Financing trends in Latin America[1]

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1. Introduction: Latin American financial markets in historical perspective

Financial markets expanded rapidly beginning in the early 1970s in the world's largest, most developed economies. According to the World Bank, financial markets underwent such an expansion that the combination of bank credit, stock market capitalisation and private bonds outstanding for G7 countries reached on average approximately 250% of GDP in 2000, compared to only 75% in 1970.

We can distinguish two stages of global financial innovation during the period 1970–2005. The first of these waves can be traced back to the demise of the Bretton Woods system in 1971 and the oil shocks of 1973 and 1979. The disintegration of the Bretton Woods arrangement of fixed exchange rates allowed countries to open up to greater capital mobility, while the surge in oil prices provided markets with an influx of new funds. At the same time, capital market activity became concentrated in a few major international financial centres, mainly Frankfurt, London, New York and Tokyo.

Before then, most emerging markets, including those in Latin America, imposed tight capital controls on their financial sectors. Domestic capital markets were predominately bank-based and securities markets were unimportant and illiquid. Governments heavily regulated interest rates, intervened in the operation of financial institutions and interfered in the allocation of bank credit. As such, most of the newly available funds were used by international banks to finance public sector borrowing in emerging markets, notably in Latin America.

Sovereign lending in the 1970s and early 1980s played an instrumental part in the debt crisis that began in Mexico in 1982. In an attempt to solve this crisis, the George H.W. Bush administration devised and implemented the Brady Plan. This initiative was aimed at restructuring distressed commercial bank loans into liquid, tradable securities, but it also created a market for sovereign emerging market bonds. With the establishment of this new market in 1989, investor confidence in developing countries began to recover, and soon the international financial community would be ready to embrace Latin America again.

The second wave of financial innovation started in the early 1990s. At the heart of this new wave of financial development were important advances in communication technologies that brought about faster, more efficient transmission of data across the globe. These technological innovations further influenced global trading by reducing transaction costs, and this in turn increased market liquidity.

Like other developing regions, Latin America tried in several ways to attract a share of the newly available capital in international markets, including by introducing pro-market reforms and liberalising its financial systems. As part of this process, governments and private agents

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sought to raise capital in overseas markets, and foreign investors were permitted to invest in domestic assets. The liberalisation of financial systems also meant that international financial institutions established their presence in developing nations, either by purchasing local businesses or by establishing themselves as local subsidiaries.

Another method used to attract foreign capital was through the privatisation of public enterprises. The privatisation proceeds were quite substantial in Latin America and throughout the developing world, rising from US$ 2.6 billion in 1988 to US$ 25.4 billion in 1996, according to World Bank estimates. In addition, lured by the potential benefits of developing domestic capital markets, governments also passed new legislation aimed at creating the proper market infrastructure and institutions for capital markets to flourish. In particular, countries created domestic securities and exchange commissions, enhanced their regulatory and supervisory framework and improved the operational aspects of how markets operated, including creating centralised exchanges, securities clearance and settlement systems.

Latin American countries also tried to improve the overall climate by pursuing macroeconomic stabilisation policies, creating better business environments and improving economic fundamentals. In addition, they passed new laws and regulations intended to protect the rights of investors.

During the 1990s the composition of capital flows into Latin America changed significantly relative to what it was in the 1970s. Flows to public investment decreased more than 50%, with flows into the private sector becoming the prime destination of foreign investments. Both portfolio flows and foreign direct investment (FDI) grew continuously throughout the decade. This later wave in financial globalisation also brought an internationalisation of financial services. This trend is partially explained by the greater presence of international financial intermediaries, but also by the fact that issuance and trading of local securities continued to migrate to international markets.

At the end of the 1990s, Latin American political and economic uncertainty contributed to the decline in capital flows. Behind this economic uncertainty were the devaluation of the Brazilian real, which affected the competitiveness of Argentina and other Southern Common Market (MERCOSUR) economies; the banking and currency crisis in Ecuador; and the economic and financial crises in Argentina and Uruguay. In addition, economic reform fatigue and a general discontent with the failure of the reform process to improve living standards contributed to political turmoil in the region.

Nevertheless, by 2003, an increasingly stable Latin America – one that coped with crises without a contagion effect – created a more attractive environment for the return of capital flows. International investors liked the narrowing spreads that resulted from macroeconomic stability and fiscal discipline despite economic turmoil. Moreover, Latin American economies remained steady even during 2005 and 2006, which were election years in most countries in the region and, consequently, also times of political “noise”. These economies continued to experience macroeconomic stability in a positive external environment of high commodity prices and high liquidity.

Overall, while capital markets in many developed countries witnessed a boom over the last decade, the picture is more blurred for the emerging economies in Latin America, which have a high level of heterogeneity across nations. The domestic capital markets of some countries did not experience any growth, and for those that did, their growth was not nearly as robust as that in the advanced economies. Nevertheless, interesting differences arise when comparing the level of development of domestic markets across different emerging regions, ie across East Asia, Eastern Europe and Latin America.

The most important developments experienced by Latin American financial markets during the period 1990–2005 are documented below. These sections focus on three of the four main components of financial markets in Latin America: equity markets (both portfolio equity investments and FDI), the domestic banking sector and the more recent phenomenon of

remittances. Each major component is analysed in an individual section. The development of the fourth component, bond markets, is covered extensively in a paper in this volume by Jeanneau and Tovar.

