative external shocks, to which the region remains quite vulnerable. In their absence, the region was poised to maintain a path of relatively high growth.

International terms of trade and commodity prices deteriorated substantially in 1998, in large part as a result of the East Asian crisis. Most Latin American countries are still quite vulnerable to changes in commodity prices. Some countries were severely hit by natural disasters, including El Nino.

These external shocks could have been accommodated with additional external financing, but it was not available. Worse yet, normal external financing dried up and became the main problem. Not only were international capital markets not there for Latin America when they were most needed, but they actually aggravated the problem. Unfortunately, this procyclical pattern with external financing, drying up when external conditions (such as terms of trade or interest rates) deteriorate, is typical in Latin America.

Right there you have a core problem in our region: precarious access to external financing that disappears when it is most needed. That is why our hosts, our Mexican friends, decided to arrange a special stand-by financial package under the umbrella of the IMF, "blindaje" as we say in Spanish, to insure against any market surprise during the electoral season despite the strength of their economy. This is a good example for the entire region.

In this episode, fundamentals were quite strong and access would have been maintained if it were not for the *coup de grace* of the Russian crisis. Subsequent financial contagion led to external financial conditions totally misaligned with the region's strong fundamentals. This collapse in external financing resulted from the problems faced by our main foreign investors, not problems in our economies. The problem was not our countries' creditworthiness but that of our foreign investors. Over time, however, difficulties in accessing external finance do hurt fundamentals and may render countries truly uncreditworthy. From a Latin American perspective, international financial contagion and financial panic are new and dangerous sources of external shocks associated with financial integration.

The combination of negative shocks led to a severe contraction in imports and a greater growth slowdown than during the Tequila crisis in 1995. The exception is Mexico, which benefits from its current association with the US economy; but South America experienced negative growth in 1999. The collapse in private foreign financing was similar in both the Tequila and the current episodes. However, this time there was a significant deterioration in the terms of trade and less help from official sources.

Recovery is now well under way (albeit hesitant in Argentina) and this year's growth rate will be above 4%, despite the fact that commodity prices and risk spreads have not completely returned to normal. Prospects are excellent, barring new external shocks. However, the volatility of financial conditions and their overall deterioration in recent months sound a clear warning that recovery is vulnerable to external shocks. In fact, our concerns for the future, to which I now turn, are concentrated on the extent to which we have made progress in achieving deeper and safer financial integration.

3. Is the financial world a better place now? Will growth and stability prevail in the future?

How is the Region responding to the challenge of strengthening its financial systems?

The IDB is convinced of the importance of strengthening financial systems throughout the region. At the IDB we have pioneered efforts to warn against the risk associated with credit booms and to derive its implications for macroeconomic policy, to highlight the importance of standards to make regulation meaningful, to insist on strong and countercyclical regulatory requirements, and to suggests ways to improve the independence and quality of the institutions of bank supervision. In particular, we have highlighted the need to adopt more strenuous capital and liquidity standards on account of the higher volatility of our economic environment. I have just received an invitation from Andrew Crockett for the IDB to cooperate with the Financial Stability Forum in raising awareness in our region of the international standards that have been developed and to promote the discussion of the implementation issues that would arise. It is a pleasure for me to announce here that I am delighted to accept this invitation to cooperate in this issue of common interest.

Countries are also very interested in finding ways to further strengthen their financial systems, to the point that many of them would like to have the opportunity to participate more actively in the development of new ideas and standards. As you can imagine, more participation in the elaboration process would greatly facilitate the productive discussion of the implementation issues of the Forum's international standards that I have just mentioned. This issue of participation is critical in the case of reform of the credit risk capital rules to ensure that it addresses the needs of all global market participants. The regulatory capital framework must be drafted with a view to its implementation in emerging markets as well as advanced markets, which requires more intensive and effective participation by emerging market regulators in the drafting process. It is my hope that Latin American banking regulators will be involved in finalizing the regulatory capital rules in the next and final round of consultation starting, I understand, in January 2001, so that we are not surprised by the final standards.

As I already mentioned, there has been a solid response on the part of countries concerning the two underlying factors of financial strength: macroeconomic stability and domestic reforms of prudential regulation and supervision. You will find a very receptive ear to ideas to further strengthen the countries' financial systems. But we need to recognize that domestic protection is limited and costly. For example, countries in Latin America hold huge amounts of international reserves with a significant carrying cost at current rates and no clear stabilizing effect. In fact, there is the fear that the very use of the reserves may signal weakness and prompt an attack. Many countries in the region follow prudent policies such as stringent bank liquidity requirements, or long debt maturities, or controls on short-term capital inflows, but none has been spared from financial contagion. It is clear that the systemic problems that threaten growth and stability in Latin American countries require systemic solutions, so the key question is:

How is the financial community responding to the challenge of countries exposed to contagion effects?

Let me start by saying that we welcome the efforts of the international /financial community to work on systemic initiatives. But one concern we have is that the systemic initiatives to reform the international financial architecture that are currently being implemented may not be of much help to Latin America. For example, standards on banking regulation and supervision, information, etc. are all very important and good. However, our region is already advanced in these areas, especially after the Tequila crisis. The fact is that our high standards do not appear to have protected us much from instability during recent financial turmoil. Therefore, our region could benefit only marginally from the application of these initiatives. Furthermore, moral hazard induced by implicit public guarantees of poorly regulated and supervised financial systems, which some identified as an important factor in the recent Asian crisis, is not a significant risk factor in Latin American financial systems. Therefore, initiatives aimed at reducing moral hazard might have little beneficial impact in our region.