Additionally, in an effort to understand what distinguishes this region from other emerging economies, we compare, whenever possible, the performance of Latin America with other developing regions worldwide. It should be noted that unless otherwise indicated, when we refer to "Latin America" we are referring specifically to the seven largest markets in the region, or LAC7: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.[4]

2. Equity markets

As mentioned above, equity markets comprise mainly portfolio equity flows and FDI. The former involves the acquisition of company shares, usually through stock markets, without gaining effective control of the firm. The latter involves the forging of longer-term relationships with firms, a process that usually includes the actual attainment of some degree of control of the enterprise. Since both components evolved differently during 1990–2005, we analyse each component separately.

2.1 Portfolio equity flows and stock market development in Latin America

Figure 1 displays average values of different measures of stock market development for Latin America, emerging Asia and emerging Europe for the years 1990–2005. As the figure shows, stock markets in Latin America have grown considerably in recent decades. The average domestic stock market capitalisation in terms of GDP in Latin America more than tripled between 1990 and 2005. Moreover, value traded in domestic stock markets (a measure of market liquidity) also increased significantly during this period, from an average of 2% of GDP in 1990 to 8.5% in 2005. On average, Latin American capital markets have not only increased in size but have also become deeper during the last 15 years.

Regional differences are also quite informative. Chile's stock market registered the greatest regional capitalisation, with an impressive 118% of GDP, followed by Brazil's at 59.6% and Peru's at 45.4%. Brazil is the most liquid of these markets, with a value traded well above the average, at 19.3% of GDP, followed by Chile at 16.3% and Argentina at 8.9%.

Despite strong growth, stock markets in Latin America remain underdeveloped compared to some emerging markets. In terms of stock market capitalisation, at the end of 2005 the region was below the average 67.2% of GDP registered by emerging Asia, but greater than emerging Europe's 36%. However, when we look at the evolution of these markets, we can see how Latin America and emerging Europe have been catching up with emerging Asia, consistently delivering higher growth rates for the last five years.

In terms of liquidity, Latin American economies seem to be facing harsher constraints than other developing markets. In this sense, both emerging Europe and Asia far surpassed Latin America, with an average traded value of 16.4% and 49.2% of GDP, respectively. The most liquid markets in Europe are Turkey and Hungary, while in Asia the front-runners are South Korea and India.

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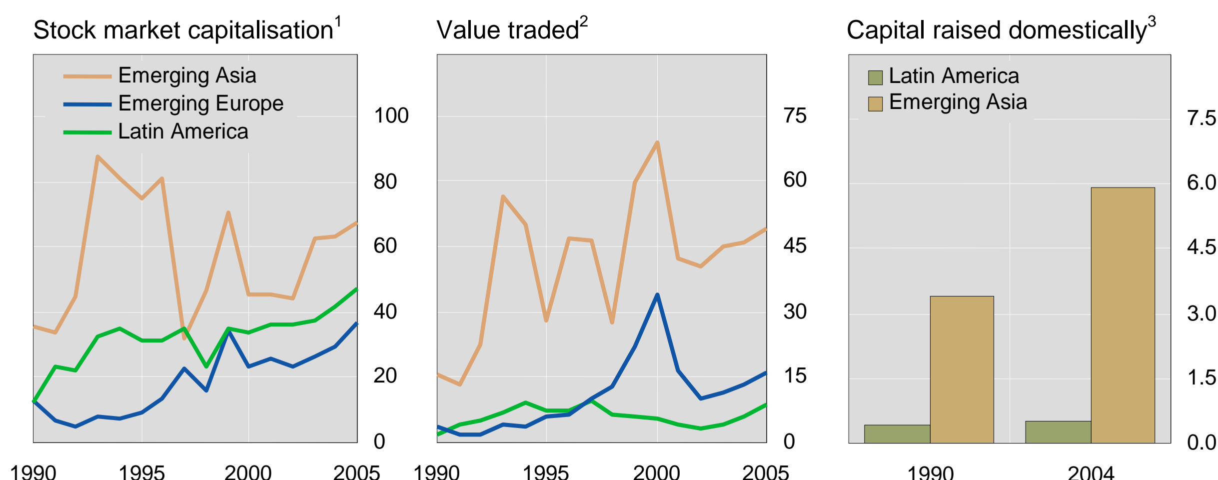
[4] Similarly, "emerging Europe" refers to the economies of Croatia, Cyprus, Hungary, Poland, Turkey, Slovakia and the Russian Federation; and "emerging Asia" includes the economies of China, India, Indonesia, South Korea, Malaysia, the Philippines and Thailand.

Figure 1

Emerging capital markets development[1]

As a percentage of GDP



Emerging Asia refers to the economies of China, India, Indonesia, Malaysia, the Philippines, South Korea and Thailand; emerging Europe refers to Croatia, Cyprus, Hungary, Poland, the Russian Federation, Slovakia and Turkey; Latin America refers to Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

[1] Shares outstanding valued at market prices. [2] Value of shares traded during the period; the indicator complements the market capitalisation ratio by showing whether market size is matched by trading. [3] Value of funds raised by domestic companies in their local capital markets.

Source: World Bank (2007), *World Development Indicators*.

The amount of capital raised domestically as a percentage of GDP is yet another indicator commonly used to assess the development of domestic capital markets. On this account, Latin America has, unfortunately, not made significant strides, registering a rise of 0.4% of GDP in 1990 and 0.5% of GDP in 2004. As Figure 1 shows, the difference between Latin America and emerging Asia might be explained by the contrasting deepness in capital markets in these regions.

The average number of firms listed in domestic stock markets can also be used to gauge the possibilities available for local businesses to tap local sources of funding. In this case, the evolution, rather than a point estimate, is the more relevant measure. Unfortunately, in Latin America, the average number of listed companies has actually decreased, from 232 in 1990 to 176 in 2006. This seems to be the regional trend, with the exception of Chile and Colombia, where the number of listed firms increased. This speaks to the internationalisation of financial services, as well as the preference of Latin American business owners for either foreign capital markets or alternative sources of finance.

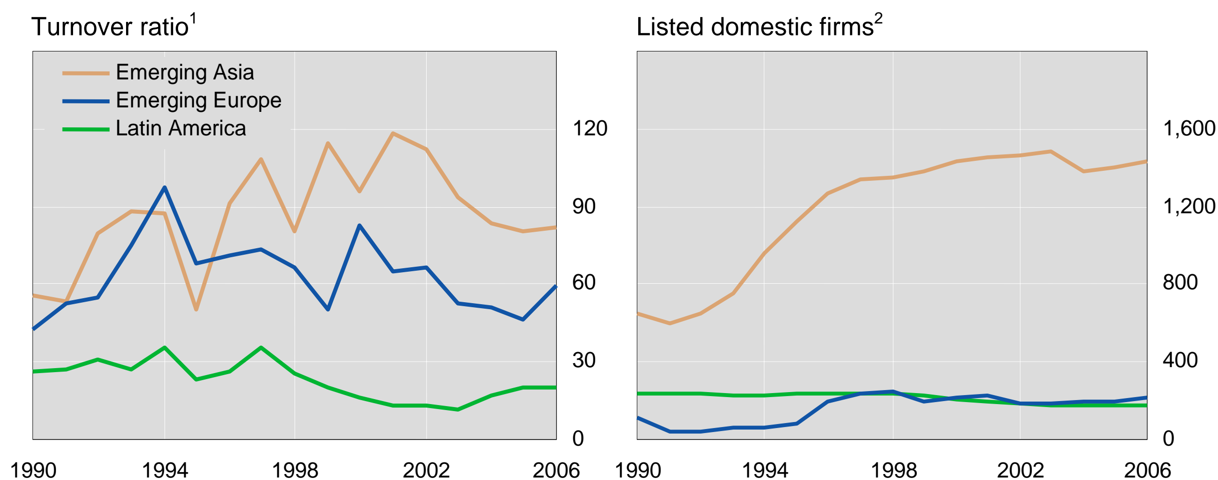
Finally, an additional indicator of stock market development which relates to its efficiency is the turnover ratio (see Figure 2). This indicator consists of the value of shares traded as a percentage of market capitalisation. A high turnover ratio implies low transaction costs, a measure that to some extent is a proxy for the degree of maturity and sophistication acquired by a particular capital market. On this account, we find that Latin America has, on average, worsened its situation, with a turnover ratio of approximately 26 in 1990 and 20 in 2006. There are regional exceptions, as in Brazil, Mexico, Chile and Colombia, which all show positive improvements during this period.

As for the other emerging markets, both Asia and Europe reflect different realities (see Figure 2). In terms of efficiency, both regions deliver much higher turnover ratios. Emerging Asia improved from 55.6% of GDP in 1990 to 82.1% of GDP in 2006, and emerging Europe went from 42.4% of GDP to 59.22%. In Asia in 2006, South Korea at 173.6% and China at

136.4% were well above the average, while in Europe, the front-runners were again Turkey, at 143.1%, and Hungary, at 88.1%.

Figure 2

Turnover and listed firms in emerging markets



For a list of countries included in each region see Figure 1.

[1] Value of shares traded as a percentage of average market capitalisation. [2] Incorporated companies at the end of each year; does not include investment companies, mutual funds or collective investment vehicles.

Source: World Bank (2007), *World Development Indicators*.

The average number of listed companies also shows much different behaviour than that in Latin America. Specifically, the average number of companies in emerging Asia has more than doubled from 1990 to 2006, with India, South Korea and China leading the way (4,796, 1,694 and 1,440 companies, respectively; see Figure 2). As for emerging Europe, the growth rate has been similar, with the average number of companies almost doubling from 1990 to 2006. Turkey, Poland and the Russian Federation registered the biggest increases, with 314, 309 and 267 listed firms, respectively.

In 1993 portfolio equity flows represented 39% of total capital flows to Latin America. This share shrank in the following years, reaching 7.6% in 2005. The continuous fall of portfolio equity flows in Latin America can be explained by geopolitical uncertainty since 2001, concerns about global economic activity and higher returns in international debt than in stock markets. Moreover, in 2002, political and economic turmoil, mainly in Brazil and Argentina, drove equity investors to other markets. Portfolio equity flows increased to US$ 12 billion in 2005, the best year in this century so far, owing to liquidity in international markets and narrow spreads in Latin American countries.

Despite the economic and institutional reforms in Latin America, stock markets have a long way to go to reach the development of other emerging markets. According to de la Torre et al (2006), to flourish, capital markets require a “regulatory and supervisory framework for securities markets, accounting and disclosure standards, corporate governance practices, and securities trading custody, clearing, and settlement systems” (p. 13). Additional factors limiting the development of deep financial markets could be the small size of Latin American economies, lack of risk diversification opportunities, presence of weak currencies and prevalence of systemic risk. Finally, the development of stock markets takes place within the context of global market integration, leading to a revision of the concept of financial development, where “financial development is characterised as the sustainable deepening and broadening of access to financial services regardless of whether such services are

provided at home or abroad" (p. 15). In these terms, domestic and international markets would be working in a complementary fashion to support the financing of the economy.