In particular, we are concerned that Latin America's main problem of precarious access to external financing, subject to contagion and panic, is not being specifically addressed. Latin America is now as vulnerable to contagion and panic from abroad as it was before this last episode. (I will come back to this key point at the end of my talk).

We are also concerned that current thinking about international financial architecture does not enthusiastically support official rescue packages of the kind that were so successful in our region, in 1995 in Mexico and Argentina and in 1998 in Brazil. The current debate points to promoting stability by impeding capital inflows through the increase in the cost of capital to the point that it reflects the true risk of investments, which would be underestimated by investors because they believe that the official sector will bail them out. The problem is that, again, this source of moral hazard is not a significant factor in Latin America. The simple fact is that rescue operations of past years stopped the countries' downfall, led to fast recovery, and were quickly repaid. Nobody was bailed out from high risk. Rather, the rescue packages eliminated an unnecessary risk (the liquidity risk), yielding an enormous benefit to countries and to the whole region. I grant you that there is the risk that such operations may not always work as anticipated. But, I wonder: how conservative would donor countries have to be in order not to favor rescue packages in countries with strong economies after crisis prevention fails?

More generally, it is cause for deep concern that new thinking on international financial architecture may involuntarily have counterproductive effects on Latin America. Our concern is that we simply end up with lower capital inflows and growth but no worthwhile gain in stability. Subjecting the private capital to uncertainty and discretion will have this effect. The curtailment of official financial support with the purpose of eliminating moral hazard would at the same time fail to prevent liquidity crises. If the latter is more relevant than the former, as I think it is in Latin America, the result would be not only less capital but also less stability!

Let me offer some concrete examples of our concerns in connection with the currently proposed modification of the Basle Capital Accord for bank credit risk. As I already mentioned, IDB has long had an interest in strengthening the regulatory framework for banks and making it flexible to

accommodate financial stress. To the extent that the new regulatory capital rules provide emerging market supervisors with stronger tools for assessing the strength of a bank and for encouraging bankers to improve their risk management systems, I believe that the proposed new rules could contribute greatly to the development of more mature lending markets. Having said that, it is important to recognize that in this proposal the cost of capital will increase in most of our countries. As you know, at present net bank lending has largely disappeared already and this may be a lethal blow to this class of credit. I am not sure this is a cost worth paying. Apart from that, there are a number of concerns that I take the liberty to stress:

- We do not think that the use of private rating agencies to determine capital requirements for sovereign lending is a good idea. First, it puts the agencies in a position to play God with countries' fortunes, which neither the region nor the agencies want. And second, it is likely to be destabilizing as agencies try to conform to market perceptions.
- In contrast, in Latin America we like to think that internal rating systems are a more sensible basis for a BIS system. I should also mention that a number of countries in the region have successful public credit bureaus that should also be taken into consideration as a possible standard to be used in setting requirements.
- The proposal that no private company should receive a rating better than its sovereign's is not consistent with the evidence of corporate and sovereign market risk spreads and appears to be an artificial limitation.
- Capital requirements on short-term loans ought to be lower for countries in which domestic liquidity provisions are more prudent. This is the case of Latin America. Uniformly higher requirements would implicitly put our region at a disadvantage and discourage its own prudential policies.
- Finally, I understand that according to private banks the proposed changes to the definition of short-term credit could adversely affect the trade financing business, and if so, I would be very concerned too.

I would like to close by sharing some thoughts with you on the kind of reforms that we think would be needed to address our key problem of precarious and unreliable access to external financing.

- First, liquidity crises appear to have become common in emerging countries. Like bank runs, these crises can be prevented and solved by the provision of liquidity. An international mechanism is needed to produce the required funding. Real progress demands addressing this issue. I recognize the difficulties and risks, and think that easy access to liquidity has to be restricted to countries prequalified on the basis of their fundamentals. The Contingent Credit Line (CCL) Facility of the IMF, perhaps made more attractive to countries, is a good first step in this direction.
- Second, it is imperative to contain the degree of financial volatility to which countries are subjected during episodes of panic and financial contagion. I think we need to look at regulations in developed countries and ask ourselves how they can be adjusted to address the problems created by contagion and panic in emerging countries. It seems to me that regulations ought to be flexible in order to lean against the wind of financial turbulence and discourage the propagation of contagion. For example, impose less stringent regulation on emerging country financing in times of international financial contagion. At the same time, the IDB and the rest of the official sector need to be ready to offer financial support during these temporary emergencies.
- And finally, there is the important issue of how to coordinate the efforts of countries, the private sector, and the official sector, especially in the most severe crises. I think that the official sector should lead, move first, and propose a consistent plan. However, this coordination requires some rules of the game, and not be left to improvisation, so that official intervention is not perceived as arbitrary by countries and private investors. "Constructive ambiguity" in this case produces "destructive ambiguity". *Ex ante* rules would

> go a long way in solving some of the tensions surrounding private sector involvement. But I would go further. It seems to me that those rules should contemplate a private sector contribution only to the extent needed, so that countries can quickly regain access to private financial markets.

In a recent article in Financial Times, Martin Wolf, commenting on emerging market economies, ended with these words that deserve our attention:

> "Optimists are not wrong: we do know how to make emerging market economies more seaworthy than they have been. But pessimists are also right: the turbulent global capital markets remain dangerous for the unprepared. Those managing emerging market economies should be aware of the risks. They must understand, too, that they will receive only modest help from outside. The price of safety remains careful preparation and eternal vigilance."

Thank you very much for your attention.