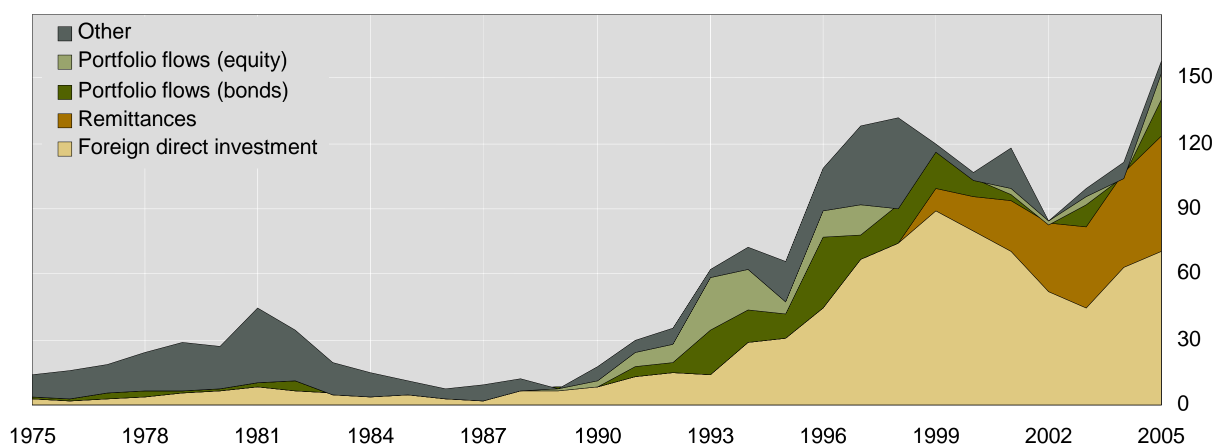
2.2 Foreign direct investment

Foreign direct investment (FDI) has become the dominant source of private capital flows to emerging markets internationally, and Latin America is no exception. Currently, as Figure 3 shows, FDI accounts for approximately two thirds of all financial flows to the region. Not surprisingly, FDI grew more than threefold, soaring from approximately 1% to 3.8% of GDP during 1990–2005.

Figure 3

Flow of funds to Latin America

In billions of US dollars



For a list of countries included in each region see Figure 1.

Sources: World Bank (2007), *World Development Indicators*; ECLAC; IADB.

The decreasing relative importance of portfolio equity and bonds flows is regarded as a mostly positive development, since FDI is presumed to be a source of capital that is more stable and less prone to reversals than portfolio equity flows. In addition, this type of investment is also believed to bring with it many of the indirect benefits of financial globalisation, such as transfer of technology and managerial expertise.

Regional differences within Latin America provide some insights into how foreign investors have been allocating their capital. Relative to the size of their economies, the three biggest Latin American recipients of FDI in 2005 were Colombia (8.48%), Chile (5.78%) and Ecuador (4.51%). Most of these figures reflect investments in these countries' commodity and infrastructure sectors.

FDI experienced a similar trend in other emerging regions during 1990–2005. In emerging Asia, FDI has on average grown from 1.67% to 2.01% of GDP. The biggest FDI recipients in 2005 as a percentage of GDP were China (3.54%), Malaysia (3.04%) and Thailand (2.56%). In emerging Europe, FDI soared from an average of 1% of GDP in 1990 to 3.74% in 2005. Hungary, Croatia and Slovakia led the way, with FDI accounting for 5.89%, 4.57% and 4.11% of GDP, respectively, in 2005.

During the privatisation and liberalisation processes in the 1990s, foreign investors established their presence in the region, buying companies in such industries as telecommunications, power, water and sanitation, oil and natural gas and steel. However, since the early 2000s this trend has reversed. Some Latin American firms, after consolidating

their position in their home markets, acquired companies in the region when foreign firms downsized or closed their operations; this is what happened with Mexico's Telmex and Chile's Falabella in the retail sector. Other Latin American firms concentrated on acquiring companies in their home countries, as did Brazil's Banco Itaú. This local expansion shows not only the strength and competitiveness built by firms during the liberalisation process but also the risk of a takeover by a developed transnational company (WIR 2006).

High commodity prices and changes in regulations may affect the future of FDI. Owing to improvements in current accounts, currency appreciation might adversely affect business prospects for FDI in export-oriented activities. Moreover, high oil prices have led some countries, such as Bolivia, Ecuador and Venezuela, to increase state intervention in this sector. In other countries, high commodity prices have also increased state-owned companies' revenues, reducing their dependence on financing from foreign investors and leading to policy changes deterring FDI in these sectors. However, soaring prices and global and regional growth prospects are outweighing these adverse effects.

3. Domestic banking system

Banks have traditionally played a very important role in the financing of economic activity in Latin America. The reasons for this prominent position could be the relatively later development of the bond and stock markets, government intervention and their comparative advantage in risk diversification due to information processing. Although banks share several common characteristics, they are also heterogeneous across the region in terms of their development.[5]

Since the 1990s, the banking system has been through a financial liberalisation process that involved its deregulation, regional openness to foreign bank entry and the decline of government intervention due to privatisation. Despite this financial reform, Latin American banks are still vulnerable to macroeconomic and external shocks and to new risks such as market, credit and liquidity risks.[6] Mexico in 1994, Ecuador in 1999, Argentina in 2001, Uruguay in 2002 and the Dominican Republic in 2003 faced banking crises, the sources of which were macroeconomic or external shocks. Today, however, current favourable conditions in international markets and stable macroeconomic policies are providing excellent opportunities for the growth and development of the banking system in Latin America. If banks take advantage of these opportunities, they will be better prepared to face and mitigate future domestic and external shocks.

Despite the dominance of banks, the size of the banking system in Latin America is relatively small when compared to emerging Asia and Europe. Figure 4, which looks at liquid liabilities as a percentage of GDP – an indicator of the relative size of the banking system[7] – illustrates that the banking system in Latin America is approximately 35% of GDP, underscoring its lack of depth when compared to shares of 90% and 50% of emerging Asia's and emerging Europe's GDP, respectively.

Brazil's banking system expanded from 2000 to 2005; recent structural changes and improvements in the macroeconomic environment have helped to deepen credit penetration

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[5] Jeanneau (2007) points out that some of these differences could be based on the financial crises faced in previous years.

[6] For a discussion of the evolution of risks in Latin American banking systems see Tovar (2007).

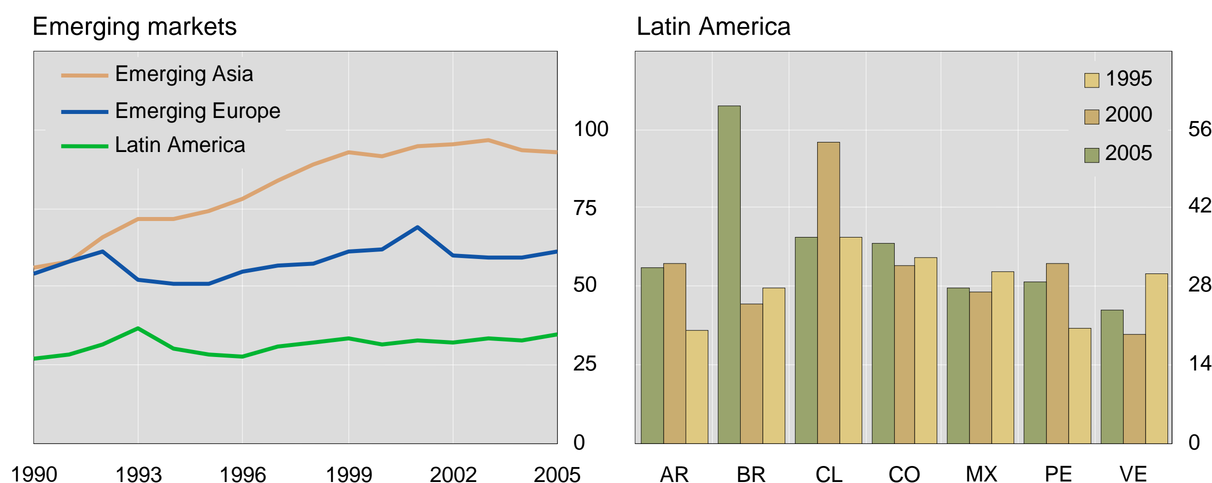
[7] This factor is actually an indicator of the size of the financial system, but given that banks are the most important component, we use it as a proxy.

(see Figure 4). Despite the size of their economies, the liquidity share in GDP of banking systems in Mexico and Argentina are at the levels of those in Colombia and Peru, which could have resulted from the long-lasting negative impact of the financial crises in 1994 and 2002.

Figure 4

Banking system size in emerging markets

Liquid liabilities as a percentage of GDP



For a list of countries included in each region see Figure 1.

AR = Argentina; BR = Brazil; CL = Chile; CO = Colombia; PE = Peru; VE = Venezuela.

Source: World Bank (2007), *World Development Indicators*.

Another indicator of the depth of the banking system is domestic credit provided by the banking sector as a percentage of GDP (see Figure 5). The financial intermediation activity of Latin American banks has remained unchanged over the last 10 years, while in emerging Asia and Europe, the ratios of domestic credit provided by banks have improved, highlighting a deeper banking sector in these regions. A common denominator among all these countries is the small decline of this ratio from 2000 to 2005. This decrease might be explained by the development of alternative sources of financing, such as stocks and bonds, or by external financing sources.

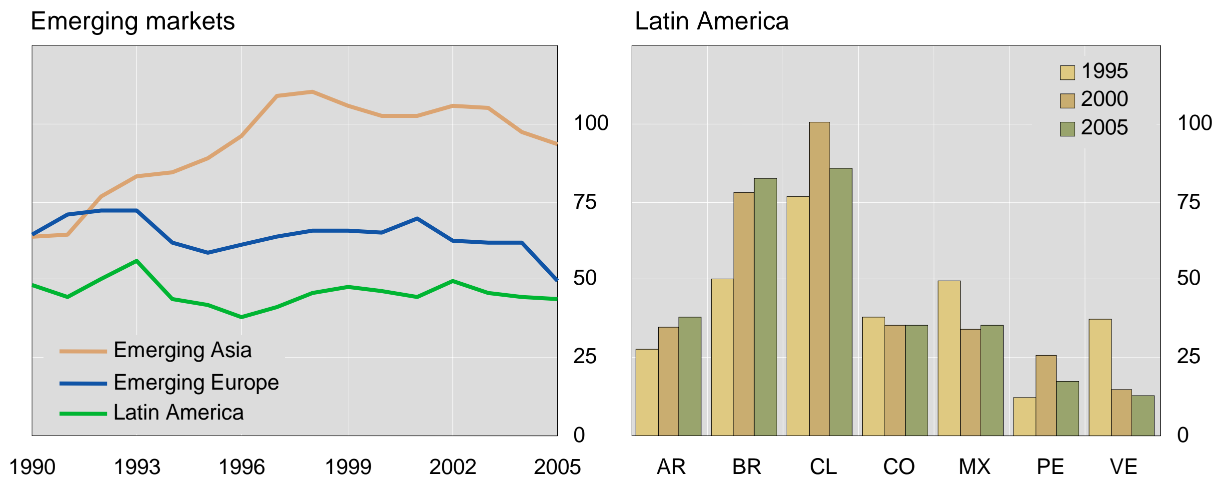
In Latin America, Brazil and Chile are the countries with the higher domestic credit shares as a percentage of GDP. However, they show different trajectories (see Figure 5). Brazil had an increase from 2000 to 2005, while Chile experienced a decrease. Argentina, Colombia and Mexico present similar levels of domestic credit provided by the banking sector, but these levels are lower than 40% of GDP. Despite strong economic growth in Latin America, there is a decline in domestic credit provided by the banking sector, which could be the result of the slow pace in banking activity to support growing economic activity and the presence of alternative sources of financing. This might be the case for Chile and Peru, where domestic capital markets, FDI and financing from abroad might be crowding out the banking system.

Figure 6 shows the difference between the lending rate and the deposit rate. Latin America has had an average spread around 10% higher than that in emerging Asia and emerging Europe. This difference might be the result of more competitive banking systems in emerging Asia and Europe and the higher concentration and market power of Latin American banks.

Figure 5

Domestic credit provided by the banking system in emerging markets

As a percentage of GDP



For a list of countries included see Figures 1 and 4.

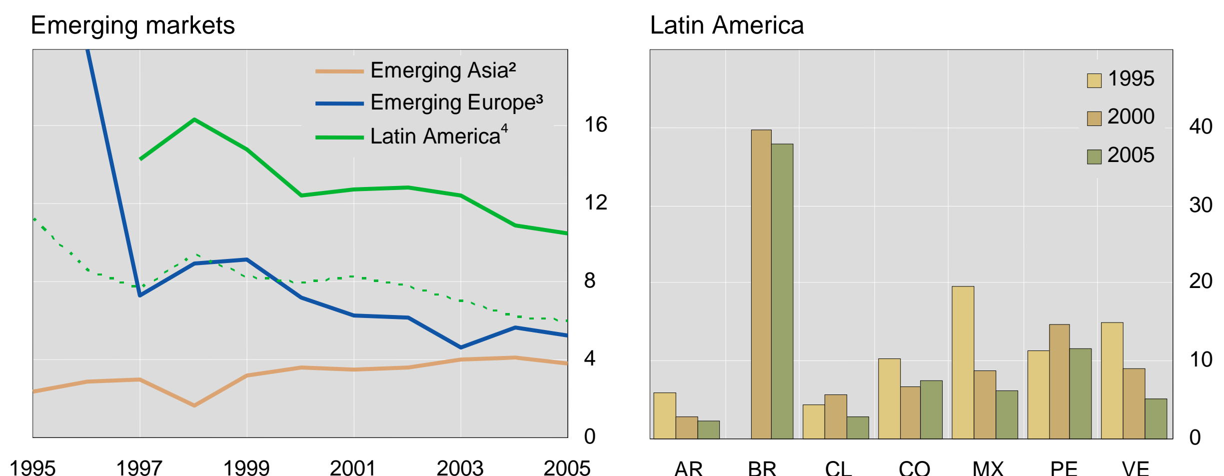
Source: World Bank (2007), *World Development Indicators*.

Figure 6 looks at the Latin American countries and shows that the large average spread in this region is driven by the spread of Brazilian banks, revealing the greater degree of government involvement in the financial system. Latin America's average interest rate spread for 2000 and 2005 without Brazil would be approximately 8% and 6%, respectively, which is closer to the levels of other emerging regions. Peru is another country with a spread above the Latin American average, showing the conservative approach of Peru's banks.

Figure 6

Interest rate spreads[1]

In per cent



For a list of countries included see Figures 1 and 4.

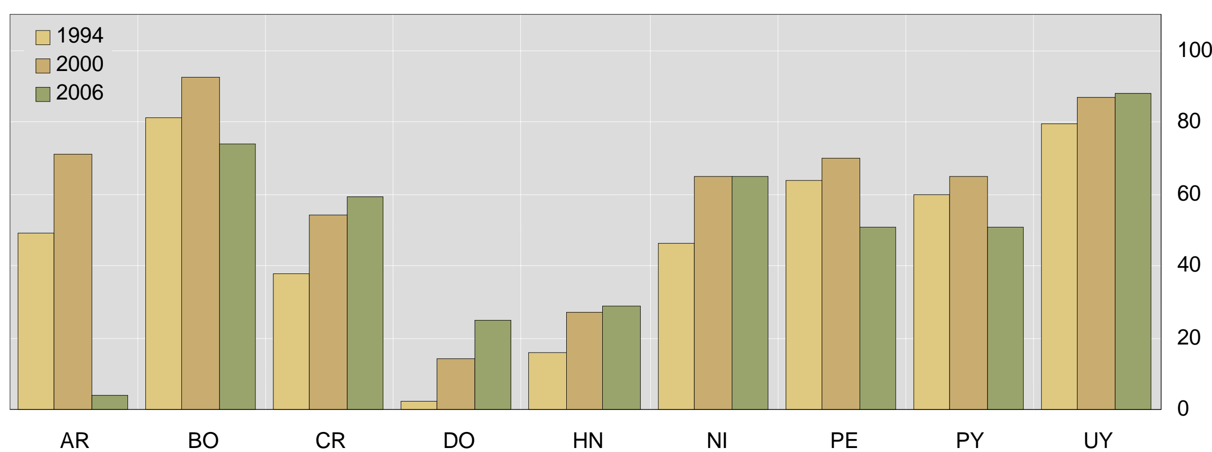
[1] Difference between lending and deposit rates. [2] Excludes India. [3] Excludes Turkey. [4] The thin line represents the average for Latin America excluding Brazil.

Source: World Bank (2007), *World Development Indicators*.

The presence of deposits and/or loans in foreign currency or dollarisation in bank balance sheets is another characteristic shared by the banking sectors of many developing countries. In Latin America, dollarisation started as a response to high inflation rates and consequently the loss of purchasing power of bank deposits. Figure 7 shows some Latin American countries with dollarisation ratios above 40% of the total banking deposits. We can also see that the dollarisation process has slowed in some countries or reversed in others, as in Bolivia, Paraguay and Peru. This reversal has been in response to a continual appreciation of the domestic currency and to several measures to encourage deposits in domestic currency, such as a tax on financial transactions, denomination of goods and services in domestic currency, and so forth.

Figure 7

Dollarisation in Latin America[1]



AR = Argentina; BO = Bolivia; CR = Costa Rica; DO = Dominican Republic; HN = Honduras; NI = Nicaragua; PE = Peru; PY = Paraguay; UY = Uruguay.

[1] Foreign currency deposits as a percentage of total deposits in the banking system.

Source: Central banks.

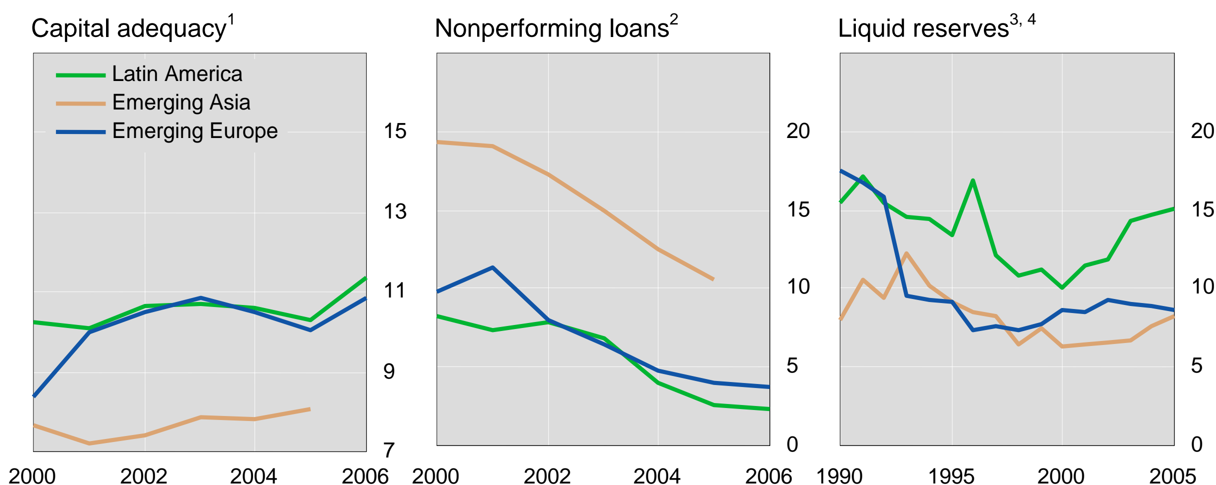
Bank performance in emerging markets has improved in recent years. Figure 8 shows the capital adequacy ratio defined as the bank capital to bank assets ratio, indicating that banks are complying with regulations and are on average approximating Basel requirements. In Latin America, capital adequacy ratios range from 7% in Chile to 13% in Argentina, but in most countries are between 9 and 10%.

Regarding asset quality, Figure 8 shows nonperforming bank loans as a percentage of total gross loans. In all regions, asset quality has improved, although some economies in emerging Asia still face an overhang of bad loans, making them vulnerable to economic downturns. Latin American banks have been allocating credit in safer loans, going along with declines in delinquency rates.

Figure 8 shows the ratio of bank liquid reserves to bank assets for emerging areas. Here, emerging Asia and Europe present lower ratios than those in Latin America. Higher ratios in Latin American banks are driven by higher liquid reserves held by dollarised economies, such as Peru and Uruguay, as well as by countries with high political uncertainty, such as Venezuela. In addition, this position of higher liquidity could be the result of inflows of currency due to high commodity prices that banks do not want to internalise in the economy. It is important to mention that Argentine banks have tripled their ratios during this period. This increase could be a double-edged sword. On the one hand, banks are prepared to face times of uncertainty and high demand for deposits. On the other hand, there is a cost (and inefficiency) to keeping these liquid reserves.

Figure 8

Bank system indicators



For a list of countries included in each region see Figure 1.

[1] Capital-to-assets ratio, in per cent. [2] As a percentage of total gross loans. [3] Liquid reserves to assets ratio, in per cent. [4] Excludes India from the regional classification.

Source: World Bank (2007), *World Development Indicators*.

4. Remittances

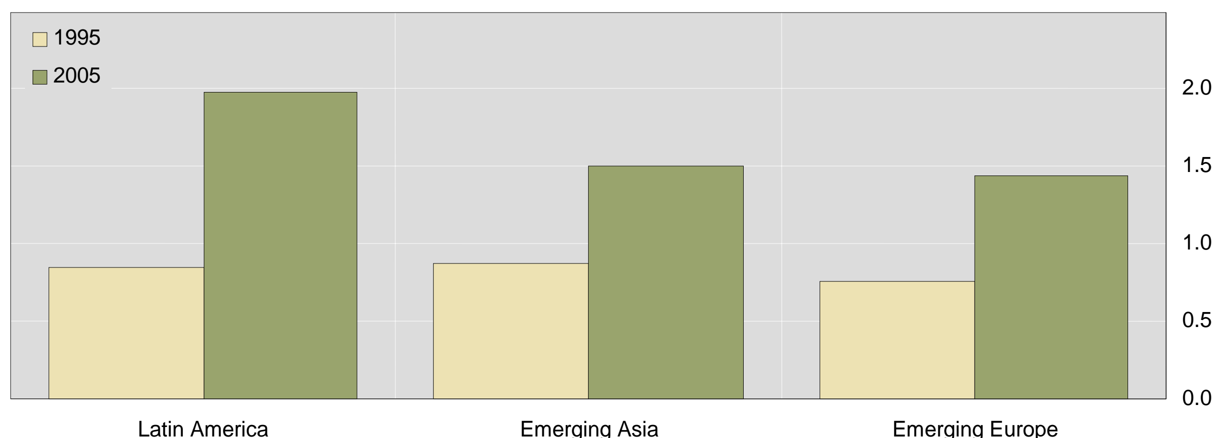
The share of international migrant workers' earnings sent back to family members in countries of origin – usually referred to as remittances – has for several generations been an important means of support for those remaining at home. As migration has increased in recent decades, the corresponding growth of remittances has come to constitute a critical source of finance to many emerging economies. Moreover, the implications for national economies and the corresponding multiplier effects on GDP, consumption and investment of this source of funds are significant.

Latin America is perhaps a prime example of this trend. As a share of the region's output, remittances have on average more than doubled, increasing from 0.81% to 1.91% of GDP from 1995 to 2005. In this respect, Ecuador (5.59%), Mexico (2.83%) and Colombia (2.74%) have led the way in the Latin American markets (see Figure 9). However, the impact and importance of remittances is far more impressive if we expand this classification to include some of the smaller economies. For example, in the case of Haiti, remittance flows accounted for almost 40% of GDP during 2006. Similarly, in El Salvador and Nicaragua, this ratio reached almost 18% of total output. Remittances are by no means an exclusive Latin American phenomenon. Workers' earnings sent back to their country of origin have also soared in other emerging economies. In Asia, these flows have grown from an average of 0.8% of GDP to 1.5%. The Philippines, where remittances represented flows equal to 13.7% of GDP, and India, with flows equal to 2.9% of GDP, have led the expansion in this region.

In contrast, emerging Europe's remittances have grown from an average of 0.76% of GDP in 1995 to 1.44% of GDP in 2005. Reliable data prior to 1994 are hard to obtain; the breakup of the Soviet Union in 1991 caused the reclassification of many people living in one of the newly independent countries who were born in another country as international migrants. Nonetheless, the growth trend is quite robust in countries like Poland and Croatia, where remittances grew from 2.9% to 3.2% of GDP and from 0.6% to 1.2% of GDP, respectively.

Figure 9

Flow of remittances[1]



For a list of countries included see Figure 1.

[1] As a percentage of the region's GDP; includes all countries of each region according to the World Bank classification.

Source: World Bank (2007), *World Development Indicators*.

Clearly, global remittance flows are on the rise. Yet these flows tend to grow faster and represent on average a greater share of the economy in Latin America than in other emerging regions. As Figure 9 shows, the World Bank estimates that for 1995–2005, remittances as a percentage of GDP grew 133% in Latin America, 89% in emerging Europe and 72% in emerging Asia.

5. Conclusion

Although financial development in the largest industrial economies started to accelerate in the 1970s, Latin American financial markets remained stagnant until the early 1990s, when financial intermediation by both financial institutions and capital markets increased exponentially and the array of financial services and instruments reached new dimensions. Capital flows waned at the end of the 1990s and continued to decline until 2002, due to economic and political turmoil in Latin America as well as in the rest of the world. Capital flows started a new wave in 2003, when concerns about Latin America declined and international investors returned to the region with decreasing spreads and a favourable international environment.

Capital markets in the region have grown considerably during the last decade but remain behind Asian and European emerging markets in terms of liquidity and efficiency. The development of domestic capital markets in Latin American countries arguably should provide additional insurance against a major destabilising sell-off in the debt or equity markets. Sell-offs are less likely when domestic investors hold a greater share of their own government's debt, and on average these investors are holding all domestic assets with longer-term horizons.

FDI has become the primary source of private capital flows to Latin America, accounting for two thirds of the flows to the region. In addition, the internationalisation of financial services demonstrates the preference of Latin American owners for foreign capital or alternative sources of financing. The banking sector appears generally sound, with adequate capitalisation, rising profitability, and improved asset quality. However, Latin American banking systems have a lot of room to grow as financial intermediaries. In the short run, the

banking sector may weather risks from international market volatility. However, Latin American banks will need to comply with Basel II standards and governments in the region need to develop comprehensive programs for financial development in order to strengthen the banking system and capital markets in the long term.

Remittances have for several generations been an important means of support for those remaining at home. As migration has increased, the corresponding growth of remittances has come to constitute a critical flow of finance to many emerging economies. Movement of people, most often through migration, is a significant part of global integration. Remittances have become a major financial and development topic throughout the region. While circumstances vary, the positive developmental implications of remittances are similar in each country.

As we enter this second half of the first decade of the 21st century, the combination of good economic fundamentals and policymakers' intentions to maintain macroeconomic policies are likely to anchor international and domestic market expectations. Perhaps the greater risk associated with the domestic economy is reform paralysis. Latin American governments that give in to social pressure may have little incentive to push forward with any of the remaining – and much-needed – reforms, such as in the fiscal, pension and financial arenas. Should external conditions deteriorate, the longer-term challenge confronting Latin America will be maintaining market confidence in the international capital markets.

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